Managerial Safety and Soundness and Maximization of Shareholder Interests: Sifting Through Bifurcated Governance Strands over Managerial Conduct of United States Banking Organizations

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By
Hung-Lieh Liang

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University of London

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Supervisor: Professor George A. Walker, BA, LLB (Hons), DIPLP, DAES, LLM, Ph.D, D.Phil
Centre for Commercial Law Studies-QMUL
Abstract

The recent trend reflecting the erosion of the traditional boundaries between banking and other financial businesses by virtue of financial deregulation and liberalization has resulted in a more complex and dynamic risk-profile for banking institutions. One upshot of this transformation is, whilst promoting safe and sound banking still remains the overriding bank regulatory objective, the focal point shifts more and more to managerial function and responsibility, a subject traditionally more generally associated with the corporate-law domain but now being recognized as a core subject-matter for banking regulation and supervision. This text will analyze the subject of managerial function and responsibility in the context of United States banking institutions, specifically the national bank, the bank holding company and the financial holding company.

The primary thesis to be presented and supported is in banking the governance order concerning the “control and direction” mechanism over managerial conduct can only be fully appreciated by not only looking into the economy specific dimension, as informed primarily by applicable corporate law standards addressed generally to and among the shareholder, the board and the senior management as they interact with the corporate entity, but also by investigating the industry specific dimension (in the instant case as to banking institutions), as reflected by required regulatory standards enshrined in statutes, regulations and other regulatory pronunciations addressed specifically to their industrial particularities and their derived implications on the society as whole. In the context of the United States, the governance order of banking institutions, as such, is placed in the applicable (i) state law corporate governance framework under the Delaware General Corporate Law and related Delaware case law and (ii) federal statutes and the prudential regulations and practices of federal banking regulators.

As will be seen, these two regulatory strands that impact the U.S. bank governance order have separately evolved under separate statutory and regulatory frameworks with separate policy underpinnings. Traditionally, banks as corporate entities have been treated under general corporate governance principles developed under corporate statutes and case law. For federal banking institutions, the federal regulators have generally deferred to the fiduciary standards under Delaware corporate law. The policy of the Delaware statute and case law directs corporate directors and officers towards maximizing corporate value for the shareholders: the law recognizes that corporate management is engaged in business risk-taking and grants corporate management considerable leeway as to their good-faith decisions and activities, while placing constraints on grossly negligent, illegal, bad faith and self-dealing decisions and activities. The U.S. federal bank regulators’ primarily are concerned with the “safety and soundness” of banking institutions and the stability of the U.S. banking system. In pursuing the prudential objective, the U.S. Congress and these bank regulators have externally imposed numerous regulatory requirements on bank management, backed by intensive supervision and vigorous enforcement. This text will argue that these federal banking laws and regulations have significantly intruded- in depth and in breadth- into the traditional state law domain of corporate governance of banking institutions, and, as a result of which, the ensuing confusions and inconsistency in governance standards to be addressed. This intrusion refers to a stand-alone bank, as well as a bank held by a corporate parent.

An appreciation of this “push and pull” tension between these two bifurcated strands influencing the governance structure facing bank management is critical as management plans its prudent profit-seeking strategies. Whilst a needed, comprehensive reform able to bring about a set of uniform and industry-specific governance standards is outside the scope of this work, this text will consider possible ways to reconcile conflicts generated and will make some modest recommendations in this connection as conclusions thereof.
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Introduction

This text explores, from a legal and regulatory perspective, the control and direction mechanism over managerial conduct of US banking organizations.

As a starting point, although at the international level the fruits of the ongoing standard convergence processes spearheaded by the Basle Committee on Banking Supervision and other international agencies on banking regulation and supervision have been widely recognized and generally accepted by domestic banking regulators cross-jurisdiction as important reference points, at the domestic level these best-practice standards alone remain insufficient in shedding the full light on the legal and regulatory forces actually directing and controlling the banking organizations and their management of an individual economy. First, in adapting these international best practices to their domestic contexts, individual economies’ approaches are often also economy-specific, albeit among them certain common regulatory values or objectives being shared. As further elaborated in the main chapters, this distinctiveness, easily found in such crucial areas ranging from affiliation pattern to permissible banking activities, has led to discrete regulatory consequences over managerial conduct of banking organizations one jurisdiction from another. Second and for current purposes a more compelling one, limitations of international regulatory standards rest also with another domestic factor. Apart from the bank regulator to which the bank management is held accountable to, as directed under the relevant domestic banking legislation, regulations and other regulatory pronouncements, the same management is also mandated to maximize the interest of the bank shareholder who exercises ownership rights and interacts with the bank corporate entity based on the corporate law of the jurisdiction where the bank is incorporated. The ownership right enjoyed by the shareholder is most noticeable for jurisdictions of Anglo-American legal tradition.

It is therefore recognized only by sitting in a domestic context, where the bank regulatory and ownership dynamics have been carefully examined, would one be in a proper position to appreciating and evaluating the real face of the control and direction mechanism over managerial conduct. This research puts such regulatory and ownership interactions in the context of the United States — one that displays great
governance dynamics over time when the significantly expanded bank regulatory stakeholder governance model interacting with the traditional shareholder governance model.

For the benefit of clarity, it is worthy of some length here giving substance to certain crucial concepts used herein, as well as delineating the scope and limitations of this research. The two US governance models referred to in the previous paragraph should be understood as follows.

The bank regulatory stakeholder governance model denotes the US federal banking regulatory, supervisory, examination and enforcement regime, particular the aspect where the US bank regulators utilizes their open-ended and open-textured “bank safety and soundness” rule-making and enforcement power controlling and directing the management of a stand-alone bank or that of a parent company exercising control over a bank subsidiary towards safe and sound management, so as to protect bank depositors and to sustain the safe and sound ongoing operation of a stand-alone bank or a bank subsidiary. In this respect, bank safety and soundness is identified as a fundamental statutory and regulatory notion that is an evolving concept largely shaped by the federal bank regulators and regulatory practice and that is essentially an umbrella term to take into consideration all prudential regulations and related supervisory, examination and enforcement practices. The stakeholder role the bank regulators assume in this capacity is functionally similar to the position a creditor or insurer takes in protecting its interests—exerting control over managerial decisions so as to limit bank risk-taking to, from the regulator’s perspective, a satisfactory level.

The shareholder governance model is referred mainly to the US state corporate-law system, represented by Delaware corporate statutes and Delaware common law, traditionally considered as the primary source governing the internal legal relationships among the shareholder, the director and the senior management, aimed at encouraging the bank management’s risk-taking and directing them towards maximizing the bank shareholder’s interests as opposed to those of other stakeholders as they interact with the bank corporate entity. On the US state corporate-law system, the approach adopted by Delaware corporate statutes and Delaware common law in formulating within the legal-entity boundary the concept of fiduciary duties (duty of good faith, loyalty and
care) owed by the bank management to the bank corporate entity and the bank shareholder as a whole, which as the bank safety and soundness concept also by nature poses as a set of open-ended and open-textured standards of conduct and review over every aspect of managerial conduct of banking organizations will be a focal discussion point. Predicated on the shareholder’s limited liability privilege applying to the parent company, the parent-subsidiary relationships will also be considered.

The above-stated therefore makes clear it is not intended to expose the full control-and direction (i.e., governance) order governing the management of the US banking organizations. Such order may also include other regulatory (or stakeholder) elements, including consumer-protection, competition and, for large banking organizations, federal securities regulations. The author particularly recognizes that the disclosure-based compliance requirements deriving from traditional federal securities regulatory regime and the corporate governance requirements prescribed in the Sarbanes-Oxley Law of 2002 and its implementation regulations, as a critical compliance point for large or public US banking organizations, also directly or indirectly contribute to the bank management fashioning their business decisions. The current approach of focusing the stakeholder-shareholder dynamics on the regulatory requirements for safe-and-sound management co-relating to the managerial mandate of maximizing the shareholder’s interests rests with the conviction it is in this area where the shareholder-stakeholder confrontation becomes most acute.

On the bank regulatory stakeholder governance model, further clarifications might be helpful. The peculiar and complex regulatory matrix where US banking organizations ply their trade rests with the presence of both federal and state authorities (the dual banking system) and of a diffuse regulatory structure. The US banking regulatory system is *sui generis*. Over time it has developed into a diffuse structure that spreads regulatory authority across different governmental agencies. On the federal level, three primary federal banking agencies, the Office of Comptroller of the Currency (“OCC”), the Federal Reserve Board of Governors (“FRB”) and the Federal Deposit Insurance Corporation (“FDIC”), have developed regulatory mandates sometimes distinct the other overlapping, in response to problems of the banking sector. Further regulatory overlaps have arisen as a result of the dual banking, the three primary
federal regulators co-existing with 50 state banking agencies and thus federal (or national) co-existing with state charters. This work concerns only the federal banking regulation. Discussion on federal banking regulation will focus on three types of federal banking organizations—national banks ("banks") and, to a limited extent, bank holding companies ("BHC") and financial holding companies ("FHC") (collectively, "US banking organizations"). Since this work's primary focus is on the bank safety and soundness concept in relation to managerial conduct of the US banking organizations, a comprehensive treatment on the US federal bank regulatory system is not intended. The following therefore, by way of background, provides only a brief account on how these three types of banking organizations are being regulated and supervised under the US federal banking regulatory system.

On national banks, the diffuse federal regulatory structure means, first and foremost, national banks fall under the supervision and regulation of the OCC, as the chartering authority and the primary regulator. The OCC exercises control over the national bank’s operations in a variety of areas, including issuing regulatory pronouncements of restricted or prohibited unsafe and unsound bank practice, regulating an increase or decrease in capitalization, payment of dividends, change of names or place of business, and the national bank’s establishment of a new branch, an operating subsidiary or a financial subsidiary. OCC supervises activities of national banks and

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1 For a useful historical account on developments of the US banking industry and the corresponding bank regulatory regime, see KENNETH SPONG, BANKING REGULATION- ITS PURPOSES, IMPLEMENTATION AND EFFECTS 15-33 (5th ed. 2000).
2 A "bank" is by statute defined either as (1) a federally insured bank under the Federal Deposit Insurance Act, 12 U.S.C. § 1813 (h) (1); or (2) a national bank or state-chartered bank that (a) accepts demand deposits or deposits that depositors may withdraw by check or similar means for payment to third parties or others; and (b) makes commercial loans, 12 U.S.C. § 1841 (c) (1). Except for otherwise defined, throughout the work a bank shall mean a national bank.
3 The OCC has primary regulatory authority over the activities of a national bank, whether it is owned by a bank holding company or is individually owned. 12 U.S.C. §§ 21 et seq., 93a.
4 See the relevant discussion in chapter four.
9 It is well settled that banks may own operating subsidiaries to perform activities (except deposit-taking) that could be performed within banks. 12 U.S.C. §§ 24 (Seventh), 93a : 12 C.F.R. § 5.34. With certain
their subsidiaries and is authorized by statute to examine them. In addition, the OCC has a variety of administrative remedies, ranging from cease-and-desist orders, civil money penalties and removal and suspension, to enforce against national banks and their institution-affiliated parties (including the bank’s directors and management) for, among other things, breaches of OCC-prescribed bank safety-and-soundness regulatory pronouncements. To resolve troubled banks, the Comptroller may appoint a conservator or receiver for failed or failing national banks. Where the national bank is put into conservatorship, the conservator is normally the FDIC and, in consultation with the FDIC, the bank will be subject to the OCC’s examination and supervision. When the Comptroller appoints a receiver, the receiver will be the FDIC.

Apart from OCC, as national banks are covered by deposit insurance, they are also

exceptions. Federal banking laws and regulations that apply to operations of the parent bank also apply to operating subsidiaries. Operating subsidiaries of national banks are subject to supervision and examination by the OCC. On enforcement, the OCC also has the authority to direct a national bank or its operating subsidiary to take remedial action whenever necessary for bank safety and soundness. See 12 C.F.R. 5.34 (c)(3).

The general powers that national banks may exercise are outlined in section 6 of the National Bank Act of 1864: “...all such incidental powers as shall be necessary to carry on the business of banking, by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; by obtaining, issuing, and circulating notes according to the provisions of this act...” 12 U.S.C. § 24.

After the passage of the Gramm-Leach-Bliley of 1999, through “financial subsidiaries”, national banks may conduct an even broader set of financial activities, provided, among others, the bank and any depository institution affiliates are well capitalized and well managed and also have received Community Reinvestment Act ratings (CRA ratings) of satisfactory or outstanding in their last examinations at the time the activity is first undertaken. 12 U.S.C. §§ 1843 (i)(2), 2903 (c)(1). These activities must be either that a bank can engage in directly or financial in nature or incidental to a financial activity. In general, financial subsidiaries of national banks can engage in any financial activity other than insurance and annuities underwriting, insurance company portfolio investments, real estate development and investment, and merchant banking (collectively “Financial-subsidiary Restricted Financial Activities”). It should be noted, nevertheless, Financial-subsidiary Restricted Financial Activities are permitted to be conducted by a national bank’s other nonbank affiliates owned by a common holding company. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 121 (a) (2) (amending the National Bank Act to add new R. S. §§ 5136 (A)(a)(1), (a)(2)(A)-(a)(2)(B), (g)(3)), 13 Stat. 1338, 1373, 1377-78 (1999).

subject to certain statutes of the Federal Deposit Insurance Act and the regulations of the FDIC, who may conduct special examinations at national banks for insurance purposes. National banks would automatically become members of the Federal Reserve System once a charter is granted. This status would then give Federal Reserve Board authority to promulgate regulations applying to all member banks, including national banks.

Formation of a bank holding company or a financial holding company subjects national banks to an additional layer of regulation and supervision at the parent company level. A BHC is defined by statute as any company that: (1) directly or indirectly owns, controls, or has power to vote 25 percent or more of any class of the voting shares of a bank; (2) controls in any manner the election of a majority of the directors or trustees of a bank; or (3) exercises controlling influence over the management or policies of a bank. The FRB has exclusive oversight authority over BHCs under the Bank Holding Company Act of 1956 and the 1970 amendment thereto. In the Bank Holding Company Act, a general separation between banking and commerce is mandated. With their control over bank subsidiaries, BHCs may not own other types of companies except for companies engaged in banking or in managing or controlling banks and their authorized subsidiaries; companies that furnish services to the holding company’s subsidiaries; and companies engaged in exempt nonbank activities. Upon the passage of the Gramm-Leach-Bliley of 1999, US Congress

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18 12 U.S.C. §§ 248(j), 321, 324. Note whereas the FRB has regulatory oversight authority over national banks in their capacity as members of the Federal Reserve System, it generally defers to the Comptroller for purposes of primary supervision.
21 See 12 U.S.C. §§ 1843 (a) (2), (c)(8). Before the passage of the Gramm-Leach-Bliley of 1999, the most important exception was for subsidiaries engaged in activities that were “so closely related to banking as to be a proper incident thereto.” See 12 U.S.C. §§ 1843 (c)(8). Upon the passage of the Gramm-Leach-Bliley of 1999, traditional bank holding companies may remain in operation, so long as they confine their activities to owning, controlling or managing banks and any other activities that are
created a new type of BHC known as a financial holding company that may engage in broader nonbank activities. After satisfying the necessary requirements, including all the depository institutions controlled by the holding companies being well-managed and well-capitalized, FHCs may conduct any activity, in their own right or through financial subsidiaries, that is financial in nature or incidental to such financial activity, in addition to the same activities as BHCs. FHCs may also even expand into activities that are complementary to a financial activity, provided those activities do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. Each BHC and FHC must register with the FRB and file annual reports and the FRB regulates and supervises BHCs and FHCs through the process of approvals, rule-making and periodical examinations. One critical aspect of the FRB's supervision and periodical examinations concerns the BHC or FHC regulatory obligation of serving as the financial and managerial source of strength for its bank subsidiary.

It is against the above-summarized bank safety and soundness regulatory backdrop, the US banking organizations, as corporate entities, are incorporated under and subject also to the general state corporate laws (represented by Delaware law) as to their internal affairs. The resultant state of law and governance, as perceived by the US Supreme Court's 1997 seminal decision of *Atherton v. FDIC*, is underscored by an implicit division of responsibilities. *Atherton* perceives, with certain marginal, background restraints concerning stakeholder protection, among other things, prohibited or restricted unsafe and unsound bank activities prescribed by banking statutes, regulations and other laws. "closely related to banking." Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 102 (a) (amending 12 U.S.C. § 1843 (c)(8)), 113 Stat. 1338, 1341 (1999).

24 See 12 U.S.C. §§ 1844 (a), (c). In this respect, the passage of the Gramm-Leach-Bliley of 1999 brought in an element of functional regulation, entrusting primary regulation of certain securities and insurance activities to the respective securities and insurance regulators, not the banking regulator. See the relevant discussion in chapter two.
25 *Atherton v. FDIC* 117 S. Ct. 666 (1997); see also notes 198 to 217 and accompanying text of chapter three.
regulatory pronouncements, largely stopping at the border of the regulated comes the full-blown domain of state corporate law. Promoting optimal performance on efficiency or profitability as the primary policy underpinning, Atherton considers a state corporate law that goes all the way to the managerial core, which agenda is to maximize gains of the shareholder as a whole. Atherton considers that, to foster shareholder gains, the state law's initiative of promoting risk-taking formulates the standards of conduct and review applying to the bank management's conduct. Atherton also considers that the said profitability object is further achieved by the status of the bank shareholder — the only class of non-fixed claimants among corporate constituencies as the exclusive enforcer and ultimate beneficiary of various fiduciary duties owed by the management to the bank.

The above-stated perception as to the current state of law and governance, as an official, explanatory account on the making of the governance structure prevalent in modern banking in the United States, is a primary subject matter this text will be addressed to.

The author argues, this responsibility-divide statement, in particular those concerning marginal treatment over protecting interests of non-shareholder corporate stakeholders, which include the bank regulator's agenda of safe and sound banking, can only stand on one premise. That is, those externally imposed regulatory arrangements backed by supervisory and enforcement actions are, by nature and approach, regulation of institution, restraining from reaching deep into the traditional preserves of state corporate law of ownership and management. It is believed in the United States, the developments of federal bank safety and soundness regulation and supervision have proven this is not the case.

A decade since the decision of Atherton, the author argues, the trend working to the opposite of the Atherton's premise has been set, first evidenced by the state law's defer-to-management review standards aimed at upholding the policy of shareholder-interest primacy being substantially compromised in the course of the bank regulator's safety and soundness pursuit. The same regulatory force has also intruded into, in depth and in breadth, other ownership and management elements as well as the prevalent disciplinary mode traditionally associated with the shareholder model of
corporate governance under state corporate law, notably on the limited liability privilege enjoyed by and the corporate separateness principle applying to a corporate parent, as well as on the market-based interest alignment mechanism.

The governance regime over the US banking organizations is evolving from a shareholder towards a stakeholder model, with banking regulators as not only the key stakeholder but also the key monitor equipped with superior monitoring capability pursuing stability over profitability. The genuine current state of law, as argued by the author, is actually that the regulatory consideration for safe and sound management is not merely directly competing with the state corporate law’s policy value of promoting risk-taking, but has installed a new internal interest hierarchy with the well-being of the deposit insurance fund and of the ongoing operation of banks topping the interest ladder.

Drawing primarily on banking regulators’ safety and soundness pronouncements publicized post-Atherton that were contained in enforcement orders and examination material, as well as regulatory and supervisory directions, the author in the main chapters will demonstrate the ubiquitous presence of the concept of unsafe and unsound bank management by indicating its various result-oriented and defer-to-regulator attributes. They range from those earmarked as deemed unsafe and unsound practices as a result of banks or bank managements’ unsatisfactory performance identified in supervisory reports, through those restricted or prohibited risk appetites specified by the regulator as excessive often disregarding the institution’s financial and managerial strength, to those simply unlawful activities, traditionally categorized as compliance now moving into safety and soundness topics. These regulatory, supervisory and enforcement pronunciations have enormous repercussions on managerial mindsets.

Distilled from them, the objective reasonableness standard or the industry standard required of the bank management and established by the bank regulator represents a step further than even the hypothetical “reasonable person” standard that was categorically dismissed by the Delaware Chancery Court in its due care review for being too strict to sustain the corporate management’s risk-taking enthusiasm for maximizing shareholder gains. Confusion and inconsistence on governance standards thus ensue. On one hand, in reviewing managerial conduct, the state court abstains from reviewing almost all substantive aspects of the bank management’s disinterested and good-faith business
decisions in order not to give them an incentive at the margin to authorize less risky investment projects. The federal banking agency, on the other hand, more than often reviews the same disinterested and good-faith business decisions from a bank safety and soundness standpoint. A prominent example involves the bank agency’s review over purchases of loans and participations in loans, where the OCC pronounced unsafe or unsound banking practice for a purchaser institution’s failing to contain a “prudent” transfer arrangement in such transactions.26

In deriving their bank safety and soundness pronouncements, the author argues that the banking regulator therefore has actually injected a general loss avoidance psychology on the bank management. It is more so when one considers those formidable enforcement measures that could impose liabilities and force through corrections against even innocent safety and soundness violations. Overall, it is argued, the US banking organizations are in reality being directed to achieve dual corporate objectives, of profitability and of stability, translated respectively to two sets of sometimes diverging risk-taking strategic mindsets required of the same bank management. This push-and-pull phenomenon flowing from two often disparate sets of review standards over the same managerial conduct is thus a genuine presence.

The consideration for banks’ (or bank subsidiaries’) safe and sound management also implicates at the holding company level with their corporate parents, which, under the operation of the “source of strength” and other regulatory doctrines, are obligated to serve as the ultimate financial and managerial source for their banking subsidiaries. This represents a major deviation from the state corporate law’s attitude towards parent-subsidiary relationships, as reflected by the limited liability privilege enjoyed by corporate shareholders and the insistence on corporate separateness, where corporate subsidiaries doing parents’ bidding is considered the norm of business.

Furthermore, evidence also shows that, rooted in the concern pursuing efficiency or profitability at the potential cost of putting the bank “into play” might have endangered the banking system’s stability, the banking regulator’s intuitive suspicions towards vibrancy of the market for corporate control, as the most important disciplinary

26 See note 17 and accompanying text of chapter four.
mechanism under the US shareholder model of corporate governance, have dampened the change-of-control transactions that were directed for the disciplinary purpose in the banking industry. Instead, it is the banking regulator, as argued by this author as monitor of comparative objectivity and proximity, who assumes a prominent oversight role.

Sifting through the above-stated bifurcated governance strands, the bank safety and soundness regulatory or stakeholder strand and the shareholder-interest centred state corporate law strand, over the managerial conduct of United States banking organizations, this text is organized as follows.

Chapter one will first explore the extent to which economy-specific domestic factors have implicated with the traditional bank regulatory model enshrined in the standard convergence process at the international value. By so doing, chapter one establishes the need to place the bank regulatory and ownership concerns in a domestic context, for the instant case the US context, so as to fully discern the governance force directing and controlling managerial conduct of banking organizations.

In chapter two, evolving from well-capitalization to well-management, the shifting focus of the bank safety and soundness concept, as a regulatory objective, will be charted, examined and commented. Chapter two also establishes the statutory and judicial foundations mandating the banking regulator’s adoption of their prominent regulatory and supervisory stance in relation to upholding bank safety and soundness as it is.

Chapter three will then examine the US state corporate law (as informed by the Delaware law) in its application to the banking context. The focus will be on the triad of state corporate law’s building blocks, i.e., shareholder-interest primacy, limited liability privilege and corporate separateness, as well as the law’s review standards over managerial conduct. By which the author identifies, under the shareholder model of corporate governance, it is primarily through extralegal means, featuring the prominence of those monitors of objectivity and of private ordering over judicially enforced
constraints and mandatory rules, the bank management is required to strive for the bank shareholder’s well-being, and their well-being only.

In chapter four, by examining the extent to which the regulatory requirements for safe and sound management have impacted with the elements of the shareholder model of corporate governance as discussed in chapter three, the author presents the real state of current legal order concerning the control and direction mechanism facing bank management — one underscored by clashes between two bifurcated strands of governing forces and the resultant confusion.

Some final remarks and modest suggestions provided in chapter five conclude this text. They identify the need for the US banking regulator to establishing clearer criteria when pursuing their bank safety and soundness agenda and suggest some possible approaches. Whereas a wholesale reform proposition being outside the scope of this text, it also indicates the desirability of an industry-specific construct of corporate governance.
CHAPTER ONE –
Domestic Factors as Imperative Link to Internationally Converged
Bank Safety-and-Soundness Regulatory Framework

“Globalization does not mean necessarily ‘global order’. To a large extent, to date at least, it has meant global disorder — not a global system, but a global non-system.”

An appreciation of the ongoing standard convergence processes that have been happening at the international and regional levels concerning the construction of a bank regulatory framework predicated on promoting the banking organization’s safe and sound status is methodologically essential to a study of banking law. The concise style in which these standard-setting works are often presented could facilitate one to quickly have a grip on some common denominators internationally agreed concerning the desirable shape to which domestic regulation and supervision over the banking industry should be led. It is nevertheless equally important for one to appreciate the inherent limitations international standards as such would entail — that they fall short on accounting for domestic particularities. The purposes of this chapter are therefore twofold: to outline the elements of the generally accepted bank regulatory framework as enshrined amidst the international and regional standard convergence processes; and to manifest that the regulatory consequences brought about by domestic implementation of such framework are economy-specific and often diverging one jurisdiction from another.

This chapter first provides a theoretical overview concerning the special-status presumption that is traditionally associated with the banking industry and its corresponding regulation. In light of the Basle Committee’s landmark document Core Principles for Effective Banking Supervision of 1997 and the EU’s convergence program, section two will outline some critical regulatory, supervisory and protective measures contained therein, which underpins an internationally accepted bank regulatory

1 JOSEPH NORTON, FINANCIAL SECTOR LAW REFORM IN EMERGING ECONOMIES 6 (2000).
framework.

In section three, to highlight the extensive extent various domestic factors and regulatory concerns have implicated with such framework, including its safety-and-soundness objective, its credit-risk based and risk-specific approach in structuring prudential restraints and arrangements, and its sector-specific division of supervisory responsibilities and point-in-time supervisory style, three subject matters will be covered. They are, first, New Zealand’s particular banking landscape associated with pre-eminence of large and foreign banking organizations that has underpinned a bank regulatory model emphasizing competitive rather than prudential banking; second, the strength on financial and technologic innovation displayed by certain economies that has resulted in hybrid-risk financial products and demanded a regulatory response departing from the traditional risk-specific approach; and, finally, amidst the overriding liberalization process of cross-sector institutional integration and functional deregulation, the diverging domestic strategies on fusion model selection and fashioning of corresponding regulatory and supervisory responses. The chapter provides in section three some concluding observations.

I. Banking Industry’s Special Status: Foundation of Prudential Banking Regulation and Supervision

The safety-and-soundness (or prudential) concern, standing as a distinctive regulatory objective, sets banking and its regulation apart from non-banking (both financial and  

3 Conceptually, some commentators separate prudential regulation from systemic regulation, despite recognize both require “the regulation and supervision of institutions rather than of the functions they perform” and both share similar regulatory/supervisory approaches, such as capital requirements. This is because, as asserted, prudential regulation is about safety and soundness of financial institutions (aiming for customer protection while systemic concern does not necessarily arise); while systemic regulation involves purely systemic reasons (aiming for prevention of the effect of negative externality that “the social costs of the failure of an individual institution exceed the private costs”). See CHARLES GOODHART ET AL, FINANCIAL REGULATION: WHY, HOW AND WHERE NOW 5 (1998).

In practice, however, these two breeds of regulation could be hardly separated. First it could be difficult to distinguish them and attribute to their respective prudential and systemic categories, given their similar, if not identical, regulatory/supervisory approaches. And second, the policy underpinnings justifying
non-financial) industries. This regulatory objective, aimed for steering banks on a stable course and holding them as a going concern, comes from the premise banks have a special status, a status justifying governmental regulation and supervision, as well as intervention and protection, to a prominent degree. While banks are considered as financially healthy, such status gives rise to the entry limit (the need for a bank license) and other prudential requirements. Compliance of which is monitored by supervisory agencies, and violation punished by civil, criminal and administrative sanction. The locus of holding them as a going concern also prompts various protective measures such as deposit-insurance regime and lender-of-last-result rescue as conducted by central banks for both troubled banks and their depositors.

It is generally believed systemic concerns and the presence of government-funded deposit insurance arrangements that generate elevated moral hazard and the propensity of excessive risk-taking render banking industry special. It is also presumed in the banking industry the presence of market imperfection, flowing from particular fragilities of core banking and high leveraging of banks' capital structure. Additionally and in the political sense, there is the general public's demand for a safe banking system as these institutions hold household and corporate savings. These factors, collectively, lead to the general policy that banks should be subjected to extensive regulation, supervision and protection for they are regarded as "having 'public' character or at least as having 'public' attributes".

This section investigates this bank special-status premise, including some classic prudential regulation over individual institutions could also be intertwined with the more profound systemic concerns that safety and soundness of each individual institution is the precondition of stability of the system as a whole.

4 In this chapter, bank or depository institution denotes an undertaking whose core business is to receive deposits or other payable funds from the public and to grant credits for its own account. See Art. 1 (1), Directive 2000/12/EC of the European Parliament and of the Council (24 April 2001).

5 Distinctions between banking regulation and supervision are frequently made by regulators and academics. The US Federal Reserve Board distinguishes regulation, which "entails making and issuing specific regulations and guidelines governing the structure and conduct of banking, under the authority of legislation," from supervision, which "involves the monitoring, inspecting, and examining of banking organizations to assess their conditions and compliance with relevant laws and regulations." See Federal Reserve Board, The Federal Reserve System-Purpose & Function 72 (8th ed. 1994); see also PATRICIA A. McCoy, BANKING LAW MANUAL §12.01 (2nd ed., 2000).

debate surrounding it.

A. Special Fragilities of Core Banking

Amongst modern banks' multiple functions such as trading (notably on securities and derivatives) and other intermediary services including insurance, deposit-taking and lending (the core banking function) stands out for its perceived particular fragilities connected to being susceptible to "runs" by depositors which gives rise to the first reason why the banking industry is considered special.

The core banking function, as a transformational service, is generally understood operates by pooling short-term demandable deposits to advance long-term loans to the needs of households and production firms. By manipulating and mismatching maturities, banks convert illiquid investments into liquid ones. Maturity mismatch, combined with the perceived opaqueness of bank balance sheets, and the comparatively unmarketability of banking assets, would then lead to a "fire sale" scenario, i.e., substantial diminishment in value of a bank's loan portfolio in liquidation than on an on-going basis, when banks actually or allegedly run into troubles. To avoid being caught up in a fire sale, "rational" depositors would then engage in deposit runs in the immediate

7 For the UK's experiences concerning the banking sector deregulation and the formation of multifunctional banking, see Cranston, supra note 7, at 20-30.
8 See Jonathan R. Macey, The Business of Banking: Before and After Gramm-Leach-Bliley, 25 Journal of Corporation Law, 691, 695-696 (2000) (Macey contends by providing transformation services banks economize on transaction costs for depositors and borrowers, which is the dominant economic explanation for the persistence of banks. Other reasons why banks' deposit taking and loan-making business generate such economic effects include: (1) banks diversified portfolios reduce risks benefiting for both borrowers and depositors, (2) banks allow borrowers and depositors to exploit economies of scale due to the size of bank, and (3) banks benefits depositors by specializing in identifying and monitoring credit risks).
9 Opaqueness of banks' balance sheet is connected to the characteristics of their core assets such as commercial loans. Contrasting to securities firms' assets, it was noted "traditional banking involves the acquisition of long-term non-marketable loans which are typically held on the bank's balance sheet until maturity. By contrast, investment firms experience rapid asset turnover as a result of their market making, underwriting and trading activities. .... Furthermore, securities firms are evaluated on a liquidated basis and their accounting is mark-to-the-market, while banks are evaluated as going concerns and their accounting is often based on original cost". See Richard Dale, Regulating Investment Business in the Single Market, Bank of England Quarterly Bulletin, 333, 333-334 (1994).
10 In general, this is due primarily to evaluating commercial loans being largely based on insiders' information that is difficult to be credibly reflected in a secondary market.
12 Id. at 328-331 (arguing, from the perspectives of depositors, running a financially healthy bank is a rational decision as opaqueness of bank assets (commercial loans primarily) renders the "fire sale" effect
aftermath of a signal, however speculative it might be, showing instability of their banks. As a result, even financially healthy banks can be brought down and be forced into bankruptcy, if large enough depositors demand repayment of their funds simultaneously. Such market imperfection and its derived potentially unpredictable financial losses thus gave justifications to regulatory safeguards to either reassure depositors (such as the mandatory deposit insurance scheme) or to buffer banks’ unexpected losses (such as the regulatory capital requirement).

There is longstanding debate regarding banks’ balance sheets. For example, some argued financial statements of banks were much more informative than those of large non-financial firms for, among other things, intangible assets (such as patents, research and development, advertising, and customer goodwill), which often accounted for substantial amounts of non-financial firms’ assets and were insignificant for banks, were not even reported as assets on non-financial firms’ financial statements. Moreover, non-financial firms’ businesses are suggested being more unique and diversified than banks’.

B. Systemic Concerns

Another source of fragility associating with the banking industry rests with the systemic rather than the individual-institution level. The risk of systemic or industry-wide collapse of the banking system is understood to be closely related to the contagious effect for banks’ interconnectedness with one another in inter-bank lending markets and through the payment system. Besides, rather than real exposures, contagion was suggested also able to work its way through informational channel, which could lead

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that a bank’s loan portfolio is worth significantly less in liquidation than on a going concern basis).


14 Id.

15 Generally see Elena Carletti and Philipp Hartmann, Competition and Stability: What’s Special About Banking?, Special Paper No. 140, (LSE Financial Market Group, 2002). (contending for the purpose of cushioning daily liquidity fluctuations and conducting large amounts of payment transfer, banks are closely linked to each other. Such a linkage might also simultaneously bring a large number of banks into trouble if macroeconomic deterioration severely impairs the viability of their correlated activities).

16 For an extensive theoretic studies and empirical evidences on systemic risk, see Oliver De Bandt and Philipp Hartmann, Systemic Risk: A Survey, Working Paper No.35 (European Central Bank, 2000)
to "contagious withdrawals when depositors are imperfectly informed about the type of shocks hitting banks (idiosyncratic or systemic) and about their physical exposures to each other (asymmetric information)." Contagion spreading through the above two channels and happening at a wholesale scale then bring with it the concern that key macroeconomic functions performed by the banking system might be seriously hampered. Traditionally, these functions embody banks acting as suppliers of credit to the economy; as the backup source of liquidity for all other institutions; and as the transmission belt for monetary policy.

These far-reaching spill-over effects are not recognized by all. Insights into how they work in the real world, to what extent they could havoc a system-wide disruption and therefore justify corresponding regulatory and preventive measures, might be not sufficient enough. Some commentators, for example, considered it an overstatement to have a mandatory deposit insurance scheme forestalling bank runs and safeguarding

17 Id, at 2.
18 For the effect of negative externality in association with systemic collapse, See C.W. Calomiris and B. Wilson, Bank Capital and Portfolio Management: The 1930s Capital Crunch and Scramble to Shed Risk, Working Paper No 6649, NBER, Cambridge, MA (1998) (providing a model applied to the capital crunch of the 1930s in the US, and concluding during the Depression banks often contracted the supply of credit rather than replaced capital for compensating capital losses as the latter was too expensive. Protective regulation therefore can insulate bank credit supply either by removing the constraint of low default risk on deposits or by replacing lost capital).
19 The credit-supplier argument contends if bank failures cut across the industry, it would then lead to a reduction in money supply and contraction of credit. Credit crunch would in turn force other sectors of the economy into restraints of operation, thereby possibly inducing a full-scale recession. See PATRICIA A. McCoy, supra note 5 at §1.03 [4] (citing Daniel R. Fischel et al., The regulation of banks and bank holding companies, 73 Vanderbilt Law Review, 301, 307-09 (1987)). The payment-system related argument upholds that banks fuel payment systems by providing reliable liquidity and thus transactions will be reassured only if banks, as underlying intermediaries, are insulted from insolvency. Id. (citing Stephen G. Cecchetti, The future of Financial Intermediation and Regulation: An Overview, 5 Current Issues in Economy and Finance 1 (Federal Reserve Bank of New York, 1999); Thomas M. Hoenig, Financial Modernization: Implications for the Safety Net, 49 Mercer Law Review, 787, 788-89 (1998); Jonathan Macey & Geoffrey Miller, Deposit Insurance, the implicate Regulatory Contract, and the Mismatch in the Term Structure of Banks' Assets and Liabilities, 12 Yale Journal on Regulation 1, 15 (1995)).
20 As noted in a recent survey, despite a few investigations into cross-border banking crises have taken place, insights into payment system contagion remains scarce. Moreover, many empirical studies on banking contagion are puzzling because they "do not control for all the macroeconomic factors that might be behind the observation of joint bank failures in history". See Oliver De Bandt and Philipp Hartmann, Systemic Risk: A Survey, Working Paper No.35, 6 (European Central Bank, 2000).
the banking system for they believed empirical studies suggested damaging runs on banks by non-insured depositors had been rare.\textsuperscript{21} The others argued that vulnerabilities due to fractional-reserve banking connecting to inter-bank exposure and payment system could be properly redressed by open market operations of a central bank that “has no regulatory powers or responsibilities”.\textsuperscript{22}

Amidst all these, one dimension to this debate is of practical interest. As stated by one leading commentator, “[t]he probability that the failure of a single bank will induce a systemic problem maybe low, but, if systemic failure were to occur, it could be serious and the costs could be high. Thus, regulation for preventing systemic problems may be viewed as an insurance premium against a low-probability occurrence”.\textsuperscript{23} These remarks are politically robust and likely in accord with what have been really perceived by policy makers and banking regulators, who might be more inclined to pay in advance such “premium” rather than risk public criticisms at a system being unregulated if a systemic event did happen. Consequently, it is likely systemic concerns will continuously play an integral part in the making of the banking industry’s special status.

C. Moral Hazard Problems Associating with Mandatory and Government-sponsored Deposit Insurance Arrangements

Moral hazard was defined as “the tendency to maximize one’s own utility to the detriment of others when one does not bear the full consequence or enjoy the full


\textsuperscript{22} Benston moved forwards by indicating part of the root causes of the Asian Financial Crises starting in 1997 is “….government interference or direct participation in banking decisions, rather than poor oversight of decisions made by independent bankers who were attempting to maximize their shareholders’ wealth, that resulted in banking insolvency”. Id., at 33 & 43 (1998).

benefits of one’s action because of uncertainty and incomplete or restricted contracts".\(^{24}\) In relation to moral hazard, the presence of a government-sponsored deposit insurance,\(^{25}\) as a protective mechanism aimed for retaining the confidence in the banking system\(^{26}\) and insulating depositors, who are the major stakeholder in terms of providing funds making up most of the bank’s capital base, from default risk at the expense of taxpayers was considered another characteristic of the banking industry. By insulating depositors, the system removes them from acting as a motivated class of monitors who would otherwise demand risk premium on their deposits for the bank’s overly risky operation, and, as a result, could induce a risk-prone mindset on the bank management’s risk-taking decisions.\(^{27}\) The direct cause of hazard here therefore rests with the potential of an insured bank to operate in a risky fashion with the public bearing the risk and without real economic risk to its shareholders and management — that a government-provided, compulsory deposit insurance scheme “privatized the gains and socialized the losses.”\(^{28}\) This concern gives rise to particular capital requirements and heightened regulation over risky activities being considered necessary.

In theory, distorting effects of this form of government subsidy are recognized by even those who rejected the bank special-status premise and thus denounced the corresponding preventive and protective measures. One leading expert, who was against


\(^{25}\) A government-sponsored, mandatory deposit insurance scheme is an integral part of the safety net policy that include such other components as implicit protection of depositors (e.g., the too big to fail policy as applied in some cases to large banks), and the central bank’s role as the lender of last resort and the backup of settlements in the payment systems. See Richard Dale, *Deposit Insurance in Theory and Practice, 8 Financial Regulation and Compliance, 36, 36-56* (2000); see also Benston, supra note 13, at 44-47.

\(^{26}\) But see Cranston, supra note 7, at 78 (arguing in the United Kingdom, deposit insurance is justified primarily as an investor-protection rather than institution-protection measure.)

\(^{27}\) While deposit insurance affecting perverse incentives remains the majority view, arguments against it run on the ground that unsophisticated depositors are in no position to be vigilant because of their incapability of monitoring banks however in the presence or absence of deposit insurance. This view is supported by two observations: first, only experts rather than ordinary depositors are able to interpret information related to financial health of a given bank; and second, as to management dishonesty, one of the major reasons for the insolvency of some banks, ordinary depositors are in no position to detecting it before it emerges to the surface. *Id.* at 79.

the government-sponsored deposit insurance, for example, indicated, with the presence of deposit insurance, “banks can and do operate with much less capital than otherwise comparable companies [; consequently,] regulatory intervention to insure that depository institutions hold and maintain sufficient capital to absorb almost all expected losses, therefore, is justified—indeed, necessary.”

D. Bank’s Capital Structure, Leveraging, and Perverse Risk Propensity of Bank Shareholders and Management

Elevated leveraging tendency, inherent in the particular capital structure of banks, is perceived as another attribute making up the banking industry’s special status. This capital structure is featured by often over ninety percent of banks’ overall liabilities coming from debt, mostly taking the form of deposits, while only below ten percent coming from shareholders’ equity—a stark contrast to, in non-banking firms, where shareholders’ equity in general covers 50 to 60 percent of the company’s liabilities. Such an eccentric debt-equity ratio was indicated a source leading to the worsening of the conflict of interests between shareholders and depositors (and other debt-holders) in that in the banking industry the asset-substitution phenomenon tilts dramatically to the depositor’s detriment as shareholders (the residue claimant) are much more inclined to take excessive risks.

II. International and Regional Standard Convergence Processes and Resultant Traditional Bank Regulatory Model Aimed for Promoting Safe and Sound Banking

A regulatory model generally embodies three elements. The first is the policy

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29 See Benston, supra note 13, at 45.
30 See McCoy, supra note 5 at §1.03[2]
31 See Patricia A. McCoy, A Political Economy of the Business Judgement Rule in Banking: Implications for Corporate Law, 47 Case Western Reserve Law Review, 2-80 (arguing American courts curtailing business judgement rule in banking, as a reaction to the bank management’s perverse tendency of engaging in overly risky lending practices that wiped out depositors and triggered banks runs, could date back to long before 1933 when the federal deposit insurance scheme was launched).
32 For banking regulatory paradigms, generally see Taylor, supra note 32, at 794-796. While outside the scope of this study, institutional coordinations of banking supervision is relevant to the supervisory process under this bank regulatory model. Subject matters in this respect can include, for
objective, the second regulatory requirements, and the third implementing (supervisory) techniques. This section starts with looking into the traditional bank regulatory model, an end result of the standard convergence processes embroiling both international and regional bodies, and will be concluded by some observations concerning these processes' inherent limitations derived from their inability of reaching deep into some domestic particularities.

A. International and Standard-based Convergence: Basle Committee's "Core Principles for Effective Banking Supervision of 1997"

From an international perspective, this sub-section outlines the traditional bank regulatory model predicated on the special status presumption as discussed in the previous chapter, as informed by the Basle Committee's "Core Principles for Effective Banking Supervision of 1997" ("Core Principles").

1. Core Principles as Common Denominator

The Core Principles issued by the Basle's Committee in September 1997 is a landmark document. As one commentator rightfully put it, "...with this single document the Basel Committee has transformed itself from being a limited and selected co-operative forum to a global leader in the development of complete regulatory programmes for bank supervision". Aimed for functioning as a reference book used globally by the community of banking regulators as to the required minimum standards of regulatory and supervisory arrangements, this paper's significance rests with its comprehensive coverage and broad participation. The Core Principles bears a number of

example, the extent to which central banks' participation into banking supervision, and the relationship between the banking regulator and other financial regulators (the "mega v. multiple regulators" issue). For the central bank's functions vis-à-vis those of prudential agencies, see Joseph J. Norton, Selective Bank Regulatory and Supervisory Trends Upon Entering 21st Century, Essays in International Financial & Economic Law, 34 The London Institute of International Banking, Finance and Development Law Ltd. 5-8 (2001). For discussions of pros and cons and other topics associating with the institutional choice between mega and multiple regulators, generally see W. BLAIR & G. WALKER ET AL FINANCIAL REGULATION (1998); and M. BLAIR & G WALKER ET AL GUIDE TO FINANCIAL SERVICES AND MARKETS ACT (2000).

33 Basle Committee, Core Principles for Effective Banking Supervision (September 1997).
It is thus fair to say the principles set out under this Paper represent a road map endorsed by not just the most developed economies but also the rest of the international community, and they represent a set of common denominators meant to be of universal applicability. As a result, it is appropriate, for the current purpose, to adopt the framework under the Core Principles as the basis for discussion.

2. Standards Concerning Regulatory Arrangements under Core Principles

In substance, for an effective regulatory and supervisory system, the Core Principles set out a five-phase regulatory/supervisory “flow chart” whereby the minimum standards to be achieved in each phase are indicated. These phases are: (i) licensing requirements; (ii) prudential regulation; (iii) ongoing banking supervision; (iv) formal enforcement and liquidation mechanisms; (v) international cooperation on supervising cross-border


36 The Committee has worked closely with non-G-10 supervisory authorities in the process of developing the Core Principles. Apart from representatives from the Committee, the Core Principles has been drawn from the participation of representatives from Chile, China, the Czech Republic, Hon Kong, Mexico, Russia and Thailand. Nine other countries (Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore) were also closely associated with the work. See Basle Committee on Banking Supervision, Core Principles for Effective Banking Supervision, (September 1997).

37 The Core Principles set out five arrangements as the preconditions for effective banking supervision: (i) sound and sustainable macro-economic policies; (ii) a well-developed public infrastructure; (iii) effective market discipline; (iv) procedures for efficient resolution of problems in banks; and (v) mechanisms for providing an appropriate level of systemic protection (or public safety net). See Id., at Explanatory Note Sec.II.
banking; and (vi) deposit protection. Apart from these, in its Annexes, special references were made to the problems related to state-owned banks.

a. Licensing Requirement

At the initial stage, adequate licensing processes, underscored by clarity of licensing criteria and of permissible activities, can allow the licensing authority to effectively identify the institutions it is responsible for.\(^{38}\) At a minimum, issuing licenses should involve an assessment of ownership structure, fitness and propriety of directors and senior management, operating plans and internal control, and financial condition, including capital adequacy.\(^{39}\) Further, in case a foreign financial institution owns an applicant, prior consent of its home country supervisors must be obtained.

Assessing ownership structure of a banking organization is a matter of enormous complexity and dynamics. One aspect of this assessment is concerning the controlling shareholder’s character integrity and financial strength that “[t]he bank should not be used as a captive source of finance of its owners”\(^{40}\). The other can be associated with a group-structure operation where the bank is part of a large organization.\(^{41}\) The concern here is about the contagious effect that complex ownership and organizational structure could be a source of weakness as risks from the activities conducted by non-banking entities might transfer to the banking part and thus expose depositors and insurance funds to undue risks. Moreover, complex ownership and structure and the associated lack of management transparency might lead to ambiguity of individuals’ responsibilities connecting to the bank’s operation.

b. Prudential Requirements

The second phrase is regarding prudential requirements, which the Core Principles set out the minimum standards to be implemented through ongoing supervision and banking examinations. These minimum standards reflect the Committee’s long-standing efforts of basing its prudential rules on the risk-based approach. Banking risks indicated by the

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\(^{38}\) See supra note 36, at Principle 2.

\(^{39}\) Id., at Explanatory Note, Section III. A.

\(^{40}\) Id., at Explanatory Note, Section III. A.

\(^{41}\) Id., at Explanatory Note, Section III. A.
Core Principles include credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk and reputational risk.

Credit risk is the risk of the failure of a counterparty to perform according to a contractual arrangement. This risk is inherent in lending, and also applied to other on-and-off-balance sheet exposures such as guarantees, acceptances and securities investments.\(^{42}\)

Country risk could arise in connection with the economic, social and political environments of a borrower’s home country that may in turn affect the borrower’s ability to repay. There is a direct connection to such a risk when credit is extended to foreign governments. Moreover, managing country risk becomes essential under such a circumstance as lending to a foreign government is typically unsecured. One specific component of country risk is transfer risk, which could be detached from the borrower’s financial standing and may arise due to unavailability of foreign currency when such a foreign currency, rather than a lender’s local currency, is designated as legal tender.\(^{43}\)

Market risk arises from fluctuation in market prices in banks’ on-and off-balance sheet positions, trading activities in particular. Specific reference is sometimes made to one element of market risk, foreign exchange risk, the risk element inherent in banks’ acting as market-makers role and taking open foreign exchange in currencies.\(^{44}\)

Interest rate risk denotes the exposure of a bank’s financial condition to adverse movements in interest rates. Such exposure would imply both on the bank earnings, the economic value of bank assets, liabilities, and off-balance sheet instruments. Managing interest rate risk is of particular importance in sophisticated financial markets where customers actively manage their interest rate exposure.\(^{45}\)

Liquidity risk derives from the inability of a bank to accommodate decreases in liabilities (by increasing liabilities) or to fund increases in assets (by converting assets promptly). Combining with the classic arguments for the peculiar fragility of banking businesses, in an extreme case, shortage of liquidity could lead to the insolvency of a

\(^{42}\) Id., Sec. IV.
\(^{43}\) Id.
\(^{44}\) Id.
\(^{45}\) Id.
Operational risk involves the breakdown by four causes: people, processes, systems and external factors. This leads to the definition made by the Committee in one of its recent papers that operational risk means “the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events”. The Core Principles Paper indicates the most important species of operational risk involve breakdowns in internal controls and corporate governance. Such breakdowns can result in financial losses through error, fraud, or other staff failure of performing in a timely and ethical fashion. Other aspects of operational risk include, for example, major failure of information technology systems or major natural disasters with disruptive effects.

Banks might be inflicted with financial losses by misjudging legal status of investment portfolio due to inadequate or incorrect legal advice. Another source of legal risk could come within legal or judicial system whereby existing laws fail to address legal issues involving a bank or are subject to subsequent change.

Reputational risk is chiefly associated with damaging effects due to confidence loss of depositors, creditors and the general markets. Detrimental events leading to such a confidence crisis could include operational failure and compliance failure.

To minimize these risks, a wide range of prudential requirements is advanced in the Core Principles based on the nature of risks. They can be basically divided into two groups: financial and non-financial requirements. Financial requirements include capital adequacy, credit risk management, market risk management, and other risk

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47 See Basle Committee on banking Supervision, Working Paper on the Regulatory Treatment of Operational Risk (September 2001). The Core Principles Paper indicates the most important species of operational risk involve breakdowns in internal controls and corporate governance. Such breakdowns can result in financial losses through error, fraud, or other staff failure of performing in a timely and ethical fashion. Other aspects of operational risk include, for example, major failure of information technology systems or major natural disasters with disruptive effects. See Core Principles, Sec. IV.
48 See supra note 36, at Explanatory Note, Section IV.
49 Id.
50 Id.
52 These requirements embody establishment of adequate standards and processes regarding credit granting/monitoring, assessment of asset quality and provisions and reserve of loan loss, risk
management.\textsuperscript{54} For non-financial aspects, the Core Principles pointed one crucial mechanism, i.e., internal controls, \textsuperscript{55} which is of particular relevance to containing operational risk.

3. **Protective Measure: Deposit Protection**

In the Appendix of the Core Principles, a special reference was made to government-sponsored deposit insurance, which has emerged as a commonly practiced arrangement addressing banking risks. Deposit insurance, as a crucial part of financial safety net, is to increasing public confidence and hence reducing the probability of contagious effects that might spread and impact on the stability of the entire banking system.

This risk-insulation mechanism, however, functions to the unintended effects of weakening small depositors’ incentives of disciplining imprudent management, and of encouraging excessive risk-taking. In other words, to the extent deposit insurance safeguarding the system’s stability, it is at the potential cost of impairing safety and soundness of institutions individually.

One way to deal with this disincentive issue is to focus on the composition of concentration and large exposure and connected lending. See Id., Principle 7-10.

\textsuperscript{53} Apart from requiring an adequate system in place for measuring, monitoring and controlling market risks, the Core Principles stressed on the need to imposing a specific capital charge on market risk exposures. This capital charge is recognized as crucial in strengthening the soundness and stability of financial markets. See Id., Principle 12.

In fact, at the end of 1997, a new capital charge related to market risk has come into effect, which added another layer of regulatory capital requirement to the credit risk based Capital Accord of 1988. This 1997 regime is based on both quantitative and qualitative standards; fulfilment of which would give banks the option of either using a standardised method or their own internal models in calculating the required regulatory capital. See Basle Committee on Banking Supervision, *Amendment to the Capital Accord to Incorporate Market Risks* (January 1996); Basle Committee on Banking Supervision, *Supervisory Framework for the Use of “Backtesting” in Conjunction with the Internal Models Approach to Market Risk Capital Requirements* (January 1996); and Basle Committee on Banking Supervision, *An Internal Model-based Approach to Market Risk Capital Requirements* (April 1995).

\textsuperscript{54} This sphere deals with interest risk, liquidity management and operational risk. The Basle Committee’s basis standing is, for adequately managing these risks, the presence of a comprehensive risk management process to identify, measure, monitor and control these risks is essential. In particular, board and senior management oversight mush play an appropriate role in this system. See Core Principles, Principle 13.

\textsuperscript{55} See Core Principles, Principle 13-15 and accompanying Explanatory Notes. The Core Principles identified four key areas to be addresses by internal controls: “organisational structures (definitions of duties and responsibilities, discretionary limits for loan approval, and decision-making procedures); accounting procedures (reconciliation of accounts, control lists, periodic trial balances, etc.); the ‘four eyes’ principles (segregation of various functions, cross-checking, dual control of assets, double signatures, etc.); and physical control over assets and investments.”

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deposit insurance that governmental funds cover only up to a limit in percentage and/or amount of individual deposits.\footnote{See \textit{Core Principles}, Appendix II.} Another way, and probably the one of more fundamental importance, is about the perception the supervisors should have in collaborating their safety-and-soundness supervisory mandates with the primary function of deposit insurance in addressing systemic risk. While the contagious effect in its connection with systemic risk is expected to be addressed by deposit insurance, banking supervisors are actually given more freedom, freedom to let unredeemable institutions fail.\footnote{Id.} Only by the supervisors’ willingness to let problematic individual institutions fail could then benefits of deposit insurance being fully reaped, and its downsides being adequately offset.

4. Supervisory and Enforcement Standards under Core Principles

a. Ongoing Supervision

Banking supervision is devised for monitoring banks’ compliance with prudential requirements. The Core Principles indicated an effective ongoing supervision should consist of both on-site and off-site supervision.\footnote{See \textit{Core Principles}, Principle 16.}

Without the physical presence of the supervisor, by collecting, reviewing and analyzing basic financial statements and supporting schedules from submitted prudential reports and statistical returns, off-site supervision is for checking compliance to prudential requirements.\footnote{See Id., at Explanatory Note on Principle 19 & 20.} Moreover, financial information, as periodically reported by the supervised, is also expected to prompt supervisors’ forward-looking thoughts that potential problems could be detected in the early stage and be reacted rapidly.\footnote{Id.} One key point to success of off-site supervision is information must be generated on a solo as well as consolidated basis that can cover three sets of financial data: the ones of banks, of affiliated non-bank entities and of the group as a whole.\footnote{See Id., at Principle 18.}

On-site supervision could be undertaken either by examination staff or by external auditors. To deliver a successful on-site examination, examiners must be capable of independently verifying the credibility of information being provided by banks in the
process of their off-site reports.\textsuperscript{62} Further, the examiner should also be mandated to ensuring "adequate corporate governance" being in place.\textsuperscript{63}

Supervisory practices must be coordinated with regular contact with bank management and complemented by credible maintenance of financial and accounting records and of financial disclosure.\textsuperscript{64}

\textbf{b. Formal Enforcement and Liquidation Measures}

Powerful enforcing tools would correct banks' failure to comply with prudential requirements, or at least reduce damages inflicted on depositors, other creditors and ultimately insurance funds. The presence of effective enforcement could also deter management failure.

The Core Principles did not come to details the composition of effective enforcement mechanisms, but put forward a number of rules on which these mechanisms should be based. Enforcement instruments must be capable of delivering corrective measures in both a timely and graduated fashion.\textsuperscript{65} Demanding a graduated approach with finely calibrated tools is crucial in the sense heavily weighted and over-stringent formal enforcement arrangements tend to defer supervisors from using them and, as a result, opt for other informal alternatives.\textsuperscript{66}

Furthermore, supervisors should be equipped with the authority that goes beyond restricting or sanctioning existing violation to more proactively redirecting the way the institution in question is managed for the safety-and-soundness concern. These proactive measures include, among other things, withholding approvals for new activities and acquisitions, suspending dividend payment, restricting asset transfers, and replacing

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\begin{itemize}
  \item \textsuperscript{62} See \textit{Id.}, at Principle 19.
  \item \textsuperscript{63} See \textit{Id.}, at Explanatory Note on Principle 19 & 20.
  \item \textsuperscript{64} See \textit{Id.}, Principle 17 & 21.
  \item \textsuperscript{65} See Core Principles, Explanatory Note on Principle 22.
  \item \textsuperscript{66} For example, from 1940s to the late 1980s, American supervisors exhibited a strong tendency of deploying informal rather than formal instruments in their enforcement actions. This was largely due to, by then, more finely tuned enforcement tools either did not exist or were unduly cumbersome in operation. And the civil enforcement mechanisms at the supervisors' handy disposal such as license revocation and termination of deposit insurance were too dramatic that would have put institutions out of business straightaway. See McCOY, supra note 5, at §13.1.
\end{itemize}
senior management. As an overarching principle, “all remedial actions [should] be addressed directive to the bank’s board of directors since they have overall responsibility for the institution”.  

For liquidation procedures, the Core Principles proposed a two-phase processes. In the extreme case where a problematic banking institution is judged no longer financially viable, the supervisor should intervene in having it taken over by or merged into a healthier institution. When such rescues proven to fail, the supervisor should have the authority to close or assist in the closing of such institution.

c. Cross-border Banking

In this part, the Core Principles reiterated the collaborating framework among home and host supervisors set out in the Basle Concorde and its successors. From the perspective of host-country supervisors, this framework is aimed to ensuring the same set of minimum requirements applied to operations of both domestic banks and foreign establishments, i.e., foreign branches, joint ventures and subsidiaries of international banks. For internationally active banking organizations, the home-country supervisors should practice global consolidated supervision. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, including host country supervisory authorities.

B. Regional and Law-based Solution: EU’s Convergence Program (Second Banking Directive and Its Supplements)

On a global scale, the growing demands for cross-border financial services from multinational corporations have pushed financial institutions to equip themselves with the capability of providing in particular wholesale financial services across the national

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68 Id.
69 Id.
70 See Basle Committee on Banking Supervision, Principles for the Supervision of Banks’ Foreign Establishments (the Concordat) (May 1983); Basle Committee on Banking Supervision, Minimum Standards for the Supervision of International Banking Groups and Their Cross-border Establishments (July 1992); Basle Committee on Banking Supervision, The Supervision of Cross-border Banking (October 1996).
Globalization of the delivery of financial services, denoting "the cross-border delivery of financial services to foreign residents; the penetration of foreign financial markets by branches and subsidiaries of multinational institutions; and transactions between banks and investment firms from different countries that give rise to inter-jurisdictional counterparty risk", is, nevertheless, primarily predicated on regional, as opposed to global, rules in terms of the capability of providing a reasonable degree of common regulatory and supervisory solutions that are law-based and binding. In this respect, the ongoing process of regulatory convergence under the EU’s convergence program aimed for a regionally integrated market poses as a prominent example.

The significance of the EU’s program rests both with its derivative-based and thus legally binding approach placing the process of convergence on a solid ground and its adaptability in implementation that gives member states enough room for adapting to their respective domestic legal and regulatory systems where more than minor discrepancies might exist among one another. For other geographic blocks, the example set by the EU Program demonstrates the possibility of a new route - the one of straddling between "soft law" and "hard law" - which renders merits of both political practicality and substantive uniformity if regulatory convergence and market integration are something on their agendas.

1. Three Building Blocks

As the cornerstone of the Community’s strategy for the integration of the banking sector,
the Second Banking directive, adopted in December 1989, introduced three building blocks, i.e. mutual recognition, harmonization of minimum prudential standards, and home-country control, in the expectation of creating a single market in banking services.

By adopting the mutual-recognition mechanism, based on the single license granted by the home-state authorities, community-wide banking operations, either taking the form of direct cross-border provision of services or through the establishment of local branches in the host state, could be firmly assured.

As the foundation for mutual recognition, harmonizing key prudential standards was initially and partly achieved by certain provisions in the Second Banking Directive on areas such as absolute minimum capital requirements for credit institutions, vetting requirements for their large shareholders and limitations on their participations in non-financial undertakings. Subsequent adopted prudential directives related to risk-based regulatory capital requirements such as the Own Funds Directive and the Solvency Ratio Directive, and to large exposure restraints (the Large Exposure Directive), and the adoption of the Deposit-Guarantee Directive, further enhanced the common prudential and protective framework across the Community.

The last prop upholding the EC convergence and integration Program comes from the establishment of the principle of home-country control, which places the primary responsibility for prudential supervision over credit institutions on their home countries that grant the single licenses in the first place. Along the similar vein, this is coupled with the adoption of the Deposit-Guarantee Directive in 1994 that provides the costs of bank failures, insofar as official deposit insurance is concerned, are to be borne by the home country that possesses the authority of entry permission and takes the

76 Second Banking Directive, Arts. 6(1) and 18 (1).
77 Id., Arts. 19-20.
responsibility of ongoing supervision. This combination is aimed to neutralizing perverse incentives of home states to competing to laxity that would have been the case if the costs of bank failure connecting with deposit insurance had been detached from supervisory failures. 82

2. Universal-Bank Model
Notably, the main thrust of the EU’s prudential regulatory and supervisory framework was aimed to fitting in with a universal-bank type of functional fusion (conducted either directly by the bank or through a subsidiary) for which the single banking license granted by the home-country authority renders the institution freedom of conducting a wide range of financial activities beyond its traditional deposit-taking and lending (although excluding some important financial activities, especially insurance business) throughout the Community. 83

To this end, two key directives were adopted. The Consolidation Supervision Directive 84 introducing a revised, although incomplete, framework for the consolidated supervision over banking groups was adopted in 1992. To complete this framework, the Capital Adequacy Directive 85 applying both to investment firms and credit institutions, was adopted in 1993 and stipulated regulatory capital requirements covering market risk flowing primarily from the securities and foreign-exchange trading activities. Under which, a “trading-book” approach, i.e., securities activities conducted by these institutions are subject to a separate capital-adequacy regime from the one for the banking business, was employed.

83 See the Annex to the Second Banking Directive.
3. **Proposed Directive for Financial Conglomerate Supervision**

Recently, the proposal for a Directive\(^86\) introducing supplementary supervision of financial conglomerates adds a new layer of supervisory convergence, and hence promises the prospect of closer market integration. In addition to the current sectoral supervision and basic consolidation supervisory framework under the Consolidation Supervision Directive,\(^87\) the Proposed Directive demands a closer coordination among supervisory authorities of different sectors of the financial industry relating to the supervision of credit institutions, insurance undertakings and investment firms.

C. **Interim Observations: Standardized Regulatory and Supervisory Approach and Limitations of Convergence Process Due to Presence of Domestic Factors**

In pursuing safe and sound banking, the international and regional experiences involving in the overall convergence process concerning standard-setting entail some common grounds.\(^88\) Most evidently, some forms of prudential safeguards, aimed at curtailing the banking institution’s perceived risk-prone operating strategy as well as providing a financial buffer upon realized losses, are shared by both. These preventive measures are met by those of a protective nature, not least the deposit insurance requirement considered necessary to forestall bank runs. Moreover, to achieve both regulatory and supervisory ends, a risk-based approach adopted by both is also clear. This is despite, at

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88 The Basle Committee’s position of viewing the banking industry (and regulation and supervision over it) a distinctive one from other financial and non-financial industries is endorsed by other prominent non-banking international bodies such as the International Association of Insurance Supervisors (IAIS) whose primary mandate involves with standard-setting in the field of insurance regulation. In one important supervisory paper, the IAIS, for example, stated: “Because insurance companies are less vulnerable to risks of contagion than, for example, banks, and because they are more rarely a source of systemic risk to the wider financial system, insurance supervisors seek to ring fence an individual insurer.” See IAIS, *Principles Applicable to the Supervision of International Insurers and Insurance Groups and Their Cross-Border Establishments*, p. 3 (Sep., 1997).
least concerning the Core Principles, regulatory measures that have concrete contents, such as risk-based capital requirements (Principle 6), other ratio-based restraints (e.g., Principle 8 and 9 on loan loss provisions, reserves and large exposure restrictions), and loan policies (e.g., Principle 10 on arm's-length principle), are predominantly relating to credit risk. For other risks, the need of establishing “comprehensive risk management”—a much vague assertion—is indicated (Principle 13).

On the supervisory side and in particular concerning cross-border banking, the need for not only supervisory coordination and cooperation but also for a clear division of supervisory responsibilities is confirmed by both. In addition, the Core Principles has indicated a standard supervisory circle. To monitor compliance with prudential requirements, supervisors are required to conduct effective on-site bank examinations, based mainly on the institutions’ prudential returns, and off-site, primarily for checking credibility of returned data and assessing managerial quality (Principle 16-21), and in the event of any violation found, correct it with informal and formal enforcement actions (Principle 22). The outputs generated by examinations and enforcement actions could then be used for deciding the frequency of follow-up examinations and the degree of severity of subsequent sanctions. This seemingly perfect supervisory circle sits on a number of assumptions. First, it is assumed credit risk is the main type of bank risk and that probability of loan defaults can be usually assessed in advance. The institution’s risk management is thus less expected by the regulator of monitoring credit risk on a real-time basis but rather conducted ex ante in that credit analysis and audit before loan extension are the primary procedures. 89 By the same token, it is also assumed as workable loan losses occurring later could be covered by setting aside loan provision, regulatory capital and other ratio-based provisions in advance. In addition, it can also be said, as contrast to the risk profile of a securities firm, which is characterized by short-term but generally secured liabilities and liquid assets, the one of a bank is assumed relatively static. 90

One could, however, also pinpoint some clear limitations embedded in these efforts. Concerning the EU’s strategy in eradicating legal barriers, difficulties resulting from

89 See Taylor, supra note 32, at 796-797.
90 See Dale & Wolfe, Supra note 11, at 328.
discrepancies of national laws and regulations remain in such areas as bank insolvency law, consumer protection, business-conduct regulation and others. At the EU level, some existing non-legal restraints as predicted will be also persistent in the future that will be even harder to be addressed than those legal discrepancies in the pursuit for an integrated market that is perfectly contestable. For example, addressed to retail banking, one leading commentator observed: “[b]ranch networks of existing dominant banks, their reputation for soundness, and switching costs for consumers—all create non-legal barriers to entry. Consequently, while European competition in wholesale banking will continue to be strong, and competition for medium-sized firms and wealthy individuals will grow, the likelihood is of only gradual changes in European retail banking”.  

One difference between the EU program and the Core Principles is notable. That is, the EU program is actually one that goes beyond simply setting common standards as did the Core Principle. It has also confirmed “universal bank” as generally a regional pattern of function fusion among banking, securities and other financial businesses within the region. And, by the proposed directive for financial conglomerate supervision, it has started to address regulatory and supervisory particularities connecting to this particular pattern of multifunctional banking. By contrast, the failure of the Core Principles and after it other works accomplished by the Basle Committee and other international bodies in setting a generally favored pattern concerning function fusion, means, in terms of standardizing regulatory and supervisory treatments, far more restraints are in place at the international than the regional level.

It is thus clear, insufficiencies or limitations of the ongoing international convergence process (and, to a less extent, the regional one) of establishing minimum standards for bank regulation and supervision rests with, by nature and approach, these processes’ inherent inability to address domestic factors, to which the next chapter will turn.

91 See Cranston & Hadjiemmanuil, supra note 81, at 341-384.
92 See Cranston, supra note 7, at 434.
III. Domestic Dynamics Implicating with Traditional Bank Regulatory Model:

Three Examples

This section presents three examples on the domestic factor that was argued in the previous section as an imperative link to the ongoing standard convergence processes over the establishment of bank regulatory model. The first concerns the depth and strength on financial and technologic innovation as displayed by individual economies, a factor implicating with the traditional model’s risk-specific and risk-based approach. The second concerns the global trend of individual economies engaging in institutional integration and functional deregulation for their financial sectors. It will note the common goal of effecting a regulatory structure able to ensure effective oversight over complex financial groups as perceived by individual economies have been met by diverging domestic strategies during the processes of reforming their respective regulatory, supervisory and protective arrangements. Lastly, this section will present the New Zealand’s bank regulatory model, predicating on competitive as opposed to safe and sound banking, a regime fundamentally departing from the traditional regulatory approach.

A. Depth and Strength in Financial Innovation

The following provides a brief account how the depth and strength of particular economies’ capability concerning financial innovation could implicate with the risk-specific and sector-based approach of bank regulation and supervision as enshrined under the traditional bank regulatory model.

1. Risk Convergence and Functional Despecialization in Most Advanced Economies

For those most advanced financial-center hosting economies, of the most discernable effects financial innovation has brought about upon their banking industries are the phenomenon of functional despecialization and the beginning of the risk convergence process between “bank risks” and those traditionally considered only to be borne by non-bank financial intermediaries. This aspect of observation is critical to the validity of the traditional regulatory model that is based on a risk-specific and risk-based approach,
not just in terms of regulation and supervision that should be conducted by the authority, but in term of the perception the manner risk management is being adopted by the bank institution.

One pronounced feature of financial innovation relates to its ability of continuously creating exotic financial products (such as credit derivatives as the recent case) that could not be easily attributed to traditional contractual forms such as debt, equity, and insurance. Such products with their hybrid risks have been increasingly blurring the risk boundary between banks and non-bank financial institutions. This in turn propels financial institutions, particularly those largest and most complex ones, away from their traditional sector-based risk management and into a more risk-adaptable one- the one of managing risks by unbundling certain types of risks resting with industry sector into components of common nature.

Another source of risk convergence rests with the phenomenon of despecialization of the transformation service and other functions traditionally falling into the banking domain, and its ensuing effect of blurring the sector boundary. On the asset side of the balance sheet, such institutions as insurance companies, pension funds, and mutual funds in today’s marketplace compete directly with commercial banks by providing borrowers with access to medium-to-long-term funds; on the liability side, they compete with commercial banks by accepting liquid funds from investors. On a functional note, commercial banks also have to compete with other service providers on areas other than the transformation service. For example, by allowing investors to make redemptions by writing checks to third parties drawn on their mutual funds accounts, the service provided by the open-end money market mutual funds is rather similar to the one of commercial banks’ checking accounts.

2. Developments of Securitization in East Asia’s Newly Industrialized Economies

Geographically, financial innovation and its attendant effects are not simply being

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93 See Taylor, supra note 32, at 798.
94 Id.
96 Id, at 694.
restricted to the most developed economies. For banks in other parts of the world such as South Korea and Taiwan, two newly industrialized economies in East Asia, such force is gradually gathering momentum and taking hold.

The obvious example is the recent developments in securitization. By adopting the Asset Backed Securitization Act in 1998 (amended 2001) (in South Korea) and the Financial Asset Securitization Law in June 2002 (in Taiwan), these two economies took their first steps by eradicating major legal barriers to securitization transactions rooted in their civil-law tradition such as predicaments relating to the undesirable perfection of security, to the compulsory notice-giving to obligors, and to the insufficiency of security over the assets to be securitized. 97

While for both economies securitization is still at its infancy, the potential enormity of this market promises in the years to come they will not be immune from the effects of risk convergence that have been reshaping the financial landscapes in the most developed economies. 98 These effects are twofold, both for banks and securities firms, that “…securities firms will increasingly be exposed to the type of risk that is typical of traditional banking business as their assets include, for example, mortgage-backed securities or securitized bank loans. Similarly, bank balance sheets—previously characterized by their stability—are now subject to much greater volatility because assets can be securitized and sold and trading activities account for a much larger share of profitability”. 99

B. Patterns of Affiliation and Functional Integration Chosen in Financial Deregulation

Whilst relaxing affiliation restrictions of banks with financial or non-financial firms and

98 Taiwan’s Ministry of Finance approved the first asset-back securitization transaction in January 2003. The basic structure of this transaction is outlined as follows. With Taiwan Industry Bank (TIB) as the originator, backed by the TIB’s corporate mortgaged loans, which were then transferred to the Taiwan Land Bank (TLB), the trustee institution (a special purpose vehicle), senior and subordinate beneficiary certificates totalling over NT$ 36 billion were issued in February 2003 for the purpose of private placement. As predicted by Taiwan’s Ministry of Finance, the Taiwan’s securitization market could soon be worth NT$1.6 trillion ($50 billion). Chinatimes (Taipei), 2 (28 January 2003) (in Chinese).
99 See Taylor, Supra note 32, at 799.
expanding commercial banks’ functions beyond core banking are a global trend, domestically it has been met by multiple as opposed to a uniform affiliation models and patterns of functional deregulation, so has the corresponding regulatory and supervisory solutions in reacting to the boundary-blurring effect brought about by such functional and institutional integrations. Against the backdrop of a basically internationally converged bank regulatory framework, this aspect of consideration provides a good example as to such framework’s limitations in failing to reach deep into domestic economic and societal particularities.

This section will also explore the dramatic “model shopping” experience of Taiwan, as a newly industrialized East Asia economy, in her pursuit for the optimal pattern of financial sector integration, which, again, presents a stark contrast to, at the standard-setting level, an internationally converged framework.

1. Initiatives of Individual Economies Engaging in Financial Deregulation

Barings’ debacle was suggested as a testament to the damaging force that could be unleashed by globalization, financial innovation and deregulation working interactively. For an economy other than those most developed ones, the initiative of engaging in financial deregulation, featuring generally a functional and institutional framework of integration among different financial sectors, could be, however, a domestic policy addressed to its financial sector’s absence of global operational bases and insufficiency of market depth and of innovative and technologic strength. For these economies’ policymakers, financial deregulation is usually aimed for the resultant synergy expected to be drawn from such integration to somewhat mitigating the said

100 On reviewing and examining the build-up of loss concealment masterminded by Nick Leeson, the chief trader and general manager of Baring Futures (Singapore) Ltd (BFS), who incurred massive losses on unauthorized derivative trading to BFS’s parent company, Barings plc, and, ultimately, to its collapse in 1995, one leading commentator linked the Barings’ debacle to these three factors: “In the area of globalisation, regulators in Singapore, Japan and the UK failed to coordinate their roles internationally, underlining the absence of any multilateral agreement on supervisory cooperation in securities markets. On the question of functional integration, there was no clear policy on (i) whether or to what extent Barings banking arm should fund its securities affiliates or (ii) how the principle of consolidated supervision should apply to the various parts of the group. And, finally, financial innovation lay at the heart of the Barings collapse, in so far as neither Barings top management nor regulators seem to have fully understood the nature of the derivatives arbitrage operations in Singapore that were supposed to be generating such large profits”. See RICHARD DALE, RISK AND REGULATION IN GLOBAL SECURITIES MARKETS, 203 (1996).
weaknesses. This strikes a contrast to financial deregulation taking place in the most
developed economies whose initiatives could be by nature adaptive—to the markets and
technological developments.

2. A Snapshot: Fusion Models in the UK, Japan and the US

This section outlines the different corporate models concerning affiliation of banking
and other financial services adopted in the UK, the US and Japan by attributing to three
regulatory regimes—the US Glass-Steagall model (in the pre-GLBA era), the
universal banking model (in much of the continental Europe) and the US firewall
model (in the post-GLBA era).

In the United Kingdom, the presence of certain restrictions on combining banking
and securities before 1986 resulted primarily from the participation restrictions in the
London Stock Market. In 1986, as a one-stop change, member securities firms were
allowed to be acquired by banks following removal of the restriction rules of the London
Stock Exchange on the ownership of firms of “jobbers” (market makers of stocks and
shares) and stockbrokers.

In Japan, the restriction on banking-securities affiliation was removed by the
Financial System Reform Law of 1993 that allowed commercial banks, trust banks and
securities firms expanding into each other’s core business by establishing separate

101 Id., at 13-16.
102 The US Glass-Steagall separation model in the pre-GLBA era, which separates commercial banking
from investing banking by means of affiliation prohibition, was based on the idea that public deposits
should not be exposed to risky securities transactions. Such an institutional segregation then lead to a
regulatory regime that was conducted on the industry-specific basis. In the case of capital adequacy, for
instance, two sets of rules are respectively applied to banking and securities business. Id., at 13-14.
103 Under this model, mixed activities are grouped within the banking entity (so are their attendant risks)
and subject to a single regulatory authority that applies a common capital adequate regime to the bank as a
whole. Id.
104 Under the GLBA, affiliations under a financial holding company are allowed as long as “firewalls” are
in place. The function of a firewall is to restricting intra-group transactions and other connections for the
purpose of preventing risks being transmitted from the non-banking to the banking unit. As far as capital
adequacy is concerned, a financial holding company must maintain adequate regulatory capital, both on
the subsidiary (sectoral) and on the parent-company basis. Id. see also MACEY ET AL, BANKING LAW
105 See William Blair, Liberalisation and the Universal Banking Model: Regulation and Deregulation in
the United Kingdom, in INTERNATIONAL BANKING REGULATION AND SUPERVISION:
subsidiaries.106

In the US, through liberal interpretations of the Glass-Steagall Act of 1933, the US authorities empowered US banks to expand their business lines to securities through special-purpose affiliates.107 This took place even before the Gramm-Leach-Bliley Act of 1999 (GLBA) repealing Sections 20 and 32 of the Glass-Steagall Act.108 Under the GLBA, if a bank holding company qualifies as a financial holding company,109 its permissible activities include the ones determined by the Federal Reserve Board to be (1) “financial in nature”; (2) “incidental to such financial activities”; or (3) “complementary to a financial activity” and posing no “substantial risk to the safety and soundness of depository institutions or the financial system generally.”110

107 Such a special-purpose affiliate is often referred as “section 20 subsidiaries”, i.e., subsidiaries that have power to engage in securities business subject to the “application”, both through the Federal Reserve’s interpretations and the federal courts’ rulings, of the Glass-Steagall Act. Glass-Steagall-section 20 forbade affiliations between banks and firms “engaged primarily” in the investment banking. The Federal Reserve’s liberal interpretations regarding Section 20 since 1987 (marked by the agencies permitting Bankers Trust Company’s expanding into limited securities activities on the conditions of certain limits on gross revenue and market share), alongside the federal courts’ subsequent endorsements in a series of cases represented a major policy shift away from the Congress’s initial intent under the Glass-Steagall Act. Consequently, “as a result of the Federal Reserve’s actions, prior to the passage of GLBA, a bank holding company could own an investment banking business that engaged in every conceivable aspect of the business of investment banking, subject only to the twenty-five percent gross revenue test and some modest ‘firewall’ on interactions between the bank and its investment banking affiliate”. See Jonathan R. Macey, The Business of Banking: Before and After Gramm-Leach-Bliley, 25 Journal of Corporation Law, 691, at 718(2000).
108 The Glass-Steagall Act is composed of four sections (Sections 16, 20, 21 and 32) of the Banking Act of 1933, codified in 12 U.S.C.24 (seventh), 377,378&78 (1994 & Supp. V 1999). Section 16 prohibits banks from acquiring securities and from engaging in underwriting and dealing in securities; Section 20 prohibited banks that are members of the Federal Reserve System from affiliating with organisations that are primarily engaged in underwriting or dealing in securities; Section 21 prohibits the receipt of deposits by securities companies; Section 32 Prohibited management interlocking between officers, directors or employees of a bank that is a member of the Federal Reserve System and a securities firm. The GLBA (Sec. 101 (b), GLBA, 113 Stat. At 1341 (1999)) repealed Section 20 and 32, but Section 16 and 20 were retained. Therefore, running securities business directly and on a stand-alone basis by a commercial bank or a bank holding company is still prohibited, and vice versa. Besides, as Gruson indicated, “Section 20 is not completely dead”. The operating standards of Section 20 issued pre-GLBA, such as the 25 percent revenue limit, are still applied by the Federal Reserve to the Section 20 subsidiaries of bank holding companies that do not elect to become financial holding companies. See Michael Gruson, Foreign Banks and the Regulation of Financial Holding Companies, n 12 & accompanying texts (2002) (unpublished manuscript on file with the author) (citing the Federal Reserve Board’s release of 10 March 2000, 65 Fed. Reg. 14440 (17 Mar. 2000)).
109 Three substantive requirements are needed for a bank holding company qualifying as a financial holding company: being well-capitalized and well-managed and granted a CRA rating under the Community Reinvestment Act that is not less than satisfactory. 12 U.S.C. §§1843(i)(1)-(2), 2903 (c)(1).
110 12 U.S.C. §§1843(k)(1)
3. Taiwan's Dramatic Model-shopping Experience in Financial Sector Integration

For newly industrialized economies such as Taiwan, the pursuit for an optimal integration model is far from straightforward. Dramatic model shopping, starting from a universal-banking (in its narrow sense banking and securities are combined and conducted under a commercial-bank corporate entity), through a parent-subsidiary, to a financial-holding-company model, which takes place in as short as twelve years,{superscript}111 highlights the level of confusion and complexities that could entail the process of financial deregulation.

a. Credit-allocation Based Segregation and Universal-bank Model

Before 1989, the year when Taiwan’s banking sector was liberated and private banking introduced, credit allocation was the most prominent force directing the way state banks was regulated. For example, the Banking Law of 1975 distinguished among short-term, medium-term and long-term credit providers, with which commercial banks were empowered to providing short-term credits, saving banks and trust investment companies to medium-term and long-term credits, and specialized banks to credits demanded by specific non-financial industries.{superscript}112

Credit-allocation based segregation had been statutorily retained until 2001 when the Banking Law removed the type of saving bank.{superscript}113 Nevertheless, while securities business was theoretically attributed to medium-to-long-term credit provision, this segregation had not really hindered upon commercial banks’ securities engagement, not even at the outset.

In fact, back to 1960s, while a commercial bank’s business scope was not clearly spelt out statutorily, selected state banks had been already allowed to run securities business by setting up trust departments. With sate banks deployed as market makers, this policy was intended to promoting developments of the capital markets, which were

{superscript}111 This is the period from 1989, when private banking was introduced to the economy, to the passage of Financial Holding Company Act in December 2001.
{superscript}113 See Art. 20, Banking Law (2001).
rather narrow back then. Article 25 of Banking Law of 1975 carried this strategy forward and provided a commercial bank’s business capacity included saving and trust business based on “separate departments with separate capital, business and accounting arrangements”.\textsuperscript{114} As a result, before 1988, up to thirteen state banks were allowed to run the whole range of securities business-security dealings, underwriting and brokerages-via setting up trust departments.\textsuperscript{115}

This long-lasting policy of merging securities into commercial banks’ businesses subject to internal Chinese-wall type of departmental separation (a universal-banking structure) was vindicated by the Banking Law Amendment of 1989, which entrusted the Ministry of Finance wider discretion with regard to further extending commercial banks’ business lines.\textsuperscript{116}

b. Parent-subsidiary Model

A shift of policy preference towards the parent-subsidiary and away from the universal-banking model started in late 1980s.

On one hand, since the adoption of “The Standards Governing The Establishment of Security Firms” in 1988, securities power that had been fully enjoyed by a commercial bank based on departmental segregation was restricted to one of two pairs of either securities dealings-brokerages or securities dealing-underwriting.\textsuperscript{117} On the other, according to a ruling issued by the Ministry of Finance in 1996, commercial banks’ capacity of running non-banking financial businesses via subsidiaries was

\textsuperscript{116} Article 3, 71, 87, 101 of the Banking Law of 1989 added that banks’ business scope includes “other business that is approved by the Central Competent Authority”. Furthermore, the adoption of a “universal banking” model was concluded during the National Financial Conference held on 23 July 1991 that drew on participation of regulators, bankers and academia. See, Ministry of Finance, The Suggestions and Enforcements of the National Financial Conference, 13 (1996) (in Chinese).
\textsuperscript{117} This gave commercial banks competitive decline over their opponents of securities firms. Securities firms are permitted to run these three arms of securities business simultaneously and therefore able to offer more competitive fees to customers by setting cross-subsidy service fees. WENG YUI WANG, HOLDING COMPANY AND FINANCIAL HOLDING COMPANY 158 (2001) (in Chinese). The administrative order issued on 3 August 2001 by the Ministry of Finance authorized by the Banking Law of 2001 maintains the same restriction. See Ministry of Finance, Guideline of Business Scope and Risk Management on Banks’ Trust and Securities Business, Art. 4 (3 Aug. 2001) (in Chinese).
liberalized. Upon which the parent banks could embark on a wide range of financial activities (such as securities, insurance, credit card, bill securities, futures, lease finance, and trust), subject only to a gross-revenue cap of forty per cent of the bank’s paid-in capital and to the requirements for adequate capital-related ratios.\textsuperscript{118}

Of the most crucial implications this wave of liberalization brought upon was, in order to enjoy full-range securities businesses, a commercial bank could effectively escape from the pairing restriction imposed on its securities department by simply opting for setting up a securities subsidiary. This parent-subsidiary corporate structure and the range of its business scope were re-stated in the Banking Law of 2000.\textsuperscript{119}

c. Holding-company Model

A further twist came in December 2001 when the Financial Holding Company Act (FHCA) was passed.\textsuperscript{120} Article 36 of the FHCA provides:

"the business of a Financial Holding Company shall be limited to investment in, and management of, its invested enterprise(s). A Financial Holding Company may invest in the following enterprise(s): banking enterprises; bills finance enterprises; credit card businesses; trust Enterprises; insurance enterprises; securities enterprises; futures enterprises; venture capital investment enterprises; foreign financial institutions which have been approved for investment by the Ministry of Finance; and other enterprises which the Ministry considers to be financially related."

The FHCA of 2001 introduces a new model, the holding-company model, regarding functional and institutional integration among banking and securities, extending to insurance and other more risky businesses such as merchant banking. Of the most

\textsuperscript{118} On 22 March 1996 the Ministry of Finance as authorized by Article 74 of the Banking Law issued this order, entitled “The Regulation Governing Commercial Banks’ Investment Amounts and Shareholding” (File Number: Tai-Tsi-Zon 85505042).

\textsuperscript{119} The Article 74 of the Banking Law of 2000 basically restated the parent-subsidiary framework as adopted by the Ministry of Finance in 1996. Furthermore, Article 28 of the Banking Law of 2000 repealed the requirement of departmental segregation of core banking and securities/trust businesses under a universal-banking model. Nevertheless, while the “pairing” restriction on securities capacity remained, it is obvious the parent-subsidiary model would prevail should a commercial bank want to be involved in securities business.

\textsuperscript{120} Financial Holding Company Act of 2001 (promulgated by the presidential decree on 9 July 2001).
discernable changes brought about by the FHCA is such activity as merchant banking, which before the FHCA were outside the boundary of a commercial-bank involved affiliation, is now inside the business projection of a financial holding company with which a commercial bank can be affiliated. This competitive edge, as widely perceived by the industry, coupled with various taxation concessions\(^{121}\) under the FHCA, and explicit encouragement coming from the authorities, lead to a new landscape in Taiwan’s financial industries-- the one dominated by financial holding companies.\(^{122}\)

4. Boundary Blurring Effect on Markets, Products and Risks Corresponding to Domestic Regulatory and Supervisory Responses

a. Intra-group Risk Transfer as Exemplified by US Financial Holding Company’s Expanded Power Concerning Merchant Banking under GLBA

In today’s marketplace, such cross-jurisdiction phenomena displaying in individual economies as the gradual reduction of statutory barriers and limitations concerning cross-sector affiliation; commercial banks being no longer the commercial units monopolizing transformation service; the increased secondary-market trading of bank loans that has neutralized the concern of core banking being particularly fragile due to unmarketability of commercial loans;\(^{123}\) and the developments of securitization transactions that have enabled bank loans to be transacted in the form of securities\(^{124}\) present as a strong testament to now a widely accepted effect—the boundary-blurring effect—that has been brought about by financial innovation and

\(^{121}\) For example, Article 49 of the FHCA reads “[w]here a Financial Holding Company holds more than ninety percent (90%) of the outstanding issued shares of a domestic Subsidiary, such Financial Holding Company may, for the tax year in which its such shareholding in the Subsidiary has existed for the entire twelve (12) months of the tax year, elect to be the tax payer itself, and jointly declare and report profit-seeking enterprise income tax and the ten percent (10%) tax surcharge on surplus retained earnings of a profit-seeking enterprise in accordance with the relevant provisions of the Income Tax Law….”

\(^{122}\) Until March 2003, as many as fourteen financial holding companies were licensed by Taiwan’s Ministry of Finance and entered into the markets. http://www.lawbank.com.tw/fnews/news.php?nid=7321.00&&type_id=1 (Last visited: June 2002)


\(^{124}\) Id. (noting the enormous magnitude of assets which the US bank holding companies removed from their balance sheets through the sale of securitized assets).
deregulation on markets, products and risks.\textsuperscript{125}

The boundary blurring effect described above has impacted the Core Principles' bank regulatory model most potently on the credit-risk based bank risk that is traditionally perceived as of a static and compartmentalized existence. In this respect, the US financial holding company's expanded merchant-banking power under the GLBA\textsuperscript{126} provides a good reference point as to how the bank risk has been transformed from a static and sector-restricted to a fluid and cross-sector existence by way of intra-group risk transfer.

The US financial holding company's newly acquired affiliation power is notable because the resultant intermingle between banking and commerce (i.e., a bank subsidiary co-exists with a non-financial subsidiary controlled by the same holding company) have rendered dubious the continuous vitality of the traditional compartmentalized regulatory and supervisory approach based upon the separation of bank risk from commercial-firm risk. This is despite, at least nominally, a firewall

\textsuperscript{125} Other distinctive phenomena flowing from this effect were insightfully suggested as: “the decline in core deposits and proportionate increase in non-deposit liabilities; the disintermediation of highly rated corporate borrowers from banks to the capital markets (CP markets); the increased lending to smaller and potentially riskier firms and consumers; technological advancements that result in enhanced electronic product delivery; the significant increase in off-balance sheet (OBS) activities, particularly OTC derivatives activities and securitization techniques; the continuous search for fee-generating activities to expand and diversify income sources; the gradual reduction of statutory barriers and limitations to engaging in securities and insurance activities through deregulatory activism; the gradual inclusion of activities considered by the banking agencies to be as ‘incidental to’ the business of banking or ‘closely related to banking so as to be a proper incident thereto; the sustained efforts to reduce operating costs and compete more efficiently; and the increased intra-banking industry and non-bank competition in the U.S. and global credit markets”. Joseph J. Norton, Selective Bank Regulatory and Supervisory Trends Upon Entering the 21st Century, Essays in International Financial & Economic Law, No. 34, 33-4 (The London Institute of International Banking, Finance and Development Law Ltd., 2001).

\textsuperscript{126} Merchant banking denotes investments in the private equity market that are usually undertaken by professional investors in unregistered shares of private or public company. These investments are generally of less liquidity, high risk, and longer term than are equity investments on public listed companies. Private equity investments are more illiquid because potential buyers or sellers are not readily accessible to a secondary market; more risky because these investments are ordinarily made in risky companies such as start-ups and leveraged buy-outs; and less liquid because these equities are typically held for the intermediate to longer term in the hope of higher returns for higher risk. See Macey, supra note 103, at 449-452 (citing Gary Gensler, Testimony on Regulation of Merchant Banking Activities, Subcommittees on Securities and Financial Institutions, U.S. Senate Committee on Banking, Housing, and Urban Affairs (13 June 2000))

A financial holding company may exercise its merchant bank power to acquire ownership interests in any company that is engaged in activities that are not regarded as financial in nature, incidental or complementary thereto (i.e., such company as not being engaging in “any activity not otherwise authorized for the financial holding company under section 4 of the Banking Holding Company Act”). 12 C.F.R. §. 225.170 (a).
arrangement separating bank from non-financial components of a financial holding company is maintained, coupled with the presence of two sets of other traditional safeguarding—(1) restrictions on banks' transactions with non-bank affiliates, and (2) capital charges for non-financial equity investments—against internal risk-transfer. All these measures being in place, as rightfully suggested, provide only "a semblance of restrictions" rather than real ones. This is not only because, technically, these firewall and transaction restriction safeguarding can be easily circumvent, but also due to, by nature and by function, this merchant banking power a financial holding company has been accorded "the purchase, acquisition or retention of any equity instrument (including common stock, preferred stock, partnership interests, interests in limited liability companies, trust certificates, and warrants and call options that give the holder the right to purchase an equity instrument), any equity feature of a debt instrument (such a warrant or call option), and any debt instrument that is convertible to equity" is assimilated with that of any other institutional investors in the stock markets—"to sell

127 Under the GLBA, a financial holding company can acquire shares in any financial or non-financial company as far as such shares are held by a securities affiliate, an insurance company-affiliated investment adviser, or an affiliate of such entities— but not by a depository institution (or a subsidiary of it). See 12 U.S.C. §1843 (k) (4). Further restraints, such as prohibiting a financial holding company or its subsidiaries from operating or managing the portfolio company, are imposed on a financial holding company's merchant banking power that are aimed to preventing "strategic investments" and restricting its capability to "capital appreciation and ultimate resale after a reasonable period of time". See Robin Maxwell and Margaret Paulsen, Equity Investments by Financial Holding Companies, 16 Journal of International Banking Law, 131, 131-7 (2001) (citing 12 U.S.C. § 1843 (k) (4) and 12 CFR §§. 225.170-6.)

128 Sections 23A and 23B of the Federal Reserve Act impose significant limits on the size and terms of transactions between banks and their non-bank affiliates. These restraints are applied to any portfolio company that is held by a financial holding company under its merchant banking power (i.e., over fifteen per cent or more of its total equity capital is directly or indirectly controlled by a financial holding company) as such portfolio company is presumed to be an affiliate of the financial holding company’s U.S. bank subsidiaries. 12 C.F.R. §§. 371c, 371c-1; Robin Maxwell and Margaret Paulsen, Equity Investments by Financial Holding Companies, 16 Journal of International Banking Law, 131, 134 (2001).

129 See Federal Reserve Board, Final Capital Rules for Non-financial Equity Investments, SR 02-4, (4 March 2002).

130 See Macey, supra note 103, at 465.

131 Considering the example: "A bank holding company could cause a bank to make a loan to an unaffiliated corporation—a transaction to which §§ 23 A and 23 [B] [of the Federal Reserve Act] would seem to have no application. But in exchange for the loan the borrower might agree to provide a line of credit to a nonblank affiliate of the bank’s parent holding company." See Macey, supra note 103, at 480.

132 See Federal Reserve Board, Final Capital Rules for Non-financial Equity Investments, SR 02-4, para. 6 (4 March 2002).
their shares at just the right time. 133

The co-existence of banking and commerce under the same corporate roof is thus a genuine existence, so is the concern of intra-group spreading of risk from the commercial to the group's banking component. This is particular true when one considers the aspect of the markets. Sometimes referred to as reputational contagion, it is contended so far as market participants consider a financial holding company as an integrated entity (and it is justifiable for them to so perceive, given identical brand recognition, similar management and consolidated financial reporting), the idea of separating risk to prevent risk from transferring to the banking component remains implausible. 134

This is more so for those jurisdictions such as Taiwan moving further and allowing banks (or the banking component of a holding company) to acquire equity interests of non-financial companies (by which the organizational firewall is removed). 135 As one leading banker rightfully put it, "it is inconceivable that any major bank would walk away from any subsidiary [including non-financial subsidiaries directly or indirectly controlled by the financial holding company via its merchant banking power] of its holding company. If your name is on the door, all of your capital and assets are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace...would not see it that way." 136

b. Disparate Domestic Regulatory and Supervisory Responses
The above-mentioned blurring boundary effect—the fading of distinctions between banking, securities and insurance, in terms of products, risks, institutions and markets—that derived from the trend of functional fusion and expanded affiliation

133 See Macey, supra note 103, at 465.
135 Chinatimes (in Chinese) (29 May 2003), available at: http://news.chinatimes.com/Chinatimes/newslist/newslist-content/0,3546,110507+112003052900165,00.html. (Last visit: 12 June 2003) (Taiwan's Administrative Yuan (Cabinet) is proposing to list merchant banking as commercial banks' permissible business subject to certain gross revenue cap).
136 See Macey, supra note 103, at 462 (citing the remarks made by Walter Wriston, the former chairman of Citicorp).
embroiling individual jurisdictions’ banking and other financial sectors has been dealt with by individual economies’ disparate policy contemplations and regulatory as well as supervisory responses. One strand of thoughts ran to the bottom as to the need of yet still placing bank safety and soundness as a regulatory objective. It was predicted banks will be re-integrated into the economy as a whole because they are no longer special. Along with it went the proposition of removing the safety-and-soundness regulatory objective and its peripheral institutions that include regulatory, supervisory and safety-net arrangements.\(^{137}\) On this basis, it was argued the failure of a large and global financial institution like Barings should be considered as “part of a natural process in a competitive environment”\(^{138}\) as were other business enterprises rather than merely a supervisory failure.

This audacious proposition is nevertheless against what the regulators have come to term with financial-conglomerate regulation and supervision, which, either at the EU level \(^{139}\) or under the US GLBA regime,\(^{140}\) is yet still sit on the bank safety-and-soundness philosophy underpinning their previous sector-based regulations.

It is also equally notable some new and varying developments that have been introduced by individual economies, particularly on the supervisory side, approaching this regulatory objective with strategies setting a disparate tone from the traditional


\(^{138}\) See Taylor, supra note 32, at 799.

\(^{139}\) For example, at the EU level, the proposed EU Directive on supervision of financial conglomerates adopts a “solo-plus” approach. The basis of supervision is founded on the supervision of individual groups by their respective sector regulators on a solo basis. This solo supervision of industrial entities is then supplemented by a general qualitative assessment of the group as a whole and, among others, by a quantitative group-wide assessment of the adequacy of regulatory capital. Michael Gruson, *Supervision of Financial Holding Companies in Europe: The Proposed EU Directive on Supplementary Supervision of Financial Conglomerates*, No. 42, Essays In International Financial & Economic Law, 26-7, (The London Institute of International Banking, Finance and Development Law Ltd.) (2002).

\(^{140}\) At the post-GLBA era in the US, retaining safety-and-soundness of the depository institution (as opposed to other components consisting of a bank or financial holding company) is yet still the supreme objective that should be achieved by bank-holding-company supervision. The Federal Reserve Board underlined this pursuit by asserting it “will seek to determine that [financial holding companies] FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions....The purpose of FHC supervision is to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company in order to assess how these risks might affect the safety and soundness of depository subsidiaries”. Board of Governors of The Federal Reserve System, *Framework for Financial Holding Company Supervision*, para. 8, SR 00-13 (SUP) (15 August 2000).
entity-based (dividing supervisory responsibilities among agencies by institution type) and point-in-time approach. These varying responses as will be further elaborated next, addressing domestic realities yet the global topic of effecting a regulatory structure able to ensure effective and efficient oversight over complex financial groups, essentially reveal the limitations of the ongoing, international processes concerning constructing standardized regulatory and supervisory treatments. In this light, it is indeed true: "Globalization does not mean necessarily 'global order'. To a large extent, to date at least, it has meant global disorder—not a global system, but a global non-system."

In the United States, the hybrid type of supervision over financial industries is highlighted by the GLBA blending a function-based division of supervisory responsibilities (which divides them by activity or product or service) into the traditional sector or institution based one. Being reflective of the presence of a de facto two-tier banking, it can also be seen the already implemented and still evolving LCBOs

141 In the United States, the traditional entity-based regulatory and supervisory structure concerning different sectors of the financial industry was premised on the existence of relatively clear distinctions between their business lines. The products offered and risks borne by each sector were considered relatively easy to categorize, so were institutions easily distinguished and categorized into those that took deposits (commercial banks), sold securities (investment banks), and offered insurance (insurance companies). Accordingly, the businesses of banking, securities, and insurance were supervised as if they were separate industries, conducted by separate agencies along the institutional line. See Heidi Mandanis Schooner & Michael Taylor, United Kingdom And United States Responses To The Regulatory Challenges Of Modern Financial Markets, 38 Tex. Int'l L. J. 317, 317 (2003).

142 This convergence process has been spearheaded by the Joint Forum, a cross-sector international body established in 1996 under the aegis of three primary sector based international agencies, i.e., Basle Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors. For the Joint Forum's works, see e.g., Joint Forum on Financial Conglomerates, Supervision Of Financial Conglomerates (1999) (providing guidelines concerning capital adequacy, fit and proper rule, and supervisory information sharing over financial groups.)

143 See Joseph Norton, supra note 1.

144 Subject to some important exception such as fiduciary activities, the GLBA removed the bank's exemption from the definitions of brokers and dealers under Federal securities laws so as to subject them to the supervision of the SEC rather than Federal bank agencies if they engage in securities brokerage. 15 U. S. C. § 78c(a)(4)&(5) (2000) (new definition of broker and dealer).

145 The GLBA's supervisory regime is not totally function based, but a functional and institutional combination. See Eugene Katz, Securities Activities, Merchant Banking And Functional Regulation Under The Gramm-Leach-Bliley Act, 56 Consumer Fin. L. Q. Rep. 182, 189-90 (2002) (summarizing the relevant provisions and noting even after the GLBA, such securities or non-core banking activities as new hybrid products, third-party brokerage arrangements, certain permissible securities transactions, trust and fiduciary services, stock purchase plan services, private placements, and asset-backed transactions that commercial banks directly engage in may still not fall into the functional areas, but remain to be supervised by Federal bank agencies.)

146 "At one end are the dozen or so large complex banking organizations whose size is measured in the
program concerning supervising the largest most complex banking organizations ("LCBOs"). The program's stress on the resident supervision with a designated supervisory team interacting with these organizations' top management on a continuous basis concerning in particular these bank groups' design and implementation of risk-management and internal-control suggests the fundamental weaknesses of the Core Principles' point-in-time manner as to resulting in a satisfactory supervisory circle that can genuinely reflect these LCBOs' risk level. 147

Replacing the generic term "banking" with the neutral one of "authorized" or "regulated" activity 148 and "financial" or "banking" institutions with "authorized persons" or "EEA firms" or "exempt persons", 149 the UK's radical reform made against the Core Principles' traditional regulatory framework under the Financial Services and Markets Act 2000 (FSMA) 150 and the secondary legislation thereof underscores the extraordinary length the boundary blurring effect could drive a major economy into so deep a terrain as to effect an overhaul on not just her supervisory but also regulatory and protective arrangements that go well beyond the parameters set by the regional (EU's)

hundreds of billions of dollars. Some have assets in the range of one trillion dollars. At the other end are thousands of community banks, which typically have less than one billion dollars in assets." See Federal Deposit Insurance Corporation, News Release, Remarks by Chairman Don Powell ABA Annual Convention New York, F.D.I.C. PR-101-04, 2004 (4 Oct. 2004) (WL 2231523 (F.D.I.C.)); see also Joseph Norton, Conjuring An Elite Corps of Banking Institutions Within a Public Private partnership, in CORPORATIONS, CAPITAL MARKETS, AND BUSINESS IN THE LAW 394 (Theodor Baums ed., 2000) (arguing, at both the international level and in the US context, a dominant trend towards the formation of the "public-private partnership" between governments, "elite" banking organizations and bank authorities in that regulation and supervision over those global bank organizations featuring complex activities and cross-border organizational structures have been to separate them into their own class and "subtly shift the regulatory and supervisory framework towards more of a 'functional self-regulatory' framework'.

147 See chapter two
148 See CRANSTON, supra note 7, at 7 (noting, under Schedule 2 of the FSMA, accepting deposits and home mortgage lending stands alongside investment banking activities as one class of regulated or authorized activities.)
149 See E. P. ELLINGER, E. LOMNICKA & R.J.A. HOOLEY, MODERN BANKING LAW 3 (3rd., 2002) (Under the FSMA, financial institutions are categorized into "authorized persons" that are authorized and regulated by the Financial Services Authority (FSA), "EEA firms" operating in the UK under their "single European passport", which are authorized by other EEA Member State as their home regulator and subject to the FSA's regulation only insofar as they operate in the UK, and "exempt persons", which are outside the FSA's jurisdiction. For original sources, see the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, S. I. 2001, No. 544; the Financial Services and Markets Act 2000 (Carrying on Regulated Activities by Way of Business) October 2001, S. I. 2001, No. 1177; and the Financial Services and Markets Act 2000 (Exemption) Order 2001, S. I. 2001, No. 1201.)
convergence program. Created under the FSMA and on the supervisory side, the single or mega regulator, i.e., the Financial Services Authority (FSA), is unique—not only as it is a nearly universal regulator of the UK’s financial services industry, featuring a unification of the prudential oversight of banking, insurance, and other investment services, but also for its mandate of regulating business conduct (concerning the way financial products are marketed and sold), an unprecedented case for even those economies adopting integrated financial regulators before the UK. 151 On the regulatory side, while a single authorization regime for all regulated activities has been in place, the developing single sourcebook or rulebook approach for all types of financial service business that will fundamentally overthrow the traditional sector-based regulatory thinking is particularly noteworthy. 152 Finally, the FSMA establishes a single Financial Services Compensation Scheme, which, applying to banks, building societies, insurance companies, and securities and investment firms, unifies the previously separate protective schemes distinguishing between bank depositors, insurance policy holders and securities investors in the terms of coverage. 153

C. Particularities of Domestic Regulatory Environments: The Case of New Zealand

Absent on-site banking examinations and key prudential restraints such as exposure limits, New Zealand’s bank regulatory model diverges from the approach of the Core Principles even at a quick glance. Reinforcing the bank management’s incentive on pursuing efficiency, this model is aimed for building a competitive, efficient and profitable banking system, which, instead of regulatory oversight, is primarily to be achieved by strengthening market discipline on banks through comprehensive public

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152 Id., at 330.

153 Id., at 332, note 89 and accompanying text. (noting the Financial Services Compensation scheme replaced previous protective schemes that include the U.K.’s past deposit insurance arrangements, which provided for coverage up to a maximum of ninety percent of the first £20,000, the schemes under the Financial Services Act of 1986 to pay compensation to customers of securities and investment firms for losses due to fraud or misrepresentation and the Policyholders’ Protection Scheme established by the Insurance Companies Act 1972 aimed for meeting the liabilities of insurance companies to their policyholders in the event of a firm’s insolvent liquidation.)
disclosure requirements.

It can be argued this dramatic departure from the old wisdom rests with two domestic factors: the absence of a government-sponsored deposit insurance scheme and the country's peculiar banking landscape dominated by foreign large banking organizations of global presence.

1. Novelties of New Zealand's Approach

The regulatory, supervisory and protective measures comprising the New Zealand's regulatory framework are unique, featuring:154

- The non-existence of depositor insurance and protecting depositors is not the mandate of the Reserve Bank of New Zealand, the country's responsible body for banking supervision;155
- The absence of on-site banking examinations; and since 1996:
- The removal of some key prudential rules such as exposure limits (on lending and open foreign exchange transactions) and internal controls guidelines;
- The emphasis on the monitoring function of the markets: banks' quarterly disclosure statements, which are quarterly published and include a brief Key Information Summary and a General Disclosure Statement, are provided to the general public rather than privately to the banking supervisor; and
- The stressing on the managements' accountability: disclosure statements are made under the bank directors' attestations, and their falseness or misleading could subject bank directors to severe criminal and civil penalties.

Overall, New Zealand's approach goes to the heart of the prudential objective of the traditional model rather than merely works on its techniques. Enhancing the

155 While the Reserve Bank of New Zealand has no prudential mandate on safeguarding individual banks' safety and soundness status, for maintaining systemic stability measures such as entry requirements, resolutions for bank failures and minimum capital requirements remain at the Bank's disposal. Id.
market's disciplinary function aimed for pursuing efficiency or profitability has evolved as a regulatory objective, rather than a regulatory complementary measure.

2. New Zealand's Regulatory and Industrial Particularities

Suffice it to say that the New Zealand's regulatory model has been derived from her own regulatory and industrial particularities rather than an experience of universal applicability. The regulator's confidence in maintaining a stable bank system while largely forgoing intensive regulatory oversight might be based on two domestic factors.

First, the absence of a government-sponsored depositor insurance regime has provided a healthy environment promoting depositor monitoring. Second, the fact New Zealand's banking system is dominated by large foreign banking organizations of global presence 156 might have led to a free riding effect that the New Zealand's banking regulator (as the host supervisor) is able to reap the home supervisor's effort in conducting global consolidation supervision over their constituent banking organizations' foreign establishments.

IV. Concluding Remarks

The overall objective of this chapter is not to provide a comprehensive investigation into, let alone solutions towards, the issues raised, but simply to deliver one fundamental message. The dynamics of an individual economy's domestic banking factors (including its particular industry profile, its strength on financial innovation and its strategy for implementing cross-sector institutional integration and functional deregulation) implicating with a basically internationally converged bank safety-and-soundness regulatory framework are more than often economy-specific—and should be addressed that way. An economic-specific approach focusing on the United States will therefore be adopted from next chapter onwards.

156 According to Hawkesby, there is only one very small domestically owned bank in the New Zealand's banking system. *Id.*
CHAPTER TWO –
From Well-Capitalization to Well-Management: an Evolutionary and Defer-to-Regulator Process of Discerning Bank Safety and Soundness Concept

The phrase “safety and soundness” is an ever-ambiguous term under the US bank regulatory framework. This phrase is, it seems, among the least discussed in the banking-law literature in a systemic and historic manner, although, paradoxically, its practical importance could never be overestimated as prudential regulation and supervision, in their entirety, actually revolve around the idea of safeguarding the safety and soundness of depository institutions.

The chapter reviews and analyzes the evolutionary process of the concept of bank safety and soundness in the United States. It also addresses the forces that have pushed this progression and those changing institutional and market conditions this evolution has mirrored. By which it characterizes bank safety and soundness as a fundamental statutory and regulatory notion that is an evolving concept largely shaped by the bank regulators and regulatory practice and that is essentially an umbrella term to take into consideration all prudential regulations and related supervisory, examination and enforcement practices. More specific discussion of the bank management’s safety and soundness regulatory duties, particularly in their corresponding to the bank management’s fiduciary duties under state corporate law, will be dealt with in chapter four and chapter five of this text.

Traditional wisdom often associated primarily well capitalization, together with some well-rated financial indicators, with the concrete contents of safe and sound banking to the extent capital adequacy regime was regarded as “the single most important set of rules and proposals in both international and domestic banking law”.¹ This chapter argues, while today capital adequacy level might still serve some important regulatory functions, the depository institution’s safety and soundness can be better

maintained and promoted by recognizing capital deficiency being simply a symptom of a given modern-day banking crisis, with root causes to the institution's ailment lying elsewhere — usually the recipe of macro-economy deterioration and various forms of mismanagement such as imprudent risk-taking, internal-controls failure, or simply outright fraud. An acceptance of "managerial" safety and soundness as the core value to be sustained by prudential banking regulation and supervision provides significant help in reviewing the existing regulatory regime, as well as informing the suitable shape of its future.

It will first in section one indicate why safety and soundness consideration is crucially relevant in banking regulation by initiating discussion from three different but related angles. It will then in section two consider some early evidence that the management factor played a supplementary role underpinning the supervisor's capital-based safety-and-soundness decisions.

Then in Section three particular attentions are given to two sets of important regulatory mechanisms developed under the Federal Deposit Insurance Corporation Improvement Act (FDICIA): the Prompt Corrective Action (PCA) and the agencies' rule-making authority and their implementations. The elements of safety and soundness in general and of "managerial" safety and soundness in particular are then distilled, analyzed and assessed.

The developing program relating to supervision over large and complex banking organizations (LCBOs) is the focus of the next part of this chapter. The discussion in Section IV sketches the basic framework of the LCBOs program, and highlights, to safeguard safety and soundness of these complex LCBOs' banking components, regulatory emphasis is predominantly on control and system rather than on various financial indicators as before.

The concluding section of this chapter will indicate yet another repositioning of the contents of the idea of safety and soundness is now taking place. As the ongoing LCBOs program keeps its momentum, the pursuit for safe and sound banking promises in the future the well-management element will absorb and re-define the well-capitalization one rather than these two run parallel as they do now.
I. Bearings of Safety and Soundness of Depository Institutions

Promoting safety and soundness of banks\(^2\) has long been the core policy objective to be achieved by US banking regulators. This type of regulation is designed to minimize bank failures and to protect depositors or deposit insurance funds. A number of reasons justifies regulating a private industry in such a loss avoidance manner. They form the special-status hypothesis underlying prudential banking regulation and supervision, which has been detailed in chapter one and will not be repeated here. This section then turns to the concept’s practical regulatory implications in three contexts.

A. Primacy of Financial Conglomerate Regulation and Supervision

The safety and soundness consideration in the US is not just the primacy for supervising a stand-alone bank, but also the focal point for supervising a bank or financial holding company (BHC or FHC). This pursuit was underscored by the Federal Reserve Board by asserting the Board “will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions…. The purpose of FHC supervision is to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company in order to assess how these risks might affect the safety and soundness of depository subsidiaries”\(^3\).

\(2\) The term “bank” used here includes a subsidiary of a bank holding company.

\(3\) Board of Governors of The Federal Reserve System, Framework for Financial Holding Company Supervision, para. 8, SR 00-13 (SUP) (15 August 2000). In another supervisory letter and to the similar effect of the SR 00-13, the Federal Reserve Board noted “[a] key premise of GLBA [the Gramm-Leach-Bliley Act] was that sections 23A and 23B [of the Federal Reserve Act] would limit the risk to depository institutions from these broader affiliations and eliminate the need for extensive prior review by the bank regulatory agencies”. Board of Governors of The Federal Reserve System, Adoption of Regulation W Implementing Sections 23A and 23B of the Federal Reserve Act, para. 2, SR 03-2 (9 Jan. 2003). In the post-GLBA environment, regulators of particularly large and complex banking organizations have been focusing on a number of tasks, of which are “...reconciling the need for markets to function effectively while protecting the deposit insurance fund and the safety net”, and “...finding the proper balance between the objectives of protecting the depository institution subsidiaries of increasingly complex organizations and not imposing an unduly duplicative or onerous regulatory burden on the nonblank entities that are part of the consolidated organizations”. See Mark Olson, The Gramm-Leach-Bliley Act and Corporate Misbehaviour—Coincidence or Contributor?, remarks at the American Law Institute conference on the implementation of the Gramm-Leach-Bliley Act, Washington, D.C., (6 Feb. 2003) (transcript available on http://www.federalreserve.gov/boarddocs/speeches/2003/20030206/default.htm )
The Federal Reserve Board's position of underpinning bank safety and soundness with BHC or FHC regulation is actually a mirror image of the Gramm-Leach-Bliley Act (GLBA) of 1999 under which a BHC’s subsidiary depository institution’s well-capitalized and well-managed status serves as a prerequisite for the BHC to convert its charter to a FHC and therefore enjoy powers of extensive permissible activities the group as a whole. The starting point of considering banking safety and soundness under a conglomerate structure concerns the managerial incentive. Economically, the management of those complex organizations was suggested has the incentive to exploiting governmental subsidy made accessible to the group’s banking component through transactions between a bank and its affiliates that work to the favour of the bank’s affiliates (and thus of the group) yet at the expense of the bank. To deal with this, a variety of measures placing qualitative and quantitative restraints on transactions as such is in place and they all direct to the same policy objective; that is, such operation is not allowed as long as it poses a substantial threat to bank safety and soundness.7

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5 12 U. S. C. §§ 1843 (f) (1)-(2). By the same token, if a FHC’s depository institution ceases being well-capitalized and well-managed, the FHC would face sanctions, taking the form of conduct or activity restrictions or even a compulsory divesture of the bank subsidiary it controlled. 12 U. S. C. § 1843 (m).
6 A FHC may engage in, either directly or through subsidiaries, activities that the Federal Reserve Board has determined to be “financial in nature”, “incidental to such financial activity”; or “complementary to a financial activity” and posing no “substantial risk to the safety and soundness of depository institutions or the financial system generally.” Id. § 1843 (K)(1). For an extensive list of these permissible activities, see Macey, supra note 6, at 436-37.
7 Governmental subsidy enhances credit standings of banks through credit backing of payment system assurance and discount window accessibility. This results in banks' competitive advantage over non-banks in debt markets. It also enables them to taking deposits with lower costs with the reinsurance of the government-sponsored deposit insurance scheme that largely insulates depositors from being exposed to banks' default risk upon insolvency. As a result, depositors are willing to accept low returns on their deposits by charging risk premium that is far below they would have otherwise done should the deposit insurance not exist. See PATRICIA A. McCOY, BANKING LAW MANUAL §4.02 (2nd ed., 2000).
8 It is largely settled under a group structure the banking component is susceptible to heightened risk of self-dealings and other forms of abuses with the parent’s heightened incentive to exploiting its banking subsidiary’s cheap source of funds to finance the group’s activities by effecting affiliate loans on irregular terms. See e.g., Macey, supra note 6, at 472-73.
9 In this area, sections 23A and 23B of the Federal Reserve Act and the Regulation W, the implementing rule, are the primary legal sources. Regulation W was adopted by the Federal Reserve Board on 12 December 2002 and made effective shortly after on 1 April 2003. The statute and rule regulate inter-group transactions that are directly or indirectly involved with a bank subsidiary and its affiliate. The sheer scale of complexity brought along with this facet of prudential regulation is demonstrable. They impose quantitative and qualitative restraints on not only transactions whereby banks extend credit to, or engage in certain other activities (relating to, inter alia, derivatives, intraday credit, credit card and loan purchase) with, an affiliate or a non-affiliate that benefit an affiliate of the bank; but also, to some extent,
B. Pivotal Reference Point to Functional and Institutional Division of Financial Conglomerates

The safety-and-soundness consideration of depository institutions also formulates the functional and institutional division inside a financial conglomerate. In the build-up to the enactment of GLBA, with the general consensus of allowing further combination of banking, securities, insurance and other financial related activities under an umbrella financial holding company and expanding beyond the pre-GLBA's "closely related to banking" product line,10 the consideration of preventing losses in a financial component from spreading to a banking component led to a firewall arrangement that the banking subsidiary of a financial holding company is inhibited from being, either directly or through a "financial" subsidiary, engaged in some of the most risky non-banking businesses (such as insurance underwriting, issuing annuities, merchant banking, and non-financial activity of real estate development).11 Instead, these non-banking financial activities are only allowed to be conducted by the bank's non-bank affiliates owned by a common holding company.12

Most intriguingly, while safeguarding safety and soundness of depository institutions remained the pivotal point commonly shared by the Federal Reserve Board (concurred by the FDIC) and the Department of Treasury, they actually adopted diametrically opposite grounds in associating this concern with the banking subsidiary's nonbanking powers—comparing to the current state of law, one for a more liberal treatment, and the other a more stringent one.13 Consequently, the final form of the transactions between an affiliate of a bank and a financial subsidiary of the bank. See Board of Governors of The Federal Reserve System, Supra note 3, para 6-16.

10 See McCoy, supra note 7, at §4.01

11 Except for these prohibited businesses, under the GLBA, financial subsidiaries of national banks are permitted to engage in activities that the Treasury finds incidental but not complementary to financial activities, provided the bank remains highly safe and sound (well-capitalized and well-managed). 12 U.S.C. §§24a (a)(2)(A)-(B), 1843(K)(7)(B).


13 By emphasizing depository institutions' safety and soundness could be further enhanced by providing their subsidiaries with more freedom in conducting non-banking activities, the Treasury argued that "[a] subsidiary's earnings accrue directly to the benefit of the benefit of the parent bank, and help diversify the bank's earnings. More importantly, if the bank ever gets into trouble, the bank's depositors and the FDIC have a claim on the bank's ownership interests in the subsidiary; that interest can be sold to replenish the bank's capital or reduce the FDIC's loss." Richard Scott Carnell, Straining Out Gnats and Swallowing
firewall arrangement between a parent FHC’s bank subsidiary and the bank’s own subsidiary discussed here is virtually a compromise between the grounds of the Federal Reserve Board and the Department of Treasury.

C. Safety-and-soundness Enforcement Actions

The significance of safety-and-soundness consideration hinges also on unsafe and unsound banking practices could trigger almost every official enforcement proceeding against depository institutions, their parent holding companies, other affiliates and all these institutions’ “institution-affiliated parties”, which include officers, directors, employees, controlling shareholders and even certain professionals, e.g., attorneys, appraisers and accountants who participate in those unsafe and unsound practices. Based on a finding that an institution or institution-affiliated party has engaged in an unsafe or unsound practice the appropriate federal banking agency may issue a cease and desist order against an institution requiring it to cease certain actions and/or take corrective measures, remove an individual from a banking institution and permanently ban that individual from banking, terminate the deposit insurance of an institution.


On the contrary, Federal Reserve was against the idea of providing depository institutions’ subsidiaries with such freedom. Based on exactly the same safety-and-soundness grounds, it contended “...the losses that would accompany riskier activities from time to time would fall on the insured bank’s capital if the new activities were authorized in bank subsidiaries. Such losses at holding company affiliates would, of course, fall on the uninsured holding company...The potential for loss and bank capital depletion is another reason for urging that the new activities be conducted in a holding company affiliate rather than in a banking subsidiary”. Alan Greenspan, Testimony On H.R. 10 and Financial Modernization, Subcommittee on Finance and Hazardous Materials, Committee on Commerce, U.S. House of Representative, 28 April 1999. (See also Macey, supra note 6, at 496-500)

14 Under the Federal Deposit Insurance Act (FDIA), as substantially amended by the enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) (Pub. L. No. 101-75 Stat. 183 (1989)), the “appropriate federal banking agencies” may use a large variety of administrative enforcement powers addressing abusive banking practices that are regarded as unsafe and unsound against institutions and their affiliated parties. These powers include cease and desist orders (including orders for restitution, reimbursement or indemnification), removal from the office, prohibition from participation in the banking business, for now or the future or both, and civil money penalties. See 12 U.S.C. §1818(a)(2), (b)(1), (c)(1)(A) & (i)(2)(A). The only formal enforcement action that will not be triggered by unsafe and unsound banking practice is the first-tier civil money penalties.

16 12 U.S.C. § 1818(b)
or place that institution in receivership.\textsuperscript{19}

The breath and depth of the supervisor’s safety-and-soundness based enforcement actions are further broadened and enhanced by the “gap-filler” capacity\textsuperscript{20} as accorded by Congressional delegation\textsuperscript{21} and judicial deference\textsuperscript{22} to the banking agencies. This gap-filler capacity manifests itself outside the boundary where legislations or regulations have clearly prescribed certain banking practices as unsound and unsafe\textsuperscript{23} as, outside those practices particularly earmarked as unsafe and unsound, the institutions and their affiliated parties are subject to the agencies’ general safety-and-soundness vetting on a case-by-case and fact-by-fact basis. Safety-and-soundness concern as a generic concept therefore fills legislative or regulatory deficiencies as a universal test examining every material aspect of banks and their affiliated parties’ activities by deriving content through application to specific circumstances. From the supervisor’s standpoint, this certainly enhances its supervisory latitude to deal especially with newly emerging banking activities with risks that could hardly be expected beforehand.

\textsuperscript{19} 12 U.S.C. § 1821(c)(5)(H)
\textsuperscript{21} Section 132 of Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”), for example, mandates and actually obliges federal banking agencies to publish safety and soundness standards for federally insured depository institutions.
\textsuperscript{22}US Courts have long recognized safety/soundness judgement as a matter of Congressional delegation. They also acknowledge special expertise demanded of the banking agencies warrants a high degree of deference from the courts to the agency. See e.g., Independent Bankers Ass’n of American v. Heimann, 613 F. 2d 1164, 1169 (D.C.Cir. 1989), cert.denied, 449 U.S. 823. (“Absent a clear congressional expression to the contrary, the Comptroller is entitled to accomplish his regulatory responsibilities over unsafe and unsound practices both by cease and desist proceedings and by rules defining and explicating the practices which in his discretion he finds threatening to a stable and effective national bank system”); Also see Lawrence G. Baxter, The Rule of Too Much Law? The New Safety/Soundness Rulemaking Responsibilities of the Federal Banking Agencies, 47 Consumer Finance Law Quarterly Report, 210, 211, note 21 (1993) (citing cases, \textit{inter alia}, Franklin Sav. Ass’n v. Director of Thrift Supervision, 934 F. 2d 1127, 1145-46 (10th Cir. 1991); First Nat’l Bank of Bellaire v. Comptroller of the Currency, 697 F. 2d 674, 688-89 (5th Cir. 1991)).
\textsuperscript{23} The US Congress has specified certain practices as unsound and unsafe, for instance, failing to maintain minimum regulatory capital, or failing to obtain an independent, outside auditor for any fiscal year (as applied to insured credit unions). See 12 U.S.C. s 1464(s)(3)(Supp. V 1993) and the Federal Credit Union Act (12 U.S.C. s 1782 (a)(6)(B) (Supp.V 1993)). In a similar piecemeal manner, some areas were also identified in the federal regulation as susceptible to being unsafe and unsound, e.g., brokered deposits, standby letters of credit, insider loans and transactions with securities affiliates. See 12 C.F.R. §§337.2-337.6, and 12 C.F.R. 208.8 (Federal Reserve), 563.39 (a) (OTS).
II. Discerning Managerial Safety and Soundness: Early Evidence

Safety and soundness was suggested by a leading commentator as the concept reflecting collectively an acceptable level of liquidity and stability for the banking system, or individually a desirable level as to financial health and proper management of banking organizations. It was also noted, in the similar vein, "...safety and soundness represents a single concept-centred on financial health but often with overtones of the sort of prudential management practices needed to keep a healthy bank healthy." In other words, these arguments uphold the idea of safety-and-soundness consists of two distinct prongs: the one of well capitalization and of well management. It could also be implied quality of management should be judged in its own right rather than by having recourse and being subject to banks' financial strength.

These two attributes of the safety-and-soundness concept as weighed equally as accepted and operated in today’s US is nevertheless an evolutionary result that mirrors the phase-by-phase progression of banking regulation and, more fundamentally, of evolution of banking business. In fact, some early evidence actually revealed to the opposite that prudential management requirements were subordinated or supplementary to well-capitalization requirements.

A. Solvency Related Safety and Soundness Enforcement under the FISA

The early face of safety-and-soundness in the US could only be attributed to legislative history as a clear definition was intentionally avoided. During the enactment of the Financial Institutions Supervisory and Insurance Act of 1966 (FISA) (authorizing federal banking agencies to issue, among others, cease-and-desist order based on

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24 See JOSEPH JUDE NORTON, DEVISING INTERNATIONAL SUPERVISORY STANDARDS, xxvii at Prelude (1995). This definition seemingly incorporates systemic concern as referred to as "stable banking system" into the idea of safety and soundness. Arguably this system related topic is more often and likely to be the one under systemic-risk regulation, which concerns primarily the externality effects of banking failures. Discussions under or relating to the phrase "safety and soundness" hereinafter, therefore, will focus on the individual-institution level only.

25 See Macey, supra note 6, at 275.

26 12 U.S.C. §1813 (q) (defining the appropriate Federal banking agency for specific types of regulated entities). Namely, the Office of the Comptroller of the Currency (OCC) is the regulator for national banks; the Federal Reserve System for state banks that are members of the Federal Reserve System and all bank
unsafe/unsound banking practices against the institution or the management),
the memorandum written by John Horne, the former Chairman of the abolished Federal
Home Loan Bank Board, considered safety-and-soundness "...has a central meaning
which can and must be applied to constantly changing factual circumstances. Generally
speaking, an 'unsafe and 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" (emphasis added). Horne's memorandum marked Congress' first and, up until now, only
attempt to define the term unsafe or unsound practice.

By mainly targeting solvency related activities that entail abnormal risk or loss or
damage, clearly the regulator was intended to neutralize the Congressional concern of
the term "unsafe and unsound" being so vague as to hardly signaling what conducts
would have fell in its spectrum. With Congress accepting this boundary set by the
holding companies; the Federal Deposit Insurance Corporation (FDIC) for state banks that are not
members of the Federal Reserve System; the Office of Thrift Supervision (OTS) (established in 1989
replacing the Federal Home Loan Bank Board) for savings and loan associations, some savings banks, and
those savings and loan holding companies that are not also bank holding companies; and the National
Credit Union Administration (NCUA) for federally insured state credit unions.

The enactment of the GLBA added a new class of entities to the Federal Reserve's regulatory/supervisory
domain—the financial holding company (FHC), converted from the qualified bank holding company. It
also added a new oversight role to the Federal Reserve Board—the umbrella supervisor focusing on
consolidated or group-wide oversight of the BHA or FHA. The introduction of umbrella supervision,
however, does not change the pre-GLBA regime as to the allocation of regulatory/supervisory mandates
among primary federal regulators as the GLBA "is not viewed as an extension of more traditional-like
supervision throughout an FHC....The GLBA did not alter the role of the Federal Reserve, as holding
company supervisor, vis-à-vis the primary supervisors of FHC-associated bank and thrift subsidiaries
because the Federal Reserve has traditionally relied to the fullest extent possible on those supervisors".

See Board of Governors of the Federal Reserve System, Framework for Financial Holding Company
Supervision, SR 100-13 (SUP), (15 Aug. 2000).

empowered the agencies to issue cease and desist orders on the basis of finding unsafe and unsound

Before the House Comm. On Banking and Currency, 89th Cong., 2d Sess. 50 (1966); 112 Cong. Rec. 26,
This account was subsequently cited by court as the authoritative definition of an unsafe and unsound
practice. See, for example, Gulf Fed. Sav. & Loan Ass'n v. Federal Home Loan Bank Bd., 651 F.2d 259,
264 (5th Cir. July 1981, cert. Denied, 458 U.S. 1121 (1982)).

29 Thomas Holzman, Unsafe Or Unsound Practices: Is The Current Judicial Interpretation Of The Term

30 Banking Law Manual \S13.03 [1]
banking agencies, safety and soundness under the FISA was fashioned with Congressional delegation (to the agencies) as the law deliberately avoided providing an explicit definition.  

The FISA's legislative background was also reflected by judicial decisions. In general, American courts acknowledge the existence of a clear Congressional delegation. Nevertheless, sizable cases did set a condition to the extent the agency's safety and soundness construction and enforcement could not go beyond targeting financial-integrity related practices; that is, practices that do not otherwise pose risk to the insurance funds should not be labeled as unsafe and unsound practices. For example, the court tended to reject the agencies' enforcement actions based otherwise on such grounds as customer protection or maintaining financial institutions' fair competition. Nevertheless, some early cases might have kept the agencies some room for maneuver as the agencies' safety-and-soundness judgments were regarded as predictive in nature. In other words, a forward perspective was allowed that a potential threat (the one posing a medium-to-long-term rather than an upfront and actual danger to the institution's financial integrity) would have been enough to make the case.

In the hindsight, clearly ensuring "well management" of depository institutions was hardly envisioned by American Congress with the enactment of FISA of 1966, nor was it a judicially recognized supervisory mandate. Instead, under the FISA, ensuring financial health of the depository institutions so as not to jeopardize the financial standing of the insurance funds was the one to be dealt with in the name of safety and soundness. In other words, unsafe and unsound practices relate only to the risk of bank

31 The then Representative Wright Patman made the following remarks: "[t]he cease-and-desist powers and management removal powers are aimed specifically at actions impairing the safety or soundness of our insured financial institutions. These new flexible tools relate strictly to the insurance risk and to assure the public of sound banking facilities." See 112 Cong. Rec. 26, 474 (1966).


33 Otero Savings & Loan Ass'n v. Federal Home Loan Bank Board, 665 F. 2d 288 (10th Cir. 1981).


35 However, it should be noted the FISA did introduce the concept of fiduciary duty in the specific context of removal and suspension powers of bank management. Federal Institutions Supervisory Act of 1966, Pub. L. No. 89-695, §202, 80 Sta. 1046 (adding new subsection 8 (e) (1) to the Federal Deposit Insurance Act of 1950).
insolvency.

B. Managerial Safety and Soundness as a Supplement to Capital-based Supervision

Safety-and-soundness consideration has been closely associated with capital-based supervision. Despite in the US it was not until 1983 (the passage of the International Lending Supervision Act (ILSA))\(^{36}\) legislatively failing to comply with risk-and-asset based capital requirements alone would have been considered as unsound and unsafe,\(^{37}\) capital-based regulation took its root as early as the beginning of twentieth century where a capital/deposit liabilities ratio was in place.\(^{38}\) In the early age of capital regulation, the management factor played a supplementary part in determining the overall safety-and-soundness level of depository institutions. In 1972, Charles Van Horn, the then Regional Administrator of National Banks for the Second Region, made the following remarks regarding the OCC’s position in capital adequacy:\(^{39}\)

In evaluating capital adequacy, the Comptroller’s Office considers the following factors: the quality of management; liquidity of assets; the history of earnings and of retaining thereof; the quality and character of ownership; the burden of meeting occupancy expenses; potential volatility of the banks’ deposit structure, the quality of operating procedures; and the bank’s capacity to meet present and future financial needs of its trade area, considering


\(^{37}\) The ILSA requires each federal banking agency to “cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions and by using such other methods as the ... agency deems appropriate”. “The agency may treat failure to maintain such capital as an unsafe and unsound practice warranting such enforcement action as a cease-and-desist order against the bank and its directors and officers” See 12 U.S.C. §3907.

\(^{38}\) In the late 1930s, the Federal Deposit Insurance Corporation (FDIC) advanced a regime based on capital v. total-assets ratio. One of the first risk-asset based regime was introduced in the examination practice as launched in 1952 by the Federal Reserve District Bank of New York that broke risk assets into various categories and assigned different risk variables accordingly (reporting Form “ABC”). In 1956, this capital-analysis approach was endorsed and adopted by the Federal Reserve Board and capital-liquidity analysis was added as a new element to the original formula. See Norton, supra note 24, at 47 (citing G.A. FREEMAN, THE PROBLEMS OF ADEQUATE BANK CAPITAL 11 (1952), G.S. VOJTO, BANK CAPITAL ADEQUACY Annex I & II (1973).

\(^{39}\) Prior to the emergence of banking holding companies in the 1970s following the enactment of Bank Holding Company Act 1956, national banks rather than bank holding companies are the dominant business form of banking business. As a result, OCC, rather than the Board of the Federal Reserve System, was the primary supervisor of banking industry. See Norton, supra note 24, at 48-49 (citing from American Banker, 2 Aug. 1972)
the competition it faces....

*Only after weighing capital adequacy and asset quality is management assigned a rating*...(Emphasis Added)

In judging the quality of management, we take into consideration the overall condition of the bank, its liquidity position, its earnings compared with banks of similar size, the adequacy of its credit files, the effectiveness of collection efforts, the quality and distribution of the investment account, the adequacy of internal controls, the efficiency of operations, provision for management succession, and the bank’s service of the community.

This account suggests, in 1970s, management regulation remained secondary to capital regulation. Firstly, the composition of managerial quality or criteria to judging its desirability substantially embodied ratio-based financial indicators such as liquidity and earnings position. Secondly, judging managerial quality would have been deferred until the institution’s financial strength had been decided-- “only after weighing capital adequacy and asset quality is management assigned a rating”. The major reason of incorporating the management factor into the supervisory processes was probably to more aptly and qualitatively judging the institution’s financial strength (capital adequacy).

Drawn from the OCC’s approach, the Uniform Financial Institutions Rating System (UFIRS) was later adopted under the auspices of the Federal Financial Institutions Examinations Council (FFIEC) in 1979, which introduced the CAMEL (and since January 1997 CAMELS)\(^{40}\) rating system that is used by state and federal examiners in evaluating the safety and soundness of banks and thrifts, and the BOPEC (or BOPEC/F-M) system,\(^{41}\) the rating system used by the Federal Reserve Board inspecting

\(^{40}\) 61 Fed. Reg. 67,021, 67,024-29 (1996); 63 Fed. Reg. 66,351 (1998); 62 Fed. Reg. 3,779 (1997); and 62 Fed. Reg. 752 (1997). Under this system, the state and federal examiners require to look at six components in evaluating the safety and soundness of banks and thrifts. They are (1) Capital adequacy; (2) Asset quality; (3) Management capability; (4) Earnings quality and quantity; (5) Liquidity; and (6) Sensitivity to market risk. The sixth component, added in 1996, focuses on the degree to which changes in interest rates, foreign exchange rates, commodity prices and/or equity prices can adversely affect the institution’s earnings or capital. The 1996 revisions also put increased emphasis on risk management processes in the other five components and sought to clarify the application of all six components.

\(^{41}\) The BOPEC rating system contains five components: (1) Bank subsidiaries’ condition; (2) Other
bank holding companies and their affiliates.

III. Upholding Managerial Safety and Soundness—the FDICIA and Its Implementations

A. Background

Upon the enactment of International Lending Supervision Act of 1983, failing to comply with capital requirements has been regarded as an unsafe and unsound practice on which the agencies’ enforcement actions could be derived. However, the fundamental problem with capital-based safety and soundness regulation rests upon capital could only be a lagging indicator of problems. The inherent time lags in detecting insolvency is due, among other things, to the basis of calculating regulatory capital is on the institution’s historic instead of current values, which is particularly unreliable in volatile economic periods when the value of a bank’s assets can change dramatically.

Consequently, capital deficiency could well be simply the symptom of an ailing institution with the root causes to its ailment lying elsewhere. As widely recognized, the root causes of a given modern-day banking crisis are largely associated with the recipe of macro-economy deterioration and various forms of mismanagement—excessive subsidiaries’ condition; (3) Parent company’s condition; (4) Earnings on a consolidated basis; and (5) Capital adequacy on a consolidated basis. In addition to these five individual components, each bank holding company was assigned a composite rating, which represented the overall financial and managerial strength of the institution. For more background accounts of the BOPEC system, see Satish Kini, New Bank Holding Company Rating System Revises The Focus Of The Federal Reserve’s Supervisor’s Practices, 121 Banking L. J. 784, 185-87 (2004); see also Federal Reserve Board, Bank Holding Company Supervision Manual, §§4070.0-4070.1.

Since 1 January 2005, the BOPEC has been replaced by the Federal Reserve Board with a new rating system, i.e., RFI/C(D), standing for Risk management, Financial condition, Impact, Composite, and Depository institutions, and replaced the BOPEC system.

42 See Richard Scott Carnell, A Partial Antidote To Perverse Incentives: The FDIC Improvement Act of 1991, 12 Annual Review of Banking Law, 317, 348-351 (1993) (noting the cases of forty-six large commercial banks failing between 1986-1990 in the USA that, despite only gradual declination of their book-value capital had been detected during the second and third years before these institutions’ closure, these institutions were in fact economically insolvent throughout that time span).


It was also noted there are “seven sins” residing in the 1988 Capital Adequacy Accord set out by the Basle Committee—inaccurately micromanaging banking risks; inadequacy of the composition of regulatory capital; lacking any empirical justification in establishing the 8 percent capital ratio; falsely presuming equity other than debt better cushions banks’ risks; failing to level the playing field among nations; ignoring the risk-reduction effects by diversification when measuring risk-based assets; and being too rigid to cope complexities of modern banking. See Heath Price Tarbert, Are International Capital Adequacy Rules Adequate? 148 University of Pennsylvania Law Review, 1771, 1799-1800 (2000).
risk-taking, internal-controls failure, or simply outright fraud.\textsuperscript{44}

In the US, dealing with mismanagement related problems was brought to the forefront of banking supervision in the wake of the 1980s banking crises\textsuperscript{45} that involve both savings and loan (S & L) and commercial bank industries.\textsuperscript{46} One of the most critical legislations passed in the aftermath of the crises is the Federal Deposit Insurance Corporation Improvement Act (FDICIA).\textsuperscript{47} The FDICIA introduces two sets of mechanisms to controlling mismanagement of banking institutions. The first is the Prompt-corrective-action system that integrates the management factor into the revised capital regulation. The Act also accords the agencies with a rule-making mandate whereby a set of safety and soundness guidelines, whose locus is on the institutions' internal control and monitoring mechanisms, were published.

The FDICIA's approach is unique as it is not just set against the institution (as do capital rules) but also directs towards the management, the persons taking charge of the institution. It is proactive in the sense the agencies are legally demanded to promptly detecting and correcting managerial flaws and replacing them with adequate and prudent practices. All these supervisory reactions are primarily triggered by unsatisfactory results of on-site safety and soundness examinations, and tied to a trip-wire system of capital classification.

\textsuperscript{44}One leading commentator noted the root causes leading to the failures of five high-profile international banks as—

"Hersatt failed because of fraudulent bookkeeping concealing exposed foreign exchange positions; Franklin National, because of a volatile wholesale deposit base and excessive speculation in foreign exchange markets; the Secondary Banking Crisis, because of the decline in the UK property market and a large wholesale deposit base for the unsupervised "fringe banks;" Ambrosiano from excessive concealed loss on foreign loans (which as a result did lead to a capital deficiency and insolvency) and serious gaps in prompt and effective international cooperation among the relevant national supervisory authorities; Continental Illinos, from imprudent international and energy lending practices and a volatile wholesale deposit base; and BCCI, from the outright worldwide fraud." See Norton, supra note 24, at 32.

\textsuperscript{45} The linkage between mismanagement and bank failures was obvious in this period. According to an OCC review (on the causes of national bank failures between 1979 and 1987), deficiencies in management were a contributing factor in 89% of the failures. Moreover, in 81% of these failures, loan policies were simply ignored or failed banks had no loan policies at all. See MICHAEL K. ONG, INTERAL CREDIT RISK MODEL- CAPITAL ALLOCATION AND PERFORMANCE MEASURE 12 (1999).

\textsuperscript{46} See Lawrence G. Baxter, Administrative And Judicial Review of Prompt Corrective Action Decisions by Federal Banking Regulators, 7 Administrative Law Journal of the American University, 505, note 2 and accompanied text (1993) (noting the magnitude of S &L and bank failures were so massive as to deplete and prompt an extensive recapitalization of the Federal Deposit Insurance Funds).

\textsuperscript{47} FDICIA §131 (a) (adding FDI Act §38, 12 U.S.C. §1831o (Supp. IV 1992)).
B. Prompt Corrective Action (PCA) System

As an attempt for the agencies stepping in at the first sight when problems emerge, FDICA provided the federal banking regulators must “take prompt corrective action [PCA] to resolve the problems of federally-insured depository institutions.”48

The PCA system, although widely recognized as a capital-based system, works actually two-way interactively for the criteria determining the level of activity restrictions and supervisory interventions are also drawn from non-capital factors, primarily the management factor. While unsatisfactory capital level would lead to gradually severe activity restraints and enhanced supervisory interventions, unsatisfactory management would lower the otherwise higher classified capital level and direct to the same result. Consequently, both unsatisfactory capital level and unsatisfactory managerial performance would invite more stringent regulatory measures, whose main targets are the incumbent top management, the corporate policies they make, and the corporate practices they are involved.

1. Capital Classifications

The FDICIA adopts three indicators, i.e., the total risk-based capital ratio, the Tier 1 risk-based capital ratio and the leverage ratio, 49 to classify the first four categories (well-capitalized, adequately capitalized, undercapitalized, significant undercapitalized). Institutions are considered critically undercapitalized where their ratio of tangible equity to total assets is less than 2 percent. 50

2. Implications of PCA Classifications

The main thrust of the PCA regime is the mandate given to the banking agency to exercise supervisory powers by making entrepreneurial-type decisions well before an institution is technically insolvent and subject to conservatorship or receivership. 51 PCA

48 Id. (adding FDI Act §38 (a) (2), 12 U.S.C. §1831o (a) (2)).
49 12 C.F.R. §§ 6.4 (a), 208.43 (a), 303.200 (a)(2), 325.103 (a), 565.4 (a). For definitions of those indicators, see 12 C.F.R. §§ 6.2 (d), (i), (k), 208.41 (c), (h), (j), 326.2 (k), (u), (w), 565.2 (c), (h), (j).
51 See Lawrence Baxter, Fiduciary Issues in Federal Banking Regulation, 56 Law and Contemporary
classifications could positively impact on depository institutions that well-capitalized institutions would enjoy more business freedom and less stringent on-site examinations.\textsuperscript{52} The capital categories, however, are mainly used for deciding activity restrictions and supervisory actions of increasing intensity as the institutions move from well capitalized downwards to critically undercapitalized categories. While some restrictions apply to all institutions, such as the restriction on capital distribution or management payment,\textsuperscript{53} the majority of them apply only to the undercapitalized institutions.

All undercapitalized institutions have to submit an acceptable capital restoration plan.\textsuperscript{54} Their activities are further restricted by limits on asset growth\textsuperscript{55} and the need to obtain prior regulatory approval for acquisitions, branching, and new lines of businesses.\textsuperscript{56} Even at this early stage of capital deterioration, regulators may appoint a conservator or receiver for an undercapitalized institution that: (1) has no reasonable prospects of becoming adequately capitalized; (2) fails to submit a timely and acceptable capital restoration plan; or (3) materially fails to implement a restoration plan.\textsuperscript{57} This early-closure capability suggests the need for the regulator to employing forward-looking strategy to the effect unredeemable institutions, i.e., institutions as objectively unsound or subjectively less compliance-minded, could be solved before their franchise value eroding further, thereby reducing the costs of deposit insurance funds.\textsuperscript{58}

For significantly undercapitalized institutions, additional safeguards would be

\textsuperscript{52} Well-capitalized institutions are permitted to accept brokered deposits. If these institutions are also well-managed and below a certain size, they are subject to less frequent on-site examinations. See FDICIA §131 (a) (amending FDI Act §29 (a), 12 U.S.C. §1831f (a) (Supp. IV 1992)); See also FDIC, Unsafe and Unsound Banking Practices, 57 Fed. Reg. 23, 933-01 (1992) (implementing, as 12 C.F.R. §337, FDICIA §301)

\textsuperscript{53} For example, all institutions, however satisfactory their capital level, are not allowed to make capital distribution (such as dividend payment or stock redemption) or management payment if, as a result, the institution would be undercapitalised. 12 U.S.C. §1831o (b)(2)(B); 12 U.S.C.§1831o (d)(1)(A); and 12 U.S.C.§1831o (d)(2). Therefore, for undercapitalized institutions, capital distribution and management payment as such are not allowed to be made at all.

\textsuperscript{54} 12 U.S.C. §1831o (e)(2)

\textsuperscript{55} 12 U.S.C. §1831o (e)(3)

\textsuperscript{56} 12 U.S.C. §1831o (e)(4)

\textsuperscript{57} 12 U.S.C. §1821 (c)(5)(k)

\textsuperscript{58} See Carnell, supra note 42, at 341.
imposed. These include some mandatory measures that the agency must normally apply: sale of stock or subordinated debt or merger/acquisition for recapitalization;\(^{59}\) deprivation of the sister-bank exemption (under section 23 A of the Federal Reserve Act),\(^{60}\) hence imposing a set of fully-fledged arm’s length safeguards, i.e., percentage-of-capital restrictions, collateral requirement, and prohibition against acquiring low-quality assets; and restrictions on interest rates on deposits.\(^{61}\) In addition to these mandatory measures, the appropriate federal banking agency has some other safeguards at their discretion.\(^{62}\)

For a critically undercapitalized institution, which is likely already economically insolvent, albeit some marginal regulatory capital being maintained, the PCA system works for two policy objectives: protection of deposit insurance funds (by curtailing subordinated debtholders’ claims);\(^{63}\) and preparation for an orderly closure (the PCA provisions essentially assume such institution as already insolvent to counteract regulatory forbearance of continuously holding such institution as a going-concern).\(^{64}\)

### 3. Non-capital Criteria of the PCA System

Most notable, the FDICIA also factors non-capital criteria into the PCA’s tripwire capital

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\(^{60}\) 12 U.S.C. §371c (a)(1), (3), (c)(2), (d)(1).


\(^{62}\) The agency may further restrict the institution from transactions with affiliates, asset growth, engaging in overly risky activities, or accepting deposits from correspondent institutions. It can also demand such institution reducing its total assets, holding a new board election or employing new executive officers, or divesting its investments. More stringent restrictions could be further applied to the senior executive officer of such institution by the need to secure the agency’s prior written approval before any bonus can be paid to or any rate of compensation increased for such officer. The agency at this stage could also deploy its far-reaching power to the upward effect of requiring the institution’s parent bank holding company to obtain the Federal Reserve Board’s approval before making any capital distribution, or even of requiring divestiture of affiliates of such institution. 12 U.S.C. §1831o (f)(2); 12 U.S.C. §1831o (f)(4)(A).

\(^{63}\) Upon 60 days since being judged as critically undercapitalised, the institution is generally prohibited from making any payment of principal or interest to any subordinated debtholder. A grandfathering exemption is applied that subordinated debt outstanding on 15 July 1991, and is not extended or otherwise renegotiated after that date, is exempt from the general prohibition until 15 July 1996. 12 U.S.C. §1831o (h)(2)(A); §1831o(h)(2)(C).

\(^{64}\) Upon the institution being judged as critically undercapitalised, within ninety days the agency must either appoint a conservator or receiver for the institution, or, upon the FDIC’s concurrence, take alternative actions (after documenting why such alternatives would better achieve the purpose of section 38). A determination to take alternative action would expire after 90 days, unless renewed, the agency must then appoint a conservator or receiver. 12 U.S.C. §1831o (h)(3)(A), 1831o(h)(3)(B). See also See Carnell, supra note 42, at 346-348.
classifications. The impacts of this treatment on bank management are enormous as they are now facing the regulator’s safety and soundness challenges in the ordinary course of the bank’s operation. Namely, banking agency is legally mandated to supplant the bank management’s position and make entrepreneurial-type decisions for a bank whose financial standing is not only far from distressing but actually relatively sound.

For example, an originally adequately capitalized bank that receives an unsatisfactory M (management) rating due to inappropriate internal controls and fails to mend it would be reclassified as an under-capitalized institution. As a result, such bank would not be allowed to distributing any dividend to shareholders, nor to paying any extra bonus and compensation exceeding the level offered at the point of the finding of internal control insufficiency to its senior executive officer. In other words, under the PCA system, theoretically bank management could no longer take coverage under a “satisfactory” regulatory capital level while the institution’s managerial strength is indicated actually otherwise. More broadly, given the banking industry as being highly protected with immense public interests at stake, this is also yet another example that when a clash of interests happens between the shareholders pursuing wealth maximization and the regulators sustaining safety and soundness, the latter will prevail. And, in order to implement this prevailing goal, the banking regulator can go so far as to “reach deep into traditional preserves of bank management and ownership”.

C. Safety and Soundness Examinations and the PCA’s Non-Capital Criteria
Under the PCA, a depository institution would be downgraded to the next lower capital-classified category if the institution fails to meet safety and soundness standards or receives an unsatisfactory rating (or less) in its latest on-site safety-and-soundness examination report (and has not corrected the deficiency) for any of the four non-capital elements (asset quality, management, earnings, and liquidity) of the CAMEL

66 See Baxter, supra note 21, at 210.
67 According to section 111 of the FDICIA, each appropriate federal banking and thrift agencies has to conduct a full scope, on-site examination for ensuing safety and soundness of federally insured depository institutions under their supervision at least once during each twelve month period. See Federal Reserve System, The Federal Reserve System’s Definition of a Full Scope, On-site Examination for Safety and Soundness, SR 94-12 (FIS), para 1 & 5 (24 February 1994).
rating. Nevertheless, it would be misleading by taking the statutory word at face value as these four non-capital factors actually carry different weight. From the examiner's viewpoint, sound management of the institution has reached the forefront as a matter of safe and sound banking.

On 20 December 1996, the Federal Reserve Board adopted the revision of the Uniform Financial Institutions Rating System (UFIRS), which came into force on 1 January 1997. Of the major measures this new system brought on board is a reference requirement to the quality of the management factor when examiners assign composite ratings to other three components that “...the descriptions [of composite and component rating] accompanying each component...[should] reflect in the rating management's ability to identify, measure, monitor, and control risks”.69

The techniques used in conducting on-site safety-and-soundness examinations also reveal the predominant position of the management component in today’s banking examination. In this respect, there is an obvious shift of emphasis, moving away from targeting portfolio towards management. As manifested by the Federal Reserve Board, historically heavily relied “transaction testing procedures” in safety-and-soundness examinations that were conducted by reviewing, among other things, a high proportion of commercial and industrial and commercial real estate loans in order to evaluate the adequacy of the credit administration process and to assess the quality of loans, have been regarded as insufficient to keep abreast with banking organizations' ability to swiftly reposition their portfolio risk exposures.70 As a result, to the extent the examiners could be reassured that the examined institution is under sound management, i.e., sound internal risk management and internal controls, additional transaction testing

68 12 U.S.C. §1818 (b)(8), 1831o(g).
Another earlier SR letter from the Federal Reserve Board was to the same effect that “the definition [of a full-scope, on-site safety and soundness examination] emphasizes assessing management’s performance as regards internal controls and compliance with laws and regulations.” See Federal Reserve System, The Federal Reserve System’s Definition of a Full Scope, On-site Examination for Safety and Soundness, SR 94-12 (FIS), para 5 (24 February 1994).
would be substantially reduced.\textsuperscript{71}

D. Safety and Soundness Standards

1. Safety and Soundness Rule-Making and the PCA Connection

As a reaction to the widespread phenomena of mismanagement directly leading to the bank and thrift crisis of 1980s, section 39 ("section 39") of the Federal Deposit Insurance Act\textsuperscript{72} was added by section 132 of the FDICIA\textsuperscript{73} that instructed each federal banking agency to prescribe certain safety and soundness standards by regulation or guideline,\textsuperscript{74} applying across the board to all federally insured depository institutions.

In contrast with the traditional regulatory approach emphasizing transaction-based, and mostly one-formula-for-all restraints such as lending limits,\textsuperscript{75} this section 39 regime stressed the need of, institution-based, an appropriate level of internal risk-management strength, as revealed by the three types of standards the regulator was mandated (and statutorily demanded) to prescribe:\textsuperscript{76} (1) operational and managerial standards;\textsuperscript{77} (2) standards regarding asset quality, earnings, and stock valuation "that the agency determines to be appropriate";\textsuperscript{78} and (3) compensation standards.\textsuperscript{79}

\textsuperscript{71} See Federal Reserve System, Risk-focused Safety and Soundness Examinations and Inspections, SR 94-14 (SUP), para 9 (24 May 1996).
\textsuperscript{72} 12 U.S.C. 1831p-1.
\textsuperscript{74} Codified as amended at 12 U.S.C.A. §1831p-1. This clause was amended by the Riegle Community Development and Regulatory Improvement Act of 1994 to apply solely to federally insured banks and thrifts, exempting holding companies of these depository institutions and allowing the agencies' prescriptions taking a looser form of guideline rather than regulation. See Pub. L. No. 103-325, 108 Sta. 2160 (1994)
\textsuperscript{75} See McCOY, supra note 7, at §6.04.
\textsuperscript{76} For general background, see Paul A. Schott, FDICIA-mandated Safety and Soundness Standards Pose Compliance Burden, 16 Banking Policy Report 6 (1995).
\textsuperscript{77} Section 39 (a) requires the agencies to establish standards relating to: (1) internal controls, information systems and internal audit systems according to section 36 of the FDI Act (12 U.S.C.1831m); (2) loan documentation; (3) credit underwriting; (4) interest rate exposure; (5) asset growth; and (6) compensation, fees, and benefits, according to subsection (c) of section 39. See 12 U.S.C. § 1831p-1(a).
\textsuperscript{79} The agencies are required to prescribe standards prohibiting as an unsafe and unsound practice any employment contract, compensation or benefit agreement, perquisite, stock option plan, post-employment benefit, or other compensatory arrangement that (1) would provide any executive officer, employment, director, or principal shareholder of the institution with excessive compensation, fees or benefits; or (2) could lead to material financial loss to the institution. Furthermore, when compensation is considered excessive (and thus unsafe and unsound) is a matter to be specified by the agencies. See 12 U.S.C. §
In connection with the PCA regime, Section 39 violation can create some immediate effects. In the event an agency determines that an institution fails to meet any one of the section 39 agency-made standards, the agency may immediately pursue the PCA mechanism against the institution at question. The agency may demand the institution to submit an acceptable plan in a timely manner to achieve compliance with the standard; if the institution fails to do so or fail to demonstrate satisfactory implementation, the agency then must issue an order requiring the institution to correct the deficiency. Until the deficiency has been corrected, the regulator is again obliged to impose a prompt corrective order restricting asset growth, requiring infusion of capital or otherwise order action that will better ensure the institution’s safety and soundness.

Apart from the enforcement connection, the section 39 regime could be linked to the PCA in their evolving the managerial element of the regulatory idea of safe and sound banking. To the extent certain managerial indicators that were incorporated, alongside those of capital ones, into the PCA regime’s early intervention mechanism had provided some clues that the managerial side of bank safety and soundness consideration was indeed present and recognized, the section 39 regimes—approximating to some core managerial functions without even mentioning the capital side of consideration—offered a definitive testament to this observation. Ultimately, the underlying policy consideration shared by both could well be the belief that banking safety and soundness can be better protected should the regulators be capable of “identifying and addressing problems at insured depository institutions before capital becomes impaired”.

1831p-1 (c).

81 12 U.S.C. § 1831p-1(e)(2); 12 C.F.R. §§ 30.4(d), 206.303 (d), 308.303 (d), 570.3 (d).
82 Id. 12 C.F.R. §§30.4 (d), 163.303 (d), 308.303 (d), 570.3 (d). In the case a section 39 prompt corrective order is not complied by the institution, apart from activity restriction, the agencies can also opt for imposing monetary penalties against the institution and any “institution-affiliated party” that includes bank management.
2. Safety and Soundness Guidelines

In compliance with this statutory requirement, federal banking regulators jointly published their final safety and soundness guidelines on 10 July 1995, entitled “Interagency Guidelines Establishing Standards for Safety and Soundness” (the “Guidelines”).

a. Compensation Standard

The Guidelines are rather loose in substance. The only area the Guidelines explicitly and substantively refer to as unsafe and unsound is regarding the level of compensation paid to management or principal shareholders. While compensation leading to a material loss to an institution clearly constitutes an unsafe and unsound practice, the Guidelines works to the same effect as does section 39 and prescribed “excessive” compensation alone that does not endanger the institution’s solvency or its adequate regulatory capital level will also be considered as an unsafe and unsound practice. By clear statutory and regulatory pronunciations, an unsafe and unsound banking practice could therefore (to say the very least in this compensation area) totally detach itself from the capital side of consideration. This inference — a crucial pointer in conceptualizing the bank safety and soundness idea — will be revisited later in this chapter.

b. Operational and Managerial Standards

For the Guidelines’ other managerial and operational areas, one can hardly detect any explicit unsafe-and-unsound parameter such as “excessive” (albeit even this adjective is far less than concrete) as used in the compensation part but only some principles or policy objectives to be followed or achieved when the institution is building up and

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84 12 C.F.R. § 364.101 App. B.
85 Id., at III. B.
86 Compensation will be considered excessive if amounts paid to the services are unreasonable or disproportionate. A number of factors are to be considered, and the institution’s financial condition is only one of them. The others are: (A) the combined value of all cash and noncash benefits provided to the individual; (B) the compensation history of the individual and other individuals with comparable expertise at the institutions; (C) comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the loan portfolio or other assets; (D) for postemployment benefits, the projected total cost and benefit to the institution; (E) any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution” 12 U.S.C. §1831p-1(c)(2)(A)-(F); and 60 Fed. Reg. 35,674, Appendix III (1995) (Codified in 12 C.F.R. § 364.101 App. B. III. A. )
87 See supra note 84, at III. A.
maintaining their own various control and monitoring systems. The standards regarding
“internal controls and information systems”, for example, are set out as (A) establishing
clear lines of authority and responsibility for monitoring adherence to established
policies; (B) effective risk assessment; (C) timely and accurate financial, operational and
regulatory report; (D) adequate procedures to safeguard and manage assets; and (E)
compliance with applicable laws and regulations.88 This formula is repeatedly used in
the areas of internal audit system;89 loan documentation;90 credit underwriting;91
interest rate exposure,92 and asset growth.93 Methods for achieving those objectives are
then left to each institution’s cost-benefit analysis, self-tailoring to fit in with the size of
the institution and the nature, scope and risk of its activities.94

88 12 C.F.R. § 364.101 App. B. II. A.
89 A prudent internal audit system consists of the following elements: adequate monitoring of the system
of internal controls through an internal audit function; independence and objectivity; qualified persons;
adequate testing and review of information systems; adequate documentation of tests and findings and any
corrective actions; verification and review of management actions to address material weakness; and
review by the institution’s audit committee or board of directors of the effectiveness of the internal audit
systems. 12 C.F.R. § 364.101 App. B. II. B.
90 Loan documentation practices are expected to attain the following objectives: enable the institution to
make an informed lending decision and to assess risk on an ongoing basis; identify the purpose of a loan
and the source of repayment, assess the ability of the borrower to repay the indebtedness in a timely
manner; ensure that any claim against a borrower is legally enforceable; demonstrate appropriate
administration and monitoring of a loan; and take account of the size and complexity of a loan. 12 C.F.R.
§ 364.101 App. B. II. C.
91 Prudent credit-underwriting look into the following aspects: commensurate with the types, terms of
loans and conditions under which they will be made; consider the nature of the markets in which loans
will be made; provide for consideration, prior to credit commitment, of the borrower’s overall financial
condition and resources, the financial responsibility of any guarantor, the nature and value of any
underlying collateral, and the borrower’s character and willingness to repay as agreed; establish a system
of independent, ongoing credit review and appropriate communication to management and to the board of
directors; take adequate account of concentration of credit risk; and are appropriate to the size of the
institution and the nature and scope of its activities. 12 C.F.R. § 364.101 App. B. II. D.
92 The objective demanded is periodic reporting with adequate information along the chain of command
to top management and the board for their assessment as to the the level of risk. 12 C.F.R. § 364.101 App.
B. II. E.
93 A prudent strategy regarding asset growth should consider: the source, volatility and use of the funds
that support asset growth; any increase in credit risk or interest rate risk as a result of growth; and the
effect of growth on the institution’s capital. 12 C.F.R. § 364.101 App. B. II. F.
94 Except for the compensation part where parameters of safety and soundness are to some extent
indicated by the federal regulators, every other part of the Guidelines contains the sentence “[a]n
institution should have …systems that are appropriate to the size of the institution and the nature, scope
and risk of its activities…”, or the like to the same effect.
E. Interim Observations and Comments:

1. Balance Striking

The Guidelines are a set of enabling rather than binding rules. Federal agencies can decide whether or not to take a Guidelines violation as an unsound and unsafe banking practice\(^{95}\) and, if they do, the PCA and a variety of enforcement mechanisms would be at their disposal against the institution or any institution-affiliated party. As explicitly stated by the agencies, the converse is also true; compliance with the guidelines does not prevent the agencies otherwise deciding the institution or any institution-affiliated party’s engagement with an unsafe and unsound practice.\(^{96}\) The Guidelines provides no “safe harbour” arrangement that would allow institutions to submit their internal control and monitoring plans to the regulator’s approval and therefore enjoy immunity. It therefore entails various undesirable effects, those commonplaces flowing from ambiguity of regulation. For one thing, even with the publishing of the Guidelines, bankers will still have to pay close attention to the regulators’ safety and soundness pronunciations embedded in individual enforcement actions or other forms of regulatory paper that are issued on an *ad hoc* basis if they are to keep abreast with the regulator’s pace as to the permissible scope of banking activity. In this regard, the passage of the Guidelines renders little in terms of alleviating compliance burdens and risks on bankers.\(^{97}\)

This general approach that emphasized objectives or general criteria as opposed to any definitive substance except, perhaps, in the area of compensation was, however, originated from the industry’s strong recommendation. Moreover, regulators’ attempt to strike a balance—illuminating only the core value and framework pertaining to sound management under the overall safety and soundness regulation while leaving room for (hence preserving) the private sector’s innovation in developing techniques of risk management — is no doubt based on a right conviction of the need for private-sector

\(^{95}\) 12 C.F.R. § 364.101 App. B. III.

\(^{96}\) *Id.*

\(^{97}\) Both before and after the passage of the Guidelines, the persistence of enormous safety and soundness based enforcement discretion placed in the hands of the banking agency is the primary source of this compliance risk that “innocent violations” can lead to government interventions or other severe legal consequences. McCOY, supra note 7, at § 6.02[2]
regulatory complements. Uncertainty is probably the cost that must be paid if this formula is to be followed.

Nonetheless, the complementary formula provided in the Guidelines that delegates the concrete substance of an institution’s internal risk management to its own “cost-benefit” analyses entails one major problem. Nowhere do the Guidelines compel the banking organization considering regulatory concerns when conducting cost-benefit analysis. Considering the profit-seeking (or cost-saving) tendency of any given private enterprise, weighing in the costs of such externalities as the potential loss to the deposit insurance fund can be therefore very much an option to be “rationally” excluded by the institution’s management in the process of deliberation. From a safe and sound perspective, a self-tailored version of an institution’s control or information or other such mechanisms concerning internal risk management can be much likely a diluted one, comparing to what expected by the banking agency.

2. Managerial Element of Safety and Soundness as Independent Safety-and-soundness Prong alongside Financial Element

One virtue of the section 39 Guidelines was suggested as the effect of shifting prudential regulation “from ad hoc supervision to generalized standards.” Despite these

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98 A regulatory regime encouraging innovation is indispensable to enhancing the ability of the regulated to promptly reacting to the ever-changing risks in today’s marketplace. One good example of financial innovation in this regulatory sense is the wide-ranging development of financial derivatives permeating in some of the most developed economies in recent years that has tremendously contributed to risk dispersion. By demonstrating the great resilience American financial institutions exhibited in responding to the boom-and-bust telecom sector, Alan Greenspan, the Chairman of Federal Reserve Board, noted as follow:

“One prominent example is the response of financial markets to a burgeoning and then deflating telecom sector. Worldwide borrowing by telecom firms in all currencies amounted to a trillion US dollars during the years 1998 to 2001....At the time, the financing of these investments [made by the telecom firms] was widely seen as prudent because the telecom borrowers had very high valuations in equity markets that could facilitate a stock issuance, if needed, to take down bank loans and other debts. In the event, of course, prices of telecom stocks collapsed, and many firms went bankrupt. In decades past, such a sequence would have been a recipe for creating severe distress in the wider financial system. However, a significant amount of exposure to telecom debt had been laid off through instruments that mitigate credit risk, such as credit default swaps, collateralised debt obligations, and credit-link notes. Taken together, these instruments appear to have significantly reduced telecom loan concentrations and the associated stress on banks and other financial institutions.” See Alan Greenspan, Speech Delivered at Lancaster House, London on 25 September 2002, TIMES (London), 27 September 2002, at 30 2w.

99 McCoy, supra note 7, at § 6.02 [1].

100 See Baxter, supra note 21, at 218.
regulator-pronounced standards are by no means definitive, they did indeed provide some essential clues as to the elements of bank safety and soundness. It is worthy noting again the crucial importance of the regulator's stance when interpreting the "safety and soundness" idea, a regulatory term deliberately left ambiguous by Congress: "Absent a clear congressional expression to the contrary, the Comptroller [the regulator of national banks] is entitled to accomplish his regulatory responsibilities over unsafe and unsound practices both by cease and desist proceedings and by rules defining and explicating the practices which in his discretion he finds threatening to a stable and effective national bank system". On this basis and as enshrined in the Guidelines the clear detachment of management from financials, safe and sound banking should be indicated not only by a reference to an institution's sound financial condition (such as adequate regulatory capital level) but also by independently relating to its sound managerial strength. This proposition could be also supported by the PCA regime's factoring non-capital criteria into the foundation that derives proactive supervisory actions.

As a result, while an unsafe and unsound banking practice is referred commonly by regulators and courts as "[a]ny conduct that is contrary to generally accepted standards for prudent bank operations and that, if continued, might result in abnormal risk or loss or damage to the bank", such conduct should not be limited to one that would have "a

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101 Independent Bankers Ass'n of American v. Heimann, 613 F. 2d 1164, 1169 (D.C.Cir. 1989), cert.denied, 449 U.S. 823; see also Chevron USA, Inc. v. Natural Resources Defence Council, Inc., 467 U.S. 837, 843 (1984) (ruling judicial deference is rendered to any reasonable agency interpretation of an ambiguous statute where the agency has primary administrative responsibility for the statute); First State Bank v. FDIC, 770 F. 2d 81, 82 (adopting the arbitrary and capricious standard) (6th cir. 1985); Sunshine State Bank v. FDIC, 783 F. 2d 1580, 1582-84 (11th Cir. 1986) (stating the agency's judgments in appropriateness of classifying loans are entitled to significant deference given the expertise of bank examiners).

Absent explicit Congressional expressions, the court defers to the regulator not only in terms of statutory interpretations but also factual findings in the process of enforcement actions. A judicial review reversing an enforcement order issued by the banking agency on the safety and soundness ground, therefore, happens only when the court finds either the enforcement action is not supported by substantial evidence or it is otherwise arbitrary and capricious. 5 U.S.C. § 706 (2)(E) (providing findings of fact must be respected unless they are "unsupported by substantial evidence"); 5 U.S.C. § 706 (2)(A) (providing the "arbitrary, capricious, an abuse discretion" as the judicial review standard).

102 OFFICE OF THE COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK, THE ROLE OF A NATIONAL BANK DIRECTOR 64 (1987). A number of cases stated to the same effect, "conduct deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder". see e.g., First Nat'l Bank of Eden v. Department of the Treasury, OCC, 568 F. 2d 610, 611 n.2 (8th Cir. 1978) (per curiam); Northwest Nat'l Bank v. United States, 917 F. 2d 1111, 1115 (8th Cir. 1990).
reasonably direct effect on an [institution’s] financial soundness”\textsuperscript{103} or “threaten the financial integrity of the [institution]”\textsuperscript{104} as suggested by some earlier cases and commentators.\textsuperscript{105} The “direct financial effect” addition obviously runs counter to the position of the Guidelines and the statements expressed by federal banking regulators in numerous explanatory letters or enforcement orders published or issued under Congressional delegation and judicial deference.\textsuperscript{106} This line of thought is hardly sustainable also because of a more fundamental reason. The financial effect restraint is against the underlying policy on which the FDICIA regime was established—the policy of enabling supervisors to step up early rather than late, to identify and deal with problems before the institution’s financial standing becomes impaired.\textsuperscript{107} FDICIA, as a regime directly responding to the late 1980s’ thrift crisis, therefore represents a shift on regulatory and supervisory emphases— from saving the industry to “changing the way it conducted business”.\textsuperscript{108}

\textsuperscript{103} See Gulf Fed. Sav. & Loan Ass’n v. Federal Home Loan Bank Bd., 651 F. 2d, 259, 264 (5\textsuperscript{th} Cir. 1981), cert. denied, 458 U.S. 1121 (1982).

\textsuperscript{104} See Id. at 267.

\textsuperscript{105} See e.g., Heidi M. Schooner, Refocusing Regulatory Limitations On Banks’ Compensation Practices, 37 B.C.L. Rev., text accompanying note 45-50 (1996); and Heidi M. Schooner, Fiduciary Duties’ Demanding Cousin: Bank Director Liability For Unsafe and Unsound Banking Practices, 63 George Washington Law Review, 177, 202 (1995); see also Holzman, supra note 29, at 427 (noting the disparity of opinions held by circuit courts over if or not an adverse financial effect (as opposed to a potential risk) is a prerequisite to constitute an adverse banking practice).

\textsuperscript{106} Without any reference to financial loss, the Federal Reserve Board has reiterated ideas such as “[s]erious lapses or deficiencies in internal controls, including inadequate separation of duties, can constitute an unsafe and unsound practice…” and “[a]n institution’s failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business has long been considered unsafe and unsound conduct”. See Board of Governors of The Federal Reserve System, Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies, para 7 & para 1 of Attachment. SR 95-51 (SUP) (14 Nov. 1995).

\textsuperscript{107} See, inter alia, Laura Pringle, Safety And Soundness Standards and Bank Officer And Director Responsibility, 27 Oklahoma City University Law Review, 1017, 1020-2 (2002). The idea that the presence of a direct financial effect on the institution as a prerequisite for constituting an unsafe and unsound practice can be also rejected on the ground of the FIRREA based enforcement actions. It can be argued while the statutory language provides a removal order needs not only a finding of unsafe and unsound practice but the “resultant effect”, i.e., the bank has suffered or will probably suffer substantial financial loss, a cease and desist order as provided by law needs nothing further than an unsafe and unsound practice. Evidently, the wording structure of the law indicates a direct financial effect, as a resultant effect, was not intended by the lawmaker as an indispensable component of an unsafe and unsound banking practice. See Holzman, supra note 29, at 434-35 (note 50-2 and accompanying text).

\textsuperscript{108} See James Pitts & Eric Bloom, FDIC/RTC Suits Against Bank And Thrift Officers And Directors-Why Now, What’s Left, 63 Fordham L. Rev. 2087, 2087 (1995) (delineating the failures of relying on market forces, and, subsequently, of resulting to the bail-out strategy by recapitalizing the deposit insurance fund,
Messages the Guidelines sent to the banking industry is clear and appropriate to the Congressional intent. As interpreted by this author, they could be boiled down to the following: a banking practice, regardless of its direct financial bearing, is unsafe and unsound if such conduct runs counter to generally accepted prudent banking practice and demonstrates the institution's substantial financial or managerial weaknesses that, if continued, would potentially pose the institution to undue financial or non-financial risk. For the current purpose, it is enough to establish this managerial aspect of safety and soundness consideration, whose concrete substance will be further elaborated elsewhere in this volume (particularly in chapter four).

3. Examining the PCA System
   a. Capital-Management Incompatibilities

We then turn to the PCA system and its two-prong safety and soundness measures. What comes from the PCA mismanagement-focused supervisory interventions that are predicated on and pegged to capital classifications and reclassifications is a presumption—managerial degeneration could be drawn parallel to capital erosion; hence, same degree of intensity and same types of supervisory interventions and activity restrictions are applied to both. In other words, implications of a CAMELS examination that assigns the management factor an unsatisfactory rating are just, by nature and degree, the same when an institution’s regulatory capital drops to the next undesirable level, as far as the PCA regime’s effects are concerned. The success of the PCA system, therefore, largely rests with the appropriateness of this management-capital tying in that if or not this arrangement can genuinely and timely indicate the institution’s financial as well as managerial safety-and-soundness status.

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109 This proposition was reflected by some post-FDICIA judicial decisions. For example, in Greene County Bank v. FDIC, the court categorically rejected the idea that unsafe or unsound practices are “limited to practices having a reasonably direct effect on the bank’s financial soundness, a situation not present in this case”, and, therefore, “[p]roof of misconduct alone entitles the FDIC to invoke its broad cease and desist enforcement powers”. Green County Bank v. FDIC, 92 F. 3d 633, 636 (8th Cir. 1996); see also Simpson v. OTS, 29 F.3d 1418, 1425 (9th Cir. 1994); but see Johnson v. OTS, 81 F. 3d 195, 204 (D. C. Cir. 1996) (stating risk or threat to the “financial integrity” or “financial stability” of the institution as a prerequisite of an unsafe and unsound banking practice.).
We have justifiable doubts about this management-capital tying arrangement. First and foremost, such intrinsic limits capital signaling being associated with in particular as a lagging indicator of mismanagement give strong support to the argument that the degree of capital degeneration might not coincide with that of managerial deterioration. Consequently, by tying two connected but different regulatory concerns together the PCA regime runs the risk of failing the legislative initiative of early intervention for problematic banks. While an institution’s capital classification remains adequately capitalized, unsound managerial practices could have well taken place and could have been serious enough to have negative repercussions on the institution in the long run. Further, whereas tackling mismanagement concerns primarily with addressing lax internal controls and system failures, curing capital shortage is basically something to do with fund injection or asset reduction. Qualitatively, they therefore should be responded differently.\textsuperscript{110}

The above arguments give rise to the general need of a detached system, and a particular one of such system for those economies short of mature financial infrastructures able to producing credible assessments on their banks’ capital strength, which would then worsen the initial lagging problem of the inadequacy of regulatory capital level reflecting managerial strength. Taking the case of Taiwan, an East Asia’s newly industrialized economy, for example, fundamental weaknesses embedding in accounting\textsuperscript{111} and the auditing system\textsuperscript{112} were frequently cited as primary culprits undermining credibility of the regulatory capital level as recorded in the bank’s book. As pointed out by one leading commentator, strengthened regulatory capital and other ratio-based financial indicators “are meaningless if accounting systems and auditing

\textsuperscript{110} GEORGE WALKER, INTERNATIONAL BANKING REGULATION-LAW, POLICY AND PRACTICE 584 (2001) (commenting the Basle Committee’s proposed capital charge on operational risk: “To the extent that operational risk is more concerned with procedural, process and systems failure it is arguably more an aspect of internal controls and should be treated on that basis and not through the imposition of additional flat capital charges”.)

\textsuperscript{111} As standardized accounting and reporting systems are yet to be established in Taiwan, consistence and credibility of financial data and on which of calculation of capital adequacy ratio are open to question. See Nai-Pin In, Examinations and Suggestions of Financial regulation System, 27 Taipei Bank Monthly, 2, 17 (1997) (in Chinese).

\textsuperscript{112} According to one Taiwan’s leading accounting scholar, Professor Di-Wang Chang, combination of auditing and advising businesses as currently pursued by external auditors in Taiwan renders illusory independent and credible auditing results. This is exacerbated by regulation over auditing profession has long taken the norm of self-regulation. See Daily Economics (Taipei), at 4 (28 April 2002) (in Chinese).
procedures permit banks to misrepresent the quality of their loan portfolios, the quality of their earnings, or the quality of their capital." 13

Admittedly, the fact supervisors could detach themselves from the PCA's capital classification and deploy a range of safety and soundness based enforcement actions addressing mismanagement to some extent offsets drawbacks flowing from the management-capital incompatibility. It is however still imperative the difficulties of fully mapping managerial strength to the institution's capital classification (and reclassification) are appreciated. Such appreciation can be a good reference point for future reforms on early intervention systems such as the PCA.

b. Detecting Top-down Dishonesty as PCA’s Functional Limit and Need for Complements

Successful on-site examinations are inextricably linked to effective implementation of the PCA, as an early intervention system. On-site banking examinations remain vital and irreplaceable for the banking agency to test the credibility of management's statements, to review the adequacy of internal controls, and to verify solvency. All these first-hand information provides the groundwork on which the judgment of whether a prompt corrective action should be taken is made. Functional limits of on-site examinations are therefore vitally important as they largely represent the limits of the PCA itself.

A successful on-site examination is predicated on examiners' ability to rely on the senior management's assertions because their resources are too limited to verify every fact. 114 Banking frauds directly plotted by or involved with bank directors or senior management are therefore extremely hard to be detected during the process of on-site banking examinations. Daiwa debacle provides a good example in this regard. 115

114 See McCoy, supra note 7, at §12.04 [1].
115 Toshihide Iguchi, a trader at the New York state-chartered branch of Daiwa Bank (the 19th largest bank in the world as of 1995) lost $1.1 billion from trading US treasures at its New York branch between 1984 and 1995, and theses losses were concealed through liquidations of securities held in the bank's custody accounts and falsification of its custody record. It transpired in 1992 and 1993 Daiwa management falsely assured Federal Reserve Board examiners that trading and custody had been split whereas they both were under the control of Iguchi. Further, when management discovered the loss in July 1995, they did not promptly report them to US regulators, who finally found the losses on 18 September 1995. In October
Curtailing this “top-down” type of dishonesty is thus the very task the PCA-type regulatory efforts must be complemented by other screening mechanisms. While the powerful safety and soundness formal enforcement measures would certainly effect some level of deterrence, in the post-Enron era reinforcing internal checks-and-balances by strengthening functions of independent directors and audit committee is the direction being pursued although the effectiveness of these reforms itself remains unclear.

IV. Managerial Safety-and-soundness and LCBOs Supervision

A. Background

The past two decades witness a sea change in banking industry in the US brought about by market transformation, financial deregulation and innovation and their attendant effect—asset consolidation.

Nowadays financial activities conducted by the US banking organizations have extended far beyond traditional deposit-taking and lending. Of the most noticeable developments is the exponential growth in derivatives transaction with the ten largest banking institutions accounting for nearly 95 percent the notional amount of derivatives contracts entered into in the markets. More generally, total assets of non-bank subsidiaries (such as securities arms) of the largest fifty banking organizations now account for nearly a quarter of the groups’ overall consolidated assets.

As the result of a long-term trend of consolidation, the largest most complex banking organizations (LCBOs) now occupy the pinnacle of the US’s banking landscape. In the space of ten years (from 1989 to 1999), the number of independent banking organizations (organized with or without a holding company) in the US dropped from

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1995, Daiwa announced further losses of approximately $97 millions as a result of trading activities. Consequently, Daiwa’s US banking operations were terminated by consent orders effective 2 February 1996 despite Daiwa had abundant capital to absorb all these losses; Daiwa entered into a plea bargain to the effect it pled guilty and was fined $340 million; Iguchi received a four year prison sentence and a & 2.6 million fine. The executive and former executives of Daiwa were ordered by a Japanese court in September 2000 to pay $775 million to the bank for the losses caused by the mismanagement of the New York branch. The facts were summarized from HAL S. SCOTT, INTERNATIONAL FINANCE: LAW AND REGULATION 83-84 (2004).


117 Id.
9,500 to 6,800,\textsuperscript{118} while the share of total banking assets owned by the largest U.S. banking organizations rose from 55 percent in 1989 to 74 percent in 1999, with the ten largest increasing from 26 to 49 percent.\textsuperscript{119}

B. Risk-focused Supervising for LCBOs

With no single factor qualifies or disqualifies an organization from being considered an LCBO, the following fifteen business features single out those banking organizations with most drastic change in their risk profiles and subject them under the LCBO supervision program, which was officially established in 1999 by the Federal Reserve Board.

These criteria are: total assets; size of off-balance-sheet exposure; activity in derivative markets; trading assts and trading revenue, foreign assets and foreign deposits; funding from market sources (non-deposit); securities borrowed and securities lent; incomes from fiduciary activity; mutual fund sales and mutual fund fee income; revenue earned in mortgage markets; assets under management; activity in payment systems; involvement in securities settlements; geographic scope of operations; and merchant banking activities and proprietary investments.\textsuperscript{120}

For those banking organizations characterized as LCBOs, the following table demonstrates how differently banking supervision and examination are being conducted over an LCBO from a traditional banking organization.

Table 1.1\textsuperscript{121}

\textbf{Comparison of Traditional Bank Examinations with Risk-Focused Supervision for LCBOs}

\textsuperscript{119} See Deferrari & Palmer, supra note 116, at 47-8.
\textsuperscript{120} Id., at 50.
\textsuperscript{121} Id., at 51.
Traditional Banking Examinations
Supervision

Supervisory process is focused on a single point in time and is rarely continuous unless there is a crisis.

Significant emphasis is placed on valuation of assets.

Dialogue with management is mostly related to examination findings unless there is a crisis.

Risk-focused LCBOs

Supervisory process is continuous and is more tuned to market development.

Institutions are assigned designated Supervisory teams. The teams are supplemented with specialists, who may be drawn from across the Federal Reserve System.

Focus is on risk-management processes and control systems.

There is more frequent communication with senior management.

Supervisory process includes more interaction with line management of business activities and risks.

Programs includes business line and functional reviews that incorporate identification of best practices.

All these changes were made to correspond with the LCBOs’ business that involves complex transfers of risk such as complex securitization or other secondary credit activities. The core of this new approach is the “[g]reater emphasis on the organization’s management processes and core proficiencies for identifying, measuring, monitoring and controlling key risks, including credit, market, and operational risks, and less
emphasis on traditional ‘point-in-time’ balance sheets assessments”.122

Despite emphasizing internal risk management and controls obviously falls into the established “procedure prudence” mode re-confirmed in the 1995 the Safety and Soundness Guidelines, the task here has proven something different from before. For one thing, identifying the industry’s “best practice” is now an extraordinarily important step in the process of formulating regulatory rules. Admittedly, commonly recognized best practices always carry certain weight in terms of safety and soundness regulation even for non-LCBO banking organizations. Elevating industry practices to such a height as “identification of best practices” being one crucial source of deriving regulatory rules is nevertheless rare, if ever. Furthermore, given a kind of communicator role expected to be played by federal agencies, it is safe to say a dramatic change is now underway as to the approach these organizations are “supervised”.

These novelties reflect the regulators have recognized the management of a mega organization simply have better grasp as to complex and transferable risks inherent in those diversified business their institution involves with, and, consequently, stand in a better position to manage these risks than they do. The same can be said for the supervisory side where the regulators have to work in partnership with LCBOs’ management rather than direct their way as before to achieve regulatory goals. One consequence effected by these changes might be a consummation of a de facto self-regulation regime applied specifically to these “elite” organizations.123 If this is the case, it will guarantee a split between LCBOs and non-LCBO banking organizations in terms of regulatory contents and supervisory style.124

123 Joseph J. Norton, Conjuring an Elite Corps of Banking Institutions Within a Public-Private Partnership, in CORPORATIONS, CAPITAL MARKETS, AND BUSINESS IN THE LAW 394 (Theodor Baums ed.al., 2000) (noting “a dominant trend in international bank regulation and supervision over the past several years has been to separate (de facto) elite banks into their own class for purposes of regulation and supervision and subtly shift the regulatory and supervisory framework towards more of a “functional self-regulatory” framework.”)  
124 Differentiating supervisory treatments towards banking organizations of different level of sophistication has been adopted in practice. See Board of Governors of the Federal Reserve System, Revisions to Banking Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of $ 5 Billion or Less, SR 02-1, para 5 & 10 (9 Jan. 2002) (noting assessing the
While the LCBO program is still growing, one aspect of the LCBO regulation is clear; that is, LCBOs’ board directors and senior management will be rendered much more autonomy and much less restraints as to risk-taking than their non-LCBOs’ banking counterparts. In this respect, while the regulators have been relaxing external restraints on the LCBO managements’ discretion and autonomy in making business judgments, whether internal governance mechanisms traditionally formulated under the corporate-law regime could function commensurate to the regulators’ safety and soundness consideration will become vital. In addition, an adequate disclosure system and effective enforcement of such a system will be also compelling to provide a basis for at least an ex post check.

V. Concluding Remarks

Evolution of the concept of managerial safety-and-soundness in the United States encapsulates the transformation of banking industry and its supervision. As the pendulum has swung away from the era where predominantly deposit-taking and lending was the business banks engaged in, credit risk they had to deal with, and well capitalization could have been equated with safe and sound banking, it does not necessarily declare a gradual phase-out of the capital regime but certainly promise yet another repositioning of the contents of the safety and soundness consideration.

It begins to be seen the well-management component is being repositioned and absorbing and defining the well-capitalization requirement rather than these two will still run parallel as they are now. Of the most prominent example of this repositioning financial condition of a banking holding company with total consolidated assets of $1 billion or less can be conducted off-site and, as a principle, only a management rating and a composite rating are required to be assigned; by contrast, a complete holding company rating is required to be assigned to a company with total consolidated assets of between $1-5 billion).

See Norton, supra note 128, at 394 (noting “[t]his ‘risk-based supervision’ framework essentially redirects responsibility and accountability for the design, development and implementation of risk-management and internal-control process to the elite banks themselves, subject to purported oversight of and imposition of general parameters and standards set forth by the authorities.”)

126 The dual safety-and-soundness demands for FHCs to ensuring their subsidiary depository institutions’ well-management and well-capitalization are one of the focal points of the current FHC prudential regulation. See 12 C. F. R. sec 225.83 (A FHC must notify the Federal Reserve Board in writing within 15 days of becoming aware that any depository institution it controls has ceased to be well capitalized or well managed. Until the Federal Reserve Board determines the FHC has corrected its depository institution’s
is regarding capital adequacy assessments of the LCBOs. In one supervisory letter, by dismissing simple ratios (including risk-based capital ratios) and "traditional rules of thumb" as insufficient in assessing the overall capital adequacy of large banking organizations, the Federal Reserve Board emphasized the imperativeness of these institutions' "internal capital management processes" in relation to their capital strength.\textsuperscript{127} The quality of these processes as for the present reflected by the examiners in the institution's management ratings is to be in the future repositioned as an integral part of the institution's ratings for capital adequacy.\textsuperscript{128}

In other words, the ongoing developments of prudential banking regulation and supervision in the US and at the international level\textsuperscript{129} have proven safe and sound banking are of shifting substance — from ratio-based indicators taking predominant weight, through managerial quality and integrity (indicated by the strength of internal risk-management, internal control and other control mechanisms) supplementing such indicators, to the management factor defining including risk-based capital and other ratios and standing out as a set of absolute determinants to which the regulator's attention has turned. Recognizing such objective shift is clearly indispensable to deliver satisfactory results for American banking regulators whose constituencies are now permeated with those large, complex banking organizations taking firm hold of financial industries across the board (banking, securities, insurance and others). The same case

financial or managerial weaknesses, limitations or conditions on the conduct or activities of the FHC or any of its affiliates, including suspension of share or control acquisition of other company, might be imposed. Persistent failures to bring the depository institution back to both financial and managerial safety and soundness might result in a mandatory divestiture of the depository institution at question.\textsuperscript{127}

\textsuperscript{127} Board of Governors of the Federal Reserve System, \textit{Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles}, SR 99-18, para. 1 & 3 (1 July 1999).

\textsuperscript{128} Id. para. 9-10.

\textsuperscript{129} There have been efforts put in to rehabilitate the 1988 Basel Capital Accord to address, among others, the one-size-fits-all formula of deciding required regulatory capital level. In June 1999, the Basel Committee issued a consultative paper (entitled "A New Capital Adequacy Framework") introducing a new capital adequacy framework to replace the 1988 Accord. The proposed new framework ("Basel II Program") consists of three pillars: regulatory capital, supervisory review and market discipline. Among the measures to be probably introduced and implemented when the work is finalized in both international and domestic levels is adopting a more risk sensitive system based on bank's internal ratings and credit risk modelling for regulatory capital purpose. For more background information concerning the Basel II Program, see, \textit{inter alia}, Heidi M. Schooner & Michael Taylor, \textit{Convergence And Competition: The Case Of Bank Regulation In Britain And The United States}, 20 Michigan Journal Of International Law, 596, 642-3 (1999).
can also be made for regulators coming from economies with no clear presence of such mega banking organizations, yet with financial liberalization and institutional integration continuously taking swift pace, presenting the same nature (not the same scale) of task as their US counterparts now face — to tackle complex “bank risk” that can no longer be reduced to a set of threshold ratios and addressed by the financial cushion they imply.
CHAPTER THREE –
Managerial Conduct of US Banking Organizations under Shareholder
Model of Corporate Governance

"Where review of board functioning is involved, courts leave behind as a relevant point of reference the decisions of the hypothetical 'reasonable person', who typically supplies the test for negligence liability. It is doubtful that we want business men and women to be encouraged to make decisions as hypothetical persons of ordinary judgment and prudent might…. If those in charge of the corporation are to be adjudged personally liable for losses on the basis of a substantive judgment based upon what persons of ordinary or average judgment and average risk assessment talent regard as 'prudent' 'sensible' or even 'rational', such persons will have a strong incentive at the margin to authorize less risky investment projects."1

As discussed in chapter two, the regulatory concept of safe and sound management has emerged as an independent component of the overall regulatory objective of bank safety and soundness. Whist the discussion concerning the substance fleshing in this regulatory concept and how it is being promoted by the banking regulator will be deferred to next chapter, this chapter will first try to locate standards governing the conduct of bank management under a different matrix. This chapter sets forth the current legal and regulatory state of the shareholder model of corporate governance as primarily informed by state corporate law concerning the bank management’s functions. The particular jurisdiction the current chapter will focus on is Delaware, which is not only the leading corporate-law state in the United States,2 but also the only state whose corporate governance procedures were designated by the banking agency as the rules that could be elected by any national bank in its bylaw to follow, wherever the state the bank’s main office is located or the bank’s holding company is incorporated.3

1 In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, 968, at note 16 (Del. Ch. 1996)
2 Delaware is the state of incorporation of more than 40 percent of the companies listed in on the New York Stock Exchange and more than half of Fortune 500 companies. See Cammon Turner, Shareholders vs. the World: Revolon Duties and State Constituency Statutes, 8 Business Law Today 32, 34 (1999).
This chapter notes that the current shareholder model of corporate governance (as informed by Delaware corporate law) controls and directs the conduct of bank management towards refraining from at the margin to authorize less risky investment projects so as to foster ownership rights, whereas certain background restraints informed by external regulations indicate the boundary of such profit pursuit and address stakeholder considerations. The regulatory objective for bank safety and soundness, as any class of stakeholder considerations in this matrix, is therefore posed no more than a topic of compliance rather than itself a corporate objective, and is by design supposed to take up a marginal place.

This chapter is organized as follows to pinpoint this shareholder model of corporate governance. Section one will first provide a theoretical review over the contractarian concept of corporation, depicting tensions amongst corporate constituencies and the state corporate law’s shareholder-oriented solution, whereby minimizing managerial agency costs, encouraging risk-taking and upholding entity separateness are indicated as three policy objectives to be advanced by the US shareholder model of corporate governance.

Section two first sets forth the general framework of the Delaware’s fiduciary duty system, a set of open-ended and open-textured standards of conduct and review controlling and directing managerial conduct towards advancing the said triad of policy objectives. The section also covers the fiduciary law’s application in particular areas — insolvency, change-of-control transactions and the constituency statute — whereby the status of various corporate stakeholders in relation to the shareholder will be examined and analyzed.

Section three devotes to the build-up to the US Supreme Court’s 1997 seminal decision of Atherton v. FDIC, which confirms the applicability of the shareholder model of corporate governance as informed by state corporate laws in the banking context. This chapter is concluded by section four, which will provide some observations over the extensive implications of the Atherton decision, whose reasoning will be also critically examined.

I. Policy Attributes of Shareholder-model of Corporate Governance

The term "corporate governance" is essentially an idea of "direction and control". Under Anglo-American legal tradition, this direction-and-control mechanism is generally devised to work under a shareholder model — the board of directors is to be responsible for directing the company’s affairs through its monitoring and decision-making functions and made accountable to and controlled by the shareholders. The primary participants of corporate affairs are therefore the shareholder, the management and the board of directors. For modern-day corporations, while such new developments as the emergence of institutional shareholders have apparently made them different from before, the underlying philosophy of upholding shareholder

4 The Committee On The Financial Aspects Of Corporate Governance (Cadbury Committee), Report Of The Committee On The Financial Aspects of Corporate Governance (Cadbury Report), 2.5 (Gee Ltd., 1992) (“Corporate governance is the system by which businesses are directed and controlled”); The Organization for Economic Co-operation and Development (“OECD”) provided a broader definition that corporate governance is “a set of relationships between a company’s management, its board, its shareholders, and other stakeholders”. OECD, OECD Principles Of Corporate Governance, SG/CQ (99) 5, at Preamble (1999). While the “direction and control” theme remains the same, it was suggested different methodologies are deployed by economists, lawyers, policy makers and other groups of this interest. See Jeswald W. Salacuse, Corporate Governance In The New Century, 25 Company Lawyer, 69, 70 (2004) (noting while lawyers and policy makers primarily focus on formal rules and institutions of corporate governance, economists often employ a wider view and their works touch upon “the informal practices that evolve in the absence of formal rule”); see also Edward Adams & John Matheson, A Statutory Model for Corporate Constituency Concerns, Emory Law Journal, 1085, 1085 (2000) (“Corporate governance involves a system of contractual and fiduciary duties that influence directors and officers to make decisions consistent with defined obligations”); For the economists' approach, see e.g., Andrei Shleifer & Robert Vishnu, A Survey of Corporate Governance, LII The Journal of Finance 737, 737 (“Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”).

5 The directors, “whether or not they have executive responsibilities, have a monitoring role and are responsible for ensuring that the necessary controls over the activities of their companies are in place—and working”. Report Of The Committee On The Financial Aspects of Corporate Governance (Cadbury Report), 1.8 (Gee Ltd.,1992). The shareholders are vested with the power of appointing directors, and control them through auditors, other monitoring mechanisms, and through laws and regulations working to their aide for this control purpose. Id. at 2.5. Robert Monks, Equity Culture at Risk: the threat to Anglo-American Prosperity, 11 corporate governance, 164, 169 (2003) (noting, in a normative sense, corporate governance is a process of effective accountability of management to informed and active owners).

6 See, e.g., ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 1 (1995). (Defining corporate governance as relationships among various participants in determining the direction and performance of corporations, and the primary participants are shareholders, management and the board of directors);

7 See e.g., Melvyn Westlake, Corporate Governance-Time To Clear Up, The Banker, 16, 16-7 (June 2002) (pinpointing one of the trends concerning global corporate governance reform is pressing institutional shareholders into playing a larger role in the oversight of corporate governance standards.)
interests still guides the formulation of corporate law, one primary source of corporate governance. This section will outline some characteristics of the US shareholder model of corporate governance, by which the policy objects underpinning these arrangements will be identified and pinpointed.

A. Starting Point: Disentangling Human Relationships and Contractarianism

Theory of Corporation

Under traditional Anglo-American corporate law, dealing with the issue “to whom the management owes corporate-law duties” seems curiously redundant as the standard formulation of the director’s corporate-law duties is generally stated not in terms of benefiting the shareholders or other corporate constituencies, but of benefiting the corporation. As a matter of law, one modern version of this formulation points at the corporation’s “long-term wealth”. In the United States, this is particularly true in the takeover or the insolvency situation. In the insolvency context, for example, the Delaware Chancery Court’s famous dictum in Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp. reads “where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers [shareholders], but owes its duty to the corporate enterprise... to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.” The dictum implies the interest of the corporation, i.e., the “long-term wealth creating capacity”, may not at all times coincide with that of its shareholders.

The idea of promoting welfare or “wealth-creating capacity” of a corporate-form

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8 With respect to English law, See PAUL DAVIES, GOWER’S PRINCIPLES OF MODERN COMPANY LAW 599 (Sweet & Maxwell Ltd., 1997) (noting directors’ fiduciary duties are owed to the company and to the company alone; citing Percival v. Wright [1902] 2 Ch. 421 and Bell v. Lever Bros. [1932] A.C. 161, H.L. in their applying this formulation to even the parent-subsidiary context where the company’s shares were totally owned by its holding parent); L.S. SEALY, CASES AND MATERIALS IN COMPANY LAW 259 (Read Elsevier, 2001).

The traditional view in the US, to a less extent, worked to the same effect. See e.g., Bawden v. Taylor, 254 IL 1.464, 467, 98 N.E. 941, 942 (1912).

9 See Credit Lyonnais, supra note 9, at *34; see also ALI, PRINCIPLES OF CORPORATE GOVERNANCE 4.01(A), stating "...[a] director or officer has a duty to the corporation to perform the director’s functions in good faith...".
fiction, a reminiscent of the entity theory line of thinking, however, renders much confusion on closer examination. The source of this confusion was forcefully articulated by John Parkinson as: “A requirement to benefit an artificial entity, as an end in itself, would be irrational and futile, since a non-real entity is incapable of experiencing well-being”, and, therefore, “…[it is] impossible to assign any definite content to a duty framed in terms of benefitting the enterprise as such”. (Emphasis included) Thus, interests of the corporation can be made sense only after they have been put into the context of the ultimate beneficiaries who enjoy such interests. The corporation is then no more than a collection of human relationships, or a “nexus of contracts”, i.e., a collection of explicit and implicit contracts which allows management, shareholders and various other kinds of self-interested corporate constituencies to contract freely concerning their relationship to, and rights against, the corporate

10 The idea that the nature of a corporation, as a juristic person, is largely the same as a natural person as advanced by entity theorists used to have a prominent place in the US to the extent corporations have even been accorded some constitutional protections previously applied only to natural persons. Ann E. Conaway, Re-examining The Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors’ Duties to Creditors, 20 Del. J. Corp. L. 1, note 9 and accompanying text (1995) (citing First Nat’l Bank of Boston v. Bellotti, 435 U.S. 765, 784 (1978) (corporation is protected by a First Amendment right to freedom of speech); Hale v. Henkel, 201 U.S. 43, 76 (1906) (corporation is insulated from unreasonable searches and seizures)). Today it is the contracterianism theory taking the central stage structuring corporate law. Entity theory lost its prominence because it is considered fails to provide a set of realistic explanations that is commensurate to the way modern corporations operate. Addressing corporate law issues from the standpoint that a corporation by law is an entity, independent from its capital-contributing shareholders, capable of having entitlements and bearing obligations misses the point because by fact it is shareholders, employees, lenders and other corporate constituencies rather than the company reaping the interests and bearing the brunt out of the company’s operation.


12 Id.


14 Corporate constituencies embody the shareholders and other stakeholders. In today’s marketplace, corporate stakeholders represent a wide range of constituencies other than shareholders that pursue disparate agendas and are differently affected by and interested in operation of a company. While the shareholders seek maximizing returns of the company’s stocks; the suppliers aim at having steady sales to the company; the customers want the company provide high quality goods with reasonable prices; the banking institutions, who extended loans to the company, seek to exert influence in the company’s financial safety to ensure its ability to make repayment; the labor unions, who represent the company’s employees, target goals such as high salaries and social security. There can be many other interest groups indirectly related to the company pursuing broader targets such as environmental sustainability. See Leo Schuster, The Shareholder Value and Stakeholder Discussion: An International Overview, in SHAREHOLDER VALUE MANAGEMENT IN BANKS 3-4 (LEO SCHUSTER ed., 2000).
One attendant product of the contracterian perception of corporation is corporate-law rules governing the corporation’s activities tend to be devised or viewed as enabling. It was argued the function of corporate law is to provide a set of standard rules concerning the activities of corporate constituencies to economize on contracting costs that would have otherwise arisen in the absence of such standard rules. A prominent example in this is the duty of care as owed by directors to the company, which from a contracterian perspective functions as a set of standard contractual terms. In other words, due care is among others enabling rather than rules of mandatory or regulatory character and they can be replaced by terms better suited to the perceived needs of the parties concerned. In the US, this is exactly what happened after Delaware’s seminal case Smith v. Van Gorkom that the majority of state corporate statutes, with their “contract out” clauses, allowed corporations to eliminate or alleviate directors’ due care liability by adopting exculpatory provisions in the certificates of incorporation.

This contracterian model is not unassailable. It was contested from the angle of the inherent contractual incompleteness arising out of information asymmetries and transaction costs. Further, commentators contended its ignorance of the negative

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16 See William Allen, Contracts and Communities in Corporation Law, 50 Wash. & Lee L. Rev., 1395, 1340 (1993) (noting “[t]he essence of the corporate form may ... be seen...as the identification of structures or processes by which (1) persons will be designated to make certain sorts of discretionary judgments, and (2) those so designated will be monitored. Thus, in the dominant view, a corporation may be said most fundamentally to be a contractual governance structure.”)

17 See infra note 56 and accompanying text.

18 See e.g., Del. Code Ann. Tit. 8 sec. 102 (b) (Supp. 1986). Despite corporation law statutes in America are primarily enabling, these statutes inevitably stipulate some non-waivable terms in the corporate charter, such as annual meetings to elect directors, stockholder access to books and records, and stockholders’ rights to amend the corporation by-laws. See William Allen, Contracts and Communities in Corporation Law, 50 Wash. & Lee L. Rev., 1395, 1340, note 18 and the accompanying text (1993).

19 See e.g., Alan Schwartz, Legal Contract Theories and Incomplete Contracts, in CONTRACT ECONOMICS 76-80 (Lars Werin & Hans Wijkander eds., 1992).
externality effect to the extent many individuals who are not direct parties to, but
affected by, the corporate contracts are left aside. Finally, the contractual idea of
corporation is not so much a precise legal conception as a metaphorical use of business
dynamics. Despite all these incompleteness, it is however true the corporation’s claim
to being should rest upon the interests of the constituencies that constitute it. The idea
that the interests of particular constituencies of the corporation could be submerged
before those of the corporation is against the commercial reality that a modern-day
corporation operates on corporate constituencies interacting with one another, nothing
more and nothing less. The contractual perception of corporation is therefore
rightfully considered as a theory comparatively capable of providing realistic
explanations that are commensurate to modern corporations’ operation and will be
followed in this chapter as a basis for discussion.

20 See generally Kose John et al., Cross-Border Liability of Multinational Enterprises, Border Taxes, and
Capital Structure, Fin. Mgmt., at 56 (winter 1991). This criticism is advanced from an inclusive and
communitarian ground, which argue the “fulfilment of the true needs of society’s members” as the
fundamental justification of corporate activities. See Michael Bradley et al., The Purposes and
Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads, 62
Law and Contemporary Problems, 10, 43 (1999). For in-depth theoretical analyses of the communitarian
school of corporate governance, see Parkinson, supra note 11, at 260-303.

21 Ronald Coase was the first to articulate the insightful view that firms exist to minimize the costs of
trading in markets, and this is done by the firm functioning as a nexus of contracts that governs trade
among the contracting parties. To this end, Coase noted the key role played by the “entrepreneur”, the
provider of capital and the firm’s residual claimer, who organizes the firm, directs its affair and holds the
exclusive power to dissolve it. See Ronald Coase, The Nature of the Firm, 4 Economica 386,392 (1937).
For a modern public company, the most obvious difference from the Coase’s entrepreneur-centred firm is
the absence of an entrepreneur. Coase’s observations are believed still valid nonetheless as functions used
to be performed by the entrepreneur are now respectively shared by the management and the shareholders.
See, e.g., William J. Bratton, Jr., The New Economic Theory of The Firm: Critical Perspectives from
History, 41 Stan. L. Rev. 1471 (1989); Ronald Daniels, Stakeholders and Takeovers: Can Contractarianism Be Compassionate?, 43 U. Toronto L.J. 315 (1993); Michael C. Jensen & Richard S.

22 The pre-eminence of the contractarianism view was stated by the former Chancellor of the Delaware
Chancery Court, William Allen, to the extent “[o]ne of the marks of a truly dominant intellectual paradigm
is the difficulty people have in even imaging any alternative view.” See Allen, supra note 18, at 1441; Michael Bradley et al., The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads, 62 Law and Contemporary Problems, 10, 41 (1999) (noting “[t]he contractarian ideology has clearly dominated the discourse in the worlds of law, economics, and
management…”); see Conaway, supra note 10, at note 9 and accompanying text (noting increasingly,
corporate theory has moved away from the entity theory and in the direction of a contractarian model of
governance).
B. US Corporate-law’s Guiding Principles Governing Conflicts of Interests among Corporate Constituencies: Minimizing Managerial Agency Costs, Encouraging Risk-taking and Entity Separateness

Against the backdrop of various corporate constituencies with their competing agendas interacting with the corporate entity, this section articulates, largely evolving along the corporation’s entity boundary, the two policy objectives of US shareholder model of corporate governance: minimizing managerial agency costs and encouraging risk-taking.

I. Vertical and Horizontal Tensions

From a contractarian perspective, there are two main strands of relationships working within or connected to a nexus-of-contracts corporation—the one between the management (those controlling the corporation) and the shareholders (those contributing equity capital to the corporation); and the one between the shareholder (as the sole class of residual claimers) and various other constituencies including employees, lenders and many others (as a collection of fixed claimers). The former was suggested by commentators as a vertical relationship and the latter horizontal. Tensions existing respectively inside the vertical and horizontal relationships are the primary reasons why including fiduciary duties various corporate governance mechanisms are needed to direct and control managerial conduct. Dealing with the vertical tension remains the focal point both of corporate and securities laws for long, particularly in the post-Enron era, calls for an even closer scrutiny over effectiveness and efficacies of the traditional disclosure-based securities law and the enabling corporate-law rules, focusing on public traded companies’ corporate governance, have brought fresh attentions to shareholder-management conflicts of interests. As to the horizontal tension, whereas the shareholder-stakeholder debate that bears a long intellectual pedigree is still

24 See e.g., A.A. Berle, Jr., Corporate Powers as Powers in Trust, 44 Harv. L. Rev. 1049, 1060-63, 1074 (1931) (arguing that corporate powers are held in trust for only the shareholders); But see E. Merrick Dodd, For Whom are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145, 1152-62 (1932) (arguing that corporate managers are trustees for employers, consumers, and the general public); see also Edward Adams & John Matheson, A Statutory Model for Corporate Constituency Concerns, Emory Law Journal,
ongoing, under current US corporate law it has been largely settled by dramatically tilting towards the shareholder’s side.

2. Dealing with Vertical Tensions: Minimizing Managerial Agency Costs

It is commonly agreed that the design of the shareholder mode of Anglo-American corporate governance is premised on the Berle-and-Means hypothesis of the separation of ownership from control, which leads to the tension between the shareholders and the management.

This premise came from the observation of inability and lack of incentive of the widely spread shareholders with their small shareholdings to exercise control over the increasingly large and complex corporation—the absence of block shareholders leads to the operational dominance of corporate managers. Consequently, a typical agency problem was deemed necessary to be dealt with to tempt the entrenched management, as the agents of the shareholders, out of their self-interest propensity and to act in the best interest of their principals. In other words, one primary objective of corporate governance under this management-shareholder tension is to “facilitate the development of a corporate structure that allows management the discretion to utilize its expertise on behalf of shareholders, but at the same time establish safeguards in situations in which management might utilize that discretion to favour itself at the expense of shareholders”. This is to be achieved, among other things, by a set of enabling and

1085, 1091-94 (2000) (noting the prominent shareholder/stakeholder debate by Professor Adolf Berle and Merrick Dodd in the 1930s);
25 This hypothesis was originated from the 1932 classic work “The Modern Corporation And Property” by Adolf Berle and Gardiner Means. ADOLF BERLE, JR. AND GARDNER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Macmillan, New York:, 1932)
26 Comparatively stronger minority shareholder protection against the majority under the UK and US corporate and securities laws is believed to be one crucial factor furthering this dispersed shareholding structure. Shareholders are encouraged to take small shareholdings because they know they are generally safe from the expropriation of majority shareholders. See e.g., Simon Deakin, Squaring The Circle? Shareholder Value and Corporate Social Responsibility in The UK, 70 George Washington Law Review, 976, 978-80 (2002) (noting protection accorded to minority shareholders in a hostile takeover under the UK’s City Code on Takeovers boosts their incentive to take small stakes).
29 See ALI, PRINCIPLES OF CORPORATE GOVERNACE, introductory note to Part VI.
procedure-oriented liability rules, by interest alignment practice including such incentive-enhanced arrangements as stock options in the managements’ compensation packages, by strong product, managerial labour and corporate control markets and by internal and external vetting over corporate management.

3. Dealing with Horizontal Tensions: Pursuing Allocation Efficiency through Promoting Risk-taking

Another justification for this shareholder mode of corporate governance entails one fundamental prop of capitalism — that is, unleashing the individuals’ self-interest nature will lead to the optimal allocation of society’s resources. The limited liability privilege enjoyed by the shareholders of publicly traded corporations is partly devised to this end. Shareholders are not personally liable for debts of the corporation but are only obligated to contribute capital as much as the initial purchase price for their shares to the corporation. With this privilege, the shareholders are the only residual claimers (bearing limited downside losses yet enjoying theoretically unlimited upside gains) of corporate constituents and therefore the only group that has the incentive to promote the company’s risk-taking for their potential maximized interests by monitoring the management’s decision-making. For creditors (including various fixed claimers), it was suggested they have no incentive to take risk to increase the value of the corporation beyond the point where repayments of their claims can be assured because taking such risk can be only harmful if failed and for the best irrelevant if succeeded as all realized profits will then go to the shareholders.

In short, here the risk-aversion tendency connecting with the nature of creditors’ claims is considered undesirable a factor that, if upheld, would have chilled managerial innovation and risk taking. This possible chilling effect was considered would have fundamentally worked against the utility of the modern corporation that “largely comes

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from its ability to allow diversified investors to accept greater investment risk." The tension arisen from the different views as to the optimal risk level to be taken by the corporation is therefore resolved by dramatically tilting to the side of the shareholders. The directors are made accountable exclusively to the collective interests of the shareholders, and, for at least disbursed, passive shareholders of publicly traded corporations, such interests are primarily represented by short-term share price surge.

Implications of this approach manifest in two fronts. First, it directly implicates with formulation of statutory and common-law rules governing the internal structure and internal operation of the corporation's decision-making processes. These rules are guided by the policy objective of encouraging risk taking so as to take advantage of emerging business opportunities and to broaden new business frontiers. Upholding such entrepreneurial spirit is an explicit and essential judicial guidance. In Re Caremark, the former Delaware Chancellor Allen's reasoning went to such lengths, when laying down the adequate standard of judicial reviews over directors' disinterested business decisions, as:

"Where review of board functioning is involved, courts leave behind as a relevant point of reference the decisions of the hypothetical 'reasonable person', who typically supplies the test for negligence liability. It is doubtful that we want business men and women to be encouraged to make decisions as hypothetical persons of ordinary judgment and prudent might.... If those in charge of the corporation are to be adjudged personally liable for losses on the basis of a substantive judgment based upon what an persons of ordinary or average judgment and average risk assessment talent regard as 'prudent' 'sensible' or even 'rational', such persons will have a strong incentive at the margin to authorize less risky investment projects."

Second, it addresses the classic wealth-transfer conflict between the shareholders and including creditors other fixed claimers by not mediating the competing interests of

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34 See Caremark, supra note 1, at 968 (note 16).
36 See Caremark, supra note 35.
the two camps but siding with the shareholders to the detriment of the fixed claimers.37 By excessive dividend distribution made to shareholders, by raising business risk, by taking up additional debt, wealth transfer occurs, taking the bondholders' situation for example, by increasing the value of equity and bringing down the market value of the firm's outstanding debt.38 This is further prompted by the establishment of such incentive alignment instruments as stock option that the management who are best at shifting risk from the shareholders onto including creditors other corporate constituencies are rewarded the most.

4. Entity Separateness

It is important to note the entity boundary has largely been the scope within which the above-mentioned two strands of corporate-law guiding principles have been evolving under the US shareholder governance model. The principle of entity separateness has been strongly guarded even after the emergence of corporate groups,39 where as a matter of commercial reality a holding company holding controlling interests in its operating subsidiaries would operate the group as one single integrated commercial unit fostering the parent's interest or the group's interest as a whole rather than that of the individual corporate entities making up the group.40 Against this group-based operation mode, the law's extension of shareholder limited-liability privilege, originally designed to protect individuals who were solely investors and unable to control the management,

37 See e.g., See Mitchell, supra note 13, at 1213-228 (discussing this shareholder/creditor conflict and arguing the need for extra-contractual protection for the bondholders).
38 See Peter Sigfrid & Judy Day, Who Needs Merger Covenants? An Analysis of The Effects of Takeover Covenants Within a Corporate Governance Perspective, 16 Journal of International Banking Law, 12, 13 (2001) (noting these practice as the three main categories the management can accomplish wealth transfer from fixed claimers to shareholders).
39 See e.g., Tom Hadden, Regulating Corporate Groups: An International Perspective, in CORPORATE CONTROL AND ACCOUNTABILITY 345-6 (Oxford U. Press, Joseph Mc Cahery ed. al., 1994) (noting the background of the emergence of corporate groups in the United States: the formation of corporate groups was initiated in New Jersey in 1888; further developing in the middle of the twentieth century through the process of internationalization of USA based corporate groups; and the dominance of conglomerate groups since 1970s led by the "expansion by acquisitions" takeover wave.).
40 See Enriquez, supra note 35, at note 6 and the accompanying text (citing PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: TORT, CONTRACT, AND OTHER COMMON LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS xxxi (Little, Brown and Company 1987) that "each corporation is a separate legal entity with its own legal rights and duties, even when owned by another corporation and collectively engaged with it and other affiliated corporations in the conduct of fragmented portions of a single integrated business").
to those corporate parents who themselves deeply involved in conducting the groups' business and whose ultimate individual shareholders were already protected by limited liability, has therefore been cited by some leading commentators as a major source leading to various types of corporate-form abuses and to the unjust detriment of corporate stakeholders and therefore posed as a matter to be reformed.

The reformist's proposals, such as the argument for establishing "enterprise liability" and disregarding entity boundary, have however met the court and the laws' consistent reluctance to "piercing the corporate veil" and restricting unlimited liability reach to the corporate parent to only those abusive practices intended to "evade an existing obligation" or presenting "a form of moral culpability". For current purposes, the lenient treatment associated with the corporate parent-shareholder's liability status could thus serve as yet another vindication point that stakeholder protection is by design not to be addressed under the US shareholder governance model, as reflected in the ambit of US corporate law. Promoting shareholder gains then acts as the single yardstick against which managerial performance is to be measured and corporate value fostered.

42 See e.g., Tom Hadden, Regulating Corporate Groups: An International Perspective, in CORPORATE CONTROL AND ACCOUNTABILITY 358-64 (Oxford U. Press, Joseph Mc Cahery ed. al., 1994) (identifying a number of areas where potential and actual abuses associating with using the corporate-group form most likely occur: manipulation of control holdings, misleading accounts, oppression of minority interests, avoidance of liability, avoidance of taxation, and avoidance of competition regulation).
43 See also Blumberg, supra note 41, at 307-8 (arguing for "enterprise liability" and the need to disregarding entity boundary); also see Henry Hansmann & Reinier Kraakman, Toward Unlimited Shareholder Liability For Corporate Torts, 100 Yale L. J. 1879 (1991) (arguing for unlimited shareholder liability for corporate torts).
44 By the same token, another possibility of penetrating the entity boundary by means of establishing subsidiary-to-parent "fraudulent conveyances" is also subject to strict conditions under the Uniform Fraudulent Conveyance Act, the Uniform Fraudulent Conveyance Act, the Uniform Fraudulent Transfer Act, or the Bankruptcy Code in the US. See JONATHAN MACEY ET AL, BANKING LAW AND REGULATION 753 (3d ed. 2001).
46 Id.
II. Managerial Conduct and Multiple Facets of Fiduciary Duties under Delaware Corporate Law

The board of directors and senior management stand at the core of a corporation’s operation in their performing decision-making and oversight functions. Parameters by which their performance is reviewed therefore indicate the desirable pattern of corporate activities to be led to. From a legal and regulatory perspective, one such parameter under the US shareholder model of corporate governance is obviously the open-ended and open-textured fiduciary duty owed by the management to the company. Fiduciary duties owed by directors and corporate officers (collectively “management”) are owed in part to protect the interests of the company and its shareholders.

By law the board has a residual mandate that it could “[a]ct as to all other corporate matters not requiring shareholder approval”. See ALI, Principles of Corporate Governance, § 3.02 cmt. f. Over time it has nevertheless become clear a large publicly traded corporation can not be directly managed by its board, given complexities of such corporation’s affairs and the board’s limited investment of time and its lack of expertise compared to professionally qualified management. Rather, it is more appropriate to rest the first-line managerial responsibility concerning in particular decision-making with the senior executive and the chain of commands under him. As a result, whereas the board still performs certain important management or decision-making functions, such as reviewing or approving the corporation’s financial objectives, major corporate plans and actions, major changes in and choice of the appropriate auditing and accounting principles and practices in the preparation of financial statements, the general division between the board’s general oversight function (over the management) and the professional manager’s decision-making and other managerial functions (including active supervision or day-to-day scrutiny over the corporation’s affairs) is present in a modern-day large company where the board’s primary functions are to “[s]elect, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives, . . . [and oversee] the conduct of the corporation’s business to evaluate whether the business is being properly managed.” ALI, Principles of Corporate Governance, § 3.02(a)(1)-(2); see also Sarah Worthington, The Duty to Monitor: A Modern View of the Director’s Duty of Care, in PERSPECTIVE ON COMPANY: 2 194-7 (Fiona Macmillan Patfield ed., 1997).

The general oversight duty owed by the board and the senior management in terms of installing certain control mechanisms (e.g., information, internal-control and compliance systems) was the focal point of the Caremark decision. The derivative suit in the Caremark involved claims that the members of Caremark International, Inc. (“Caremark”) breached their fiduciary duty of care to Caremark in connection with alleged violations by Caremark employees of laws regulations governing health care providers, which ultimately led to a payment of approximately $250 million to be made by the Caremark as the case finally settled. Where there was no fraud or other knowingly violation at the board level and there was obvious laxity or failures of Caremark’s compliance program, the issues were: first, whether the board’s oversight duties include establishing internal control and information systems; and second, if so, to what extent the board’s should be liable for failure to establish such systems. See Caremark, supra note 1, at 960-61. By stating that satisfaction of the board’s supervisory and monitoring role rested with relevant and timely information, the court was affirmative on the first issue. Id., at 970. However, the board was only liable for failing to establish such control systems to the extent sustained and systemic failures had been found so as to demonstrate the existence of bad-faith.

See ALI, Principles of Corporate Governance, § 4.01 cmt. a (noting it is well settled through case law and statutory provisions in at least 18 states, the officers will be held to the same duty of care standards as directors.)
to companies are regulated by state common law in the United States. This section examines Delaware’s statutory law (the Delaware General Corporation Law) as well as its common law, two major legal sources informing the state’s fiduciary duty law, over their evolving many facets of this open-ended concept in the course of fostering the three guiding principles — minimizing agency Costs, encouraging risk-taking and upholding entity separateness — of the US shareholder model of corporate governance.

By demonstrating the Delaware court’s review modes and standards over the management’s fulfilling fiduciary duties as well as the Delaware General Corporation Law’s exculpation provision, this section will demonstrate on a practical note the largely irrelevance of the due care duty in terms of managerial liability exposure. The Delaware jurisprudence shies away from directing the management not to have an “incentive at the margin to authorize less risky investment projects” in order to correspond to the shareholder’s risk-prone, residual-claimer mindset. The focal point of Delaware’s fiduciary duty system then rests with the scrutiny over disloyal,

49 The duty of care owed by directors and corporate officers to the corporation is considered of different natures across the Atlantic. In the United States, it is generally regarded as one category of the fiduciary duty owed by the directors to the corporation under their stewardship—the common usage of fiduciary duty of care and of loyalty. See e.g., Laura Lin, Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors’ Duty to Creditors, 46 Vand. L. Rev., 1485, 1510 (1993) (noting “[w]hen a company is financially healthy, directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.”)

Under English Law, by contrast, the duty of care as such is not considered a duty of fiduciary nature as fiduciary duties are suggested “prescriptive in nature, and do not encompass the positive duties laid on those described as fiduciaries”. See R.C.Nolan, The Proper Purpose Doctrine and Company Directors, in THE REALM OF COMPANY LAW 2 note 2 (Barry Rider ed., Kluwer Law international,1998) (noting “[w]hile it is correct to describe a director as a fiduciary...not all the duties which affect him are fiduciary duties. For example, duties of care and skill are laid on company directors, yet such duties are not fiduciary duties”); citing cases, inter alia, Breen v Williams (1996) CLR 71, noted (1997) 113 LQR 220; See also Sarah Worthington, The Duty to Monitor: A Modern View of the Director’s Duty of Care, in PERSPECTIVE ON COMPANY: 2 185 (Fiona Macmillan Patfield ed., 1997 ) (noting fiduciary duties are independent of “any more general and wide-ranging ‘duty of care, whether equitable or tortious’

The American version will be used in the following discussion with respect particularly to the application of the “business judgment rule”.

50 See Caremark, supra note 1, at 967 (note 16). It is worthy of recording in its entirety the relevant passage of In re Caremark, which representatively articulated the Delaware Court’s longstanding position that the deferential court review and the aggressive risk-taking incentive it created on part of the corporate management would yield macroeconomic benefits: “The corporate form gets its utility in large part from its ability to allow diversified investors to accept greater investment risk. If those in charge of the corporation are to be adjudged personally liable for losses on the basis of a substantive judgment based upon what persons of ordinary or average judgment and average risk assessment talent regard as ‘prudent’ ‘sensible’ or even ‘rational’, such persons will have a strong incentive at the margin to authorize less risky investment projects.” Id.
self-interest managerial conduct and that of intentional dereliction that can be equated with a good-faith breach.

A. General Fiduciary Duty Framework under Delaware Corporate Law — Disparity of Standards of Conduct and of Review

Traditionally, managerial fiduciary duty is conceptualized under Delaware jurisprudence in primarily two types of cases: duty of loyalty claims entailing directors’ self-interest, primarily pecuniary interest (fiduciary duty of loyalty) and claims involving corporate management did not act with required care (fiduciary duty of care). In June 2006, by affirming in its entirety the Delaware Court of Chancery’s decision in the high-profile Disney litigation, the Supreme Court of Delaware’s seminal decision pinpoints the categories of managerial conduct that may result in a breach of a third type of fiduciary duties, which has been historically an uncharted territory—the fiduciary duty of good faith.

1. Aspirational Standards of Conduct

The conceptualization of the duties of loyalties, care and good faith as reflected in Delaware common law represents the aspirational dimension of standards of conduct expected of the corporate management.

The duty of loyalty, in essence, “mandates that the best interest of the corporation and its shareholders take [ ] precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.” And the classic example that implicates the duty of loyalty is therefore when a fiduciary either appears on both sides of a transaction or receives a personal benefit not shared by all shareholders.

As to the duty of care, case law authorities setting common law duty of care standard can date back to at least the early 1800s. One of the early leading cases,

52 Pogostin v. Rice, 480 A.2d 619, 624 (Del.1984)
Percy v. Millaudon, 54 was decided in 1829 and held that directors were required to use the same care and diligence that an ordinarily prudent person would exercise under similar circumstances. 55 Nowadays, this “ordinarily prudent person” or “conduct of reasonableness” standard largely holds true as the standard of conduct required of corporate directors in performing monitoring and decision-making functions. 56

The duty to act in good faith, which meaning and contours previously observed by the Delaware Court of Chancery as “[s]hrouded in the fog of ... hazy jurisprudence” 57, is affirmed as an independent type of fiduciary duty by Supreme Court of Delaware’s seminal decision In re Walt Disney Co. derivative Litigation in June 2006. 58 Categorized as an intermediate type of fiduciary misconduct between “conduct motivated by substantive bad intent” and “conduct resulting from gross negligence”, 59 the concept of “intentional dereliction of duty”, “a conscious disregard for one’s responsibilities” 60 is now at the heart of deciding whether corporate fiduciaries have acted in good faith. A director’s conscious disregard for his duty of good faith, as suggested by the court, manifests “where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act.” 61

In short, the conceptualization of fiduciary duties suggests that the “conduct of

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54 8 Mart. (n.s.) 68 (La. 1829).
55 Id. at 74-75, 78.
56 See e.g., ALI, Principles of Corporate Governance, 4.01 (a) (“A director or officer has a duty to the corporation to perform the director’s or officer’s functions...with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances”). Insofar as the board’s duty to exercise due care in making a business decision is concerned, for example, a decision made by an “ordinarily prudent person” means the one flowing from a reasonable decision-making process and of reasonable quality in substance. See Melvin Eisenberg, The Divergence of Standards of Conduct and Standards of Review in Corporate Law, 62 Fordham L. Rev. 437, 441 (1993); see also William T. Allen et al, Realigning the Standard of Review of Director Due Care With Delaware Public Policy: A Critique of Van Gorkom and Its Progeny As a Standard of Review Problem, 96 Nw. U. L. Rev., 449, 452 (2002) (noting the normative standard of conduct is “reasonableness”).
57 In re Walt Disney Co. Derivative Litigation 907 A.2d 693, 755 (Del.Ch., 2005).
58 In re Walt Disney Co. Derivative Litigation 907 A.2d 27 (Del., 2006).
59 Id., at 67.
60 Id.
61 Id.
reasonableness” requirement\(^6\) appears to suggest a seemingly negligence standard of conduct in relation to managerial decision-making and oversight functions, akin to the objective reasonableness due care in tort law. This aspirational aspect of fiduciary duties however remains incomplete an observation. One has to read it into both the court review context and the context of statutory law to fully comprehend the fashion in which it functions as a control-and-direction mechanism over managerial conduct. The court review context concerns primarily the judicial exercise of the business judgment rule, while the enactment of the exculpation provision (section 102 (b) (7)) of the Delaware General Corporation Law (“DGCL”) impacts tremendously on the reach of the duty of care.

2. Business Judgment Rule and Divergence between Standards of Conduct and of Review

The business judgment rule is not a substantive rule of law, but instead a rebuttable presumption. When reviewing a fiduciary duty claim, the Delaware court presumes the defendant-director had met three prerequisites underpinning the rule, and employs a “rationality” review standard should the plaintiff fail to rebut the presumption. The three prerequisites are, in making a business decision, the director had acted in good faith; been disinterested; and employed a decision-making process that had him informed.\(^6\) If all these prerequisites fail to be rebutted, then the directors’ honest, informed business decision will be protected by the business judgment rule with a “rationality” reviewing test employed,\(^6\) which “as a practical matter, is that the decision is not reviewed”.\(^6\)

If these prerequisites are successfully rebutted on the ground of self-dealing, i.e., the director having a personal interest in the transaction at question that is adverse to the

\(^{6}\) See, e.g., Allen et al, supra note 56, at 452 (noting the normative standard of conduct is “reasonableness”).

\(^{6}\) Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); See also In re Walt Disney Co. Derivative Litigation 907 A.2d 693, 746-47 (Del. Ch., 2005).

\(^{6}\) Smith v. Van Gorkom, 488 A. 2d 858, 872 (Del. 1985); See also Aronson v. Lewis, 473 A. 2d 805, 812 (Del. 1984). Accord, e.g., Brehm v. Eisner, 746 A. 2d 244, 264 (Del. 2000). For the current purpose, an irrational act is “one that is so blatantly imprudent that it is inexplicable, in the sense that no well-motivated and minimally informed person could have made it”. Allen et al, supra note 56, at 452.

\(^{6}\) Id., at 457.
shareholders, the “absolute fairness test” applies. The director then will be imposed the burden of showing that the transaction is entirely fair, both as to the decision-making process and the transaction price. As to rebuttal on the ill-informed ground, the plaintiff-shareholder will first establish the decision had not been made on an informed basis (an element established since the Delaware Supreme Court’s seminal decision of *Smith v. Van Gorkom* in 1985)\(^66\) and, second, such defective decision-making procedure came out of “gross negligence”, a review standard observed by some leading commentators as “akin to the reckless standard employed in other [non corporate-law] contexts”.\(^67\)

It should be noted the business judgment rule applies only to the extent where there is a director-made or authorized decision.\(^68\) By decision the applicable scope of the business judgment rule however does not restrict to only those risk-taking or economic corporate decisions where a third party is usually involved; a decision on such internal procedures, programs and systems as “not to establish a written compliance program, but instead to delegate to an appropriate officer” is also within its range.\(^69\) Thus, as a matter of law, only those inactions that are “unconsidered”\(^70\) would fall outside the

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\(^{66}\) The element of “being informed” as one prerequisite qualifying the application of the business judgment rule as the review standard was firmly established by the Delaware Supreme Court’s watershed decision of *Smith v. Van Gorkom* in 1985, the year when “the duty of care emerged in Delaware as an independently enforceable obligation”. See Allen et. al., supra note 51, at 1290. In *Van Gorkom*, outside directors who had approved, out of good faith, a sale of the corporation (a merger deal) at a fifty percent premium over the stock market price were held to have breached their duty of care by the Delaware Supreme Court for their decision was considered gross negligent. See Smith v. Van Gorkom. 488 A.2d 858, 893 (Del. 1985). The gross negligence came not from the decision’s substance but derived from the matter of process—the outside directors were held liable for having reached their decision too hastily as the right information had not been obtained and the right questions not asked. The court decided the board had failed “(i) to require an independent valuation of the corporation or, alternatively, a reliable post-signing ‘market check;’ (ii) to negotiate an adequate “no shop” clause that would enable the board to consider a higher offer and give the board a reasonable basis to terminate the agreement; and (iii) to resist the CEO’s domination of the decisionmaking process leading to the sale of the company.” See Allen et. al., supra note 51, at 1300-01 (summarizing Smith v. Van Gorkom. 488 A.2d 858, 870-93 (Del. 1985)).

\(^{67}\) See Allen et al, supra note 56, at 453, note 18-9 and accompanying text (“In the corporate context, gross negligence means ‘reckless indifference to or a deliberate disregard of the whole body of stockholders’ or actions which are ‘without the bounds of reason’ ”, citing from Tomczak v. Morton Thiokol, Inc., No. 7861, 95 Fed. Sec. L. Rep. (CCH) 327 (Del. Ch., 1990)).


\(^{69}\) ALI, *Principles of Corporate Governance*, cmt. (a)(1)-(a)(2).

\(^{70}\) See Caremark, supra note 1, at 968 (using the phrase “unconsidered inaction” to refer to cases implicating with the liability for failure to monitor).
coverage of the business judgment rule.

The above summations of the manner in which the Delaware court conducts their fiduciary duty reviews suggest a distinction between the standard of deferential judicial reviews and the standard of an aspirational or rhetorical ordinary-negligence duty — referred by some leading legal scholars as the divergence between the “standard of conduct” and “standard of review”. Whereas the former aspirational or rhetorical goal is addressed to directors, the latter setting forth review criteria is addressed to courts. One version of this analytical framework is now contained in the Model Business Corporation Act.

This divergence is arguably even greater than the negligence vis-à-vis gross-negligence gap in the decision-making context where the alleged misconduct falls into an unconsidered inaction context. As enshrined in In Re Caremark, “only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists — will

71 MELVIN EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 544-49 (8TH ED. 2000); Melvin Eisenberg, The Divergence of Standards of Conduct and Standards of Review in Corporate Law, 62 Fordham L. Rev. 437, 437 (1993) (“A standard of conduct states how an actor should conduct a given activity or play a given role. A standard of review states the test a court should apply when it reviews an actor’s conduct to determine whether to impose liability or grant injunctive relief.”); see also Allen et al, supra note 56, at 449 (discussing policies underlying this approach and applying this framework to reviewing several Delaware cases regarding directors’ duty of care); but see Stephen Bainbridge, The Business Judgment Rule As Abstention Doctrine, 57 Vand. L. Rev. 83, 89 (2004) (arguing the operation of the business judgment rule constitutes an abstention doctrine as opposed to conceptually any standard of liability, however lenient such standard might be, and it establishes a presumption against judicial review of duty of care claims).

72 Allen et al, supra note 56, at 451.

73 MBCA 8.30 requires the directors to act in good faith and in a manner the director reasonably believes to be in the corporation’s best interest. Model Bus. Corp. Act 8.30 (a)(2002). Conduct falling short of those sec 8.30 requirements can only result in liability to the extent it violates the liability standards stated in MBCA 8.31. Id. 8.31 cmt. Namely, liability can be imposed where the director acted in bad faith, did not reasonably believe the action to be in the corporation’s best interest, was not informed to the extent the director reasonably believed appropriate under the circumstances, was interested in the transaction, was not independent, engaged in self dealing, or failed to exercise oversight over a sustained period. Id. 8.31 (a)(2).

This divergence was noted in at least one federal case in early 1990s. See Joy v. North, 692 F. 2d 880, 885 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983) (“While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading...Whereas an automobile driver who makes a mistake in judgment...will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment...will rarely, if ever, be found liable for damages suffered by the corporation”); See also Charles Hansen, The Duty of Care, The Business Judgment Rule, And The American Law Institute Corporate Governance Project, 48 Business Lawyer 1355, note 15 and accompanying text (1993).
establish the lack of good faith that is a necessary condition to liability".\textsuperscript{74} The \textit{In Re Caremark} standard stretching so far as to require an establishment of the defendant-director’s “lack of good faith” (that is, bad faith) before liability imposition suggests outside the decision-making context a blurred boundary between due care and good faith (or loyalty) reviews.

3. Managerial Due Care Duty under Exculpation Statute

The Delaware system’s refraining from second-guessing disinterested and good-faith managerial conduct manifests not only in court reviews but also in statute. Delaware’s quick response to the Van Gorkom decision by enacting the director exculpation statute (section 102 (b) (7)\textsuperscript{75} of DGCL) has substantially reversed the potentially enormous liability impact\textsuperscript{76} emanating from the process due care requirement established since Van Gorkom. Section 102 (b)(7) of the DGCL allows Delaware corporations to include in their certificates of incorporation a provision limiting or eliminating the monetary liability of their directors for breaching fiduciary duty, subject to the statute’s explicitly prohibiting exculpation for duty of loyalty violations, for transactions deriving an improper personal benefit, and for actions not taken in good faith. The Delaware’s move was followed by the vast majority of states, which adopted the similar version of liability exculpation as Section 102 (b) (7).\textsuperscript{77}

The practical effect of the enactment of Section 102 (b) (7) as shown by a survey is, of one hundred of the largest American corporations, only seven did not have such protection for their directors.\textsuperscript{78} In other words, corporate directors in the United States

\textsuperscript{74} See Caremark, supra note 1, at 966; See also Charles Hansen, \textit{The Duty of Care, The Business Judgment Rule, And The American Law Institute Corporate Governance Project}, 48 Business Lawyer 1355, 1358 (1993) (detaching the “good faith” concern from due care discussion but noting “express abandonment of duty or patterns of exacerbated neglect amounting to an abandonment of duty” as the basis of due care violations).
\textsuperscript{75} Del. Code Ann. Tit. 6, § 102 (b) (7) (2003).
\textsuperscript{76} The case of Van Gorkom was finally settled for $ 23 million, and the directors sustained in person for damage a total of $ 13 million, which was the amount beyond the coverage of the D & O insurance. See John Reed & Matt Neiderman, “Good Faith” and the Ability of Directors to Assert §102 (B)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty, 29 Del. J. Corp. L. 111, 113 (2004).
\textsuperscript{77} See Model Bus. Corp. Act Ann. §2.02, Statutory Comparison, note 6, at 2-31 (comparing more than 40 states that have exculpation provisions).
are now largely immune from the gross negligence liability pertaining to the process-centred due care requirements. With the adoption of the exculpation statute, the remaining relevance of the due care duty is therefore limited to its acting as the basis for rescinding or enjoining a transaction, subject to the same deferential process-oriented judicial review as applied to liability review. 79

4. Intentional Dereliction and Disloyalty Cases as Fiduciary Duty Claims of Practical Relevance

The Delaware court’s review over directors’ disinterested and good-faith activities is highly deferential to the extent, as noted by one authority, “the pre-Van Gorkom case law reflected a judicial aversion to reviewing directors action for any purpose other than identifying (and remedying) breaches of the duty of loyalty”. 80

In fact, even after the 1985 Van Gorkom decision, the substance or quality of a managerial decision is still off limits to the court’s review; instead, it is the process due care concept81 emerging as the core of the due care review — a director will only be personal liable for, out of gross-negligence, being ill-informed during decision-making processes which incur losses on the corporation entrusted to him. With this process-oriented review mode being subsequently rendered largely irrelevant upon the enactment of the exculpation statute in Delaware (and followed by other states) and a vast majority of Delaware companies’ adoption of it, so has due care duty become irrelevant in term of the management’s liability exposure.

On a practical note, the recent high-profile decision of re Walt Disney Co. Derivative Litigation 82 is then instrumental. By explicitly linking deliberate indifference83 in performing managerial functions to a breach of good faith duty, which

79 Allen et al, supra note 56, at 451, note 10 and accompanying text (arguing for the same reason of promoting beneficial risk-taking, the same review standard should be adopted in the context of rescinding or enjoining a transaction as should in the liability context).
80 Allen et al, supra note 56, at 450.
82 825 A. 2d 275 (Del. Ch. 2003).
83 The court concluded the alleged facts had been successful in giving rise to a reason to doubt business
falls outside the protection of Section 102 (b) (7), the Delaware judiciary indicates that intentional abdication of managerial function has emerged as a primary type of misconduct implicating with managerial fiduciary liability exposure. Specifically, the projection of these intentional dereliction claims might at least cover two subsets of misconduct demonstrating a good-faith breach: first, the Re Caremark type of sustained and systemic failures concerning establishing internal controls or procedures; second, the intentional violation of applicable positive law and regulations. 84

Overall, intentional dereliction good-faith violations, alongside self-interest loyalty breaches, would then become the focal point implicating with managerial fiduciary-duty liability under Delaware law.

B. Shareholders as Enforcers and Ultimate Beneficiaries of Managerial Conduct

The shareholder’s general exclusive beneficiary status in connection with managerial conduct is manifest under Delaware law. 85 Shareholders’ dominance over other corporate constituencies is further enhanced by being the exclusive enforcer of fiduciary judgment protection by stating “...the facts alleged in the new complaint suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a ‘we don’t care about the risks’ attitude concerning a material corporate decision.” (Emphasis included) Id. at 289.

84 See E. Norman Veasey, State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors, 28 J. Corp. L. 441, 447 (2003) (noting that intentional violations of law implicate good faith by stating that “the utter failure to follow the minimum expectations of Sarbanes-Oxley, or the NYSE or NASDAQ Rules ... might ... raise a good faith issue”).

85 Delaware’s jurisprudence holds firm the primacy of shareholder interest in connection with the management’s decision-making and oversight functions. Among the rare exceptions where other corporate constituencies’ interests might override that of the shareholder concerns the board’s deliberation over a hostile takeover threat. The shareholder’s exclusive duty-recipient status was clearly supported by the Delaware courts. For example, the Former Chancellor William Allen in a 1986 case stated: “[i]t is the obligation of directors to attempt, within the law, to maximize the long-term interests of the corporation’s shareholders; that they may sometimes do so ‘at the expense’ of others...does not for that reason constituting a breach of duty.” See Katz v Oak Indus, Inc., 508 A.2d 873, 879 (Del Ch 1986); see also Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A. 2d 173, 182 (Del. 1986) (to the same effect of Katz); Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1993) (“the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.”) (quoting Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) (citations omitted); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) (directors owe “fundamental fiduciary obligations to the corporation and its shareholders.”) (footnote and citations omitted); Guth v. Loft, 5 A.2d 503, 510 (Del. 1939) (“Corporate officers and directors... stand in a fiduciary relation to the corporation and its shareholders.”).

The takeover exception might occur in connection with directors’ defensive measures towards a hostile takeover and the deciding factor considered can be the “impact [of the takeover] on ‘constituencies’ other than shareholders...perhaps even the community generally”. See Unocal Corp v Mesa Petroleum Co, 493 A.2d 946, 955 (Del 1985).;
C. Managerial Functions in Change-of-control Context and Corresponding Judicial Review

Delaware courts’ disparate responses in reviewing transactions of mergers and acquisitions or transactions involving tender offers (hereinafter “change-of-control deals”) are a typical exercise of how the triad of the intertwined policy concerns embedding Delaware corporate law — promoting shareholder interests to boost risk-taking, minimizing the managerial agency cost and maintaining corporate separateness — is considered and realized. For our current purposes, change-of-control deals are instrumental for at least two reasons.

First, the lion share of fiduciary duty claims takes place in the change-of-control setting. Based on data of all suits filed in 1999 and 2000 in the Delaware Chancery Court, a study suggested approximately 80 percent of the fiduciary duty claims are class actions against public companies challenging director conduct in mergers and acquisitions. 87

Second, the diversity of judicial reviews in the change-of-control setting concerning fiduciary duty claims provides a wealth of sources for legal and policy analyses. This diversity comes from certain inherent tensions in the change-of-control context. Where there are different kinds of change-of-control deals, different levels and natures of built-in tensions among various corporate constituencies arise, met by judicial reviews predicating on disparate review parameters. For one thing, the incumbent management’s stake of continuously holding on to office might clash with the stockholders’ interests of simply securing the best tender price on offer. 88

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86 See Mitchell, supra note 13, at note 73 and accompanying text (citing cases regarding the shareholders’ procedural standings as to bringing derivative actions on behalf of the corporation and appraisal proceeding).


88 This category of cases differs from the traditional one of breaching duty of loyalty, which primarily involved self-interest transactions from which the directors derived personal financial interests. In a
another, even absent dispersed shareholding and thus entrenched management, the shareholder interest could still directly compete with that of stakeholders such as the employee in a change-of-control deal context—the former might be willing to sell out the company to the highest bidder; the latter might tend to reject the deal to avoid job losses. Furthermore, the judicial considerations of upholding the principle of entity separateness might add an extra twist to tension scenarios in the parent-subsidiary context of a change-of-control deal.

The above-stated tension scenarios corresponding to selective leading Delaware judicial decisions will be discussed and analyzed below. It is found in various tension scenarios the court decisions are meant to direct managerial conduct to exclusively fostering the interest of the shareholder, not that of those non-shareholder stakeholders. And the court in generally honors the corporate separateness principle during review, notwithstanding this approach might actually work against the commercial reality.

1. Judicial Reviews over Tensions Deriving from Entrenched Management

Absent a parent-subsidiary or a controlling-minority shareholder context, even though Delaware courts generally recognize that managerial decisions made in the change-of-control context would more likely involve self-dealings or conflicts of interests and hence more likely pose greater risk of agency costs than otherwise, the court’s normally deferential standard of review would generally apply to such deals should the court have been convinced the deal at question was negotiated on an arm’s length basis.

Against this backdrop, *Unocal Corp. v. Mesa Petroleum*, the celebrated case decided by the Delaware Supreme Court in mid 1980s, is instrumental in that it shows the possibility of an enhanced fiduciary duty in the change-of-control context by recognizing “there is an enhanced duty which calls for judicial examination at the change-of-control case, the director has no direct pecuniary interest but an entrenchment interest—“an interest in protecting their existing control of the corporation”. See Allen et al, supra note 51, at 1290.


90 The business judgment rule, including the standards by which director conduct is judged, is applicable in the context of a takeover. *Pogostin v. Rice*, 480 A.2d 619, 627 (Del., 1984).
threshold before the protections of the business judgment rule may be conferred".  

In Unocal, the court reviewed tactics adopted by the board intended to purchasing shares with corporate funds (a self-tender offer by corporation for its own shares) against a hostile deal of two-tier “front loaded” cash tender offer launched by a minority shareholder. Whereas such defensive measure was considered not universally disallowed, the Unocal court noted “...the inherent danger in the purchase of shares with corporate funds to remove a threat to...” control and, under such circumstances, “[t]he directors are of necessity confronted with a conflict of interest...” to secure their remaining in office by deploying corporate funds. As a result, despite the court’s findings the defensive tactics had been effected by an independent board acting good faith, an intermediate review standard (of the intensity between the deferential business judgment rule and the entire fairness principle) was adopted: in order to sustain defensive measures over a judicial-review challenge, the board was required to prove the existence of a threat to the corporate policy and effectiveness and that the defensive tactic was a proportional response to that threat.

2. Judicial Reviews over Tensions between Shareholders and Stakeholders

In Revlon v. MacAndrews & Forbes Holding, Inc., the Delaware Supreme Court affirmed the Court of Chancery’s decision which found the directors of Revlon, Inc. (Revlon) had breached their fiduciary duty of loyalty to the shareholder by entering into transactions that effectively ended an active auction for Revlon, and consequently enjoined three defensive measures accorded to one bidder by the board against another, i.e., a lock-up option, a no-shop provision and a promise of payment of $25 million

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92 Id., at 955.
93 Unocal Corp. v. Mesa Petroleum Co., 954-5.
cancellation fee. 95

Revlon was the case dealing with the tension between stockholders and other stakeholders. In the change-of-control context, the shareholder-stakeholder tension becomes imminent when the break-up of a company is inevitable, following a high bidding price that would almost guarantee stockholders to be tempted to tender their shares. While the stockholders are happy to accept the premium price on offer, the company’s ultimate break-up and sold-out upon the deal’s consummation might see such stakeholders as the employee loses their jobs. 96 In Revlon, imminence of this tension in the face of an active hostile bidding contest for corporate control happened when Pantry Pride (one of the bidders in question) increased its offer to $50 per share, and upon which, as directed by the Court, “[t]he directors’ role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.” 97 Ultimately, it was decided the Revlon board had breached its duty of loyalty to the shareholders by deciding not to sell the company to the highest bidder. 98

The Revlon duty was expanded by the Delaware Supreme Court in Paramount Communications Inc. v. QVC Network Inc. that brought back the application of the test to well ahead of the corporation’s inevitable break-up to include simply “a sale of control”. 99

3. Judicial Reviews in Parent-subsidiary Context and Entity Separateness

Subsidiary directors’ fiduciary duty is one extremely troublesome topic of American

95 Id, at 176
97 Id, at 182.
98 Id.
99 The Court noted: “There are few events that have a more significant impact on the stockholders than a sale of control or a corporate break-up. Each event represents a fundamental (and perhaps irrevocable) change in the nature of the corporate enterprise from a practical standpoint. It is the significance of each of these events that justifies: (a) focusing on the directors’ obligation to seek the best value reasonably available to the stockholders; and (b) requiring a close scrutiny of board action which could be contrary to the stockholders’ interests.” See Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 47-8 (1993).
The root cause at the heart of this difficulty is that the domination-accountability mismatch normally embedding the management-shareholder relationships on which the *Unocal* rule was premised simply does not exist in parent-subsidiary transactions. The parent with its block shareholding as the subsidiary’s majority shareholder (or in simply a sole-shareholder capacity) is fully equipped to control the subsidiary’s management if it chooses so. The parent-subsidiary tension therefore lies elsewhere.

Comparing to the minority shareholder’s predicament in a change-of-control transaction where the majority block-holder may force through an offer with a below-market price to have the minority shareholder tender their shares in order to wholly own the company, the subsidiary’s minority shareholder in a merger deal would suffer just the same from inferior bargaining power against the parent’s offer. Whereas in case law it is well established that the majority owes fiduciary duty to the corporation’s minority shareholder when in relation to the corporation it controls the majority stands on both sides of the transaction, the problem is much more complex in the parent-subsidiary setting as, unlike the ordinary majority-minority shareholder tension that goes on under the same corporate roof, here at least two legal entities are involved.

In Delaware, the review standard of a transaction between the parent and its subsidiary was addressed by the Delaware Supreme Court’s seminal decision, *Weinberger v. UOP*, re-confirmed and reinforced by the same court’s several

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101 Id.

102 See Id., at 290 (illustrating the divergence of interests between the parent (as the majority shareholder) and the subsidiary’s minority shareholder that, under a group structure, would give the parent incentive to command over its subsidiaries deals that are detrimental to one particular subsidiary’s minority shareholders but beneficial to the group as a whole, e.g., an overly risky loan commanded by the parent to be made by its bank subsidiary to its another subsidiary that is nearly bankrupt.)


following decisions. Of the primary issues in Weinberger was to whom the fiduciary duty were owed by the directors holding dual directorships at both parent and subsidiary companies’ boards. Putting in context, it involves two directors holding the parent-subsidiary dual directorships failed to disclose to the subsidiary’s board information regarding a feasibility study made by them exclusively for the interest of the parent’s proposed merger with the subsidiary. The court decided the two directors breached their fiduciary duty of loyalty to the subsidiary as the disclosure to the subsidiary board was wholly flawed and thus failed to pass the strict “entire fairness” judicial challenge. The fact they held dual directorships simply put them on the two sides of the transaction in question, invited the application of the stringent entire fairness review and provided no safe harbor for such divided loyalties. Weinberger court then fashioned its ruling along the entity line and decided “...individuals who act in a dual capacity as directors of two corporations, one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations”. It further noted in this context the duty is to be performed and reviewed judicially “in light of what is best for both companies”— a review standard hardly sheds any light on its substance.

105 See e.g., Kahn, supra note 103, at 1120-21 (noting the burden of proving entire fairness shifted to the plaintiff-shareholder in an interested merger transaction upon the approval of an independent, informed committee that had the freedom to negotiate at arm’s length); Emerald Partners v. Berlin, 787 A.2d 85, 97 (Del. 2001) (“The decision in Weinberger continues to be the seminal pronouncement by this Court regarding the entire fairness standard of judicial review.”).

106 Since the subsidiary at question was not wholly owned by its parent, Weinberger also addressed the fiduciary duty owed by the majority shareholder to the minority shareholder. The court restated the entire fairness review test as applied to the fiduciary duty owed by the parent (the majority shareholder of the subsidiary) to the minority shareholder of the subsidiary. And it found the directors (taking the parent/subsidiary dual directorship) withholding information did result in the subsidiary’s minority shareholder losing over $17,000,000 by not being able to secure a better deal with the parent. See Weinberger, supra note 104, at 714.

107 Id., at 708 & 711.

108 Weinberger Court opined the concept of fairness has two fundamental aspects, i.e., fair dealing and fair price. While “[a]ll aspects of the issue must be examined as a whole since the question is one of entire fairness”, in the absence of a fraudulent transaction, the court noted, the price may be the predominant consideration outweighing other factors of the merger. See Id., at 711; see also Kahn, supra note 103, at 1115 (“[a] controlling or dominating shareholder standing on both sides of a transaction, as in a parent-subsidiary context, bears the burden of proving its entire fairness.”)

109 Id., at 710.

110 Id.

111 Id. 711

112 One may try to justify the Weinberger approach of requiring the subsidiary director to pledge their
What makes the Weinberger formula more puzzling is its application to wholly-owned subsidiary directors’ fiduciary duty. What if in Weinberger the subsidiary in question was wholly owned by a single shareholder and by withholding information from the subsidiary board, actually none of the shareholder interest could have possibly been hurt, but, on the contrary, such practice would have only facilitated the shareholder — the parent — entering into and consummating the deal. Under this hypothetical situation, could the requirement for undivided loyalty pledged to the subsidiary (as opposed to the sole shareholder) still be realistic and reasonable for the subsidiary director who was appointed by the parent and whose job, in reality, might be no more than doing the bidding of the parent?\textsuperscript{113}

Delaware Supreme Court has at least in one case (Anadarko Petroleum Corp. v. Panhandle Eastern Corp.) explicitly ruled out the ordinarily prevalent formula: “...in a parent and wholly-owed subsidiary context, the director of the subsidiary are obliged only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders”.\textsuperscript{114} The Anadarko decision is a logical adjustment to the judiciary’s ordinary formula working along the entity-boundary. This approach is coherent with the current system’s core value of safeguarding shareholder interests, and shareholder interests only.

It is for practical reason as well, as observed by Gouvin:

“They [directors of the wholly owned subsidiary] understand that ultimate control of the corporation rests with the shareholders, who can either sell their shares to other investors

\textsuperscript{113} The subsidiary director’s dilemma under current law was aptly put by one commentator as: “[c]ase law leaves subsidiary directors wondering whether their duty runs primarily to the parent corporation as shareholder, to the subsidiary corporation itself as an entity, or even to other constituencies such as creditors, regulators, employees, and communities.” See Gouvin, supra note 100, at 289.

\textsuperscript{114} 545 A. 2d 1171, 1174 (Del. 1988).

To whom the wholly-owned subsidiary’s director owes his fiduciary duty is certainly not a settled issue in the United States. See, e.g., Enriquez, supra note 35, at 97 (“...directors of a wholly-owned subsidiary owe the corporation fiduciary duties, just as they would any other corporation.”, cited from First Am. Corp. v. Al-Nahyan 17 F. Supp. 2d 10 (D.D.C. 1998)).

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or vote different directors into office. The directors also understand that the shareholders are the only group that can sue the board on behalf of the corporation. This centralization of power in the shareholders focuses director attention on shareholder interests to the exclusion of other interests."

Consequently, before any fundamental change being made to the current shareholder-centered corporate law environments, the shareholder’s exclusive legal standing of enforcing fiduciary duty claims and the corporate representative system for example, the reality is that the wholly-owned subsidiary’s director can only have the incentive to work towards the interest of the subsidiary’s parent, as the sole shareholder, not that of the company, notwithstanding the law may require an undivided loyalty.

D. Stakeholder Protection

In terms of stakeholder (as opposed to shareholder) protection, corporate management are under an established duty to refrain from knowingly causing or permitting the corporation to violate the law or regulation that is aimed at protecting stakeholders. If they did breach the duty and, consequently, financial damages had been inflicted on the corporation (e.g., taking the form of penalties against the corporation imposed by a governmental agency), they could be sued by the shareholders on behalf of the corporation for fiduciary duty violations. Other than this deliberate violation of stakeholder law or regulation, stakeholder protection is largely not a corporate-law agenda standing in its own right but simply the one relegated to the overall consideration for promoting shareholders’ profits.

1. Stakeholder Protection in General: Derivative Approach under Corporate Law

For stakeholders such as employees or creditors who stand outside the insolvency context, efforts to promote their interests by resorting to the corporate management’s

115 See Gouvin, supra note 100, at 303.
duty owed to the “company” will be much likely nothing but a futile operation. This observation holds true notwithstanding some reform proposals seemingly display a more inclusive approach. Although addressed to the UK’s context, the “enlightened shareholder value” approach included in the UK’s recent company law reform provides a good reference point to the “constituency clause” adopted by American state corporate statutes.

The term enlightened shareholder value was used in the Final Report published in July 2001 by the Steering Group, the body leading the UK’s Company Law Review launched since March 1998. As declared by the government, this value will set the tone in implementing changes recommended by the Company Law Review to the current law. As far as directors’ duties are concerned, one draft statutory statement in the Final Report provides that “a director of a company must in any given case (a) act in the way he decides, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole…; and (b) in deciding what would be most likely to promote the success, take account in good faith of all the material factors that it is practicable in the circumstances for him to identify”(emphases added). It follows immediately in the explanatory note that “the material factors” to be taken into account for the purpose of “promoting the benefit of its members as a whole” when directors discharge duties include business relationships (such as those with employees, suppliers and customers), impacts on the communities and environments and reputation of the company. With the key-phrase “success of the company for the benefit of its members as a whole”, obviously the lip service provided here will not alter the current duty framework, which place stakeholder interests (if considered at all)

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118 In March 1998, the Department of Trade and Industry (DTI) launched a fundamental review of English company law whose aim is to “develop a simple, modern, efficient and cost effective framework for carrying out business activity in Britain for the twenty-first century”. For more background information of the Company Law Review, see the DTI website http://www.dti.gov.uk/cld/review.htm.

119 The DTI expressly declared the concept of enlightened shareholder value as a core value to the company law reform. See http://www.dti.gov.uk/cld/review.htm.

120 Steering Group, Final Report, Section 2, Sch. 2, Annex C.

121 Steering Group, Final Report, notes to Section 2, Sch. 2, Annex C.
subordinated to that of the shareholder rather than they are enforceable and valid in their own right. 122

The English “enlightened shareholder value” approach with respect to concerns over non-shareholder corporate constituencies is comparable to the constituency clause incorporated into more than half of state corporate laws back to 1980s in the US. For one thing, they are all permissive rather than mandatory in nature. An Indiana Clause, for example, provides: “In discharging the duties of their respective positions, the board of directors, committees of the board, individual directors and individual officers may, in considering the best interests of the corporation, consider the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices or other establishments of the corporation are located and all other pertinent factors”. 123 Noticeably, this seemingly broad coverage concerning stakeholder interests was qualified by the ALI that “directors may take into account the interests of other constituencies but only as and to the extent that the directors are acting in the best interests, long as well as short term, of shareholders and the corporations.” 124 Moreover, in Revlon v. MacAndrews & Forbes 125 where the Supreme Court of Delaware for the first time addressed the extent to which the management, in the takeover context, may consider the impact on constituencies other than shareholders, 126 the court decided whereas a concern for various corporate constituencies was proper when addressing a takeover threat, “that principle is limited by the requirement that there be some rationally related benefit accruing to the stockholders”. 127 As a result, the net effect of these enabling constituency clauses is no more and less than the proposed enlightened shareholder value, working to the similar effects of diluting the shareholders’ power on one hand and restating the boards’ broad business discretion

122 See e.g., Lilian Miles, Company Stakeholders, 24 The Company Lawyer 56, 57-8 (2003).
123 ALI, PRINCIPLES OF CORPORATE, Note 6 to Sec. 2.01 (citing this Illinois clause from III. Ann. Sta. ch.32, sec. 8.85 (Smith-Hurd Supp. 1989))
124 Id. (citing from Committee on Corporate Laws, Other Constituencies Statutes: Potential for Confusion, 45 Bus. Law. 2253, 2269 (1990)).
126 See id. at 176.
127 See id. At 182. The passage is “[a] lthough such [stakeholder] considerations may be permissible, there are fundamental limitations upon that prerogative. A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the shareholders”.

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under the traditional business judgment rule on the other. 128 "The statutes are a shield for managers, not a sword for...other non-shareholder groups". 129

One extra caveat warrants mentioning here is that Delaware never adopts constituency statute. Apart from the management’s knowingly violating the positive law and regulations addressing stakeholder protection leading to the corporation’s losses (for example, taking the form of the labor agency’s penalty assessment on the corporation for breaching the minimum wage protection accorded to the employee), which upon the Disney decision has been confirmed as a sub-set of the bad-faith breach, the slim likelihood that stakeholder protection can somehow be covered by the management in discharging their fiduciary duties could therefore come only from a reference to the “long-term” interests of the shareholders. In other words, in real world these permissive “good-cause” rules can give only very little, if any, impetus in guiding the behaviors of corporate management beyond philanthropic activities that have secured the shareholder’s endorsement.

2. Creditor Protection under Insolvency Exception

One of the rare situations under which there is a possibility the Delaware corporate law and the court might put the interests of stakeholders ahead of those of shareholders is insolvency. 130 Some Delaware courts go further back that while the company’s

129 See Brett McDonnell, Corporate Constituency Statutes and Employee Governance, 30 Wm. Mitchell L. Rev. 1227, 1231 (2004). McDonnell noted today the constituency statutes have very little use in the courtroom: "Few court cases have even mentioned constituency statutes, and the statutes do not seem to have been decisive for the outcome in cases that do mention such statutes". One reason constituency statutes do not make a visible impact in court was suggested to be if “…an action is defensible only by reference to groups other than shareholders is not likely to help the corporation’s share price" See Id. at 1232; see also Jonathan D. Springer, Corporate Constituency Statutes: Hollow Hopes and False Fears, 19 Ann. Surv. Am. L. 85 (1999).
130 An insolvency situation can be legally indicated differently. It can be “the inability of a corporation to pay its debts as they become due in the usual course of business.” See MODEL BUS. CORP. ACT § 6.40 (c)(2). The U.S. Bankruptcy Code adopts a different standard and defines insolvency as “a financial condition such that the sum of such entity’s debts is greater than all of such entity’s property at a fair valuation.” See 11 U.S.C. § 101 (32)(A).
It was suggested the Delaware Chancery Court routinely chooses to use the “inability to repayment” formulation of the Model Business Corporation Act as it better reflects the dynamics of corporate business. See Gary Marsh, The Many Faces of Directors’ Fiduciary Duties, 22 American Bankruptcy Institute Journal 14, 15 (2003). This view is supported by cases such as Geyer v. Ingersoll Publications Co., 621
financial situation is “in the vicinity of insolvency” or “approaches insolvency” the directors might owe some forms of fiduciary duties to the creditors. Conversely speaking, one basic rule is that director of a solvent company does not owe fiduciary duties to the company’s creditor, and, rather, it is by way of contractual arrangements for creditors to protect their interests.

The rationale underpinning this insolvency exception is, in essence, because while the shareholders’ capital become depleted, creditors become residual risk bearers whose recovery is dependent on the business decisions of directors and management. The following examines in case law, apart from the management’s duties in relation to protecting creditors’ contractual and priority rights, the extent to which the court extends an affirmative and general claim to the creditors. The findings are, while as indicated by the Delaware Chancery Court’s Credit Lyonnais decision, the management could be under a duty to mediate among the interests of the shareholder and the creditor when the corporation approaches insolvency but remain solvent, the court failed to establish more substantive standards to flesh in such duty. The end result might be, in practice, the same defer-to-management formula as used in ordinary, solvent situations would be applied to insolvency or near insolvency. This ambiguity is compounded by the

A.2d 784, 787 (Del. Ch. 1992) (concluding that the fiduciary duty to creditors arises upon insolvency in fact).

See e.g., Credit Lyonnais, supra note 9, at *34 (Del. Ch. Dec. 30, 1991) (holding a directorial duty to creditors arises where a corporation is “operating in the vicinity of insolvency” that he has “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.”)

Robert Millner, What Does It Mean For Directors of Financially Troubled Corporations to Have Fiduciary Duties To Creditors? 9 Journal of Bankruptcy Law and Practice 201, 206 (2000) (“[T]t is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors’ fiduciary duties expand to include general creditors”, cited from In re Kingston Square Associations, 214 B. R. 713, 735 (Bankr. S.D.N.Y. 1997)).

See Id., at 205-6. The American case law is rather explicit on this point. See, e.g., Simons v Cogan 549 A. 2d 300, 304 (Del. 1988) (holding holders of convertible debentures are not owed fiduciary duties, and “before a fiduciary arises, an existing property right or equitable interest supporting such a duty must exist”).

See PHILIP WOOD, INTERNATIONAL LOANS, BONDS AND SECURITIES REGULATION 122 (1995, Sweet & Maxwell) (noting some standard risk-control covenants in a loan agreement, e.g., negative pledge, pari passu clause and anti-disposal clause, working to the creditor’s favour by putting in place certain restraints over the debtor’s assets to assure their repayment capacity); See also Ann Stilson, Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors’ Duties to Creditors, 20 Del. J. Corp. L. 1 (1995) (noting the creditors may negotiate contractual safeguards to reduce risk of the debtors’ breach. They may negotiate a security interest, seek limited proxy rights, or even negotiate representation on the debtor’s board for the term of their contract).

See Millner, supra note 132, at 206-8.
disparate judicial rulings regarding to whom the management of insolvent corporations owe such duty.

a. Duty to Protecting Creditors’ Contractual and Priority Rights

Under insolvency circumstances, some courts considered the corporate management, as trustees, were obliged to managing the insolvent corporation for the corporate creditor, as beneficiaries. The trustee-beneficiary relationship naturally leads to the loyalty demand that directors are disallowed to engaging in self-dealings, criminal or fraudulent acts, or otherwise put their interests ahead of creditors. The extent to which fiduciary duties owed by the management to creditors in insolvency might be comparable to another prescriptive obligation refraining the management from transferring assets for the benefit of insiders and shareholders, and from making preferential payments to the detriment of the corporation’s creditor. Namely, the duty as such is simply aimed at protecting creditors’ existing contractual and priority rights in insolvency, rather than proactively fostering their interests.

In Ben Franklin, this point was explicitly made by the court: “...[C]reditors have a right to expect that directors will not divert, dissipate or unduly risk assets necessary to satisfy their claims. This is the appropriate scope of a duty that exists only to protect the contractual and priority rights of creditors.”

b. Credit Lyonnais Affirmative Duty to Mediate and its Limitations

The broadest possible scope of fiduciary duties that might be enjoyed by the creditor was presented by the groundbreaking yet controversial Delaware decision of Credit

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136 A leading case to this effect is Bovay v. H. M. Byllesby & Co. where the Delaware Supreme Court’s dicta read: “An insolvent corporation is civilly dead in the sense that its property may be administered in equity as a trust fund for the benefit of creditors.” See Bovay v. H. M. Byllesby & Co., 38 A. 2d 808 (Del. 1944); See also Gary Marsh, The Many Faces of Directors’ Fiduciary Duties, 22 American Bankruptcy Institute Journal 14, 16 (2003).

137 These insider misconduct cases most likely arise where a “triple insider”, a dominant shareholder, who was also a director and CEO of a failing corporation, is involved. See Pepper v. Litton, 308 U.S. 295, 60 S. Ct. 238, 84 L. Ed. 281 (1939).

Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp. The court noted "the potential differing interests between the corporation and its 98% shareholder", and then set out the dictum "at least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise." This duty was explained as "...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". In footnote 55 of the decision, the court further emphasized:

"[t]he possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behaviour and creating complexities for directors...[D]irectors who are capable of conceiving of the corporation as a legal and economic entity...will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may 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".

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139 Credit Lyonnais, supra note 9, at *34. In Credit Lyonnais, the creditor bank entered into the Voting Right Agreements and the Voting Trust Agreement to obtain control of the financially distressed corporation at question. The creditor bank subsequently exercised the contractual right and vetoed the shareholders' proposal of selling certain corporate assets to repay the creditor bank in order to regain control. Id, at **1138. The court's holding to the plaintiff's favour was therefore partly based on contractual ground. Id.
140 Id.
141 Id.
142 Credit Lyonnais, supra note 9, WL 277613 at **1157.
143 Id., at *34 (note 55). One hypothetical was posed by the court in note 55 of the decision to demonstrate how to reach the corporation's "long-term wealth creating capacity", an idea by itself hard to be apprehended. The essence of this approach is actually a spirit of reconciliation by which the disparate risk appetites possessed by creditors and shareholders and others (employees for example) who consist of the "community of interest" are settled in the middle grounds. And as a result, the ruling here should be explained as no more than a managerial duty to mediate.

The hypothetical is:

"Consider, for example, a solvent corporation having a single asset, a judgment for $51 million against a solvent debtor. The judgment is on appeal and thus subject to modification or reversal. Assume that the only liabilities of the company are to bondholders in the amount of $12 million. Assume that the array of probable outcomes of the appeal is as follows:

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<th>Expected Value</th>
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<td>25% chance of affirmance ($51mm)</td>
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The dicta of the *Credit Lyonnais* actually did not directly address the scope to which the management owed fiduciary duties to the creditor, but represented an attempt to resolve the matter of competing interests between the shareholder and various fixed claimers that becomes acute when a corporation operates with modest equity value yet remains solvent. The above quoted strikingly advanced a new approach applying to the management performing functions as demanded by law when the corporation operates in the vicinity of insolvency; that is an affirmative duty to *mediate* interests of not just shareholders and creditors but also employees and other stakeholder groups with interests relating to the corporation, in order to “maximize the corporation's long-term wealth creating capacity”. This marks a fundamental disparity from the traditional policy that, upon insolvency, prescriptive-nature fiduciary duties owed to the creditors are simply for protecting their existing priority and contractual rights.

<p>| 70% chance of modification ($4mm) | $2.8  |</p>
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Thus, the best evaluation is that the current value of the equity is $3.55 million. ($15.55 million expected value of judgment on appeal--$12 million liability to bondholders). Now assume an offer to settle at $12.5 million (also consider one at $17.5 million). By what standard do the directors of the company evaluate the fairness of these offers? The creditors of this solvent company would be in favor of accepting either a $12.5 million offer or a $17.5 million offer. In either event they will avoid the 75% risk of insolvency and default. The stockholders, however, will plainly be opposed to acceptance of a $12.5 million settlement (under which they get practically nothing). More importantly, they very well may be opposed to acceptance of the $17.5 million offer under which the residual value of the corporation would increase from $3.5 to $5.5 million. This is so because the litigation alternative, with its 25% probability of a $39 million outcome to them ($51 million - $12 million = $39 million) has an expected value to the residual risk bearer of $9.75 million ($39 million x 25% chance of affirmance), substantially greater than the $5.5 million available to them in the settlement. While in fact the stockholders' preference would reflect their appetite for risk, it is possible (and with diversified shareholders likely) that shareholders would prefer rejection of both settlement offers.

But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than $15.55 million, and one below that amount should be rejected.”

144 Employing the phrase “maximize the corporation's long-term wealth creating capacity” to illuminating the court’s true intention of imposing a mediator-like duty on directors, i.e., the one of reconciling all concerned corporate constituencies' interests, is arguably inadequate as seemingly the entity-theory assertion suggested the company can somehow enjoy certain forms of well-being. A contractorian expression of a mediator-like role expected of (or a duty to mediate imposed upon) the director while the corporation is in or near insolvency would be a clearer and more adequate one.

145 One commentator suggested *Credit Lyonnais* added nothing to the then existed as the court was aimed to protect the creditors’ contractual rights. See Lin, supra note 49, at 1523 (“Arguably...the creditor contracted for the director's duty to maximize the long-term profitability of the firm instead of shareholder wealth, and the court merely enforced the parties' agreement”). This comment can not be
The dramatic departure from the contractual treatments afforded to creditors of solvency-remote corporations placing employees and creditors and other fixed claimers outside the fiduciary-duty context has come under attacks. First, at what point in time a corporation is considered as having entered the “vicinity of insolvency” and thereby its management are obligated to take into all corporate constituencies’ interests into account in making decisions remains unknown. Second, even restrictively applying to the “vicinity of insolvency” occasion, the shareholders’ plight is not yet hopeless and it can be argued they have a right to demand management to try their best to salvage their fortunes. Credit Lyonnais failed to justify why on the occasion when the management are needed the most by the shareholder, they are allowed to forgo their duty. Third, that the directors are required to mediate interests of all parties concerned means the management have to pledge loyalty to all competing constituencies. This is hardly attainable theoretically as well as practically.

Collectively, the Credit Lyonnais legal reasoning entails one fundamental weakness. If this was a sustainable way to settle the shareholder-creditor conflicts existing almost throughout the entire corporate life, why only until the corporation has reached “the vicinity of insolvency” would a conciliatory task start to replace the one focusing on maximizing the shareholder’s interest — how about deploying such condition as “substantial deterioration of financial condition” indicating the corporation’s perilous financial strength as a trigger. Credit Lyonnais failed to fully justify the demarcation point it set.

c. Duty Recipients in Insolvency: Competing Judicial Rulings

Another difficult issue intertwined with the duty contents discussed above is, upon sustained as the dicta constructed by the court were clearly advanced from the corporate law rather than the contract law ground.

146 Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (“[T]he relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature .... The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.”)

147 Robert Millner, What Does It Mean For Directors of Financially Troubled Corporations to Have Fiduciary Duties To Creditors? 9 Journal of Bankruptcy Law and Practice 201, 220.


149 Id., at 67-8.
insolvency, whether a director has a duty running to both creditors and shareholders, or such duty works to the exclusion of shareholders, or, as Credit Lyonnais suggests, a director has a duty to consider all corporate constituencies concerned. The following discussion indicates the disparate stances judicially adopted regarding duty recipients in or near corporate insolvency have effected a considerable level of confusion concerning the desirable risk appetite expected of the management. The author argues the creditors (that is, all sorts of fixed claimers) as opposed to the shareholder should be made the exclusive duty recipients if they are to be protected at all. This is based on both, theoretically, the creditor’s residual-claimer status and, practically, the benefit of a clear corporate objective when it is needed the most.

The majority cases opined the management of an insolvent corporation owes a duel obligation — an obligation to creditors as well as to shareholders\(^{150}\) — they “stand as trustees of corporate properties for the benefit of creditors first and stockholders second”.\(^{151}\) Also, there are cases embracing the pluralist theory of Credit Lyonnais that the management is required to “…serve the interests of the corporate enterprise, encompassing all its constituent groups, without preference to any. That duty, therefore, require directors to take creditor interests into account, but not necessarily to give those interests priority”.\(^{152}\) Occasionally, courts adopted the narrowest view that upon insolvency the management owes a duty to “act solely for the financial benefit of the creditors in all matters”.\(^{153}\)

The three disparate attitudes have a direct bearing on one of the most difficult and vital choices the directors have to make in or near insolvency: liquidating the loss-making corporation to preserve the creditors’ prospective assets or aggressively

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\(^{152}\) In re Ben Franklin Retail Stores, Inc., 225 B.R. 655 (Bankr. N. D. Ill. 1998), aff’d in relevant part, 1999 WL 982963 (N.D. Ill. 1999); See also Ed Peters Jewelry Co., Inc. v. C&J Jewelry Co., Inc., 124 F sd 252, 176 (1st Cir. 1997)

taking risk (likely an immense one) to resurrect the corporation and avert insolvency. Whereas the shareholder might endorse a highly risky transaction that might increase the value of the equity and avert insolvency, however slim the chances, the creditors might tend to oppose this type of business propositions as the risk of reducing the corporation's left, humble, net present value to their ultimate detriment is imminent.154

If the management of an insolvent corporation owed fiduciary duties exclusively to the creditor, then they could have had a duty to liquidate the corporation if the corporation in question was continuously making substantial losses after insolvency. Here, the clear yardstick of fiduciary duties is preserving corporate assets to maximize creditor returns, provided of course the scope of fiduciary duties is not restricted to protecting creditors' contractual and priority rights. Applying the same scenario to the other two sets of dicta, the results are nevertheless not so straightforward. Where there are dual (the majority view) or multiple (the Credit Lyonnais theory) possible divergent interests to be taken into account, the management and the court would face a crisis as their yardstick against which fiduciary duties are understood and assessed will become lost — to whom the directors pledge their loyalty; what criteria a balancing decision ought to meet.155

154 A corporation's shareholders and creditors could be diametrically opposed in conditions approaching insolvency. The source of all possible conflicts of interest comes from their competing preferences as to the appropriate level of risk to be taken by the corporation. See Lin, supra note 49, at 1489-93 (discussing the two groups' race for investments recovery and their different incentives to liquidate as opposed to resurrect the corporation).

155 Courts split on this issue. See In re Logue Mechanical Contracting Corp., 106 B.R. 436, 440 (holding the directors had violated their fiduciary duty to the corporation by not to proceeding to liquidation in a timely manner where a reasonable person using ordinary care and diligence would have done so to maximize the return to the creditors); but see In re Ben Franklin Retail Stores, Inc., 225 B.R. 655 (Bankr. N. D. Ill. 1998), aff'd in relevant part, 1999 WL 982963 (N.D. Ill. 1999) (Contents of directors' fiduciaries do not contain "...a duty to liquidate and pay creditors when the corporation is near insolvency, provided that in the directors' informed, good faith judgment there is an alternative")

The problem here of balancing dual or multiple interests is exactly the same as what happens to stakeholder proposals that uphold a pluralist approach to include all concerned corporate constituencies' interests into directors' day-to-day fiduciary duty undertakings. See Philip Goldenberg, IALS Company Law Lecture—Shareholders v stakeholders: the Bogus Argument, 19 The Company Lawyer, 34, 36 (1998) (commenting from the aspect of corporate representation system: "The absence of multiple representation no doubt reflects fears that increased complexity of decision-making, and confusion over corporate objective, would seriously detract from the wealth-creating capacity of the company."); D. Sullivan & D. Conlon, Crisis and Transition in Corporate Governance Paradigms: The Role of The Chancery Court of Delaware, 31 Law & Society Rev., 713 (1997); S. Leader, Private Property and Corporate Governance Part I: Defining the Issues, in PERSPECTIVE ON COMPANY: 2, 85 (Fiona Macmillan Patfield ed., 1997).
Some commentators believed creditors should not be the exclusive fiduciary duty recipients upon the corporation’s insolvency as by which it might “preclude rehabilitation of the enterprise and restoration of positive net worth and cash flow.”\footnote{Millner, supra note 132, at 217.} It was asserted only upon the going concern value of the corporation clearly no longer exists, so do the management’s fiduciary duties to shareholders.\footnote{Id., note 24 and accompanying text. See also Harvey R. Miller, Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporation, Seton Hall L. Rev. 1467, 1493-4. (1993) (stressing preservation of going concern value as one of policy objectives of Bankruptcy Code).} This line of arguments may not make its case. To start with, the connection between creditors’ involvements, upon insolvency, in imposing contractual restraints or even setting up the corporation’s rehabilitation plan and the perceived hindrance to the corporation’s regaining financial wellbeing may not be firmly established. Further, ascertaining the absolute non-existence of going concern value is an extremely hard task, if possible at all. Rather, it could be used as an excuse by shareholders to unduly prolong the life of an insolvent company.

One aspect of inquiry may provide a useful response to dealing with this instead. If the contacterian theory that residual claimers stand a better position to monitor the directors, hence to be the exclusive duty recipients, holds true, when the corporation operates on negative equity value, the shareholder-model of corporate governance will then lose its policy underpinnings. As a result, at least theoretically the creditors instead of the shareholders should be the exclusive duty recipients and their entitlements should be complete. By adopting this approach, the management will not be imposed an upfront obligation to liquidate or arrange an orderly sale of the corporation upon insolvency, they should instead adopt the creditor’s conservative risk as opposed to the shareholder’s, in managing the insolvent corporation. And it is on this yardstick the business judgment rule operates and accord the management with protection. Rehabilitations would not be precluded because these efforts can also potentially benefit creditors by offering the prospect of restoration to positive net worth if, of course, through the lens of the creditor the risk involved in potential rehabilitations is considered tolerable.
E. Interim Summations and Observations:
Fiduciary duty law in Delaware is predominantly one addressing self-dealings\(^{158}\) and bad-faith managerial misconducts. The extensive extent to which the court exhibits its reluctance or even abstention from substantively reviewing corporate management performing their oversight and decision-making functions absent self-dealing or bad faith and the enactment of the exculpation statute reflect the central policy of promoting risk-taking. Reaching out from this point, the following sets out this section’s final comments and observations on the US shareholder model of corporate governance.

1. Monitors of Objectivity over Proximity
The Delaware system of fiduciary law reveals its preference of leaving the central governance task of monitoring the executive’s conduct to, as categorized by some leading commentators recently,\(^{159}\) those monitors of “objectivity” (such as hostile acquirers, investment banking analysts, credit agencies, accounting firms and other capital-market agencies) over those of “proximity” (such as corporate directors and substantial shareholders). In this regard, ensuring effective disclosure to enhance credibility of corporate information is thus not only a securities regulation agenda, but also a corporate-law one.\(^{160}\) This position is further revealed by the Delaware court’s

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\(^{158}\) Self-dealing here is used in its broad sense that includes transactions directly extracting private benefits at the expense of the corporation’s shareholders and other transactions and activities particularly in the change-of-control context where the director’s entrenched position is at stake.

\(^{159}\) It was suggested a trade-off exists that a monitor can not possess both proximity and objectivity. See Arnoud W. A. Boot & Jonathan R. Macey, Monitoring Corporate Performance: The Role Of Objectivity, Proximity, And Adaptability In Corporate Governance, 89 Cornell L. Rev. 356, 368-70 (2004) (basing on the public choice theory and the “foot-in-the-door” phenomenon derived from psychological research, arguing objectivity requires distance between management and monitor).

\(^{160}\) See e.g., Lewis v. Vogelstein 699 A. 2d 327, 330 (Del. Ch., 1997) (“a misdisclosure may make available a remedy, even if the shareholder vote was not required to authorize the transaction and the
unusual sensitivity towards managerial activities in the change-of-control context as evidenced by the impositions of the Revlon and Unocal standards. The court’s scrutiny over the management to keep the hostile take-over devices sharp and to ensure anti-taking-over measures not to be used to shield management from accountability is a startling contrast to the defer-to-director manner of review that has been consciously used under ordinary circumstances.

This monitoring mode might be underpinned by some perceived inherently functional weaknesses associated with monitors of proximity. The presence of a unitary board in the US, for example, where non-executive or independent board members and senior executives are jointly liable for the performance of the corporation, is considered leads to a combination of monitoring and managerial functions, which in turn renders highly questionable the non-executive or independent board member’s effectiveness in monitoring. Also, the monitoring utility of direct shareholder involvement, as another class of such monitors, is frustrated as frequently argued by the presence of a dispersed share holding structure.

Alternatively, the U.S. corporate finance pattern that is mainly conducted through equity and bond issues in the exchanges rather than through the banking system gives rise to a robust array of outside, market forces monitoring managerial performance. The market for corporate control was suggested as the “cornerstone of U.S. corporate governance”. As a dominant monitoring force under the US shareholder model of corporate governance, the market-based mechanism is then expected to aligning the management’s corporate strategies with the market’s risk-prone expectations — as expressed by capital market specialists, market makers and day traders in their ultimate transaction can substantively satisfy a fairness test”. See also Lawrence A. Hamermesh, Calling Off The Lynch Mob: The Corporate Director’s Fiduciary Duty Of Disclosure, 49 Vand. L. Rev. 1087 (1996).


162 See e.g., Jonathan R. Macey, Effective Capital Markets, Corporate Disclosure, And Enron, 89 Cornell L. Rev. 394, 402 (2004); but see Bengt Holmström & Jean Tirole, Market Liquidity and Performance Monitoring, 101 J. Pol. Econ. 678, 707-08 (1993) (arguing cross holdings and pyramidal structures could give rise to disproportional voting rights with limited capital commitment and therefore the widely accepted link between dispersed ownership and lack of control is not as inextricable as thought).

163 Id., at 407.
concern over stock price performance. 164

2. Private Ordering Over Judicially Enforced Constraints and Mandatory Rules

Another notable message sent out by the Delaware’s mode of conduct review over corporate management is its position of maintaining a contractarian corporation — a corporation controlled and directed by private ordering subject to minimum interruptions of mandatory legal rules and court interventions. In this regard, the court’s reluctance of dictating specifics over corporate directors’ risk taking is also reflected in the approach adopted by the court when occasionally attempting to promote certain corporate practices. For instance, although the Delaware court has long been intended to provide corporations with an incentive to comprise their boards with a majority of independent directors, 165 the effort was made in an implicit way by ruling that an approval of a self-interested transaction by a special committee consisting entirely of independent directors would give rise to certain liability-insulation effects. 166

By the same token, the similar liability-insulation approach as opposed to mandatory rulings was also adopted by the court when promoting significant but non-controlling shareholdings in order to deploy substantial shareholders’ incentives to police managerial behaviours. 167

As opposed to mandatory treatments, pursuing extralegal routes (such as a stock option plan) to align the management’s self-interested economic incentives with interests of the shareholder is therefore settled to be a prevalent governance approach under the US shareholder model of corporate governance. 168


166 See e.g., Kahn, supra note 103, at 1117 (finding that, in a judicial review based on the entire fairness standard that involves an interested merger between a parent and its subsidiary, an approval of the transaction by an independent committee of informed disinterested directors shifts the burden of proof on the issue of fairness to the shareholder plaintiff).

167 See Chandler III & Strine, Jr., supra note 165, at note 95 and accompanying text.

168 See Melvyn Westlake, Corporate Governance-Time To Clear Up, The Banker, 16, 19 (June 2002)
3. Implicit functional Divide: Corporate Law as Shareholder Law; External Regulations as Stakeholder Laws

In either In Re Caremark or Unocal, traces of the court’s attempts to somehow having regards to stakeholder protection while upholding the shareholder interest are clear. These attempts are nonetheless unpromising. Given the dividing loyalty problem, the overwhelming effects emanating from incentive alignment arrangements and market expectations based on shareholder gains and the exclusivity of shareholder representative rights on board, the extent to which the shareholder gains have been fostered will still remain the predominant parameter measuring performance of the corporate management of in particular large, public corporations. Even under the exception of insolvency where a corporate director is to some extent obligated to take creditors’ interests into account when running the corporation’s affairs, the contents of such duty as running to the creditors remains judicially unsettled.

Cumulatively, although the strong stance of Dodge v. Ford Michigan by the Supreme Court of Michigan in 1919 that “business corporation is organized and carried on primarily for the profit of the stockholders, and it is not within the lawful powers of a board of directors to shape or conduct the affairs of a corporation for the merely

(noting about 70 percent of US executive pay is in the form of stock options); Charles Elson & Robert Thompson, Van Gorkom’s Legacy: The Limits Of Judicially Enforced Constraints And The Promise Of Proprietary Incentives, 96 Nw. U. L. rev. 579, 581, note 14 (2002) (“I share the sense of many commentators that the law has played a relatively minor role in the evolution of board structure and behavior; markets and other social forces are far more important. Indeed I suggest leaving the matter of board independence and accountability largely to these extralegal incentives.”, cited from Donald C. Langevoort, The Human Nature of Corporate Boards: Laws, Norms and Unintended Consequences of Independence and Accountability, 89 Geo. L.J. 797, 800 (2000)); Chandler III & Strine, Jr., supra note 165, at 978 (arguing the need for corporate law to accommodate the corporate diversity: “[Mandatory] [r]estraints that might be useful and workable when applied to the largest fifty companies in America might be ill-suited to smaller public companies.”).

Effective as of 1 July 2001, subject to certain requirements and limitations, the General Corporation Law of Delaware grants the board more freedom to delegate to officers the power to grant stock options. DEL. CODE ANN. tit. 8, § 157 (c) (2003). For the board of director choosing not to delegate this power out but instead deciding the issuance of stock options by itself through a resolution adoption, the General Corporation Law of Delaware explicitly provides the board with a safe harbour regarding the decision to issuance and the sufficiency of such a decision: “In the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive.” Id. tit. 8, § 157 (b).
incidental benefit of shareholders and for the primary purpose of benefiting others.\(^{169}\) might no longer appear in a Delaware court’s decision nowadays, the US corporations in practice actually operate towards the same ultimate corporate objective as they did nearly 100 years ago. Further, the court’s tendency of vigilantly protecting corporate separateness in conjunction with the application of limited liability to even corporate parents has left handling of negative externalities related or stakeholder protection issues outside the realm of corporate law. Collectively, an implicit functional divide of corporate law and external regulations is formed — “[t]raditional [fiduciary law] doctrine protects only the interests of actors inside the corporation, and looks to those actors to define their own interests. The regulations, by contrast, follow from outside ethical instructions as to appropriate conduct inside corporations.”\(^{170}\)

This ring-fence approach in terms of stakeholder protection — that under Delaware fiduciary law only knowingly violating the positive law and regulations addressing stakeholder protection leading to the corporation’s losses might the management be held accountable — strongly reflects the traditional private-law vis-à-vis public-regulation differentiation, where the corporate law is considered of contractual and private nature and devised towards fostering the corporate member’s profit-maximization pursuit; stakeholder interests are then protected by ethical, mandatory instructions contained in various external public regulations serving simply as a background constraint.\(^{171}\)

\(^{169}\) 170 N. W. 668 (Mich. 1919).

\(^{170}\) William W. Bratton, Jr., Public values, Private Business, and US Corporate Fiduciary law, in CORPORATE CONTROL AND ACCOUNTABILITY 27 (Joseph McCahery et al ed., Oxford U. Press, 1993) (noting “[t]raditional [fiduciary law] doctrine protects only the interests of actors inside the corporation, and looks to those actors to define their own interests. The regulations, by contrast, follow from outside ethical instructions as to appropriate conduct inside corporations.”)

\(^{171}\) See Jonathan Macey, An Economic Analysis of the Various Rationales for Making the Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties, 21 Stetson Law Review 23, 42-3 (arguing against the need to expanding directors’ fiduciary duties to include local communities by asserting the wider issue of social responsibility should be addressed by political means); In another article, Professor Macey championed this political means as: “…[I]nvestors, capital markets, and society generally will be better off if policy makers take an enabling approach to corporate law. Under this approach, the corporate form can continue to serve its traditional role as a remarkably powerful device for financing complex, capital-intensive business ventures in advanced societies that enjoy reasonably broad distributions of wealth.” See Jonathan Macey, Corporate Law and Corporate Governance: A Contractual Perspective, 18 Journal of Corporation Law 185, 211 (1993); Daniel Fischei, The Corporate Governance Movement, 35 Vanderbilt Law Review, 1259, 1273-4 (1982) (“[b]ecause the corporation is a particular type of firm formed by individuals acting voluntarily and for their mutual benefit, it can far more reasonably be viewed as the product of private contract than as a creature of the state”").
III. Shareholder Model of Corporate Governance in Banking Context
This section discusses the current state of law in its construction of standards of conduct applying in particular to the bank management. It first investigates the unique regulatory environment facing the industry which engenders some initial doubts over the applicability of the state corporate law’s standards in the banking context. It then follows the enactment of 12 U.S.C. Section 1821 (k), which seemingly sets a uniform standard of conduct for bank management. The section concludes by exploring the US Supreme Court’s 1997 seminal case of Atherton v. FDIC, which firmly put the standard of conduct applicable to the bank management in the framework of the traditional state corporate law’s shareholder model of corporate governance.

A. Initial Doubts over Applying State-law Standards of Conduct and Review to Bank Management
At the aspirational level, it has long been recognized that the management of US banking organizations as their industrial counterparts should exercise ordinary care and prudence in managing the institution entrusted to them. 172 Progressive judicial pronouncements giving flesh to this aspirational framework then led to a wide range of specific functions expected of bank management, concerning, among others, instituting loan underwriting procedures, monitoring loan portfolio, being informed about bank affairs and supervising management and instituting audits. 173

The applicable standard of review over these aspirational managerial functions is nevertheless not as straightforward in the banking context because of certain unique regulatory arrangements. Moreover, whereas enforcing fiduciary duties under ordinary circumstances is the preserve of shareholder rights, in the banking context it is virtually an extension of the banking regulator’s enforcement muscle with the FDIC in its receiver capacity playing a key role of recovering losses inflicted on federal insurance funds following managerial failures.

173 See McCOY, supra note 172, at § 14.04[2] (citing relevant fiduciary duty cases in the banking context.)
Against this backdrop, this section charts the evolution of applying the state-corporate-law based standards of conduct applying to bank management, starting from the banking regulator’s stance of incorporating the concept of safe and sound banking into the substance of the bank management’s fiduciary duties, through the passage of the 12 U. S. C. Section 1821 (k) setting gross negligence as a national floor standard of review over the bank management’s conduct and thus pre-empting the state corporate law’s exculpation statute, to the US Supreme Court’s decision on Atherton putting the standards of conduct and review applicable to the bank management’s performing functions largely back to the traditional shareholder model of corporate governance model as reflected under the state corporate law.

1. Dual Banking System, Governmental Subsidies and Public-interest Concerns

Applying corporate governance standards set by state corporate law, including those associated with the management’s fiduciary duties, to the bank management is inherently complex in the United States.

To start with, a bank has to be chartered or licensed and is not free to simply pick among over 50 states the state of incorporation to run its business. Further, in the United States, the bank management’s functions are performed against a peculiar dual-banking regulatory environment that renders doubtful the applicability of state-law corporate governance standards to federally chartered banks. The doubt over such applicability comes also from the presence of government subsidies\textsuperscript{174} taking such form as a government-sponsored deposit insurance regime\textsuperscript{175} protecting the banking industry, which in turn make public interests constantly at stake relative to managerial conduct.

\textsuperscript{174} When it is considered healthy, a depository institution is subsidized by the federal government with a government-sponsored, compulsory deposit insurance scheme since the inception of the Federal Deposit Insurance Corporation (“FDIC”) in 1933 to forestall depositors’ runs on the bank. When it fails, the federal government assists in resolution procedures under the “least cost principle”, mandated to venturing taxpayers’ funds to institute, among other things, “purchase and assumption” transactions to allow the failed institution to remain in operation, albeit usually under a different name. For an in-depth discussion on governmental involvements and subsidy concerning failed institutions’ resolutions, see Macey, supra note 44, at 740-47.

\textsuperscript{175} The federal deposit insurance covers retailed depositors of, however state or federally chartered, and depositors are protected up to $10,000 of every individual account once the bank failed.
2. Fiduciary Duty Claims as Banking Regulator’s De Facto Enforcement Tool

Administered by FDIC

The above-mentioned unique regulatory environment has led to a crucial banking characteristic in fiduciary duty claims: the shareholder’s position as duty enforcer is marginalized in the banking context. Instead, it is the FDIC as receiver that plays the central role bringing on behalf of the failed bank suits alleging fiduciary duty violations against the failed institution’s former bank management to recover losses of the Deposit Insurance Fund (“the Fund”) sustained through failure resolution processes. In other words, in the banking context fiduciary duty claims functionally serve as yet another set of enforcement tools, vigorously pursued by the banking agency (the FDIC) normally only after the bank failed and moved into receivership.

This public-interest attribute sets enforcing fiduciary duties in the banking context apart from in non-banking where fiduciary duty suits perceived as purely of private nature are brought by the shareholder normally during the corporation’s ordinary course of business. Apart from timing and claimant, fiduciary duty cases differ between banks and non-banks also in the subject matter over which the dispute occurred. Whereas the change-of-control case makes up the lion share of fiduciary duty claims for industrial corporations, suits brought by the FDIC as a result of the bank management’s disinterested conduct center on their association with ordinary businesses, in particular their involvements with lending decisions.

This is probably because the strict bank

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176 When an insured depository institution fails, as receiver the FDIC would step into the institution’s shoes and succeed to all the rights, titles and privileges of it (including the institution’s legal claims such as the one against its former management on fiduciary grounds). Procedurally at this point, the FDIC would have taken over the existing derivative claims. Further, although legally the shareholders are entitled to institute fiduciary duty claims in the name of the bank against bank directors even while it remains financially healthy, they would tend not to do so as the risk the institution might fail accordingly would outweigh the benefit of such actions. See MACEY, supra note 44, at 699 (2001).

177 See Martin Lowy & Peter Lowy, Needed: A Standard Of Care For Bank, Thrift Officers And Directors, 15 Banking Policy Report, 1, 1 (1996). Improper lending was specifically singled out by the FDIC in a 1992 statement characterizing its claims against bank directors “…where directors failed to establish proper underwriting policies and to monitor adherence thereto, or approved loans that they knew or had reason to know were improperly underwritten, or, in the case of outside directors, where the board failed to heed warnings from regulators or professional advisors, or where officers either failed to adhere to such policies or otherwise engaged in improper extensions of credit. Examples of improper underwriting have included lending to a borrower without obtaining adequate financial information, where the collateral was obviously inadequate, or where the borrower clearly lacked the ability to pay”. See FDIC, Statement Concerning The Responsibilities Of Bank Directors And Officers 3 (FDIC News Release PR-166-92, 4 Dec. 1992).
change-of-control regulation acting as an *ex ante* screening has rendered far less space for managerial discretion, hence less disputes.

Public-interest traces of FDIC-brought fiduciary duty claims can be detected even in the investigative phase before the suit was filed. The FDIC as receiver, ordinarily a private capacity, is explicitly authorized by law to issue "administrative subpoenas" for such broad purposes as causation assessment and cost-effective analysis. The permissible targets that might be included in this type of subpoenas are also extensive, covering not only the relevant bank management but also their associated family members and business entities. As evidenced by the general defer-to-FDIC tendency associated with the manner in which the court reviews enforceability of such procedures, the need for swiftly recouping losses of the Deposit Insurance Fund or other damages on taxpayers obviously outweighs other considerations.

Judicial treatments over affirmative defenses also reveal the fiduciary duty claim's public nature in the banking context. Under normal receivership circumstances, a defendant corporate management is allowed to use an affirmative defense to alleviate his liability in connection with a fiduciary duty claim if he can substantiate that the receiver's actions have contributed to the corporation's ultimate losses. In the banking context, however, the availability of such defense is generally rejected as long as such defense is predicated on the FDIC's negligence or other misconducts associated with the FDIC acting as receiver. The court created a spate of rationales to reject an

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180 See e.g., FDIC v. Garner ET AL, 126 F, 3d, 1138, 1143-46 (9th Cir, 1997); also see Bank Brief, Enforcement Of FDIC's Subpoenas Against Former Bank Directors Family Members Upheld By Ninth Circuit, 115 Banking L. J. 295, 295-7 (1998).
181 When the bank director is the target of the subpoena that is issued on the ground of investigating relevance of his conducts in connection with the bank's losses, the court indicated "[w]e defer to the agency's appraisal of relevancy which must be accepted so long as it is not obviously wrong". See In re McVane, 44 F.3d 1127, 1135 (2d Cir.1995). In the event the subpoena issued to the bank director is solely for the basis of determining cost-effectiveness in an action against the bank director, the review standard is only marginally higher that the court would give "due weight ... to the specific reasonable inferences that the [FDIC] might draw from the information available to it in light of its experience investigating other failed institutions." Id. at 1140.
Whenever the bank director's family member instead of the director himself is subpoenaed for providing materials for the FDIC's investigation, the court would then substantially raise the bar and the FDIC might be demanded to make some showing of the need for the information beyond mere relevance to substantiate the issuance of the subpoena. Id, at 1138.
182 One commentator categorized rejected affirmative defenses in 1990s linking to the FDIC's conduct in
affirmative defense that alleges the FDIC’s post-receivership, negligent conduct (that is, alleged negligent conduct occurring upon FDIC taking on the role of operator or assuming control of the institution’s assets) in order not to relieve the defendant bank management’s pre-receivership fiduciary duty violations. Although differing on grounds, these rationales are common in their merging together the FDIC’s regulator and receiver capacities rather than breaking them apart as in a typical “dual capacity” description. One court even characterized the FDIC’s receiver capacity by analogy with its regulatory role that “the FDIC’s regulatory oversight of banks is intended only to protect depositors, the insurance fund, and the public...Likewise, FDIC’s actions as receiver for failed banks are undertaken only to fulfill its mandate to stabilize the banking system by protecting depositors and creditors of the failed bank and the public generally”.


The overriding public interest of swiftly recovering taxpayers’ money that was spent on the bail-out or the resolution process led to enforcement of fiduciary duty de facto functioning as a segment of the bank agencies’ extensive enforcement muscle. Outside enforcement, it also raises a more fundamental and substantive issue — fiduciary duties

its receiver capacity as including contributory and comparative negligence, failure to mitigate damages, waiver, estoppel, ratification, acquiescence and approval, consent, assumption of risk, laches, unclean hands, setoff and recoupment, lack of ripeness, duress, lack of causation, intervening and supervening causes, and reliance on banking regulators. See McCOY, supra note 172, at § 14.04 [2].

183 See Id. (citing, inter alia, Federal Savings and Loan Insurance Corporation v. Roy, civil No. JFM-87-1227, 1988 U. S. Dist. LEXIS 6840 (D. Md. 28 June 1988) (the “no duty” doctrine); Federal Savings and Loan Insurance Corporation v. Burdette, 718 F. Supp. 649 (E. D. Tenn. 1989) (rejecting affirmative defenses on the public-interest ground in swift asset recovery); FDIC v. Bierman, 2 F. 3d 1424 (7th Cir. 1993) (rejecting affirmative defenses on the ground the court should refrain from second-guessing the agency’s discretionary functions.) ). See also United States v. Gaubert, 499 U. S. 315, 331-34 (1991) (ruling the banking agency’s discretionary acts concerning day-to-day management of banking affairs after taking over the bank’s previous management’s decision-making function, inclusive of hiring consultants, placing the bank’s subsidiaries into bankruptcy, and mediating salary disputes, were protected and within Federal tort Claims Act’s discretionary function exception, because these acts were based on public policy considerations as other policy-making or planning acts.).

184 The FDIC’s “dual capacity” — the capacity of acting as both regulator and receiver for the same bank depending on its condition — is a widely used description. See e.g., FDIC v. White 828 F. Supp. 304, 306 (D. N. J. 1993).

that do not merely correspond to the general well-being of the shareholder as a whole, but is more in tune with the public interests this type of suits is ultimately meant to serve.

In this connection, at the height of the banking crises in early 1990s, the banking regulator advanced the idea of directing the construct of fiduciary duties owed by the bank management to the institution away from the traditional state corporate law’s locus of encouraging risk-taking and maximizing shareholder interests. The regulator considered in the banking context this traditional approach could not be justified, given the public interest involved, and the bank management’s propensity of taking overly excessive risks that corresponds to the industry’s collective underperformance in weathering deteriorating macro-economies and in handling the ensuing risks. ¹⁸⁶

In a 1992 enforcement action related to the infamous collapse of Lincoln Savings And Loan Association, for example, the Office of Thrift Supervision (“OTS”) explicitly stated bank directors and officers owed “…fiduciary duties to the institution’s shareholders, depositors, and the federal insurance fund and …the fiduciary duties of such person include the responsibility for the safety and soundness of the insured depository institution, which, in turn, precludes transactions that pose an undue risk of loss to the depositors and/or the federal insurance fund”. ¹⁸⁷ By the same token, the FDIC in 1992 also stated that “where the [bank] director or officer...participated in a safety and soundness violation” would likely trigger the FDIC’s fiduciary duty claim. ¹⁸⁸

B. Standards of Conduct of Bank Management upon Enactment of 12 U. S. C. Section 1821 (k)

The enactment of 12 U. S. C. Section 1821 (k) in 1989, which sets a “national” standard of conduct for the bank management concerning their undertakings of corporate affairs, represents a deviation from the traditional state-law based diffuse treatment. With the

¹⁸⁶ Harris Weinstein, Advising Corporate Directors After The Savings And Loan Disaster, 48 Bus. Law, 1499, 1501 (1993).
¹⁸⁷ Office of Thrift Supervision, In the Matter of Peter M. Fishbein ET AL, Former Outside Counsel Of Lincoln Savings And Loan Association, Irvine California, Order to Cease and Desist For Affirmative Relief (1992 WL 560945 (O. T. S.)).
benefit of hindsight, however, the passage of the 1821 (k) paradoxically marked the beginning of the end of an era of the banking regulator’s pluralist, safety-and-soundness approach, with a view to override the state law’s standards.189

1. Legislative Background: New Ammunition to Longstanding Debate
Confusion over the applicability of the state corporate law’s generally defer-to-management standards of conduct and review to the banking context had existed long before Section 1821 (k) was enacted. Over around one hundred years ago, the U.S. Supreme Court indicated in Briggs v. Spaulding a simple-negligence like standard of care required of the national bank’s management.190 Whereas the Briggs was cited by some as an authoritative source of federal common law,191 others contended “virtually all” of the federal courts held the bank management accountable for due care violations on gross negligence (or stricter) ground.192 With its vague wording, in particular its “savings clause”, the enactment of 12 U. S. C. Section 1821 (k) of the Financial Institutions Reform Recovery and Enforcement Act of 1989 (“FIRREA”) provided fresh ammunitions to this old debate.

FIRREA’s Section 1821 (k) prescribes a seemingly “national” standard for bank

189 See e. g., Stacey Kern, Atherton v. FDIC: The Final Word On Bank Officer And Director Liability? 2 North Carolina Banking Institute, 149, 164 (1998) (noting the Atherton Court brushed aside the suggestion that federal agency regulations could determine the standard of care for bank officers and directors).

190 “[D]irectors must exercise ordinary care and prudence in the administration of the affairs of a bank, and [ ] this includes something more than officiating as figureheads. They are entitled under the law to commit the banking business, as defined, to their duly-authorized officers, but this does not absolve them from the duty of reasonable supervision, nor ought they to be permitted to be shielded from liability because of want of wrongdoing, if that ignorance is the result of gross inattention....” Briggs v. Spaulding, 141 U.S. 132, 165-66 (quoted in Chicago Title & Trust Co. v. Munday, 297 Ill. 555, 131 N.E. 103, 105 (1921))

191 See e. g., FDIC v. Bierman 2 F. 3d 1424, 1432 (7d Cir. 1992) (noting the parties did not dispute over the applicability of the Briggs standard of care applying to bank directors). Based on the Briggs standard, the Bierman court decided “a reasonably prudent director” would not have approved the loans at question and it would impose liability for transactions “that were unreasonable at the time that they were made”. Id, at 1434.

For judicial rulings over bank directors’ standard of care pre-Atherton, also see Douglas Austin & Sidney Weinstein, Bank Officer And Director Liability Under FIRREA: The Need For A National Standard Of Gross Negligence, 111 Banking L. J. 67, 67 (1994) (arguing a majority of courts upheld a simple negligence standard).

management and on which FIRREA conferred the FDIC a federal cause of action for damages incurred upon failed institutions. Under the FIRREA and as a matter of law, the FDIC's entitlements in the receivership procedure against former bank directors are of a derivative nature that "the [FDIC] shall, ... by operation of law, succeed to--all rights, titles, powers, and privileges of the insured depository institution...." See 12 U.S.C. § 1821(d)(2)(A)(i) (1988 ed., Supp. IV). The FIRREA nevertheless explicitly relaxes or even eliminates some obstacles that would have been in place should the claim be brought by the shareholder as apposed to by the FDIC. See O'Melveny & Myers v. FDIC, 114 S. Ct., 2048, 2053 (1994) (citing 12 U.S.C. § 1821(d)(14) (1988 ed., Supp. IV) (extending statute of limitations beyond period that might exist under state law); §§ 1821(e)(1), (3) (precluding state-law claims against the FDIC under certain contracts it is authorized to repudiate); § 1821(k) (permitting claims against directors and officers for gross negligence, regardless of whether state law would require greater culpability); § 1821(d)(9) (excluding certain state-law claims against FDIC based on oral agreements by the S & L).)


2. 1821 (k): A Preemptive, Nation-wide "Gross Negligence" Standard, or Not?

On face of it, Section 1821 (k) appears to have established a national (federal) and uniform gross negligence standard of conduct on bank management—as apposed to the diffuse state corporate law based treatment with individual states' standards possibly higher or lower than gross negligence. The above-quoted savings clause of the 1821 (k), however, seems to permit any standard of liability as long as other federal and state sources of law have provided for it.

Besides the statute language itself, concerns over the widely dividing rulings of several federal circuit courts on how to adequately positioning the 1821 (k) in
connection with other sources of law were equally noticeable. These rulings posted different views on the existence of the superceding or preemptive effect of the 1821 (k) standard over other federal common law or state corporate law standards. The issue also concerned, if the state law standards were not to be superceded, whether they should be applied to federally-chartered, state-incorporated banks.

To complete this puzzle, the banking-regulator proposed standards of conduct formulated on safety-and-soundness grounds added another layer of complication. The end result was extreme volatile litigation consequences to be expected of a defendant bank management, depending on which court took charge of the trial adopting which source of law.

In 1997, the U. S. Supreme Court tried to solve this puzzle with the seminal case of *Atherton v. FDIC*.

C. *Atherton v. FDIC*: General and Preferential Applicability of State-law Corporate Governance Standards; 1821 (k)’s “Gross-negligence” as Floor and Substitute Standard

*Atherton* involves claims against the former directors of City Federal Savings Bank ("City Federal"), a federally chartered and insured savings and loan ("S&L"). While


Of course, the other way around was at issue as well—that is, whether federal common law could be applied to a state-chartered, federally insured bank if it survived the 1821 (k). See Id. at 673-5.

196 See e.g., Douglas Austin & Sidney Weinstein, *Bank Officer And Director Liability Under FIRREA: The Need For A National Standard Of Gross Negligence*, 111 Banking L. J. 67, 82 (1994) (arguing the need for a nation-wide, uniform standard to not to have bank directors expose to so great an uncertainty and risk that was unrealistic and unacceptable).

entailing no self-interest or fraud allegation, the former directors of City Federal were accused of, beginning in 1985, approving large, risky construction loans without taking reasonable steps to secure sufficient collateral to assure repayment; without verifying financial information provided by the borrowers; without obtaining an adequate appraisal of the proposed collateral; and without following its own lending policies and procedures. The loans resulted in $100 million in losses and subsequently led City Federal to its failure. The RTC then stepped in, paying off City Federal’s depositors and bearing losses resulting from a deficit in City Federal’s assets. As an effort to recoup losses, the government claimed these bank directors’ actions amounted to gross negligence (based on 1821 (k)), simple negligence (on federal common law) and breaches of fiduciary duty (on state law) and brought director liability claims in the bank’s name.

The district court agreed the defendant’s defence on the 1821 (k) ground that the statute intended to pre-empt actions based on less seriously culpable conduct and dismissed all but the gross negligence allegations, but on appeal the Third Circuit reversed. The ruling the Supreme Court was about to make therefore entailed a loss allocation judgment — either the negligent bank directors of the failed institution or the taxpayers (the Fund) have to bear the losses at question.

The court approached this from two fronts dealing with the interactions of three possible sources of law pronouncing bank directors’ standards of conduct: the federal “gross negligence” statute of 1821 (k); the “simple negligence” federal common law under the Briggs; and state corporate law such as the defer-to-management Delaware corporate law.

It first examined the current state of law and indicated that neither federal (national) banking statutes nor regulations duly promulgated under them had “set forth general corporate governance standards” contradicting those under state corporate law, although the court admitted some of them did specify certain banks’ corporate powers

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199 Id. at 1237.
200 Atherton, supra note 197, at 667.
201 Id.
202 Id., at 672.
(such as the requirement for minimum regulatory capital) while the others regulate their activities (such as the restriction on concentrated loans). The absence of general federal (national) corporate governance standards created from the regulatory side then gave rise to the court’s “federal common law” analyses. Concurring to a previous US Supreme Court’s banking decision, the court ruled the once existing federal common law standard under the Briggs did not survive the Supreme Court's later decisions.

Second, the court decided there was also no need to fashion new federal common law rules on this due care standard issue. It decided the arguments raised by the FDIC failed to convince the Court that “...the use of state law will create a significant conflict with, or threat to, some federal policy or interest” — a standard consistently illuminated by the US Supreme Court as one invoking its judicial creation function. The Court rejected the FDIC’s “uniformity” argument that was based upon the allegedly disturbing effect emanating from “[s]uperimposing state standards of fiduciary responsibility over standards developed by a federal chartering authority......” Further, the FDIC’s argument for a judge-made federal common law on the federal interest ground was rejected for a fiduciary duty claim’s “private” nature that would not be changed when the suit was brought by the FDIC-- “...[when filing a fiduciary duty claim], the FDIC is acting only as a receiver of a failed institution; it is not pursuing the Government's interest as a bank insurer”.

Consequently, the court decided that state corporate laws with their due care prescriptions were applicable to both federally and state chartered banks’ directors so long as the state standards were no less lenient than that under Section 1821 (k). In other words, state due care standards would take precedence over the Section 1821

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203 O'Melveny & Myers v. FDIC, 114 S. Ct., 2048, 2051 (1994) (on the suit brought by the FDIC (as a receiver in the name of a bank under receivership) based on alleged state causes of action for professional negligence and breach of fiduciary duty, ruling “State law governs the imputation of corporate officers' knowledge to a corporation that is asserting causes of action created by state law. There is no federal general common law”).

204 Atherton, supra note 197, at 670 (concluding Briggs did not survive Erie R. Co. v. Tompkins, 304 U.S. 64, 78, 58 S.Ct. 817, 822, 82 L.Ed. 1188.)

205 Id. (citing Wallis v. Pan American Petroleum Corp., 86 S.Ct. 1301, 1304, (1966)).

206 Id, at 669.

207 Id, at 673.
The bearings of the Section 1821 (k) on the conduct standards applying to bank directors therefore prove to be much limited than thought. Of which the most likely is on the exculpatory statute. For a state such as Delaware allowing corporate directors to be immune from due care liability altogether by way of exculpation statute, Section 1821 (k) pre-empts the exculpation statute, while leaves intact other portions of the Delaware common law and statutory law.

It is also obvious that the *Atherton* court stood by the traditional vein of thoughts— the non-shareholder corporate stakeholder’s consideration and protection is a matter to be basically addressed outside the realm of corporate law. In this regard, the *Atherton* court refused to make an exception out of the banking industry.

**IV. Concluding Observations and Comments**

The U. S. Supreme Court’s decision in *Atherton* reveals its refusal to deferring to the agency’s explanations concerning Section 1821 (k) and, more generally, to their public-interest, safety-and-soundness pronunciations of incorporating a pluralist and stakeholder approach into formulating corporate governance standards. By doing so whether the US Supreme Court has, as asserted by some commentators, invited more explicit Congressional authority to validate the agency’s stakeholder stance remains unclear. The Supreme Court’s endorsement of the applicability in the banking context of the shareholder model of corporate governance as primarily informed by state corporate laws in their pursuit for maximizing shareholder gains while leaving sideline other corporate stakeholders is nevertheless rather clear. Drawing on this stance, the following sets forth this chapter’s concluding observations and comments.

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(208) Id., at 674 & 675.


A. A Critique over Atherton’s Rejection of Pluralist Approach to Corporate Governance Standards in Banking Context

The Atherton’s formulation of corporate governance standards in the banking standards is not unassailable. The court’s stance of considering a fiduciary duty claim brought by the FDIC on behalf of the bank purely a private suit reflected its ignorance of in reality the claim’s many non-private regulatory attributes, including such claims’ primary public-interest purpose for recovering taxpayers’ losses caused by corrupt or incompetent bank management. Atherton therefore officially closed the chapter at which the banking regulator had sometimes succeeded in the past forcing through their stakeholder considerations by setting the bank management’s standards of conduct addressed to the realm of corporate law, yet for regulatory purposes. In other words, under Atherton, the nature and substance regarding the bank management’s required standards of conduct as considered primarily informed by state corporate law have been largely settled to be no different from the industrial management.

The Atherton decision in refraining from exercising its judicial creation function associated with resolving conflicts between federal and state laws was based on one critical assumption —that at the federal (or national) level, federal banking statutes and their derived regulations as well as the federal banking regulator’s regulatory pronouncements had failed to “set forth general corporate governance standards” relative to those under state corporate laws over relationships among bank directors, officers, shareholders and other stakeholders. This assumption deserves further investigation. Whilst it is obvious inconsistent with the federal bank regulatory arrangement that the applicability of state corporate law’s “corporate governance procedures” must be qualified by the requirement for “safe and sound banking”,211 the full extent of this investigation will be further developed in the next chapter. It will demonstrate the reasoning of Atherton loses sight of the reality that the longstanding bank safety-and-soundness principle based regulation, supervision and enforcement and examination practice have created a regulatory duty to be borne by the bank management that is of the same open-ended and open-textured nature as the fiduciary

duty under state corporate law, both directing to the core of key commercial business decisions and regulating their ensuing risks. It will further expose the acute clashes in the course of these two sets of conduct standards confronting each other over regulating conduct of the bank management under their bifurcated regulatory objectives.

B. Atherton’s Attendant Effects on Delaware Fiduciary Law

1. Applicability of Business Judgment Rule

Before Atherton, of the fiercest debated topics associated with the bank management’s due care standards under state corporate law was the latitude to be given to the bank management during the court’s review over due care breach claims, not least the warranted lengths of the operation of the business judgment rule. While some commentators echoed the banking regulator’s view and argued for the need of contracting the application of the defer-to-management business judgment rule during a court review that the judicial review should be extended to the substance of a business decision made or authorized by the bank management when the depositor’s interests were at stake, the majority viewed this enhanced standard as unnecessary. The majority commentators’ view, as shared by ALI’s Principles of Corporate Governance, generally indicated that modern corporate law does not need to set an exception for the banking industry as the business boundary between the banking and non-banking has become blurred and any sensible distinctions can now hardly drawn from these two.

With the decision of Atherton, although the court did not directly and explicitly

214 See AIL, PRINCIPLES OF CORPORATE GOVERNANCE, Analysis and Recommendations 4.01 (a), Reporters Note 18 (“In general, today banks and other financial institutions are often complex economic entities with activities far wider than the holding of deposits. Industrial Corporations often are, at least in part, financial institutions. No sensible distinctions can be drawn solely on the basis of the label ‘financial’ as opposed to ‘industrial’ corporation.”); also see Heidi Schooner, Fiduciary Duties Demanding Cousin: Bank Director Liability For Unsafe Or Unsound Banking Practices, 63 Geo. Wash. L. Rev. 175, 186-7 (1995); Banking Briefs, FDIC’s Simple Negligence Claims Against Former Bank Directors Were Precluded By The Texas Business Judgment Rule, 112 Banking L. J. 702, 702 (1995) (citing FDIC v. Benson, 867 F. SUPP. 512 (SD TEX. 1994) [BLJD § 23.06], the FDIC’s claims for simple negligence against a failed bank’s former directors were precluded by the business judgment rule.)
address whether the Delaware’s “process due care” fashion of court review would correspond to the gross negligence floor standard of conduct, given the U. S. Supreme Court’s clear direction that corporate governance standards enshrined under the state corporate law should remain an exclusive source of law governing conduct of the bank management, it is more than likely the Delaware’s procedure-centred mode of fiduciary duty review will prevail in the banking context.

2. Bank Safety and Soundness Consideration as Topic of Compliance

As informed by the Delaware corporate law regime, rather than itself a corporate objective, the regulator’s concern for safe and sound banking as a class of stakeholder considerations can only seek protection by posing as a topic of compliance in the realm of corporate law. As far as the bank management is concerned, in their daily course of managing the bank, achieving or maintaining bank safety and soundness therefore could either be a passive duty to refrain from knowingly violating regulatory orders or pronunciations, or, a relaxed requirement that only “an utter failure to attempt to assure a reasonable information and reporting system ... establish[ing] the lack of good faith”215 could give rise to managerial liability.

Even though the passage of Section 1821 (k), with its floor, gross negligence, and national liability imposition, has ostensibly raised the bar concerning required prudence, its practical effectiveness on promoting bank safety and soundness through prudent risk taking is likely to be limited. As argued previously, this is primarily because, given Atherton’s dictum, the high probability that the Delaware’s business judgement rule and its deriving process due care review standard will correspond to the gross negligence floor of standard of conduct. As a result, whenever there is a bank management made or authorized disinterested and good-faith risk taking decision, including one deciding on certain amount of bank resources to be put towards establishing or maintaining the bank’s internal mechanisms for bank safety and soundness causes, the operation of the business judgment rule would bar the court from substantively reviewing the substance of such decision. Instead, only after the plaintiff in a derivative suit had rebutted the

215 See Caremark, supra note 1, at 966.
business judgment rule’s connected well-informed presumption by establishing in reaching such decision, procedurally the bank management’s failing to take in necessary information (i.e., being ill-informed) came out of gross negligence or worse could any monetary damage be imposed on them. As a result, the ostensibly higher due care standards required of the bank management under the 1821 (k) might well be understood as yet another set of aspirational standards of conduct as opposed to concrete standards of review.\textsuperscript{216}

Beyond the legal requirements that have informed an implicit functional divide of corporate law addressed to the residual claimer’s interests and external regulations to stakeholder protection, also for some practical reasons, the bank safety and soundness regulatory objective may remain an area hardly fuelling the bank executive’s passion but rather they would tend to feel alienated to. As a matter of business, bank safety and soundness and other compliance topics that largely concern public interests are basically irrelevant to the parameters that have been set by private ordering and those monitors of objectivity against which the bank management’s performance is being judged. On a practical note, a bank executive who has done an excellent job can therefore only be one not only achieving but surpassing the institution’s annual profitability target, a task going well beyond simply sustaining the bank and steering it in a “safe” course.

\textsuperscript{216} Arguably, only in two areas could the 1821 (k)’s gross negligence due-care standard make a difference in the banking context. First, as noted previously, the floor standard idea has literally invalidated the state corporate law’s exculpatory statutory which made available corporate management being shielded from any due care violation. The second area that can be conceived involves those unconsidered inactions, which fall outside the application of the business judgement rule since there is no “decision” involved. Comparing with the quasi-bad faith standard of review applying to the non-banking context, arguably the bank management would be held personably liable for any unconsidered inaction connecting to their managerial functions that was considered came out of gross negligence or worse.
CHAPTER FOUR –  
Regulatory Requirements for Managerial Safety and Soundness and Their Sweeping Implications on Shareholder Governance Model over US Banking Organizations

In early 1990s when the US society was still reeling from the sheer magnitude of losses caused by the country’s banking crises, one of the hottest contested issues of the banking sector reform concerned whether there was a need to bring the banking regulator’s safety and soundness agenda into the composition of the corporate law fiduciary duty owed by bank management to banks. As discussed in chapter three, the US Supreme Court in 1997 ended this debate with the Atherton decision positioning the bank management, as their industrial counterparts, on the traditional track of the shareholder model of corporate governance. Atherton considers state corporate law based enabling rules, predicated on the supremacy of maximizing shareholders’ wealth, the general exclusion of stakeholders and judicial abstention over reviewing bank managements’ disinterested and good-faith decisions, as in general an exclusive source of corporate governance standards regulating managerial conduct and the bank’s internal affairs; whereas the banking regulator’s consideration for the safety and soundness status of the institution, including the adequate managerial quality concerning risk taking, is pursued (and should remain so) under such external rules as banking statutes, their derived regulations and the agency’s other rule-making works. One natural extension of this mode is the bank safety and soundness consideration, as a class of non-shareholder or stakeholder interests, was assumed largely irrelevant to the banking organization’s profit maximization corporate objective and could only appear as a blackletter compliance topic and find its marginalized place under the shareholder model of corporate governance. This division of responsibilities, as argued in chapter three, can only sustain on an assumption — that the extent to which the stakeholder considerations and its derived external regulations can be duly specified, and therefore can act as a specific strand of constraints against the set of general rules conducive to profit maximization. This chapter attempts to demonstrate this assumption does not hold true in the banking
context.

Primarily drawing on banking regulators' safety and soundness pronunciations publicized post-Atherton that were contained in enforcement orders and examination material and various regulatory and supervisory directives, the author demonstrates in section one the ubiquitous presence of the concept of unsafe and unsound bank management by indicating a number of its result-oriented and defer-to-regulator attributes. They range from those "deemed" unsafe and unsound practices resulting from banks or bank managements' unsatisfactory performances identified in supervisory reports, to those relating to restricted or prohibited risk appetites, prescribed often disregarding the institution's general financial and managerial strength, further to those simply "unlawful" activities, traditionally categorized as compliance now moving into safety and soundness topics. These regulatory pronunciations' repercussions on managerial mindsets are enormous. The resultant instillation of an objective reasonableness standard or the industry standard, which is a step further than even the hypothetical "reasonable person" one that was dismissed by the Delaware Chancery Court in its due care review as being too strict to sustain the corporate management's risk-taking enthusiasm, as argued in the same section, has injected a general loss avoidance psychology on the bank management. It is more so when one considers those formidable enforcement measures that could impose liabilities and force through corrections against even innocent safety and soundness violations.

As will be shown in Section two, the consideration for banks' (or bank subsidiaries') safe and sound management also implicates with bank holding companies which, under the operation of the source of strength doctrine and other regulatory principles as discussed in section two, are obligated to serve as the ultimate financial and managerial source for their banking subsidiaries. This represents a major deviation from the state corporate law's attitude towards parent-subsidiary relationships, as reflected by the limited liability privilege enjoyed by corporate shareholders and the insistence on corporate separateness, where corporate subsidiaries doing parents' bidding is considered the norm of business.

On a comparative note, section three delineates the concept of managerial safety and soundness in relation to fiduciary duties in general and also in their respective
applications in change-of-control, insolvency and intra-group contexts. Section four then focus on a broader governance dimension, articulating the sweeping impacts of the regulatory pursuit for managerial safety and soundness on the primary governance mechanisms supporting the state corporate law based shareholder model of corporate governance.

Section five offers the chapter’s concluding remarks and comments.

I. Managerial Aspect of Bank Safety and Soundness Concept: Substance and Enforcement

This section explores the bank safety and soundness concept as reflected on the managerial front from two dimensions: substance and enforcement. The federal banking regulators through general rule-making, specific enforcement rulings and examination processes have given content to this concept by mandating firm-wide risk-management policies and procedures to be devised and implemented prudently, by requiring the bank management to restricting from certain specific transactions considered as overly risky, and by equating duty of loyalty breaches with unsafe and unsound practices. The recent trends also suggest the bank regulator’s inclination of incorporating certain compliance issues into their safety and soundness agenda.

Three enforcement aspects addressing the above-listed topics will also be covered in this section. They are, first, non-culpability unsafe and unsound banking practice as triggering event for regulatory interventions; second, culpable unsafe and unsound banking practice and resultant regulatory liabilities; and, finally, the preservation of enforcement authority.

The overall impact of the regulatory pursuit for managerial safety and soundness can be twofold. First, there is an enhanced demand for the bank management’s integrity, where self-interest loyalty breaches are not only addressed by the state fiduciary law but have been incorporated into the bank regulator’s unsafe and unsound categorization. In this respect, the regulatory safety and soundness pursuit serves the interests of both the shareholder and the creditor, including the depositor. Second, safety and soundness enforcement mechanisms, with their formidable deterrence effects being exerted on the banking institution as well as their management, have instilled a
distinctively "prudent" managerial psychology in the bank management during the bank's ordinary course of business generally while the institution's insolvency risk is still rather remote.

A. Attributes of Managerial Bank Safety and Soundness

Making an exhaustive account categorizing safe and sound (or unsafe and unsound) banking practices is unattainable a task. This is because, as the concept of fiduciary duties under state corporate law, the bank safety and soundness concept is by design an open-ended and open-textured concept based on progressive recognition primarily through the banking agency's regulatory and supervisory prescriptions. An unsafe and unsound banking practice is referred commonly by banking regulators and courts as "[a]ny conduct that is contrary to generally accepted standards for prudent bank operations and that, if continued, might result in abnormal risk or loss or damage to the bank". Consequently, "[w]hile there are guidelines, there are also gray areas allowing discretion". For example, while adequate risk management, generally indicated by quality internal-control policies and processes and implementation thereof over risk-taking, has now emerged as the core of the safety and soundness concept on the managerial front, the regulator only notes functionally that such internal processes should properly correspond to the size of the bank and the degree of complexity of the product or service offered. Against this restraint, the existing regulatory pronunciations to which the sub-section will turn are however still instrumental in terms of delineating the conceptualization of this concept and its projected desirable patterns of managerial conduct.

1 OFFICE OF THE COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK, THE ROLE OF A NATIONAL BANK DIRECTOR 64 (1987). A number of cases stated to the same effect, "conduct deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder", see e.g., Comptroller of the Currency, Fist Nat'l Bank of Eden v. Department of the Treasure, 568 F. 2d 610, 611 n.2 (8th Cir. 1978) (per curiam); Northwest Nat'l Bank v. United States, 917 F. 2d 1111, 1115 (8th Cir. 1990).

2 Laura Pringle, Safety And Soundness Standards and Bank Officer And Director Responsibility, 27 Oklahoma City University Law Review, 1017, 1020 (2002).

1. Adequate Level of Prudence in Devising and Implementing Risk-management Policies and Procedures; Restricted Risk Appetites

The managerial aspect of the concept of bank safety and soundness is largely result-orientated, so is the review standard thereof. Consequential standards are frequently required of both banking organizations and their management, whose sub-standard practices ranging from non-culpability activities to deliberate violations, would lead to regulatory consequences and liabilities varying in intensity. The result-oriented nature of this concept is further enhanced by the broad latitude accorded to banking agencies by court when reviewing agency-made safety and soundness prescriptions — "the-regulators-know-it-when-they-see-it" test, as put rather vividly by one commentator.

By drawing on sources of statutes, regulator-made general rules, private rulings, as well as regulatory pronouncements in examinations and enforcement procedures, the following explore the managerial side of this consequential concept of safety and soundness in practice. The findings reveal two attributes of managerial safety and soundness: affirmatively, it points to adequacy of the bank's internal controls, systems, procedures and policies as through the regulator's lens; it further, regardless of the institution's managerial strength, forestalls certain practices and earmarks them as unsafe and unsound for the risk appetites displayed were considered by the regulator as overly aggressive or excessive.

a. Managerial Safety and Soundness as Institution's Adequate Device and Implementation of Internal Controls, Systems, Procedures and Policies as Verified by Regulator; "Deemed" Unsafe and Unsound Banking Practices

The banking agency is by law allowed to automatically deem a banking institution as engaging in unsafe and unsound banking practices upon the institution's receipt of a less than satisfactory rating in its most recent report of on-site examination for asset quality, management, earnings, or liquidity. Although a deemed unsafe and unsound practice

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5 12 U. S. C. sec 1818 (b)(8).
is directly predicated on the bank’s practice or condition, a bank director can be indirectly implicated with such practice upon failing to complying with enforcement orders issued against the institution.⁶

Before assigning a satisfactory rating to the management factor, the following will have to be established by the banking regulator — active oversight by the board and management; competent personnel; maintenance of appropriate audit program and internal control environment; and effective risk monitoring and management information systems.⁷ — a batch of managerial functions focusing on establishing effective controls, systems, procedures and policies covered already by the state corporate law’s standards of conduct and subjected to the state court’s review, only in banking the extent to which they exist would be further periodically assessed by the banking examiner during bank safety and soundness examinations.

Bank examiners review managerial conduct differently from the state court. Whereas the state court’s fiduciary duty review over managerial decisions or the institution’s strength on internal controls and procedures is conducted primarily upon institution of law suits, bank examiners periodically assess managerial functions through portfolio-level reviews and transaction-level testing. A rating 3, the starting point of a less-than-satisfactory rating, points unsafe and unsound management at, in general, underperformance of the design of the institution’s internal monitoring, information and control systems — as a result of a portfolio-level review — or, at individual transactions’ inadequately applying the institution’s existing systems (in the banking context, including underwriting, loan administration procedures as well as internal allowance and capital policies) — as a result of sampling of a transaction-level testing — or both.⁸

The above suggests the institution’s adequate procedural arrangements, both in

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⁶ See Heidi Mandanis Schooner, *Fiduciary Duties’ Demanding Cousin: Bank Director Liability For Unsafe or Unsound Banking Practices*, 63 G.W.L.Rev. 175, 206 (1995) (noting a cease and desist order whose respondent is the institution as opposed to an individual bank officer is binding on the bank and all institution-affiliated parties).


terms of design and implementation, one able to deliver prudent risk-taking decisions, is 
an essential component of safe and sound banking. In this regard, managerial safety 
and soundness means a resultant situation of procedural prudence pertaining to the 
required adequate risk management as verified through substantive regulatory reviews. 
This observation is coherent with federal banking agencies' pronouncements in the 
Interagency Guidelines Establishing Standards for Safety and Soundness, one of their 
major safety and soundness rule-making works effective in August 1995. Over the past 
ten 10 years or so, this result-oriented, procedural prudence approach was repeatedly 
adopted by the banking regulator in setting standards for more specific safety and 
soundness topics such as real estate loan, purchase of securities with high-yielding but 
low investment grade rating, and subprime lending.

Apart from periodical review through on-site banking examinations, the bank 
regulator may also on an ad hoc basis conduct special examinations reviewing the 
bank's managerial strength using the same result-oriented approach.

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9 One example is the 1992 real estate loan guidelines (a set of uniform standards prescribed by federal 
banking regulators under the direction of FDICIA, applied to federally insured depositories across the 
board). See 12 U.S.C. § 1828 (o). Apart from the imposition of loan-to-value ceilings of 65 to 85, the 
final form of the guidelines heavily emphasized adequate monitoring and control functions that include 
loan underwriting procedures, appraisals standards, compliance monitoring, credit factors analyses, 
standards for the use of pre-funded interest, and procedures for loan administration, loan extensions, and 
loan forbearance. For background information and more detailed discussion, see generally, Gary 

10 The OCC considers not inherently an unsafe and unsound practice by purchasing high-yielding 
securities that fall at the low end of the investment grade rating scale. However, when banks change their 
investing practices or strategies by taking on more credit risk as acquiring high-yielding and low 
investment-grade securities without appropriate credit due diligence, limits, and guidelines, such practices 
become unsafe and unsound. See Office of the Comptroller of the Currency, Unsafe And Unsound 
WL 1162661 (O.C.C.)).

11 As defined by the banking agency, the term “subprime” refers to individual borrowers' undesirable 
credit characteristics such as weakened credit histories as demonstrated by payment delinquencies, or 
reduced repayment capacity, measured by credit scores or debt-to-income ratios. See Federal Reserve 
Board, Subprime Lending, SR 01-4 (Gen), Attachment: Interagency Expanded Guidance For Subprime 
Lending Programs, 1, 2-3 (31 Jan. 2001).

When a bank's primary supervisor decides the risks associated with the subprime lending activity are not 
properly controlled by means of board-approved policies and procedures, as well as internal controls, the 
agency considers it an unduly high-risk activity that is unsafe and unsound. See Federal Reserve Board, 
Subprime Lending, SR 99-6 (Gen), Attachment: Interagency Guidance on Subprime Lending, 1, 2 (5 Mar. 
1999).

12 For an ad hoc case, see e.g., Federal Reserve Board, In The Matter of Daiwa Bank, Ltd. Osaka, Japan 
b. Managerial Safety and Soundness as Management’s Adequate Implementation of Risk-management Policies and Procedures

Similar to the review and control over the institution, a result-oriented approach applies also to the bank director and official, as institution-affiliated parties in the regulatory term, checking their specific risk-taking decisions and monitoring-function performance.

In a 2003 safety and soundness personal cease and desist order, for instance, a bank official was considered engaging in unsafe and unsound banking practices connecting to her underwriting of a $13,000,000 asset-based line of credit when she failed to investigate the weaknesses identified in a pre-funding audit of the borrower, and also to her management of the line of credit when she failed to take the borrower’s chronic overdraft position and collateral shortfall into account before facilitating the payment of a series of overdrafts and payments against uncollected funds on the borrower’s account.

This aspect of managerial safety and soundness, predicated on an industry standard concerning implementing or devising internal risk-management procedures that is reviewed through the industry-standard lens of the bank regulator, indicates a convergence of standards of conduct and of review. It presents a dramatic departure from the defer-to-management formula developed under Delaware corporate law and its prudent banking practices, Daiwa and the New York Branch did not adequately separate the trading function from the backroom operations, thereby permitting Iguchi to influence the performance of recordkeeping and internal controls over his own trades.

13 Office of the Comptroller of the Currency, In the Matter of Alina Cannon, Former Senior Vice President Hamilton Bank, N. A., Miami, Florida, Order for Personal Cease and Desist Issued Upon Consent, (24 Aug. 2003), 2003 WL 21275988 (O. C. C.); see also Office of the Comptroller of the Currency, In the Matter of Mary Rebecca Summers, Former Executive Vice President And Cashier, The National State Bank Of Metropolis, Metropolis, Illinois, Order for Personal Cease and Desist Issued Upon Consent, (31 Mar. 2003), 2003 WL 21206972 (O.C.C.) (cease and desist order issued on the safety and soundness ground asserting the Respondent’s “lack of effective and adequate risk monitoring and control”); Federal Deposit Insurance Corporation, In the Matter of Asia-Europe-Americas Bank, Seattle, Washington (Insured State Nonmember Bank), Order for Cease and Desist Issued Upon Consent, FDIC-04-109B, DFI-04-01 (17 May 2004) (WL 1586515 (F.D.I.C.)) (cease and desist order alleging unsafe and unsound practices concerning the bank and its institution-affiliated parties for “(a) operating with management whose policies and practices are detrimental to the Bank and jeopardize the safety of its deposits; (b) operating with a board of directors which has failed to provide adequate supervision over and direction to the active management of the Bank; (c) operating with an inadequate loan valuation reserve; (d) operating with a large volume of poor quality loans; (e) engaging in unsatisfactory lending practices; (f) operating in such a manner as to produce low earnings”).

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c. Prohibited or Restricted Unsafe and Unsound Risk Appetites

Rather than declaring unsafe and unsound banking practices along the above adequate-procedure line, federal banking regulators sometimes directly earmark certain business decisions as unsafe and unsound for their perceived risks considered overly high or complex or both. Contrasting to the trip-wire system of Prompt Corrective Action where restrictions would be imposed only after the institution’s financial or managerial strength is considered unsatisfactory, these declarations pointing to the bank’s day-to-day operation can apply across the board regardless of the institution’s financial or managerial health. Whereas the adequate-procedure line of managerial safety and soundness concept focuses on the institution’s quality of and compliance with internal risk-management procedures, policies and controls, this type of safety and soundness pronouncements directly address the risk appetite expected of the banking regulator on the bank management over specific transactions.

For instance, in addressing lending’s susceptibility to cyclical changes in economy, those lending decisions relying on “optimistic outlooks for borrowers and continued favorable economic and financial market conditions” were earmarked by the Federal Reserve Board as “departure from historically sound lending practices” that would have effected a downgrading of the institution’s risk management if “this reliance has slowed the institution’s recognition of loan problems”\(^\text{14}\). It is noticeable the above declaration was made in 1999, a year when American economy was robust and banking industry generally sound.

Other federal banking regulators from time to time do just the same as the Federal Reserve Board. For example, the OCC, as the primary regulator of national banks, declared that purchasing or holding excessive bank-owned life insurance represents an unsafe and unsound banking practice, given heightened liquidity, credit and tax risks

associated with such transactions.\textsuperscript{15} Again, this declaration applies across the board, regardless of the institution's strength on risk management.\textsuperscript{16}

In making these safety and soundness pronouncements, the federal banking regulators can go so discrete an aspect of a transaction so that a particular contractual clause, as opposed to the entire transaction, could be pronounced as unsafe and unsound. Whereas the OCC considers purchases and sales of loans and participations in loans as established banking practices, the absence of a "prudent" transfer arrangement in these transactions to the extent a purchaser's ability to obtain, assess, and maintain sufficient credit information might be compromised was pronounced as an unsafe or unsound banking practice.\textsuperscript{17}

Moreover, the agency's safety-and-soundness views can be also held against transactions that are ostensibly of low risk. When transacting on the sale and purchase of US government guaranteed loans, for example, the OCC noted it is generally considered an unsafe and unsound banking practice for a bank to pay excessive purchase premiums that do not reasonably reflect the yield on a loan. Where the purchase premiums are not guaranteed and, if the loans are prepaid, are not paid by the guaranteeing of the government, the OCC hold concerns over excessive premiums could have distorted the bank's real financial standing with the bank's actual value of assets being significantly overstated by book value.\textsuperscript{18}

The regulator's safety and soundness considerations may also implicate with decisions adopted by the banks' ostensibly independent governance mechanisms, in particular when they are considered have substantial impacts on the bank's incentive structure. One prominent example concerns the management's compensation

\textsuperscript{15} Office of the Comptroller of the Currency, Unsafe And Unsound Investment Portfolio Practices Supplemental Guidance, OCC Bulletin 2002-19, 1, 7 (22 May 2002) (2002 WL 1162661 (O.C.C.)) (A bank-owned life insurance (BOLI) in this context is used for protecting against the loss of key employees or hedging employee compensation and benefit plans. The OCC noted the complex risks inherent in the BOLI policies as: "Although banks can surrender their BOLI policies for their cash surrender value, they typically would incur substantial losses to do so. Moreover, a determination that the policies do not satisfy insurable interest requirements may result in a forced cancellation, and/or jeopardize the tax-free status of the accumulation of cash surrender value, thereby negatively impacting the originally anticipated return.").

\textsuperscript{16} Id.

\textsuperscript{17} OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK, ASSETS, LOAN PORTFOLIO MANAGEMENT, APPEN. E. 2 (1998) (1998 WL 161494 (O.C.C.)).

\textsuperscript{18} Id., at, APPEN. E. 3.
arrangement, which is typically decided by the bank's audit or compensation committees, with a view to align the interest of shareholders and that of corporate directors. The bank regulator has paid particular attentions to those compensation arrangements that likely give the bank management incentives to taking excessive risks. Implemented compensation practices that were denounced as unsafe and unsound include certain bonus provisions of employment contracts that were considered unduly tied to productivity indicators, and certain termination provisions that disabled the bank to terminate the employee's compensation however undesirable the employee's performance might be. Another example in this area concerns dividend payment. While dividend payment leading to breaching minimum capital requirements clearly constitutes an unsafe and unsound banking practice, the management's safety and soundness regulatory duty in this area does not end here. As required by the OCC, bank examiners must ensure the dividend payment decision made by the management would not have "an adverse impact on long-term capital adequacy" after taking into account the bank's projections, capital plan and strategic plan.

For a banking organization considered in a "troubled condition", a defined term referred to certain unsatisfactory financial or managerial condition, the bank regulators would go even further. Under such troubled condition and from a bank safety and soundness perspective, the incentive effects flowing from compensation arrangements may become more relevant than otherwise — among others, the management may decide to steer the bank through such adversity or simply abandon the ship, depending on the composition of their compensation package. According to the FDIC regulations, "golden parachute" payment is generally prohibited from being made by a depository

20 Id, text accompanying note 65-71.
22 Id.
23 Section 225.71 of Regulation Y defines a troubled condition for a state member bank or bank holding company as an institution that (i) has a composite rating of 4 or 5; (ii) is subject to a cease and desist order or formal written agreement that requires action to improve the institution's financial condition, unless otherwise informed in writing by the Federal Reserve; or (iii) is informed in writing by the Federal Reserve that it is in a troubled condition. See also supra note as to financial and managerial criteria as to assigning composite ratings.
institution and its holding company to directors and senior management and other affiliated-parties of the depository institution when the organization is in a troubled condition.²⁴

A troubled condition would also give grounds to more stringent restraints on the bank’s risk-taking decisions. For example, on one of trouble conditions when a bank is being subject to a cease and desist order on safety and soundness violation grounds, this otherwise well-capitalized bank will not be able to acquire another institution and will be restricted from engaging in activities that are “financial in nature” as provided under the Gramm-Leach-Bliley Act.²⁵

2. Equating Duty of Loyalty Breaches with Unsafe and Unsound Practices: Enhanced Requirement for Integrity

Applying commonly to non-banking as well as to banking industries, the starting point of a duty of loyalty analysis is a conflict-of-interest examination, i.e., whether bank management “appear on both sides of a transaction”, or they “derive any personal financial benefit from it in the sense of self-dealing”.²⁶ Nevertheless, there is a major

²⁴ Golden parachute payment restrictions (12 U.S.C. 1828 (k)) were added to the Federal Deposit Insurance Act after enactment of the Crime Control Act of 1990. With the authorization of the law, the FDIC issued implementing regulations (12 C.F.R. Part 359). Under the FDIC’s regulations, a “golden parachute” payment means any payment in the nature of compensation (or agreement to make such a payment) for the benefit of any current or former institution-affiliated party of a depository institution or its holding company that meets three criteria. First, the payment or agreement must be contingent upon the termination of the institution-affiliated party’s employment or association. Second, the payment or agreement is received on or after, or made in contemplation of, among other things, a determination that the institution or holding company is in a “troubled condition”. Finally, the payment or agreement must be payable to an institution-affiliated party who is terminated when the institution or holding company meets certain specific conditions, including being subject to a determination that it is in a troubled condition. See Board of Governors of the Federal Reserve System, Guidance Regarding Restrictions on Institutions in Troubled Condition, para 4-6, (SR 03-6) (22 April 2003).


²⁶ See e.g., In re Seidman, 37 F.3d 911, 934 (3d Cir. 1994) (quoting In re Bush, OTS AP 91-16 at 11, 15-16) (“The threshold inquiry in assessing whether a director violated his duty of loyalty is whether the director has a conflicting interest in the transaction. Directors are considered to be ‘interested’ if they either appear on both sides of a transaction,... or expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.”) This is despite fiduciary duty claims in the banking context have acted as an extensive enforcement tool and the unsettled issue of fiduciary duty recipients with banking regulators’ continuous
difference in the banking context which results in the elevated integrity required of the bank management. That is the federal banking agency’s firm position that a loyalty duty breach alone would constitute an unsafe and unsound practice.27

At first glance, this proposition seems to be a departure from the statutory language where unsafe or unsound practices are grounds for cease-and-desist enforcement orders and fiduciary duty breaches (including loyalty duty breaches) are not.28 Furthermore, some commentators have argued against this approach by pointing out the two concepts’ differences in their compositions, not least the required actual damage to be proven by the plaintiff before a fiduciary duty breach can be made actionable, which contrasts the predictive nature of a safety and soundness violation where the “potential” of undue risk to the institution would suffice an enforcement action.29

In a 1997 final prohibition order of In Re: Charles R. Vickery, JR., First National Bank Of Bellaire,30 the Federal Reserve Board demonstrated how the federal banking agency tried to overcome the above challenges to equate a loyalty duty breach, whose locus is the misconduct’s impropriety and its resultant damages on the corporate entity or personal gains on the relevant management, with a safety and soundness violation, which is theoretically underpinned by the violation’s posing risks to deposit insurance fund and to the institution’s ongoing operation.

Under the relevant statute provisions, a removal or prohibition order can only be issued by the federal banking regulators upon making three separate findings:31 (1) misconduct: violation of law, unsafe or unsound practice, or breach of fiduciary duty; and (2) prescribed effects: financial gain to the respondent or financial loss or other efforts in formulating some form of loyalty duty running to depositors or to agencies themselves. See Chapter three

27 See e.g., Board of Governors of the Federal Reserve System (F.R.B.), In Re: Charles R. Vickery, JR., First National Bank Of Bellaire, Bellaire, Texas, AA-OCC-EC-96-95, 1, 8 (14 Apr. 1997) (1997 WL 178423 (F.R.B.)) (“[The Respondent’s] ‘disregard for safety or soundness’ is established because his self-dealing constituted an unsafe or unsound practice.”)

28 Basis for a cease and desist order may be violation of law, rule or regulation, unsafe and unsound banking practice, or violation of a formal written agreement or condition imposed in writing in connection with an application submitted to the appropriate federal banking agency. 12 U. S. C. § 1818 (b).


damage to the institution; and (3) culpability: personal dishonesty or wilful or continuing disregard for the safety or soundness of the institution. In the Vickery case, the findings made by the regulator supported a text-book, self-interest loyalty duty breach claim. The respondent, Charles R. Vickery, as the former Chairman of the board of directors of a national bank, was found engaging in practices of collecting commissions (or "referral fees") from title insurance companies in return for referring borrowers to them. The self-interest misconduct, in combination with the effect of personal gains and the culpability of personal dishonesty, clearly rendered the fiduciary ground to issue a prohibition order. The less clear was, however, if the findings also supported a prohibition order on the safety and soundness ground, as also sought by the regulator in the enforcement proceedings. The regulator articulated unsafe and unsound practices in that the personal financial stake in the loans would have resulted in the institution's substandard loan underwriting and credit-risk management. The articulation deftly pointed out, where personal interests "were directly served by ensuring that loans were made in any case, the bigger the better, so that [the respondent] would receive his referral fees from the title insurance company", these personal interests were directly put on a collision course with that of the bank of every credit being prudently extended based on risk considerations.

Loyalty duty breach cases are among the rare areas where the bank regulator is not able to always secure a judicial deference when their safety and soundness based enforcement orders are contested before court. But so far as these loyalty duty breach cases enforced on safety and soundness grounds have proven to some extent a success before court, it will promise the banking agency's continuous eagerness in employing safety-and-soundness enforcement actions (including cease and desist orders by treating fiduciary duty breaches as a sub-set of unsafe and unsound banking practice)

33 Id. at 5.
34 See e.g., PATRICIA A. McCoy, BANKING LAW MANUAL § 13. 3 [4] (2nd ed., 2000) (comparing Kaplan v. OTS, 104 F. 3d 417, 421 n. 2 (D. C. Cir. 1997) ("a fiduciary breach can qualify as an unsafe and unsound practice and thus be actionable under § 1818 (b)(1)") with In re Seidman, 37 F. 2d 911, 932 (3d Cir. 1994) (an unsafe and unsound practice is not necessarily a breach of fiduciary duty and vice versa))
to address those practices where the bank management places their personal interests ahead of the institution entrusted to them. One net effect is, contrasting to their non-banking counterparts, bank management will continuously expose to this extra requirement for enhanced integrity as boosted by the bank regulator rather than the shareholder through their fully fledged regulation and enforcement actions triggered by safety and soundness violations. Commonly addressing the bank management’s self-interested activities, the supervisory effort of issuing safety-and-soundness based enforcement orders addressed to depositor protection and public interests therefore complements the derivative claim under state corporate law addressed to upholding shareholder interests.

3. Recent Trends: Incorporating Compliance Issues to Safety and Soundness Enforcements

The recent trends of safety and soundness enforcement actions are noteworthy because they might represent yet another starting point of the banking agency’s expansion of their enforcement authority in the name of managerial safety and soundness. Some recent enforcement actions embraced those violation-of-law compliance issues, such as fair lending compliance, that were already regulated under black-letter statutes and regulations and that were in the past outside the safety-and-soundness category concerning primarily risk-taking decisions. From a theoretical standpoint, attributing these compliance-violation practices to the traditional safety and soundness articulation is difficult because, whereas they have adverse effects on the bank’s certain constituencies, they in general do not endanger the going concern operation of the bank, nor do they pose any substantial threat to the well-being of the deposit insurance fund.

While the period of 2001 to 2005 also saw compliance violations such as

35 Traditionally, the three main areas where the banking agency is committed to promoting compliance are concerning federal consumer protection laws, fair lending statutes, and the Community Reinvestment Act. See FDIC, Financial Institution Letters, Revised Compliance Examination Procedures, FIL-52-2003 (20 June 2003). See Pringle, supra note 2, at 1020 (noting differences between implementing safety-and-soundness and compliance examinations—the former is more flexible in fashioning safe and sound policies and procedures of each individual institution; the latter adopts a more standard approach addressing “virtually identical issues at all banks” with legal requirements concerning compliance issues tending to be explicit).
escheating regulation violation enforced on safety and soundness, the two main strands of these cases involve unfair consumer practices and money laundering practices.

a. Consumer Protection: Tying Practice and Predatory Lending

In a combination order of cease and desist and assessment of civil money penalty (in the amount of $3 million) issued in 2003 against a bank’s compliance violations of section 106 of the Bank Holding Company Act Amendments of 1970, the Federal Reserve Board further alleged unsafe and unsound banking practices for failings of internal controls and internal procedures over the “tying” practice that extensions of credit to some corporate customers were conditioned upon their appointing the bank as a co-manager of syndicates underwriting future issues of debt securities. This case represents the first time ever the Federal Reserve System resorts to a formal enforcement action on safety and soundness grounds against a banking organization based on consumer protection violations of section 106. Interestingly, in the same year of 2003, the OCC also brought its first unfair practice enforcement case concerning the violation of the Federal Trade Commission Act that involved abusive tax lien loans to subprime borrowers.

36 Board of Governors of the Federal Reserve System (F.R.B.), In The Matter of Kenneth Goglia, A Former Officer And Institution-Affiliated Pary of Bankers Trust Company, New York, New York, Cease and Desist Order Issued Upon Consent, Docket No. 99-017-B-12 (19 July 2001) (2001 WL 855081 (F.R.B.)) (a former Managing Director was accused of participating in unsafe and unsound banking practices for leading the bank to “improperly account for and dispose of abandoned customer funds that were due to escheat to state authorities”).

37 See Thomas Vartanian, Enforcement Trends: Criminal Charges And State Participation, American Banker, 9 (26 Mar. 2004) (noting unfair consumer practices and money laundering cases, in particular under the Bank Secrecy Act, as the recent banking enforcement trends).


40 See Office of the Comptroller of the Currency (O. C. C.), Special Supervision And Enforcement Activities, 23 No.1 OCC Q. J. 1, 2 (2004) (WL 2360337 (O. C. C.)) In 2003, the OCC was rather vigorous in instituting formal enforcement actions remedying safety and soundness concerns over consumer protection compliance. Other safety and soundness enforcement actions against consumer protection compliance involved consumer protection statutes such as Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Equal Credit Opportunity Act, and Truth in Lending Act. See Id. at 3.
In the area of consumer protection, predatory lending has also attracted enormous amounts of safety and soundness attention recently. As an issue more akin to commercial morality, predatory lending could entail rather handsome returns to and little damages on the bank’s financials, leaving aside reputational concerns. The federal banking agency nonetheless categorically declared predatory lending, i.e., “loans to borrowers who do not demonstrate the capacity to repay the loan...from sources other than the collateral pledged”, as unsafe and unsound a banking practice. In an enforcement order, the agency’s predatory-lending related safety and soundness pronouncements extended to even cover the bank’s failure to properly overseeing its outsourcing vendor’s payday loan operation.

b. Fighting International Money Laundering and Terrorist Financing

With the USA Patriot Act signed into law on 26 October 2001, where the portions affecting banking organizations are generally set forth as amendments to the Bank Secrecy Act (“BSA”), fighting international money laundering and blocking terrorist access to the U. S. financial system reaches the forefront of bank compliance. Section 352 of the Patriot Act, for example, requires every bank to establish anti-money laundering program by 24 April 2002. The Federal Reserve Board’s regulations also required each bank under its supervision to maintain a BSA compliance program that

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41 For the definition of predatory lending, see e.g., Kathleen Engel & Patricia McCoy, A Tale Of Three Markets: The Law And Economics Of Predatory Lending, 80 Tex. L. Rev. 1255, 1260 (2002) (defining a predatory lending as the practice consisting of at least one of the five following components: “(1) loans structured to result in seriously disproportionate net harm to borrowers, (2) harmful rent seeking, (3) loans involving fraud or deceptive practices, (4) other forms of lack of transparency in loans that are not actionable as fraud, and (5) loans that require borrowers to waive meaningful legal redress.”)


44 For an outline of additional due diligence and recordkeeping practices set forth under the BSA as amended by the USA Patriot Act that include, among other things, prohibition on US correspondent accounts with shell banks, availability of bank records to bank regulators and law enforcement authorities, and due diligence for private banking and correspondent accounts as applied to the US insured depository institutions as well as to the US branches and agencies of foreign banks, see Board of Governors of the Federal Reserve System, The USA Patriot Act and the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001, SR 01-29 (26 Nov. 2001)
provides systemic treatments over internal controls and internal audits, as well as trained personnel, to ensure ongoing effective execution of anti money laundering compliance.  

Recently on 12 October 2004, the Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) launched its first publicly released enforcement action under the BSA following its amendment by the Patriot Act. The FinCEN’s enforcement action coincided with that of the Federal Reserve Board against the same bank under the same cause. In the Federal Reserve Board’s combination order of cease and desist and assessment of a civil money penalty (in the amount of $10 million), the bank agency enumerated various breaches relating to complying with anti-money laundering regulations that included failings of establishing and maintaining reasonable BSA-compliance procedures and of filing Suspicious Activity Reports in an accurate, complete and timely manner. In the Federal Reserve Board’s order, failing to “have adequate systems in place to prevent, identify, and report criminal activity conducted through the bank, and failing to promptly and fully cooperate with law enforcement authorities in the review and investigation of such activity” were explicitly pronounced as unsafe and unsound practices, to almost the exact extent they provided the grounds for FinCEN’s enforcement order.

c. Interim Comments: Intermingling Compliance Together with Safety and Soundness Issues

46 Id.
48 Id. See also Board of Governors of the Federal Reserve System, In The Matter Of State Bank Of India Mumbai, India, ET AL., Combination Order to Cease and Desist and of Assessment of a Civil Money Penalty, (13 Nov. 2001) (2001 WL 1432046 (F.R.B.)) (the Bank’s “failure[s] to establish and maintain procedures reasonably designed to assure and monitor compliance with the BSA and...to maintain correct and complete books and records” constitute unsafe and unsound banking practices.); Board of Governors of the Federal Reserve System (F.R.B.), In The Matter of Nelly Kann De Gouverneur, a Former Employee and Institution-Affiliated Party, Banco Mercantil, S.A.C.A., NEW YORK, NEW YORK, Personal Cease and Desist Order, Docket No. 01-000-E-11 (21 June 2001) (2001 WL 700614 (F.R.B.)) (unsafe and unsound practices connecting to assisting private banking customers’ deposits structuring that resulted in violations of the Currency and Foreign Transactions Reporting Act (31 U.S.C. § 5311 et seq.)).
Compliance and safety-and-soundness are two different sets of regulatory concerns, which, in practice, are separately addressed by safety and soundness examinations and compliance examinations. Although the newly revised compliance-risk focused program has, in appearance, emerged to resembling the risk-focused safety and soundness program that both emphasize board oversight, policies and procedures and internal audit, the two programs are originated from distinctive policy underpinnings. Compliance restraints typically specified by explicit legal rules are aimed at protecting such discrete stakeholders generally outside the realm of corporate law as the bank’s neighbouring residents, the consumer, or even the nation’s security. By contrast, safety and soundness regulation is meant to perform a gap-filler function in general terms towards the bank’s commercial decisions so as to have the institution expose to only an acceptable level of credit, market and operational risks, as perceived by the banking regulator. Thus, bundling together these two intrinsically disparate regulatory concepts as did the banking regulator in their enforcement procedure is theoretically inadequate. Moreover, it also renders no practical utility. Under the FDI Act, violation-of-law is already a cause separate from the unsafe and unsound banking practice that can trigger full-fledge enforcement actions. Attributing compliance violations to the concept of unsafe and unsound banking practices provides no extra protection. It simply confuses the bank management with exponential expansion on the regulator’s safety and soundness agenda and places them on tremendous legal uncertainties.

B. No-culpability Unsafe and Unsound Banking Practice as Triggering Event for Government Interventions and Potential Source of Liability

One essential aspect of safety-and-soundness based regulatory interventions in relation

49 Federal Deposit Insurance Corporation, Revised Compliance Examination Process, FIL-52-2003 (20 June 2003) (outlining the revised compliance examination process, which focused increasing attention on the institution’s compliance management system, for determining the depository institution’s compliance with consumer protection laws and regulations.); see also John Jackwood, Compliance Examinations: A Change in Focus, available at http://www.fdic.gov/examinations/supervisory/insights/compliance.html (visited: Jan. 2005) (noting the evolution of FDIC’s compliance examinations, the process from predominantly relying on reviewing actual banking transactions to incorporating an in-depth evaluation of a bank’s compliance management system into the examination.)

50 A violation of a law, rule or regulation can serve the grounds for a cease-and-desist order (12 U. S. C. § 1818 (b)(1)).
to the bank’s operation rests with the banking agency’s legal mandate of proactive interventions and their extremely forceful powers in enforcement. Both of which need no culpability to be attached. As discussed in chapter, unsafe and unsound banking practices are not confined to those inflicting direct, substantial financial losses on the institution, but also include sub-standard practices posing potentially undue risk to the institution in the future. Regulatory interventions on safety and soundness grounds therefore are not only aimed at addressing the banking institution’s problems related to capital shortages or insolvency risk that is imminent, but also at controlling the institution’s credit, market, operational and other risks in more general terms during its ordinary course of operation to hold it as a going concern.

1. Prompt Corrective Action
Under the Prompt Corrective Action ("PCA") regime, following an undesirable result of banking examination that exposes the bank’s weaknesses either in terms of capitalization or managerial strength or both, which usually equates with a deemed unsafe and unsound practice, the banking regulator is mandated to make entrepreneurial-type decisions overturning those previously adopted by the institution’s own management.51

2. Government Interventions by Informal Enforcement Actions: Supervisory Written Agreements
Besides the PCA regime, a much more far-reaching type of regulatory interventions comes from the bank regulator’s informal and formal safety and soundness enforcement actions, particularly the informal written agreement (such as supervisory agreements and the memorandums of understanding, MOUs52) and the formal cease-and-desist order.

51 Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), 12 U.S.C.A. § 1831o (West Supp.1992). The PCA based interventions can take place well before an institution is technically insolvent and subject to conservatorship or receivership. They take the form of a variety of such entrepreneurial-type decisions as the displacement of the bank’s management, the imposition of a cap on the interest rate the bank may pay on deposits, the compulsory new stock issues, the divestiture requirement for the bank of its subsidiaries, and the ultimate of receivership when the capital level of the bank falls in the solvent yet critically undercapitalized position. See also chapter two.

52 Supervisory agreements are functionally equivalent to MOUs where the former were commonly used by thrift regulators and the latter in the commercial banking industry. See Banking Law Manual § 13.02.
As a class of informal enforcement actions, i.e., enforcement methods not formally authorized by statute,\textsuperscript{53} a written agreement entered into by and between the regulator and the institution can be not so much a conciliatory result of bilateral negotiations as a unilateral supervisory directive reduced to the form of agreement. For those bank directors with institutions entrusted to them being in troubles, more than often they can have no choice but accept regulator-drafted “agreements” in their entirety in exchange for the regulator forbearing from initiating formal enforcement proceedings or other aggressive supervisory actions.

Moreover, such agreements, as pointed out by one commentator, typically “contain sweeping, outcome-oriented language focused on requiring the institution’s board of directors to accomplish or ‘ensure’ the accomplishment of specified objectives, such as require[ing] the board to ‘ensure’ the adoption and implementation of an effective loan review program, …[or] to take steps to cure loans criticized for lack of documentation…”\textsuperscript{54} All these sweeping elements are added by the serious legal consequences that even innocent violation of the agreement will subject both the institution and the bank director to the full array of formal enforcement punishments.\textsuperscript{55}

3. Government Interventions by Formal Enforcement Actions: Cease and Desist Orders

Cease-and-desist orders represent among the most intrusive form of government interventions that are explicitly authorized by bank statutes. They are issued under the discretion of the appropriate federal banking agency, often based on a resultant situation, and subject to the court’s ex post deferential review, both in terms of findings of fact and of interpretations of law (such as defining an unsafe and unsound practice). A cease-and-desist order can be directed against both institutions (the bank and its affiliated entire corporate family) and individuals (the institution-affiliated parties that

\textsuperscript{53} The differences between the terms “formal” and “informal” primarily rest with whether or not the enforcement methods are formally authorized by statute. Id.


\textsuperscript{55} See 12 U. S. C. § 1818 (a)(2) (termination of deposit insurance), (b)(1) (cease-and-desist order), (e)(1)(A) (removal and prohibition), and (i)(2)(A) (civil money penalties).
include bank executives and outside directors),\textsuperscript{56} who can have no culpability whatsoever.

Whereas generally considered remedial rather than punitive in nature, cease-and-desist orders have the potential deriving serious legal consequences that an innocent violation of a final cease-and-desist order alone could result in a maximum $5,500 of civil money penalties per day.\textsuperscript{57}

A typical cease and desist order is for remedial purposes, i.e., commanding depository institutions or their affiliates or institution-affiliated parties to refraining from unsafe and unsound practices or mandating affirmative relief by requiring them to take corrective actions such as growth restrictions, loan disposal, contract rescission and employment of qualified officers.\textsuperscript{58} In many cases, however, cease and desist orders, as authorized by statute, could be instituted for past violations that have been corrected.\textsuperscript{59} In other words, even after a safety and soundness violation has been corrected, some forms of preventive measures can be still imposed upon the institution, the bank directors and other institution-affiliated parties to ensure their future compliance. As far as a bank director or officer’s professional reputation is concerned, these precautious measures could be not less detrimental as punitive measures.

In a 2003 personal cease and desist order issued upon consent, for example, the OCC accused the Respondent, a former bank executive vice president, of engaging in unsafe and unsound banking practice for she “should have known that the Bank’s merchant processing operations did not adequately monitor and control the various risks

\textsuperscript{56} “Institution-affiliated party” is defined by statute as “any director, officer, employee, or controlling stockholder (other than a bank holding company) of, or agent for, an insured depository institution.” 12 U.S.C. § 1813(u) (emphasis added).

\textsuperscript{57} See generally McCoy, supra note 34, at § 13.03 [6].


\textsuperscript{59} Section 8(b) of the Federal Deposit Insurance Act provides that the federal banking agency may issue and serve a notice of charges to determine whether a cease and desist order should issue if, “in its opinion”, the bank or institution-affiliated party has engaged in an unsafe and unsound banking practice. 12 U.S.C. § 1818(b)(1).
associated with such an endeavour". More strikingly, whereas no punitive measures were imposed with the cease and desist order, conditions for her future employment were imposed that “prior to accepting any new position that causes her to become an institution-affiliated party’, Respondent shall provide the chief executive officer of the institution or agency with a copy of this [Cease and Desist] Order”. Similar preventive measures such as the requirement of obtaining the agency’s written approval prior to any perspective employment as an institution-affiliated party can also be seen.

C. Culpable Unsafe and Unsound Banking Practice and Resultant Regulatory Liabilities

Upon the banking regulator’s findings of the required culpability, the bank director who engaged or participated in any unsafe and unsound banking practice could be subjected to regulatory liabilities by means of, for example, the imposition of a restitution order or civil penalties. Where there is personal dishonesty involved or the misconduct demonstrates the respondent’s willful or continuing disregard of the bank’s safety and soundness, a bank director’s unsafe and unsound practice could subject him to removal and prohibition. These regulatory liabilities or treatments can entail disastrous financial consequences for bank directors as fines or other money payments assessed by agencies’ orders are normally outside the coverage of director-and-officer policies.

D. Preservation of Bank Agencies’ Safety-and-soundness Authority

While an attempt to hinder the banking agency’s investigation triggered by its safety and


61 Id. at Art. III (3).


63 Issuing a restitution order must be predicated on the finding of either the respondent’s unjust enrichment or reckless disregard for law or any applicable regulation or the agency’s prior order. 12 U. S. C. 1818 (b)(6)(A). For imposing second or third tier civil penalties (penalties up to $ 27500 and $ 1.1 million respectively), the “reckless” or “knowingly” manner of engaging or participating in unsafe and unsound practices must be found. See 12 U. S. C. 1818 (i)(2)(B)(i) & (C)(i).


soundness concern is by itself an unsafe and unsound practice, banking agencies also restrict certain banking practices in order to more proactively preserve their authority.

For example, in terms of the "indemnification payment" arrangement, an indemnification payment by the bank to its management could be prohibited to the extent such payment would have paid or reimbursed an institution-affiliated party for legal expense associated with administrative enforcement proceedings brought by the banking agencies. Besides, the Federal Reserve Board further expressed its discomfort "[from a safety and soundness perspective]" to those banks or bank holding companies adopting by-laws under the applicable state corporate laws to indemnify a bank director from his misconduct that "presumably violates the institution's policy of compliance with applicable law". Whilst as yet there is no regulation explicitly addressing the extent to which the effect of this aspect of safety and soundness concerns implicates with the state law's exculpation statute, the stance taken by the Federal Reserve here is a strong hint that the exculpation statute relieving the bank management's fiduciary liabilities arising out of compliance breaches might not survive the regulator's challenge.

A more specific example can be related to supervisory-linked covenants. Such covenant as "using adverse supervisory actions or the breach of supervisory thresholds as triggers for early amortization events or the transfer of servicing" in securitization transactions was straightforwardly denounced by the Federal Reserve Board as an unsafe and unsound practice.

II. Bank Safety and Soundness Applying to Group Structure: Source of Strength


67 12 C.F.R. Part 359

68 See Board of Governors of The Federal Reserve System, Guidance Regarding Indemnification Agreements and Payments, para. SR 02-17 (SUP) (8 July 2002).

69 Id. (A bank or bank holding company "should not divert its assets to pay a fine or other final judgment issued against an institution-affiliated party" for such misconduct.).

70 See Board of Governors of The Federal Reserve System, Covenants in Securitization Documents Linked to Supervisory Actions or Thresholds, Para 1, SR 02-14 (SUP) (23 May 2002).
and Similar Regulatory Doctrines

The previous section discusses the enhanced regulatory requirements for bank safety and soundness through 1990s to the early 2000s characterized by increased activity limitations stretching from restricted risky to unlawful activities that were directly imposed upon stand-alone banks and their management. On a group-based structure, these restrictions directing toward stand-alone banks’ risk-taking strategies equally apply to bank subsidiaries of holding companies.

In addition, bank safety and soundness safeguards applying particularly to a group structure can also be identified. Whereas those regulating transactions between banks and their affiliate and those pinpointing the permissible corporate structures for expanded bank activities are self explanatory and will not to be dealt with here, this section focuses on those addressing the bank parent’s (as a sole or controlling shareholder) expanded obligations for its bank subsidiary, in particular those developed under the “source of strength” regulatory doctrine.

A. Precursor: Net Worth Maintenance as Condition for Thrift Holding Company’s Acquisition Approval

From the mid-1970s, as a condition for agency approval of thrift acquisitions, the federal thrift regulator started to requiring savings and loan holding companies to ensure the solvency of the thrifts they acquired. By requiring capital infusion from the parent company prior to the use of insurance funds, the regulator attempted to deter the parent from potential abuse over its subsidiary S&L through dominant ownership and encourage prudent management of the insured institution. Whilst the regulatory practice of demanding so called “net worth maintenance agreements” or “capital maintenance commitments” subsided over time due partly to the concern of deterring acquirers, this kind of regulatory principle was later succeeded by a full-fledged

71 See generally McCoy, supra note 34, at § 4.05.
72 In 1990, OTS set the maximum liability for an acquiror under a limited net worth maintenance agreement as the difference between the institution's capital immediately following the transaction and the institution's fully phased-in capital requirements as of the same date. Furthermore, OTS modified its policy again in 1991 on net worth maintenance agreements. The new policy required a capital maintenance agreement only if the acquired thrift had failed to meet its fully phased-in regulatory capital requirements. It also required that persons or companies subject to capital maintenance obligations notify
proposition, i.e., the “source of strength” doctrine, applying to national banks and their holding parents.

B. Bank Holding Company’s Expanded Obligation to Bank Subsidiaries under Source of Strength Doctrine

As a re-confirmation of the Federal Reserve System’s long-standing policy, the regulatory term “source of strength” contained in the Regulation Y is defined as the bank holding company’s general obligation of “…serv[ing] as a source of financial and managerial strength to [their] subsidiary banks and shall not conduct [their] operations in an unsafe and unsound manner.” 73

The doctrine, despite in nature as a subset of bank safety and soundness principle and in function both serve for the purpose of distilling prudence into banking organizations’ decision-making processes, goes towards a distinct direction. Whereas the bank safety and soundness requirements, with its entity-specific reach, are meant to effect prudent management of the bank itself, the vertical coverage of the source-of-strength doctrine has direct implications on the corporate shareholder’s limited liability privilege and the concept of entity separateness.

1. Financial Element of Source of Strength Doctrine: Bank Holding Company’s Solvency Assurance Obligation for Bank Subsidiary

In one sense, the source of strength doctrine functions for solvency assurance similarly to the net worth maintenance arrangement in that bank holding companies are under the regulatory obligation to assisting their subsidiary banks by “standing ready to use available resources to provide adequate capital funds to subsidiary banks during periods of financial stress or adversity.” 74 Up until now, a bank hold company’s capability of

73 12 C.F.R. § 225.4(a)(1); see also McCoy, supra note 71.
financially serving as a source of strength continuously remains the precondition for the Federal Reserve Bank’s approval of such company’s prospective acquisition of a bank subsidiary.\textsuperscript{75}

The source of strength doctrine has, however, proven even in this financial sense much more far-reaching than the net worth maintenance commitment. Going well beyond merely an acquisition condition, a bank holding company is now under an ongoing obligation to provide financial supports throughout the company’s life for its subsidiary banks in financial distress. This duty has been enforced with the Federal Reserve’s vigor and willingness to resorting to formal enforcement actions on the parent level and on safety and soundness grounds for those bank holding companies failing to assist troubled subsidiary banks.\textsuperscript{76} Business decisions that might impair the bank parent’s capital strength so as to endanger its capability of standing ready to assist its troubled bank subsidiaries are also subjected to various regulatory restraints.\textsuperscript{77} In view of the parent company’s standby regulatory duty to supporting its subsidiary banks, some commentators regarded, financially at least, this regulatory regime represents a compulsory vertical consolidation of depository institution subsidiaries with their parent bank holding companies,\textsuperscript{78} albeit it remains unclear whether this standby obligation to supply capital is in all circumstances unlimited in amount.

\textsuperscript{75} See Federal Reserve Board, \textit{Policy Statement on Assessment of Financial and Managerial Factors}, 69 FR 68236 (1997), codified in 12 C. F. R. Pt. 225, App. C. (As applied to small bank holding companies with \textit{pro forma} consolidated assets of less than $150 million (and large bank holding companies are subjected to even more stricter requirements), the Federal Reserve Board stated its reserve for their acquiring additional banks by incurring acquisition debts. Thus, approvals of acquisitions on debt were stated on the condition that “bank holding companies demonstrate the ability to service acquisition debt without straining the capital of their subsidiary banks and, further, that such companies restore their ability to serve as a source of strength for their subsidiary banks within short period of time.”)

\textsuperscript{76} See \textit{Supra} 88 at 15708 (“A bank holding company’s failure to meet its obligation to serve as a source of strength to its subsidiary bank(s), including an unwillingness to provide appropriate assistance to troubled or failing bank, will generally be considered an unsafe and unsound banking practice or a violation of regulation Y, or both... Consequently, such a failure will generally result in the issuance of a cease-and-desist order or other enforcement action... “)

\textsuperscript{77} For example, except for those companies whose well-capitalized and will-managed status has been vindicated, obtaining Federal Reserve Board’s prior approvals is a prerequisite for a bank holding company’s redemption or purchase of its equity securities. 12 C. F. R. § 225.4 (b)(6).

\textsuperscript{78} BANKING LAW MANUAL 4.05; John Deal et al., \textit{Capital Punishment: The Death Of Limited Liability for Shareholders of Federally Regulated Financial Institutions}, 24 Cap. U. L. Rev. 67, 85-95, 100-04 (1995); see also Lissa Broome, \textit{Redistributing Bank Insolvency Risks: Challenges To Limited Liability In The Bank Holding Company Structure}, U. C. Davis Law Review, 935, 984-87 (1993) (arguing the need to break the corporate separateness treatment applying to bank holding companies and their bank subsidiaries for they being placed on a unique regulatory ground.)
It is nevertheless difficult to associate this aspect of consolidation with such corporate law thinking as the “enterprise liability” or the “piercing the corporate veil” idea — two major exceptions out of the generally entity based corporate law rules. In terms of applicability, under the state corporate law, the parent corporation’s unduly exercising dominant control over its subsidiaries could only under certain extreme circumstances result in the breakdown of entity boundary and thus compromise the limited liability privilege enjoyed by the corporate parent, by contrast, the source of strength doctrine stands as a general principle to which exceptions exist only on “unusual and limited circumstances” grounds as identified by the Federal Reserve Board, applicable regardless the actual control being exercised by the bank parent corporate over the bank subsidiary.  

Functionally speaking, the source of strength is thus aimed for reversing the idea of shareholder supremacy and to mandate a compulsory internalization of the group’s resources to the favor of its banking component’s ongoing operation.

As explicitly stated by the Federal Reserve Board, the public policy interest associated with this regulatory prioritization for a group-based operation is precisely the same as the one stressing bank safety and soundness for a stand-alone bank. What is fundamentally different between these two is bank agencies have never sought to broaden shareholders’ expanded liabilities based on the source of strength doctrine to individual owners of banks. Since failing to act as the source of strength will constitute an unsafe and unsound banking practice and such practice will subject both the bank holding company and its management to the full blunt of bank safety and soundness based enforcement actions, one of the most startling regulatory

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80 Federal Reserve Board, Policy Statement; Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 52 Fed. Reg. 15,707, 15,708 (1987) (WL 133897 (F. R.)) (giving justifications to the source of strength doctrine by implying the concern of the bank group’s risk-prone mentality due to advantages arisen from government subsidy on its banking component, and by noting the “critical fiduciary responsibilities of depository institutions as custodians of depositors’ funds and their strategic role within [the] economy as operators of the payment system and impartial providers of credit.”)
82 Except for termination of federal deposit insurance, all of the enforcement mechanisms and sanctions as applied to a stand-alone bank and its institution-affiliated parties apply to bank holding companies and
consequences may therefore be the bank holding company as a corporate shareholder is at no liberty, which the individual shareholder of a bank has, to simply sustaining the losses up to the limit of injected capital, but has to meet its obligation of injecting arguably unlimited capital to its financially distressed bank subsidiary, and to bear even higher losses as a potential consequence. By so doing, whereas the bank holding company’s management has met the regulatory duty to do their best to keep the bank subsidiary as a going concern, they would probably fail the profit-making expectation of the holding company’s owner. The acute clash presented here has as yet attracted limited attentions concerning what has been brought about with the federal regulator going so far as to tinker with shareholder limited liability.


Although the general association of the source of strength doctrine with its financial implications, the doctrine sometimes derives a unique, non-financial regulatory requirement that a bank holding company’s management has to self-refrain from the group’s certain managerial decisions, but the final responsibility of such affairs rests with the management of its subsidiary bank. This is particularly true when the group’s portfolio entails potentially high risk exposure to its subsidiary bank.

For example, in addressing the Federal Reserve Board’s concern over bank holding companies’ engaging in such financial contracts as futures, forward and options contracts and money market instruments, the agency articulated the source of strength doctrine by stating:

"In formulating its policies and procedures [over financial contracts], the parent holding company may consider the interest rate exposure of its nonbank subsidiaries, but not that of its bank subsidiaries. As a matter of policy, the Board believes that any financial contracts executed to reduce the interest rate exposure of a bank affiliate of a holding...

their non-bank subsidiaries. 12 U. S. C. § 1818 (b)(3); see also McCoy, supra note 34, at §13.03 [1].

83 12 C. F. R. § 225. 142 (a).
company should be reflected on the books and records of the bank affiliate (to the extent required by the bank policy statements), rather than on the books and records of the parent company. If a bank has an interest rate exposure that management believes requires hedging with financial contracts, the bank should be the direct beneficiary of any effort to reduce that exposure. The Board also believes that final responsibility for financial contract transactions for the account of each affiliated bank should reside with the management of that bank.**84** (Emphases added)

Although it remains unclear to what specific extent and by what specific standards the Federal Reserve Board has been articulating its source of strength doctrine into formulating, the group as a whole, internal risk-taking policies and procedures to protect bank subsidiaries, the increasing asset concentration and complex activities of bank groups will guarantee the Board’s continuous pronunciations at this direction. The recently adopted RFI/C(D) rating system applying to bank holding companies, whose indicators include “...an explicit determination as to the likelihood that the BHC and its nondepository subsidiaries ([collectively,] nondepository entities) will have a significant negative impact on the depository subsidiaries, considering the effectiveness of risk management systems and the financial strength of the nondepository entities”, 85 provides a good reference point to this prediction.

C. Difficulties of Grafting Regulatory Safety and Soundness Pursuit onto Corporate-law Line of Legal Reasoning Concerning Bank Group Operation: MCorp86 decision

In late 1988, MCorp, then a large Texas bank holding company, began encountering

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84 Id. at (c).
85 See Federal Reserve System, Bank Holding Company Rating System, Docket No. OP-1207, 43,996, 43,997, 69 FR 43996-01 (23 July 2004) (WL 1634413 (F. R.)) The new bank holding company rating system, i.e., RFI/C (D), which took effect since January 205, consists of five elements: Risk management and controls of the banking organization; Financial strength of the consolidated banking organization; Impact of the nondepository entities on the subsidiary depository institution(s); the overall Composite assessment of the organization; and Depository institutions’ composite CAMELS ratings. See Id. at 43,998-44,000. For an overview of the new supervisory rating system, see Satish Kini, New Bank Holding Company Rating System Revises The Focus of the Federal Reserve’s Supervisory Practices, 121 Banking L. J. 784 (2004)
considerable difficulties for many of its twenty-five subsidiary banks failing to meet the minimum regulatory capital requirements even though at the same time the parent holding company had considerable assets at its disposal. Following insolvency and subsequent close-down of twenty of Mcorp’s twenty-five subsidiary banks, the Federal Reserve Board pursued enforcement actions against MCorp based on safety and soundness grounds alleging the MCorp’s failure to act as a source of strength for its subsidiary banks.

Upon a federal district court ruling against the Federal Reserve Board’s case primarily on the procedural ground, the Board appealed to the U. S. Court of Appeals for the Fifth Court. On appeals, the major substantive issue was whether the Federal Reserve Board’s source of strength regulation was under an explicit statutory authorization or, absent an explicit source, reasonably derived from its broad bank safety and soundness mandate. For the first part, the appeals court ruled the Banking Holding Company Act (BHCA) “does not grant the Board authority to consider financial and managerial soundness of...subsidiary banks....”, although it admitted the BHCA did grant the Board the power to exercise supervisory control over the structure and operation of bank holding companies and their non-bank subsidiaries, and the power to approve bank acquisitions. The court further rejected arguments pursued by the Board that under the Financial Institutions Supervisory Act the explicit statutory authorization of regulating unsafe and unsound banking practices had mandated an overboard source of strength obligation on the part of the bank holding company. The appeals court therefore found the Board exceeded its statutory authorization and upheld the district court’s ruling.

Whilst ultimately the appeals court’s ruling was reversed in the Supreme Court on an unrelated jurisdictional issue, the Fifth Court’s legal reasoning against the Federal Reserve Board’s arguments is instrumental. It reveals the fundamental difficulty of grafting the particular bank safety and soundness regulatory objective concerning a bank group onto the corporate-law line of legal reasoning. The Fifth Court noted:

88 900 F. 2d at 861.
89 Id. at 863.
"Enforcement of the Board’s source of strength regulation requiring MCorp to transfer MCorp’s funds to the troubled subsidiary banks can hardly be considered ‘generally accepted standard of prudent operation.’ Such a transfer of funds would require MCorp to disregard its own company’s separate status; it would amount to a wasting of the holding company’s assets in violation of its duty to the shareholders."\(^90\)

With the benefit of hindsight, the U.S. Supreme Court’s failure to end a definitive note on the legality issue of the source of strength doctrine has not proven a major hindrance in regards to the Federal Reserve Board’s implementing source of strength authority. After the MCorp, The Federal Reserve Board continuously went back to the parent to restore the bank subsidiary to the adequate capitalization status by means of issuing mandatory capital directives based upon the doctrine.\(^91\)

D. Gramm-Leach-Bliley Act’s Statutory Confirmation on Financial Aspect of Source of Strength Doctrine

Some regulatory and legislative developments in 1990s were sometimes listed by commentators alongside the source of strength doctrine.\(^92\) In the good parts of 1990s

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\(90\) Id.

\(91\) See Leonard Bierman & Donald Fraser, MCorp and The Future of The Source of Strength Doctrine, 110 Banking Law Journal, 145, 155 (1993) (in the post-MCorp era, the source of strength doctrine continued to be rather “alive”, as noted by the authors). For example, the regulator articulated the doctrine in a written agreement when approving an acquisition bid that, apart from the acquirer’s initial investment, it would be required “to use its assets, including its cash and other short-term, liquid, investment grade assets, to provide whatever additional capital support” to the acquired subsidiary bank as may be required by the Federal Reserve. See Id. at 154-55, citing Written Agreement, by and among Baltimore Bancorp, Federal Reserve Bank of Richmond and Bank Commissioner State of Maryland, Board of Governors of the Federal Reserve System, No. 92-051-WARB-HC (5 Aug. 1992).

\(92\) The two often cited regulatory and legislative examples respectively are FDIC’s closure policies concerning abusive inter-bank loans extended within the bank group and the cross-guarantee provisions under the FIRREA applying also to bank failures. Although the logics of these two sets of arrangements are along the line of the source of strength doctrine that some extent of financial consolidation would have been effected-- solvent insured depository institutions would have borne the losses sustained on the deposit insurance fund owing to its affiliate banks’ failures--, the breath of them as applying only to failure scenarios is nowhere near the ongoing nature of the supporting duty developed under the source of strength doctrine. These two arrangements are more to do with the FDIC’s loss recovering than distilling prudence in a general term. see BANKING LAW MANUAL § 4.02 (discussing the “horizontal integration” changes made to the FDIC’s closure policies in late 1980s reacting to certain “captive funding” practices of bank holding companies pooling together deposits taken by various subsidiary banks and funneling them to certain lead subsidiary banks.); see also JONATHAN R. MACEY ET AL.,
the source of strength doctrine, however, remained a product of the Federal Reserve Board's broad rule-making function under its general mandate for ensuring bank (or bank subsidiary) safety and soundness. It was not until 1999 with the passage of the Gramm-Leach-Bliley Act that the doctrine was directly addressed by statute. The passage of the GLBA Act therefore gives its impact to the doctrine by standing it on a statutory ground which to some extent settled the doubt as raised in the MCorp concerning the legality of the Federal Reserve Board’s interfering into managerial functions on the holding company as opposed to the bank subsidiary level.

Under the title “Clarification of Source of Strength Doctrine”, Section 370 of the GLBA Act in general bans any suit brought against federal banking agencies based on their exercising the doctrine-deriving powers and, therefore, indirectly confirms the legality of the doctrine, as a legitimate expansion of the bank safety and soundness principle to the parent level. Whether or not the banking regulator being in an ordinary regulatory capacity or as conservators or receivers exercising such powers, no person may bring a claim against any Federal banking agency for assets return or for monetary damages or other legal or equitable relief based on an insured depository institution’s affiliate or controlling shareholder transferring assets to such institution, if, at the time of transfer, the bank was undercapitalized and the institution was subjected to a capital directive and appropriate procedures have been followed.93

Under Section 112 of the GLBA Act the law appears to have restricted the doctrine to basically a vertical parent vis-à-vis bank subsidiary application. The Federal Reserve Board may not require a holding company to diverting funds or assets of its other financial subsidiaries (e.g., insurance company, securities firm, investment company or investment adviser) towards injecting capital into its bank subsidiary if by so doing would have caused a material effect on the financial affiliate’s financial

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BANKING LAW AND REGULATION 754 (3d ed. 2001) (criticizing the FDIC closure policies for the potentially disastrous results of the failure of all banks in the holding company.) For depository institutions' cross-guarantee duty, see 12 § U. S. C. 1815 (e) (any insured depository institution “shall be liable for any loss incurred by the [FDIC], or any loss which the [FDIC] reasonably anticipates incurring” associating with the default of a commonly controlled insured depository institution, or any assistance provided by the FDIC to a commonly controlled depository institution in danger of default.)

condition.\textsuperscript{94}

However, the bank regulator still commands considerable implicit authority that the holding company may voluntarily at the subsidiary level engage in horizontal financial integration. This is because, to the extent the distressed bank subsidiary’s unsatisfactory financial condition can not be improved by capital injections from its parent or affiliates, the Federal Reserve Board may either require the holding company to divest the troubled bank subsidiary within 180 days with operation restrictions imposed before such divesture,\textsuperscript{95} or the agency may opt for alternative measures such as imposing acquisition bans or/and other financial activity restrictions on the holding company’s future operation.\textsuperscript{96}

Whereas the passage of the GLB Act has cleared the way for the Federal Reserve Board imposing capital directives on the bank’s parent company, it is worthy paying the same attention to the GLB Act’s failing to address the extent to which the Federal Reserve Board should be allowed to mandate group-wide risk policies under the source of strength doctrine for promoting the bank subsidiary’s safety and soundness status. As a result, the permissible depth and width of the managerial aspect of the source of strength doctrine will continuously remain unclear and will be destined to spur controversies between the regulator and the management of the affected bank holding companies in the future.

III. Implications on Shareholder Model of Corporate Governance from Enhanced Review Standards under Managerial Safety and Soundness Requirements

As two sets of open-ended and open-textured rules controlling the bank management’s decision-making and oversight function, the bank safety and soundness principle co-relates with the corporate law concept of fiduciary duties (duties of loyalty, good

\textsuperscript{94} Id. (codified at 12 U.S.C. § 1844 (g)(1)), 112 (b), amending the Federal Deposit Insurance Act to add new §§ 45 (a), (c)), 113 Stat. 1338, 1366-77 (1999).

\textsuperscript{95} Id.

\textsuperscript{96} 65 Fed. Reg. 3,785, 3,787, 3,792 (2000) (codified at 12 C. F. R. §§ 225.82 (d)); see also McCoy, supra note 34, at § 4.05 (noting the GLB Act’s legislative enactments have not really superseded the source of strength doctrine but only complemented it, and the open-ended doctrine will remain the regulator’s ultimate weapon forcing holding companies to make capital infusions to troubled banks when other regulatory tools proven inadequate).
faith and due care) with great dynamics. Bank safety and soundness enforcement actions complement loyalty and good faith violation derivative litigations by adding civil penalties and other sanctions (such as an industry-wide prohibition order) to court-imposed personal damages, exerting deterrence over the bank management’s self-interested conduct or intentional dereliction.

However, for disinterested, good-faith managerial conduct, the managerial safety and soundness requirements may clash with the due care requirements with diverging review standards. This conflict is squarely presented by FDIC v. Stahl, a suit brought by the FDIC against two officers and two outside directors of a failed savings and loan association for due care breaches based on violating a safety-and-soundness supervisory agreement.

A. FDIC v. Stahl: Diverging Review Standards over Disinterested and Good-faith Managerial Conduct

Absent deriving personal gains as usually seen in fiduciary duty violation cases, in Stahl, the alleged breaches of due care were associated with the defendant directors and officials’ making of seven loans that allegedly violated an FHLBB-drafted Supervisory Agreement (“Agreement”), which contents consisted of the FHLBB’s safety and soundness guidelines. In order to exchange for the regulator’s refraining from instituting formal enforcement proceedings, the Broward Federal entered into the Agreement, agreeing to comply with certain underwriting guidelines established by the FHLBB and to adhere to specific loan and investment procedures. As it transpired, the defendant directors and officers failed to abide by the FHLBB guidelines and other procedural requirements under the Agreement when making seven loans subsequent to the execution of the Agreement. The delinquencies include, among other things, inadequacy of appraisals, no written personal guarantee and no sales history, and a lack of feasibility studies.

Against the FHLBB’s attempt to equate the corporate-law due care standard with

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98 Id. at 1567.
99 Id. at 1567, n. 3.
100 Id. at 1568.
the regulatory standard of prudence "as measured by industry standards", the Court pointed out the differences between the two.

The Court ruled, whereas the "sub-standard unsafe and unsound practice" of this case could support various supervisory actions including the removal of officers, the regulator, although based on the same fact, chose instead to sue individual directors and officers for due care breaches. By so doing, the regulator's legal burden was "the same as that of private corporations", and the defendant directors were therefore protected by the business judgment rule and shielded from liability as there was no fraud, bad faith or an abuse of discretion involved.

Derived from the *Stahl*, some immediate results of comparison, both similarities and disparities, between the managerial safety and soundness principle and the due care duty can be presented as below.

B. Nature of Review, Enforcement Techniques, and Monitored Subjects

The managerial safety and soundness principle and the due care duty are similar to the extent both, with their gap-filler functions and open-ended textures, set standards for every aspect of bank directors and officials' decision-making and monitoring performance. The required standards are commonly enforced through liability impositions and certain forms of governmental interventions. The bank's internal procedure, control, system and policy are among the primary subject matters to be

101 Id. (cited by the court from the statement of Roslyn Hess, who was an FHLB examiner and, in this case, an expert witness).
102 Id. at 1572
103 Id.
104 Id. at 1569-70.
105 The internal control fundamentals established by the report of the Committee of Sponsoring Organizations (COSO) in 1992 entitled *Internal Control—Integrated Framework* are useful reference points both look at. Internal control was defined by the COSO Report as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives", and divided into three categories: "effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations." See COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, AICPA, *INTERNAL CONTROL-INTEGRATED FRAMEWORK 9* (1992).
From the regulator's viewpoint, "[the COSO model served as the basis for the internal control assessment and reporting requirements that have applied to depository institutions as part of the Federal Deposit Insurance Corporation Improvement Act since 1991." See Susan Schmidt Bies, *Effective Corporate Governance and The Role of Counsel*, remarks at the Annual Meeting of the American Bar Association, San Francisco, California, (10 Aug. 2003) (transcript available on
reviewed under both safety-and-soundness enforcement proceedings and due care violation derivative litigations.

C. Enhanced Governmental Interventions and Liability Impositions Based on Managerial Safety and Soundness Requirements

These two, however, can also starkly contradict with one another. Under the safety and soundness regime, governmental interventions are convenient that simply an innocent sub-industry standard activity would suffice the statutory requirement for issuing a cease and desist order, which is usually backed by the court if challenged. On the contrary, the court will normally defer to business judgments made by the management and will not rescind or enjoin a transaction decided by them when conducting due care review unless the egregious culpability of these decisions could be substantiated to the extent they actually derived from gross negligence or knowingly violating positive laws and regulations.106

In terms of liability imposition, the passage of 1821 (k) laid down a gross negligence, floor liability pre-empting the state corporate law’s exculpatory statute. The gross negligence floor standard may correspond to certain culpability requirements under the institution-affiliated party regime of safety and soundness enforcement actions. However, the fact without any finding of culpability an institution-affiliated party’s (including a bank director’s) innocent violation of a cease and desist order can be the ground for assessing first-tier civil money penalty means, a bank director may expose to much more severe liability under the safety and soundness enforcement regime than


From the perspective of board functions, designing and administering the bank-wide internal control structure is inextricably connected to bank directors’ fulfilling the due care duty. See e.g., Melvin Eisenberg, The Board of Directors and Internal Control, 19 Cardozo L. Rev. 237, 250-55 (1997).

106 Once a finding “in nature” of such an egregious act was established to constituting a due care violation, more than often the federal regulator would also launch formal enforcement actions against the perpetrator and disregard “in degree” such misconduct’s insubstantial financial impact on the institution. See e.g., Office of the Comptroller of the Currency (O.C.C.), In The Matter Of Gary W. Flanders, Director And Former Chief Executive Officer, Metrobank, N.A. Oklahoma City, Oklahoma, Personal Monetary Penalty Assessment Order, Enforcement Decision No. 2001-120, (30 Nov. 2001) (2001 WL 1789420 (O.C.C.)) (assessing monetary penalty against a bank CEO/director based upon both the due care and safety and soundness violations for abdication where the respondent was found to have failed to take any action to prevent his fellow director from making illegal overdrafts in the modest amount of $29,000 on his demand deposit account at the bank for a 20-month stretch of time.)

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under the due care regime.

One may therefore conclude whereas how much risk a bank is prepared to take for a particular transaction is off-limits to even an \textit{ex post} due care review, it has proven to be a recurring theme reviewed by the bank regulator on bank safety and soundness grounds, with a view to exert \textit{ex ante} control over such disinterested conduct or decisions.\textsuperscript{107}

D. Selective Review Areas: Change-of-control Transactions, Bank Insolvency and Intra-group Relationships

The \textit{ex ante} and result-oriented nature of managerial safety and soundness prescriptions and reviews also brings with it substantial impacts on some event-triggered fiduciary duty reviews.

In those difficult areas facing corporate lawyers such as change-of-control transactions and corporate insolvency — the former may necessitate a re-construction of the ordinarily defer-to-management review formula for preserving the market's disciplinary utility and, at the same time, for dealing with the corporate management's often intrinsic conflict of interests deriving from their entrenched managerial position; the latter may require a demarcation point as to from which stage the corporate management should pledge loyalty to creditors rather than shareholders — bank lawyers would be comparatively at ease in dealing with them.

In the change-of-control situation, managerial safety and soundness requirements together with the “fit and proper” rule, as its sub-doctrine, would be useful in addressing both the competence and the integrity concerns raised against the incumbent as well as the prospective bank management.\textsuperscript{108} Similarly, in bank insolvency, the banking regulator’s early step-in mandate under the Prompt Corrective Action regime that derives also from the bank safety and soundness concern putting the interests of

\textsuperscript{107} David Skeel, \textit{The Market Revolution In Bank And Insurance Firm Governance: It’s Logic And Limits}, 77 Wash. U. L. Q. 433, 442 (1999) (directing to banking regulators' \textit{ex ante} monitoring status from a different angle of they being relational monitors, which hold the same nature as that of the private relational monitors of German and Japanese corporations.)

\textsuperscript{108} For the approval or/and prior notice requirements connecting to change in bank control procedures, see Board of Governors of the Federal Reserve System, \textit{Guidance on Change in Bank Control Procedures}, SR 03-19 (19 Nov. 2003); see also 12 C.F.R. § 225.41-44 (2005).
depositors, as a class of creditors, ahead of that of bank shareholders, would pre-empt the dilemma concerning dividing loyalty facing the fiduciary duty regime dealing with a bank approaching insolvency.

In terms of intra-group relationships, for a banking organization operating as a subsidiary of a holding company, the source of strength doctrine gives rise to a regulatory duty on the part of the holding parent, mandating the parent to act as the bank’s ultimate financial and managerial source. This is virtually a reversal of a corporate parent relating to particularly its wholly-owned subsidiary under the shareholder model of corporate governance, where the subsidiary’s management was considered by the Delaware Supreme Court “obliged only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders.”

IV. Implications on Shareholder Model of Corporate Governance from Other Dimensions of Managerial Safety and Soundness Requirements

The section explores four broader bank governance dimensions relevant to the concept of managerial safety and soundness interacting with the shareholder model of corporate governance.

A. Reversal of Corporate Law’s Interest Hierarchy and Breakdown of Contractarian Model

As discussed in chapter three, predicated on the pursuit for allocation efficiency and as its sub-agenda for encouraging risk-taking, corporate law assigns the shareholder as the ultimate and sole beneficiary of managerial conduct, which in turn generally leaves creditors and other corporate stakeholders outside the protection of corporate law. Under corporate law, the shareholder is therefore the very class topping the interest hierarchy. This interest status is reflected in the corporate law governance system’s duty construct and its preference for yield-focused extrajudicial solutions so as to align the management’s interest to that of the shareholder.

In the banking context, although the passage of 1821 (k) has qualified the lenient

common-law due care review standard to the gross-negligence floor, the state corporate law’s governance framework remains largely intact. Under the state corporate law framework, therefore, the classic problem of wealth transfer, for example, from creditors that include depositors to shareholders, would then occur in banking as much as in non-banking corporate entities. With the bank shareholder’s commanding position in the corporate interest hierarchy, the bank management ought to adopt generally aggressive risk appetites the shareholder prefers to those the creditor does when making business decisions.  

It is against the above-summarized governance order of state corporate law, the banking regulator’s managerial safety and soundness mandate functions to a different direction.

The fact the banking regulator is required by law not to defer their interventions to the late point when the institution is in danger of becoming insolvent and the wealth transfer propensity becomes imminent means the regulator are mandated to take away from the bank management certain managerial autonomy, and superimpose a set of objective, industry-wide, “generally accepted” risk taking and risk management standards to effect the institution’s more conservative operation to meet the agency’s policy ends. This function is backed by formidable enforcement actions to the extent these standard-setting requirements “have pushed the banking agencies to reach deep into traditional preserves of bank management and ownership”.

Consequently, the new order is not any more a contractual result, but features a set of mandatory, general, ongoing, conservative requirements for risk taking and risk management permeating throughout the bank’s life.

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10 As generally recognized, this wealth transfer tendency, or, the management’s aggressive, risk-prone manner, is made even more escalating in banking with the presence of an array of government subsidy (such as the deposit insurance scheme, bank-rescue packages and the invisible but nonetheless often inevitable “to big to fail” mentality), and with the bank’s unique capital composition, which consists primarily of debts (made up of deposits most of them) as opposed to equity.

B. Bank Regulator as Monitor of Comparative Objectivity and Proximity

In one sense, the banking agency’s stakeholder status as reflected in their bank safety and soundness authority resembles that of the lender, as a class of fixed claimers, in that both exercise some level of “negative control” over the bank executive’s commercial decisions. As typically contained in a loan agreement or a subscription agreement associated with a bond issue,112 various covenants effecting such constraints as asset growth limits upon certain risk events’ occurring work similarly to the bank regulator imposing restraints on the bank’s asset expansion upon detecting the bank’s financial resources or/and management capability could not sustain such expansion.

The differences between these two are nonetheless obvious. Whereas the lender/creditor focuses primarily on the insolvency risk to ensure repayment, by means of the safety and soundness authority as granted by law, the banking agency is legally required to extending its attention to the ongoing financial as well as managerial health of the institution well ahead of the bank drawing to the brink of insolvency.113 As a matter of regulatory and supervisory practice, enormous amount of safety and soundness guidelines, policy declarations, supervisory letters, advisories, or others directives articulating restricted or prohibited risky practices point at banks whose financial standings are relatively sound. Moreover, the method of control deployed by the bank agency is as mush “positive” as “negative”. Banking organizations and their management are subjected to periodical safety and soundness examinations (or, indeed, second-guessing) concerning quality of their managerial strength by which the institution’s risk management performance is demanded to be at least on par to the industry standard and unsatisfactory performance of it is a “deemed unsafe and unsound practice”.

And even more interestingly, the contents of supervisory reports generated as a result of these examinations are not even allowed to be disclosed to banks’ shareholders

112 PHILIP WOOD, INTERNATIONAL LOANS, BONDS AND SECURITIES REGULATION 3-6, 32-33 (1995, Sweet & Maxwell).
113 See Thomas Vartanian, Have 15 Years Really Made FDIC Insurance Funds Safer? American Banker (12 Mar. 2004) (noting “[p]rior to FIRREA and FDICIA, federal banking regulators were generally prohibited by law from seizing an insured institution and putting it in receivership until its capital was zero or negative”, and after the passage of them, federal banking regulators are statutorily authorized to close those solvent but problematic banks who failed to change their unsafe and unsound operations.)
because the examiner’s mandate is irrelevant to protecting investors’ interests. Even under restricted circumstances and subject to the prior written permission of the appropriate federal banking agencies, these nonpublic supervisory information could be released, as opposed to the bank’s parent holding company and its directors and officers, shareholders are still generally precluded from accessing them.

In an OCC document containing certain passages of a report of examination (ROE) associated with the appeals process over the ROE’s loss classification of a bank’s trust investment, one might catch a glimpse how the banking agency in practice exercises as a monitor through bank examinations. The conclusion that the bank’s investment in the trust was a classified loss was based on, among other things, credit risk being overly high. The examiners went deep into typically a thorough credit risk analysis before drawing this conclusion with the following passage stated in the ROE:

“The bank’s investment in the trust was imprudent and reflects unsafe and unsound investment practices. Management and the board did not perform adequate due diligence prior to purchasing this asset. Management’s pre-purchase analysis did not adequately address the significant inherent risks in the investment.”

On appeals review, the ombudsman ultimately overturned this ROE conclusion and raised the rating of the trust business at issue from a loss to a substandard classification level upon conducting an even more detailed and technical risk analyses than did the

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115 See 12 CFR 4.37 (b)(2) (OCC exceptions); 12 CFR 309.6 (b) (FDIC exceptions); 12 USC 326, 12 CFR 26120 (b) (FRB exceptions); and 12 CFR 510.5 (c)(4) (OTS exemptions); see also FDIC, Interagency Advisory On Confidentiality Of CAMELS Ratings And Other Non-public Supervisory Information, FIL-13-2005 (28 Feb. 2005), Attach.: Supervisory Interagency Advisory On The Confidentiality Of The Supervisory Rating And Other Nonpublic Supervisory Information.


117 The ROE drew on the following reasons for its judgment: “[t]he trust is a new entity with no established operating history; [p]ayment period is protracted; [t]iming and amount of payments are uncertain; [t]he beneficial interest is last in priority of payments; and [u]ltimate residual value is unpredictable.” Id. at 1

118 Id.
ROE and identified the following weaknesses of this investment:

"The repayment period is protracted. Residual proceeds (principal repayment) will not be received until 2016 at the earliest, and potentially not until 2024. Although the bank will receive tax benefits in 1999 and 2000, it is not repayment if principal. Reinvestment of this tax benefit will still result in an extended period for principal recovery. The timing and amount of payments are uncertain. The bank's beneficial interest in the transaction is in last position for the priority of payments. There are five classes of debt that take priority over the residual interests. The ultimate residual value is unpredictable. There are variables that could affect the adequacy of cash flow through the life of the transaction, such as change in interest rates and events that could diminish the value of the equipment. Residual interest is below investment grade quality." 119

Two sets of observations might be drawn from the above example. First, it reveals yet again a classic should-have-known manner by which banking organizations and their management are periodically second-guessed and monitored by banking agencies under the standard of objective reasonableness.

Second, it suggests a unique position at which the banking agency stands as a monitor. It was suggested by some leading commentators two types of monitors existing in a corporate governance system — monitors of proximity (including such corporate institutions as independent directors, the board in its monitoring capacity, and large shareholders); and monitors of objectivity (including such market-based mechanisms as supported by credit rating agencies, stock market analysts, takeover consultants, outside lenders and other participants). 120 It was further indicated, although the optimal monitor is the one being well-informed as well as being objective, corporate monitors for the purposes of monitoring and disciplining management can not exhibit both proximity and objectivity since an intrinsic tradeoff exists between them: "The objectivity necessary for ... timely corrections require sufficient distance between management and monitor, but being well informed requires close and intrusive

119 Id., at 2.
120 For a theoretical framework of this differentiation, see Boot & Macey, supra 120, 366-75.
In other words, monitors of proximity and of objectivity hold mutually exclusive advantages and, more importantly, disadvantages when monitoring and disciplining bank management, and therefore the ensuing shortage or insufficiency.\textsuperscript{122}

Applying this theory in the banking context, however, the banking regulator’s monitoring status can hardly fit into either of the class of monitors. Banking regulators’ access to proprietary and other “soft” information concerning institutional and managerial performance in general and specific transactional details in particular as illustrated in the above-cited passages of ROE, combined with their power to enforce such access, and the confidentiality requirement concerning contents of supervisory reports (results of bank safety-and-soundness examinations) make them functionally resemble those well-informed monitors of proximity on one hand. On the other hand, banking regulators, having no direct and personal financial interests and entrenched positional interests as typically held by such monitors as large shareholders and board members, are comparatively distant from bank executives and therefore comparatively well-equipped to be objective. And more importantly, the duty for bank regulators to refrain from forbearance and to timely correcting problems found in the bank’s operation further mandate effective and efficient measures being adopted, which might not be the case for an ordinary monitor of objectivity.

In short, in the field of banking, as a class of monitors, banking regulators as mandated by law and backed by a forceful enforcement regime comparatively hold the merits of monitors of proximity and of objectivity, whilst avoiding their shortcomings. One of the ensuing consequences flowing from these analyses is banking regulators are better equipped in performing monitoring functions effectively than are the typical other two types of monitors.

C. Dampening Effects on Market-based Interest Alignment Mechanism

The above observations concerning comparative effectiveness of monitoring functions

\textsuperscript{121}Id., at 368.
\textsuperscript{122} See Macey, supra note 122, at 403-04 (discussing the failures of Enron’s Board (as monitor of proximity) in its misplaced trust over self-dealing transactions between top managers and the corporation, and of market analysts, credit rating agencies and others (as monitors of objectivity) in their inability to adequately assess Enron’s impenetrable financial statements because of information disadvantages in the build-up to Enron’s collapse.)
performed by banking regulators is crucial and instrumental in that banking regulators and the other two types of monitors may pursue their respective agendas differently, and in some cases, may even mutually exclusive. This is particularly true for those monitors whose stakes are connected to the banking organizations' equity, as opposed to debt.

As discussed previously in this chapter, banking regulators' pursuit for bank safety and soundness means they have an incentive to discourage even beneficial risk taking which from the shareholder's perspective might well be risk worth taking, if, in their opinions, such risk taking decisions would have an unacceptable impact on the well-being of depositors and of ongoing banking. They would then place negative

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123 See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, STAFF STUDY 173, IMPROVING PUBLIC DISCLOSURE IN BANKING 2 (2000) (noting "...shareholders want a firm to attain an appropriate risk-return tradeoff, not to limit risk per se. Indeed, for a leveraged firm, an increase in risk has the effect of transferring wealth from debt holders to shareholders. This problem of private-market moral hazard makes the discipline from debt holders imperative for an unregulated firm").

124 Whereas it is outside the scope of this work, which focuses on the correlations between the shareholder model of corporate governance primarily established under the state corporate law and the regulatory and supervisory arrangements for bank safety and soundness, debtholders, in particular sub-debtholders, and their functioning as a complement to the regulatory safety and soundness efforts have increasingly been explored in recent years. The perceived complementary function exercised by this particular class of bank stakeholders, in their capacities as fixed and contract-based claimers, having a reward-loss scenario and risk-averted incentives aligning most to the banking supervisors, has actually been factored into the comprehensive process of banking supervision. For example, under the GLBA, subordinated debt is statutorily adopted as a supervisory complement in securing prudential risk-taking of large insured depository institutions. § 108 (a) (1), GLB Act (codified in 12 U.S.C. § 4801) reads: "...The Board of Governors of the Federal Reserve System and the Secretary of the Treasure shall conduct a study of (1) the feasibility and appropriateness of establishing a requirement that, with respect to large insured depository institutions and depository institution holding companies the failure of which could have serious adverse effects on economic conditions or financial stability, such institutions and holding companies maintain some portion of their capital in the form of subordinated debt in order to bring market forces and market discipline to bear on the operation of, and the assessment of the viability of, such institutions and companies and reduce the risk to economic conditions, financial stability, and any deposit insurance fund." For more information of sub-debtholders' complementary function, see e.g., Joseph G. Haubrich, Subordinated Debt, 1 The Journal of International Banking Regulation, 62 (1999); also see Douglas D. Evanoff and Larry D. Wall, Subordinated Debt and Bank Capital Reform, in BANK FRAGILITY AND REGULATION: EVIDENCE FROM DIFFERENT COUNTRIES 53-119 (George G. Kaufman ed., 2000).

With the ongoing exploration on the debtholders' complementary function being well underway, one caution should be warranted. That is market discipline exercised by debtholders will inherently suffer from information asymmetry, and also from the shortage of enforceability to reduce such information disadvantages, which collectively will make them inferior to banking regulators in their ability to force through disciplinary weight against bank management.

125 See McCoy, supra note 34, at § 13.03 [3] (noting unsafe and unsound banking practices are not inherently unprofitable but quite to the opposite that under proper circumstances can be rather rewarding financially);
restrictions as well as take or mandate positive actions for these regulatory purposes at the cost of the potential surge of share prices should the risk have been allowed. At the same time, both private-sector monitors of proximity and objectivity of a publicly traded banking organization pursue profit maximization, which is largely translated to optimal performance of share prices. The safety and soundness based restrictions on dividend payments and on profit-centered pay packages may be at add with the desire of the private-sector monitors are obvious.

The bank regulator’s agenda may therefore have some more profound and structural dimension of implications on the US shareholder model of corporate governance — a system pressing monitors of objectivity over proximity (the market for corporate control being “the cornerstone of U.S. governance”). The market for corporate control works primarily through forceful disciplinary pressure exerted by the market for corporate control on underperforming bank management in that share prices lagging in banking organizations with incompetent or corrupt management will attract raiders taking over control from such management. The agenda conflicting presented here, as a loss-avoidance versus risk-taking struggling, therefore, stands at the core with ensuing disparate monitoring results expected by banking regulators and other two classes of private-sector monitors with equity-connected stakes.

The substantial offsetting effect of the safety and soundness concern on the utility of the market for corporate control for banking organizations can be also observed from some concrete regulatory and supervisory arrangements. In the US, safety and soundness based restrictions on the corporate control mechanism in banks are of long pedigree. Even after the phase-off and ultimate abolition of geographic restrictions (including state branching restrictions on state-chartered banks and geographic expansion restrictions on bank holding companies), the GLB Act of 1999 still

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126 See Macey, supra note 122, at 407.
127 Id. at 406-07.
129 See MACEY ET AL, supra note 92, at 349-378. (noting restrictions on intrastate branching raises legal issue of competitive equality enshrined under the McFadden Act of 1927). Since 1980, by means of cross-state reciprocal treatments, the gradual removal of state and federal restrictions on geographic expansion in banking is noticeable. Liberalization on banking consolidation culminated with the passage
imposed general restrictions on acquiring ownership of banks by non-bank firms or firms without being affiliated with banks (the latter referring to firms other than bank holding companies or financial holding companies) — that is, mergers between non-bank/non-bank-affiliated firms and commercial banks remain prohibited. In addition, lengthy approval processes involving including banking regulators multiple authorities in bank hostile takeover transactions make such transactions more time consuming and expensive and thus less attractive than bidders targeting non-bank corporations.

Moreover, banking regulators’ involvements in practice in a hostile takeover transaction could extend well beyond a closing role (the approval requirement) to such earlier stages as the targeted banking organization is required to obtain a supervisory “no-objection letter” to clear the supervisor’s safety and soundness concern over the bank’s proposed defensive measures.

Superiorly holding a forceful monitoring capacity and capability over their


See Macey ET AL, supra note 92, at Ch.6 (discussing affiliation restrictions among banks, non-bank financial firms and non-financial firms pre-and-after the GLB Act). Even after the passage of the GLB Act, which in general permits an FHC engaging or acquiring the shares of a company engaged in financial activities, the FHC (or BHC’s) depository institution’s safety and soundness status before and after activity expansions remains either as a prerequisite or a condition sustaining the continuation of such expansion power. For further discussion on mergers and acquisitions among bank (financial) holding companies in the post-GLB Act era in the US that are predicated on both financial and managerial safety and soundness of their banking components, see Joseph J. Norton, Global Cross-border Bank Mergers And Acquisitions—US Regulatory And Supervisory Considerations, in CROSS-BORDER MERGERS AND ACQUISITIONS AND THE LAW, 29-57 (N. Horn ed., 2001).

In the USA, bank takeovers need prior approval from federal and state bank regulators. After approval is granted a thirty-day waiting is required for the Justice of Department scrutinizing the takeover attempt. In total, the takeover process can last four months or longer. See Stephen Prowse, Corporate Control in Commercial Banks, 10 The Journal of Financial Research, 509, 511-512 (1997); but see MACEY ET AL, supra note 92, at 349-378.

The OCC’s regulation provides a national bank may elect to follow the corporate governance procedures of the law of the state in which the main office of the bank is located to the extent those procedures are not inconsistent with the applicable Federal banking statutes or regulations or “bank safety and soundness”. 12 C.F.R. § 7.2000. Based on this regulation, in a no-objection letter for example the OCC expressed its no objection to a targeted bank’s proposition to adopt a rights plan only after, among other things, the finding that even if the bank redeemed the rights, its capital strength would not have been impaired accordingly. See Office of the Comptroller of the Currency, No-objection To A Bank’s Proposal To Adopt, In Accordance With 12 C. F. R. 7.2000, A Shareholder Rights (Anti-takeover) Plan That Is Permitted Under State Law And Not Inconsistent With Federal Banking Statutes And Regulation, OCC No-objection Letter 97-01, 1, 2 (31 Dec. 1996) (1996 WL 798846 (O. C. C.)).
counterpart, private-sector monitors, empirical studies show that banking regulators’ safety and soundness pursuit has indeed offset the market-based disciplinary utility aimed at aligning shareholder interests with that of bank management, and, as a result, imbalances the state-law based corporate governance structure emphasizing extrajudicial and market-based solutions whilst relaxing judicial interventions, not least the court’s fiduciary duty reviews. One net effect that can be extracted from this imbalance is to the extent under the state corporate law regime extrajudicial solutions remain the

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133 One major empirical study investigating the corporate control mechanism that operates in commercial banks supports this conclusion. Sampling operations of five corporate control mechanisms (hostile takeover, friendly acquisition, removal of top management by the board of directors, intervention by regulators and no control change) on US commercial bank holding companies (BHCs) from 1987 to 1992, and tying them to data on the ownership structure of the sampled BHCs (including the equity stakes of insiders and outsiders on the board of directors, other characteristics of the top management structure of the bank, and measures of bank performance), the study found:

(i) the most frequently deployed mechanism in the sample period was regulatory intervention (19.2 percent of the sampled underwent regulatory intervention as against the second most frequent- friendly merger which stood at 10.7 percent);

(ii) hostile takeovers did not play an important role in disciplining BHC management (only 1.7 and 10.3 percent of the sampled underwent a hostile takeover and a management turnover, as contrast to respective 8.8 and 20.5 percent of manufacturing firms in the same time spectrum);

(iii) friendly takeovers primarily took place between profitable BHCs and were motivated by reasons other than disciplining underperforming management; and

(iv) other than regulatory interventions, the primary mechanism for disciplining managers at BHCs was intervention by the board of directors. BHC boards, however, were less assertive in replacing or otherwise disciplining managers for underperformance than were their industrial counterparts.


The following remarks made by the former Governor of the Bank of England, who used to be the head of the UK's primary banking agency that was succeeded by the Financial Service Authority for the Bank's prudential regulation and supervision mandate, represent the scepticism commonly held by banking regulators towards mergers and acquisitions, particularly those involving overseas participation, in the banking sector: “We do not look favourably on acquisitions of stakes designed to put banks `into play'. Neither do we welcome bids whose purpose is... that a bank may be broken up in ways that may be detrimental to depositors' interests...As a general rule we would not wish to stand in the way...of overseas participation in a British bank or financial institution. But it runs counter to commonsense to argue that the openness of the London market must be carried to the point where control of the core of our financial system may pass into the hands of institutions whose business aims and national interests lie elsewhere.” See Ownership and Control of UK Banks, Bank of England Quarterly Bulletin, 525, 525 (Nov., 1987).

primary means to enhance public held corporations including banking organizations’ efficiency, i.e., profitability, the demand for bank safety and soundness might inevitably dampen their utility on this efficiency objective.

D. Implications on Limited Liability and Corporate Separateness Applying to Bank Groups

As discussed in chapter three, courts honor the triad of traditional notions of state corporate law, i.e., shareholder-interest primacy, limited liability and corporate separateness, which generally directs to the law’s primary policy underpinning of promoting risk-taking, when reviewing transactions that involve parent corporations and their subsidiaries. The triad has been honored as far as a transaction between a parent and its subsidiary is not consummated with the parent (as the controlling or the sole shareholder) exerting so absolute a dominance over its subsidiary (or “standing on the two sides of a transaction”) as to bring about unacceptable prejudice to the subsidiary’s minority shareholder. The court normally refrains from second-guessing the intra-group business decision entailing two or multiple corporations separate in law but might be integrated in operation under the parent’s group-wide or simply parent-oriented business consideration.

Following this vein, in at least one case where the case to be reviewed entailed a transaction between the parent corporation (the sole shareholder) and its wholly-owned subsidiary, the supreme court of Delaware ruled the subsidiary’s directors owed fiduciary duty only to the subsidiary’s sole shareholder as opposed to the subsidiary itself. After the US Supreme Court’s confirmation in the Atherton decision that the corporate governance order established under the state corporate law should equally apply to banking organizations and bank management, theoretically at least, the similar fiduciary-duty review criteria can be expected when an intra-group transaction involving a bank and its affiliate was challenged before state courts.

It is also crystal clear, in the banking and regulatory context, the pattern of stakeholder protection advancements evolving around the bank safety-and-soundness idea over the past three decades in the general direction of expanded holding company obligation. These unique regulatory arrangements have proven the concern for bank
safety and soundness has transcended the entity boundary and found its place in the group-based operation, the dominant business pattern of bank operation in today's America. In particular, the regulatory rules and supervisory practice evolved under the source of strength doctrine, together with the resultant if unintended effects of bank-centered vertical and horizontal intra-group integrations, are a sharp contrast to the state court's long-standing insistence on the limited liability privilege accorded to corporate shareholders (parent corporations) and reluctance to pierce the corporate veil for avoiding risk aversion.

The conclusion the bank safety and soundness consideration has substantially eroded into the state corporate-group law's three-prong foundation is therefore not an overstatement. Whereas academic works on these bank holding companies' expanded obligations primarily focused on their complementary effects on the safety and soundness regulatory objective, the extensive extent to which the doctrine actually had altered the broader corporate-governance order established under state corporate law has as yet not been fully exposed.

V. Concluding Remarks

Almost 10 years on since the Atherton decision, the author argues, the expanding, ubiquitous presence of the regulatory requirements for bank safety and soundness has proven inadequate the foundation of Atherton statement. That neither banking statutes nor regulations nor other rule-making works promulgated under them had set forth corporate governance standards of a general nature for the bank management, as assumed by the Atherton court, is inconsistent with the current state of legal order applying among bank shareholders, management and banking regulators. The Atherton assumption is an inaccurate one. The issue now is not so much whether the state corporate law should accommodate the banking regulator's safety and soundness consideration and extend it beyond compliance as how the law as a whole should react to the new order established, as duly authorized by Congress and recognized by court, by the bank regulator's open-ended and open-textured consideration for safe and sound management that has pushed the banking agencies to reach deep into traditional preserves of bank management and ownership — with a full-blown agenda other than
maximizing shareholder profits.
CHAPTER FIVE –
Concluding Observations and Modest suggestions

On this text’s subject matter — the bifurcated governance standards over managerial conduct of the US banking organizations as enshrined under the bank regulatory stakeholder governance model and the state corporate law’s shareholder governance model — this chapter concludes with three final points, addressing first, the tension embedding the current overall governance order; second, some possible approaches to governance standard reconciliation; and, finally, the desirability of establishing in the US banking sector an industry-specific corporate governance system.

As opposed to the traditional perspective which wrongfully pre-supposed corporate governance standards being an exclusive domain of state corporate law, the author offers a new perspective, by examining governance standards under state corporate law together with the “shadow corporate law” created under bank safety and soundness regulation and supervision, and enforcement as well examination practice, in order to more fully expose how the bank management is being directed and controlled. This exercise reveals that banks are in reality being directed to achieve dual corporate objectives, the one of stability and of profitability. The immediate task of corporate governance in banks is therefore to establish clearer criteria for bank management concerning balancing or prioritizing these two. To this end, the author puts forward some modest suggestions in section two of this chapter, including the need to direct the face of bank safety and soundness regulation to a phase-by-phase treatment predicated on the result of the supervisory report. As a starting point to this effort, banking agencies may consider restricting those existing prohibitive or restrictive instructions concerning specific unsafe and unsound transactions to applying only to those institutions which performances on management are rated unsatisfactory or worse.

On a broader policy term, the final section of this chapter notes the much needed, full-scale reconstruction concerning corporate governance standards in banks. This process should put an end to the existing bifurcated approach by establishing a set of uniform, national corporate governance standards that can truly reconcile the banking
institution’s desired operating strategies of profit maximization and loss avoidance — that is, a set of industry specific corporate governance standards.

I. Managerial Safety and Soundness Banking Rules as Shadow Corporate Law

As discussed in chapter four, where there exist managerial abuses taking either the conflict-of-interest form or that of outright fraud, the banking regulator’s safety and soundness agenda converges with that of the state corporate law addressing agency-cost related problems to the bank shareholder’s interest, and so does the regulator’s prudential pursuit enhance the policy value to be promoted under the shareholder governance model.

But in the absence of such insider abuses, the regulatory consideration for safe and sound management and the general loss avoidance psychology it has injected on bank management as supported by vigorous regulatory monitoring and formidable enforcements is not only directly competing with the policy value of promoting managerial risk-taking zeal under state corporate laws, but also has installed a new internal interest hierarchy with the well-being of the bank depositor or the US deposit insurance system and the ongoing operation of the US banks topping the interest ladder. The status quo is that the safety-and-soundness based open-ended regulatory reach, as reflected in banking statutes, regulation, banking agencies’ rule-making works, private rulings, as well as enforcement and examination practice, has already attained a “shallow corporate law” status and moved well beyond an area of black-letter compliance, eroding into the core of the state corporate law’s policy value which holds “enhancing corporate profit and shareholder gain”\(^1\) as an overall, single corporate objective.

The US bank management is actually being governed by two disparate strands of standards of conduct and review instructing often conflicting risk appetites over even benevolent risk-taking decisions, whereby the banking institutions they attend to are expected to achieve both, through the bank shareholder’s lens, profitability and, through those of the banking agency, stability — a dual corporate goal co-existing and running

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\(^1\) The American Law Institute, Principles of Corporate Governance: Analysis and Recommendations sec. 2.01(a) (1994).
through the banking organization’s ordinary course of business.\textsuperscript{2} This status has posed a genuine governance problem pointing at within the overall bank governance framework a considerable level of confusion and inconsistencies.

II. Reconciliation of Managerial Standards of US Banking Organizations

The first compelling question one has to raise is therefore whether raising the prudential regulatory pursuit — in particular its risk-controlling approaches — to such a height can be justified.

To start with, it has been proven that the banking sector’s risk-prone propensity as a genuine existence is able to translate into a full-blown banking crisis.\textsuperscript{3} Weighing in the various public-interest attributes explored previously in this text (particularly in chapter one and two) that as generally acknowledged have contributed to the banking industry’s quasi-public nature, the need for certain regulatory interventions to hold the banking organization as a going concern could thus be established. But would stopping at the institution’s border rather than reaching deep into its managerial core by imposing for example enhanced risk-based capital requirements alone be, as argued by some commentators,\textsuperscript{4} sufficient enough to safeguard against the occurring of banking crises

\textsuperscript{2} Even from the regulatory side, one should not lose sight of the importance of maintaining the banking industry’s competitive capacity to achieve a reasonable level of profitability. Putting into the policy background behind the liberalization of financial institution powers connecting to the GLB Act relaxing cross-sector organizational integration, one would readily detect the policy-maker’s desire to reverse the decline in the profitability of financial intermediaries, in particular depository institutions. See, in general, JONATHAN R. MACEY ET AL, BANKING LAW AND REGULATION 511-86 (3d ed. 2001); see also Allan Greenspan, remarks made at the Conference of State Banking Supervisors, Traverse City, Michigan, 18 May 2001 (noting the broad policy objective of bank supervisors and regulators as: “[t]o promote safety and soundness while allowing banking institutions to innovate and compete”)

\textsuperscript{3} Despite the considerable amount of insider abuses, dishonesty was a contributing factor to only a minority of widespread failures during the US banking sector crisis of 1980s and early 1990s. See Harris Weinstein, Advising Corporate Directors After The Saving And Loan Disaster, 48 Bus. Law., 1499, 1501, note 10 and accompanying text (1993) (“Estimates of the losses due to fraud and misconduct have stretched from a low of 3% to a high of 33% of the net losses the taxpayers have suffered as a result of the savings and loan debacle.”), citing NATIONAL COMMISSION ON FINANCIAL INSTITUTION REFORM, RECOVERY AND ENFORCEMENT, ORIGINS AND CAUSES OF THE S&L DEBACLE: A BLUEPRINT FOR REFORM 70-71 (July 1993)); see also KENNETH SPOONG BANKING REGULATION-ITS PURPOSES, IMPLEMENTATION AND EFFECTS 81 (5th ed. 2000) (“...insider problems...representing one of the major reasons for failure in 26 percent of the banks.”), citing U.S. General Accounting Office, Bank Insider Activities: Insider Activities: Insider Problems and Violations Indicate Broader Management Deficiencies, GAO/GGD-94-88, 30 March 1994)

\textsuperscript{4} See e.g., Eric Gouvin, Shareholder Enforced Market Discipline: How Much Is Too Much? 16 Ann. Rev. Banking L. 311, 350 (1997) (“The only change necessary was to make the capital requirements of banks
by providing equity holders with economic incentive to monitor the management's risk-taking and also a financial buffer to cover losses should risks be realized? As explored in detail in chapter two, the history has indicated this may not be the case, considering prudential concerns being generally outside the agenda to be fostered under the shareholder governance model and the shortage of the capital adequacy regime on addressing the managerial root cause leading to bank failures. To some extent regulatory control over managerial risk-taking conduct should thus be recognized as a necessity.

The remaining problem is then how to develop within the US banking sector a coherent formula reconciling the above-discussed bifurcated strands of standards of conduct and of review over the bank management.

Efforts along this line have been made by an attempt to revamping the composition of the state law based fiduciary duty in the past. The proposition of adding the banking regulator alongside the bank shareholder as beneficiary recipients of fiduciary duty owed by bank management to the bank corporate entity has sparked fierce debates in early 1990s. At the heart of this proposal is an affirmative, open-ended mediation role and function to be assumed and performed by the bank

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5 As discussed in chapter two, the reasons against this thought include the "lagging indicator" argument that insufficiency of capital is simply the symptom as opposed to mismanagement as the root cause leading to the institution's ultimate failure; the explicit Congressional mandate and judicial differences for banking agencies reaching deep into regulating risky activities and inadequate risk-management practices; and the deep-rooted clash between shareholders and depositors in their risk perspectives.


For arguments against the above approach, see *Id.* at 23 (“Unlike a duty based on fiduciary principles, however, the duty not to engage in unsafe and unsound conduct is determined not by reference to general principles of equity, but by reference to the intention and policies of Congress.”); see also Andrew Nussbaum, *Like Money In The Bank? An Economic Analysis Of Fiduciary Duties To Protect The S & L Deposit Insurance Fund*, 44 Admin. L. Rev. 355 (1992).
management, whereby they were to mediate the interest of the bank shareholder and that of the bank regulator when making risk-taking decisions. The fundamental predicament entailing the feasibility of this approach however rests with its inherent dividing loyalty problem. One would also have a strong case arguing against this proposition based on the doubt over the need for banking regulators seeking to have their safety and soundness agenda protected under corporate law, given the regulator's prudential pursuit has to some extent already overridden the state corporate law's defer-to-management approach over managerial risk-taking decisions.

Alternatively, standard reconciliation from the regulatory end might pose as a less onerous possibility. There might be a genuine need to direct prudential intrusion into managerial risk-taking autonomy towards, based on the individual institution's risk-management strength, generally a phase-by-phase treatment, if clearer criteria concerning balancing or prioritizing profitability and stability and their projected risk-taking manners expected of the bank management are to be established. This approach will cut back on the currently full-blown, indiscriminate regulatory intrusion into specific risk-taking decisions permeating throughout the bank's life, and serve as a timely reaction to halt the trend of exponentially expanding the regulatory, supervisory and enforcement scope projected under managerial safety and soundness conceptualization, one that might compromise the desired support for a vibrant, innovative banking system.

On this point, the current regulatory status does not indicate a coherent policy. The Prompt Correction Regime, on one hand, takes a phase-by-phase approach to control an individual institution risks, the intensity of interventions in and restrictions

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7 See chapter three for arguments raised against the Delaware Chancery Court's decision of Credit Lyonnais.
8 See Nussbaum, supra note 6, at 392-96 (arguing a fiduciary duty running to the banking regulator or the deposit insurance fund would not render extra protection for the purpose of limiting risk, but could only partly mirror control devices already granted to agencies by statute.)
9 On the supervisory side, a two-tiered supervisory program, which is similar to the proposed phase-by-phase regulatory regime, applying to community banks was installed by the FDIC in January 2004. For the purpose of deciding the applicability of streamlined on-site examinations, the program separates those well-capitalized and well-managed banks and thrifts that meet basic safety-and-soundness criteria from those not. See Federal Deposit Insurance Corporation, Remarks By FDIC Chairman Don Powell ABA Annual Convention New York, New York, FDIC PR-101-04, (4 Oct. 2004) (2004 WL 2231523 (F.D.I.C.))
over the management’s autonomy increasing as the bank’s financial or managerial strength, or both, deteriorating. On the other hand, safety-and-soundness regulatory pronouncements contained in the banking agency’s policy statements and individual enforcement orders, which meticulously instruct the bank management’s desired risk-taking decisions, often indiscriminately apply to banking organizations displaying disparate conditions of financial or managerial strength.

This phase-by-phase approach might work for one practical reason which concerns the US federal banking regulator’s incentive and monitoring capability. As monitor of comparative objectivity and proximity, they are by law mandated to engaging in proactive monitoring and hold superior monitoring capability than other classes of monitors in exposing the banking institution’s genuine managerial strength through periodical on-site examinations and off-site reporting requirements. Consequently, a “deemed” unsafe and unsound banking practice, which denotes the institution’s receipt of a less than satisfactory rating in its most recent report of examination for including management and/or other indicators, provides not only a concrete but comparatively also a reliable evidence that the institution needs to cut back on its risk-taking appetites and step up its risk-management strength. More specifically, the starting point might be restricting the currently indiscriminate application of those prohibitive or restrictive instructions concerning unsafe and unsound risk-taking practice to only those institutions whose managerial quality is rated unsatisfactory or worse.

III. Industry-specific Construct of Corporate Governance

On a broader policy note, the reconciliation process on bifurcated standards of managerial conduct should serve as a stepping stone to a set of nation-wide, uniform corporate governance standards that can duly reflect the bank regulator’s overall

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10 This is despite the functional incompleteness correctly associating with periodical bank safety-and-soundness examinations by some commentators. See e.g., Richard Kim, The Federal Reserve’s Proposed Interpretation Regarding The Anti-tying Restrictions Of Section 106 of The Bank Holding Company Act Amendments Of 1970, 8 North Carolina Banking Institute, 1, 17 (2004) (noting “[a]t best, bank examiners would be able to analyze a handful of transactions during the course of an examination and, even then, would have great difficulty in assessing some of these factors, such as conversations between the bank and the customer and the customer’s course of dealing with the bank and other financial institutions. Such a fact-intensive approach runs the risk of eventually collapsing under its own weight.”)
justifiable status as a key stakeholder.

In relation to corporate governance over the US banking organizations, as a key stakeholder, the bank regulator’s safety and soundness pursuit manifests itself at least on four fronts.

First, on an ongoing basis and in pursuing its bank safety and soundness agenda, the bank regulator has reached deep into the traditional preserve of ownership and management by imposing negative restraints and mandating positive corrective actions over the bank management’s risk-taking decisions.11

Second, various bank regulatory hurdles and the bank regulator’s reluctance to put banks into play have to some extent dampened the market-based disciplinary utility aimed at aligning shareholder interests with that of bank management, and, as a result, may have imbalanced the state-law based corporate governance structure emphasizing extrajudicial and market-based solutions whilst relaxing judicial interventions.12

Third, in certain review areas such as change-of-control and insolvency where non-banking management witnesses enhanced judicial review, for bank management it is the bank regulator’s bank safety and soundness measures posing as the most dominating control force.13

Finally, in terms of the banking industry’s group-based operation, source of strength and other related bank regulatory principles mandating the bank holding company to serve as the ultimate financial and managerial source of strength for its bank subsidiary have significantly compromised the corporate separateness and limited liability privilege rules enshrined under the traditional state-law based corporate governance order.14

Such uniform governance construct, addressing particularly the US banking sector’s industrial particularities, their derived implications on the society as a whole and the regulator’s (or the taxpayer’s) stakeholder status, will represent not only a needed reconciliation of the bank regulatory stakeholder governance model and the shareholder governance model — of their corporate goals of stability and profitability;

11 Chapter 4, notes 4-34 and accompanying text.
12 Id. notes 123-33 and accompanying text.
13 Id. notes 108-09 and accompanying text.
14 Id. notes 71-85 and accompanying text.
their policy values of public interests and ownership interests; and their instructions of commercial strategies of loss avoidance and profit pursuit — but also a far cry from the traditional economy specific design of corporate governance, indicating the possibility if not desirability of a corporate governance system that is industry-specific.
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1.4.2 United Kingdom Statutes


1.4.3 United States Statutes

1.4.3.1 United States Code (Individual Provisions)

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<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>BHCs</td>
<td>Bank holding companies</td>
</tr>
<tr>
<td>BOPEC</td>
<td>Bank subsidiaries’ condition; other subsidiaries’ condition; parent company’s condition; earnings on a consolidated basis; and Capital adequacy on a consolidated basis</td>
</tr>
<tr>
<td>CAMELS</td>
<td>Capital adequacy; asset quality; management capability; earnings quality and quantity; liquidity; sensitivity to market risk</td>
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<tr>
<td>DGCL</td>
<td>Delaware General Corporation Law</td>
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<tr>
<td>FDIC</td>
<td>Federal Deposit Insurance Corporation</td>
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<tr>
<td>FDICIA</td>
<td>Federal Deposit Insurance Corporation Improvement Act</td>
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<tr>
<td>FFIEC</td>
<td>Federal Financial Institutions Examinations Council</td>
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<tr>
<td>FHCs</td>
<td>Financial holding companies</td>
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<tr>
<td>FinCEN</td>
<td>Department of the Treasury’s Financial Crimes Enforcement Network</td>
</tr>
<tr>
<td>FIRREA</td>
<td>Financial Institutions Reform Recovery and Enforcement Act of 1989</td>
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<tr>
<td>FISA</td>
<td>Financial Institutions Supervisory and Insurance Act of 1966</td>
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<tr>
<td>FRB</td>
<td>Federal Reserve Board of Governors</td>
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<tr>
<td>FSA</td>
<td>Financial Services Authority</td>
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<tr>
<td>FSMA</td>
<td>Financial Services and Markets Act 2000</td>
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<td>GLBA</td>
<td>Gramm-Leach-Bliley Act of 1999</td>
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<tr>
<td>LCBOs</td>
<td>Largest most complex banking organizations</td>
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<tr>
<td>ILSA</td>
<td>International Lending Supervision Act</td>
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<tr>
<td>OCC</td>
<td>Office of Comptroller of the Currency</td>
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<tr>
<td>PCA</td>
<td>Prompt Corrective Action</td>
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<tr>
<td>UFIRS</td>
<td>Uniform Financial Institutions Rating System</td>
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