The Corporate Governance Movement, Banks, and the Financial Crisis

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This Article discusses why a "corporate governance movement" that commenced in the United States in the 1970s became an entrenched feature of American capitalism and describes how the chronology differed in a potentially crucial way for banks. The Article explains corporate governance's emergence and staying power by reference to changing market conditions and a deregulation trend that provided executives with unprecedented managerial discretion as the twentieth century drew to a close. With banking the historical pattern paralleled general trends in large measure. Still, while the "imperial" CEO who achieved prominence in the 1980s became outmoded for the most part after corporate scandals at the start of the 2000s, this was not the case with large financial companies. The continued boldness of "star" CEOs in the financial services industry plausibly contributed to the market turmoil of 2008, but the financial crisis emphatically ended the corporate governance "free pass" banks had enjoyed.

Introduction

It has been well known since at least the 1932 publication of Adolf Berle and Gardiner Means's *The Modern Corporation and Private Property* that shareholder passivity creates latitude for top executives of U.S. public companies

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to impose what are now commonly referred to as agency costs on investors.[1] Nevertheless, it was only in the 1970s that debates in the United States about managerial accountability, board structure and shareholder rights began to be explicitly channeled through the term "corporate governance."[2] The change went well beyond mere terminology as a "corporate governance movement" quickly emerged.[3] This would ultimately evolve into a "corporate governance complex" composed of a dense array of public institutions, private firms and academic centers dedicated to the pursuit of "better" corporate governance.[4]

The basic chronology of the arrival and subsequent development of corporate governance has been traced elsewhere.[5] Still, while there has been analysis of what happened when, a topic which has gone largely unexplored is *why* the corporate governance movement gained momentum in the United States when it did and then endured through ensuing decades. If it was well-known at least as far back as the 1930s that managerial accountability was potentially lacking in publicly traded companies, why was the corporate governance movement postponed for nearly half a century? And with corporate governance's arrival being belated in the first place, what caused interest in the topic to be sustained as the twentieth century drew to a close and the twenty-first century began? Even though Ronald Gilson suggested as far back as 1996 that the next generation of corporate governance scholarship would be dynamic, examining how and why existing institutions responded to a changing array of problems,[6] these important questions have gone largely unaddressed thus far.

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1 Adolf Berle & Gardiner Means, The Modern Corporation and Private Property (1932). The pioneering work on agency cost theory was Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

2 Brian R. Cheffins, *Introduction*, *in* The History of Modern U.S. Corporate Governance, at ix, ix (Brian R. Cheffins ed., 2011).

3 Daniel Fischel coined the term in the early 1980s in Daniel R. Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259 (1982).

4 Suzanne Stevens & Michael Rudnick, *What Berle and Means Have Wrought*, Deal Mag., May 14, 2010, http://www.shareholderforum.com/e-mtg/Library/20100514_Deal.htm.

5 Cheffins, *supra* note 2; Brian R. Cheffins, *The History of Corporate Governance*, *in* The Oxford Handbook of Corporate Governance 46 (Mike Wright, Donald Siegel, Kevin Keasey & Igor Filatotchev eds., 2013).

6 Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter*, 74 Wash. U. L.Q. 327, 345 (1996); *see also* Stacey Kole & Kenneth Lehn, *Deregulation, the Evolution of Corporate Governance Structure, and Survival*, 87 Am. Econ. Rev. 421, 425 (1997) (quoting Gilson, *supra*, to the effect that "how a system of governance moves from one equilibrium to the

This Article offers conjectures on why the corporate governance movement gained momentum when it did and proved resilient thereafter, with the primary purpose in this particular context being to offer insights concerning the interrelationship between the corporate governance of U.S. banks and the financial crisis commencing in 2008. A key point the Article makes is that a reconfiguration of the business environment affecting executives, directors and shareholders helps to explain the chronology of corporate governance's arrival and its staying power. As the twentieth century drew to a close, changing market conditions and a deregulation movement affecting a wide range of industries were providing executives with unprecedented discretion in relation to companies growing in size. In this milieu, corporate governance could provide a salutary check on U.S. executives, thereby ensuring it would not be a mere 1970s fad. Indeed, despite numerous lapses, such as various high-profile corporate scandals occurring in the early 2000s, a case can be made that in the United States four decades after the corporate governance movement began a corporate governance equilibrium of sorts has been (re) established. Law professor Ed Rock has posited, for instance, in a 2013 article that "the central problem of U.S. corporate law for the last eighty years — the separation of ownership and control — has largely been solved."[7]

This Article argues that with banking the historical pattern parallels in large measure the trends just described but also varies from the basic narrative in an important way. Due to a combination of deregulation, technological change and financial innovation, senior bank executives had managerial latitude their mid-twentieth century predecessors could have barely envisaged. As would have been anticipated given trends affecting U.S. companies generally, corporate governance was strengthened to some degree in banks. Nevertheless, while nonfinancial companies were unmistakably chastened by the corporate governance scandals of the early 2000s and by the corporate governance reforms introduced by the federal Sarbanes-Oxley Act of 2002 (SOX),[8] during the mid-2000s the banking sector received something of a governance "free pass." Only in the wake of the trauma of the 2008 financial crisis did things change, resulting in more robust corporate governance. Banks are now being run less flamboyantly than was the case immediately prior to the onset of the crisis, much as nonfinancial companies operated in a more restrained way after the corporate scandals and legislative reforms of the early 2000s.

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next may come to attract more interest than the characteristics of a particular equilibrium").

7 Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. Pa. L. Rev. 1907, 1909 (2013).

8 Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745.

The Article proceeds as follows. Part I summarizes briefly corporate governance's rise to prominence between the 1970s and 1990s. Part II explains corporate governance's staying power, emphasizing that more robust corporate governance was a logical response when chief executives were managing bigger companies with greater discretion than was available to their post-World War predecessors. Part III indicates that these trends were relevant to financial companies as well as their nonfinancial counterparts. Part IV identifies, however, a crucial distinction with banks. Following the corporate governance scandals of the early 2000s they had a corporate governance "free pass" that gave autocratic chief executives scope to pursue misguided policies that jeopardized their firms, the financial sector generally, and ultimately the entire U.S. economy. Part V indicates that the financial crisis proved to be something of a corporate governance equalizer for U.S. financial companies but points out that the corporate governance reforms in the Dodd-Frank Act of 2010,[9] the primary federal legislative response to the financial crisis, potentially operate at cross-purposes to regulatory and market pressure on banks and their executives to be "boring."

I. The History of the Corporate Governance Movement — A Précis[10]

In the decades immediately following World War II, amidst widespread corporate prosperity, senior executives of U.S. public companies for the most part fulfilled faithfully the responsibilities associated with their stewardship of corporate assets. Correspondingly, while proposals had been made to foster managerial accountability that would be familiar to modern students of corporate governance — William Douglas argued as far back as 1934 in favor of statutory rules requiring a majority of board seats to be occupied by individuals not affiliated with management[11] — the internal governance of companies was not a high priority. Matters began to change in the 1970s,

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9 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203.

10 What follows draws upon Cheffins, *supra* note 2; Cheffins, *supra* note 5, at xi-xxvii; and Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P500*, 65 Bus. Law. 1, 5-11 (2009). Footnotes supporting the propositions advanced here are available from these sources.

11 William O. Douglas, *Directors Who Do Not Direct*, 47 Harv. L. Rev. 1305, 1314-15 (1934); *see also* Robert A. Gordon, Business Leadership in the Large Corporation 347-50 (1945).

when the term corporate governance first came into vogue in the United States. Executives and directors began to struggle to maintain control over sprawling corporate empires built in the 1950s and the 1960s, a trend the 1970 collapse of Penn Central, a large railway-based conglomerate, underscored. Revelations shortly thereafter of bribery and illicit kickbacks involving dozens of U.S. public companies prompted fresh concerns, quite often couched in terms of corporate governance, about insufficient managerial accountability.

When the phrase corporate governance first achieved prominence in the 1970s it seemingly connoted that the corporation was a political structure to be governed, a characterization that was out-of-step with the market-oriented *zeitgeist* of the 1980s and was at odds with the increasingly popular characterization of the corporation as a "nexus of contracts." Nevertheless, in the late 1980s and early 1990s institutional investors often invoked the rhetoric of corporate governance when they contested the adoption of anti-takeover devices by the companies in which they owned shares, pressured companies to increase the use of performance-oriented managerial compensation, and lobbied for the relaxation of rules that created obstacles to shareholder intervention in corporate affairs. With the phrase "corporate governance" becoming increasingly associated with the promotion of shareholder value, academic economists who were just beginning to turn their attention to the internal control systems of publicly held corporations, embraced the term, thereby enhancing corporate governance's intellectual credibility.

During the 1990s the promotion of shareholder rights and the fostering of boardroom accountability became topics of interest globally, rather than merely in the United States. In the same way that "corporate governance" was the shorthand typically invoked to capture what was on the agenda in the United States, the term gained currency internationally. As of 1999, the corporate governance movement had progressed to the point where a *Financial Times* columnist observed that "[t]he 1990s have been the decade of corporate governance."[12] Correspondingly, when during the early 2000s scandals rocked major U.S. public companies such as Enron and WorldCom, and when the financial crisis occurred in 2008, "corporate governance" would be the term that academics, policymakers, investors and corporate executives around the world deployed when analyzing issues relating to board structure, executive pay, and shareholder involvement in publicly traded companies.[13]

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12 *Moves to Halt Another Decade of Excess*, FIN. TIMES, Aug. 5, 1999, at 10.

13 A byproduct was that "corporate governance" was referred to in newspaper reports and academic papers considerably more often after Enron than was the case in the 1990s. *See* Lucian A. Bebchuk, Alma Cohen & Charles C.Y. Yang,

II. Explaining Corporate Governance's Arrival and Staying Power

A. A New Style of Corporate Leadership

Why didn't corporate governance end up as a 1970s fad in the same way as leisure suits, waterbeds, platform shoes and Pet Rocks? Corporate governance's staying power in the United States was due partly to changing patterns of share ownership.[14] Between the 1960s and the 2000s, pension funds, mutual funds and other institutional shareholders supplanted private "retail" investors as the dominant owners of shares in publicly traded U.S. companies. Due to pronounced collective action problems and a lack of relevant expertise, private investors were ill-suited to step forward and keep executives of public companies in check. Institutional investors were by no means ideal shareholder activists. They were, however, better resourced than retail investors. Institutional shareholders were also becoming more strongly motivated to take corrective action due to the accumulation of share ownership stakes in companies too large to unwind readily if they were concerned about managerial quality or accountability

The durability of the corporate governance movement was not merely a product, however, of shareholders who were better situated and more strongly motivated to intervene. A point thus far largely unacknowledged in the corporate governance literature is that dramatic changes affecting the manner in which U.S. public companies conducted business likely played a significant role. As the twentieth century drew to a close, senior executives were in charge of larger companies than their mid-twentieth century predecessors and had greater managerial latitude, meaning that there was more at stake for investors than ever before. The enhanced discretion executives had available to them could potentially be exercised in a manner prejudicial to the interests of shareholders.[15] Improved corporate governance could in turn plausibly function as a beneficial corrective. A logical corollary was that corporate governance had staying power that other 1970s fads lacked.

Learning and the Disappearing Association Between Governance and Returns, 108 J. Fin. Econ. 323, 329-30 (2013).

14 *See* Cheffins, *supra* note 2, at xix; Cheffins, *supra* note 5, at 52-53; Bengt Holmstrom & Steven N. Kaplan, *The State of U.S. Corporate Governance: What's Right and What's Wrong?*, J. App. Corp. Fin., Spring 2003, at 8, 11, 14.

15 Catherine M. Daily & Jonathan L. Johnson, *Sources of CEO Power and Firm Financial Performance: A Longitudinal Assessment*, 23 J. Mgmt. 97, 105 (1997) ("It may be . . . that CEOs possessing high levels of power misuse their power for their own benefit at the expense of shareholders.").

C.K. Prahalad and Yves Doz captured an important part of what was going on in a 2000 article on CEOs and wealth creation. They remarked upon "a new style of corporate leadership — one that includes a public persona for the CEO."[16] They asked whether "a more visible corporate leadership reflect[ed] a new reality in the internal governance of large corporations . . . ."[17] Prahalad and Doz answered yes, saying that due to various key changes in the business environment "top management cannot take a 'hands off' approach or content themselves with effective stewardship of the assets they inherit at the beginning of their tenure."[18]

Prahalad and Doz contrasted the style of leadership needed with that which sufficed in earlier eras, saying that "[t]he role of top management is no longer just control and coordination, it is anticipating, leading and managing change . . . ."[19] They did not specify when executives focused merely on control and coordination, but it would seem they had in mind the "managerial capitalism" prevalent during the 1950s and 1960s, characterized by Jeffrey Gordon as "the high-water mark of managerialism in U.S. corporate governance."[20] David Skeel has said of large corporations of this era that "[t]he qualities that were rewarded in most companies were dependability and loyalty, not creativity. The most prominent CEOs were more likely to be corporate bureaucrats than entrepreneurial geniuses."[21] To the extent this characterization is accurate, given the economic prosperity the United States enjoyed during the decades immediately following World War II it is hardly surprising that corporate governance was not a high priority.

While Prahalad and Doz insightfully drew attention to a new style of corporate leadership that implied the need for a reconfiguration of the governance of publicly traded companies, various caveats are in order. First, the transformation of the managerial function they remarked upon was not novel in 2000, but instead can be traced back at least a couple of decades

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16 C.K. Prahalad & Yves Doz, *The CEO: A Visible Hand in Wealth Creation?*, J. App. Corp. Fin., Fall 2000, at 20, 20.

17 *Id.*

18 *Id.*

19 *Id.*

20 Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 Stan. L. Rev. 1465, 1511 (2007); *see also* Gerald F. Davis, Managed by the Markets: How Finance Re-Shaped America 63 (2009) (identifying the period from 1920 until the 1980s as the era of managerial capitalism, with the 1950s being when the managerial "soulful" corporation came to dominance).

21 David Skeel, Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From 108 (2005).

earlier. In the years immediately following Chrysler's 1978 much-heralded hiring of the flamboyant Lee Iacocca to execute a corporate turnaround, numerous major U.S. public companies turned to youthful (by conventional CEO standards) dynamic individuals to take charge.[22] Correspondingly, by the mid-1980s the media was hailing "A New Breed of CEO" bringing "new excitement to rusty companies,"[23] while at the same time bemoaning a new "me-first" attitude among top management.[24]

Second, while as the twentieth century drew to a close there was awareness of a new style of corporate leadership, it is not feasible to measure the magnitude of the change with precision. Empirical testing of the discretion CEOs have available to them is an under-explored topic,[25] perhaps because it may not be possible to define CEO power satisfactorily along a single measureable dimension.[26] However, there is some quantitative evidence indicating the chief executive role did increase in prominence in the 1980s and 1990s. A growing "CEO pay slice" — the ratio of CEO total compensation to the average of the pay of the other two highest paid officers in U.S. public companies rose from 1.29:1 in the 1960s to 1.58:1 in the 1980s and to 2.58:1 in the early 2000s[27] — arguably reflected the growing importance of the CEO as compared to other senior executives.[28] The proliferation of CEO awards, used by Ulrike Malmendier and Geoffrey Tate to identify "superstar CEOs,"[29] similarly demonstrates the growing prominence of chief executives. While from the mid-1970s to the mid-1980s only the now defunct *Financial World* magazine identified and made awards to CEOs, numerous publications began to do

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22 Roy C. Smith & Ingo Walter, Governing the Modern Corporations: Capital Markets, Corporate Control and Economic Performance 106 (2006).

23 N.R. Kleinfield, *A New Breed of CEO*, N.Y. Times, Dec. 1, 1985, at SM 76.

24 Ann Crittenden, *The Age of "Me-First" Management*, N.Y. Times, Aug. 19, 1984, at F1.

25 Brian K. Boyd & Steve Gove, *Managerial Constraint: The Intersection Between Organizational Task Environment and Discretion*, *in* Building Methodological Bridges: Research Methodology in Strategy and Management 57 (David J. Ketchen & Donald D. Bergh eds., 2006) (indicating that searches had revealed only sixteen empirical tests of managerial discretion).

26 Adair Morse, Vikram Nanda & Amit Seru, *Are Incentive Contracts Rigged by Powerful CEOs?*, J. Fin. 1779, 1792 (2011).

27 Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective*, 23 Rev. Fin. Stud. 2099, 2112-13 (2010).

28 Lucian Bebchuk, K.J. Martijn Cremers & Urs Peyer, *The CEO Pay Slice*, 102 J. Fin. Econ. 199, 200 (2011).

29 Ulrike Malmendier & Geoffrey Tate, *Superstar CEOs*, 124 Q.J. Econ. 1593 (2009).

likewise in the late 1980s (e.g., *Business Week*, *Chief Executive*, *Industry Week*), as did various others around 2000 (e.g., *Forbes*, *Morningstar.com*, *Time/CNN*).[30]

Third, having identified "a new style of corporate leadership," Prahalad and Doz did not explain in any detail in their 2000 paper why the shift to senior corporate executives leading and managing change had occurred. Given that CEOs are likely to be granted wider latitude when their firms are performing well,[31] Prahalad and Doz's "new style" of management may have been partially attributable to a dramatic rise in share prices occurring during the "Roaring Nineties."[32] However, even if healthy shareholder returns contributed to the occurrence of the "celebrity CEO" phenomenon, various additional factors can be identified that reoriented the managerial function in U.S. public companies in a manner that set the stage for corporate governance to act as a potentially salutary corrective. We will consider these now in turn.

B. Bigger Companies

One change to the managerial function occurring as the twentieth century drew to a close which made corporate governance a higher priority was that companies were becoming bigger. All else being equal, the more there is at stake, the more worthwhile it will be for careful oversight to occur. By extension, the greater the value of assets under the control of public company executives, the more emphasis there should be on corporate governance. This logic likely helps to explain corporate governance's emergence in the 1970s and subsequent entrenchment as an essential feature of U.S. capitalism. Major U.S. public companies were becoming larger across various dimensions as corporate governance came to the fore and became well-established. The executives in charge correspondingly merited closer scrutiny, particularly given that their companies were operating in a more volatile market environment due to deregulation and financial and technological innovation reducing barriers to entry in many industries.[33]

There are various indicators that major U.S. public companies grew significantly bigger as the corporate governance movement took hold. According to a 2001 article in the *Wall Street Journal* arguing that a merger wave in

30 *Id.* at 1599-600, 1635-36.

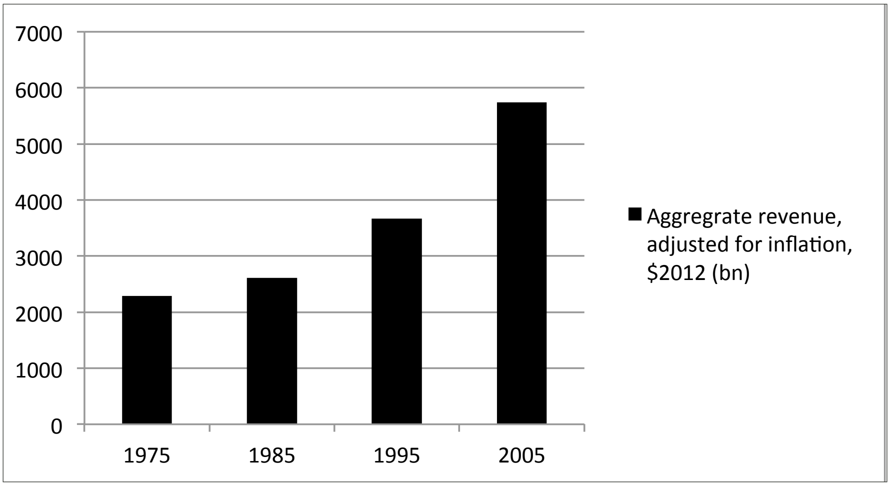
31 Daily & Johnson, *supra* note 15, at 104.

32 Joseph E. Stiglitz, The Roaring Nineties 3, 5 (2003).

33 Robert Reich, Supercapitalism: The Battle for Democracy in an Age of Big Business 50-70 (2009) (identifying factors that disrupted corporate stability in the U.S. as the twentieth century drew to a close); *see also infra* Sections II.C-D.

the 1990s had given rise to numerous new corporate behemoths, by 2001 more than fifty U.S. public companies had more than 100,000 employees, compared to only eighteen in the mid-1980s.[34] Moreover, total sales of the top one hundred non-oil-U.S. firms increased from twenty percent of U.S. GDP in 1980 to twenty-five percent in 2009.[35] Similarly, as shown in Figure 1, the aggregate revenue of Fortune 500 firms more than doubled between 1975 and 2005, adjusting for inflation.

Figure 1: Aggregate Revenue of Fortune 500 companies, 1975-2005[36]



The market capitalization of U.S. public companies grew even more rapidly than the revenues of such firms as the corporate governance movement consolidated.[37] The average market value of the largest 500 publicly traded U.S. companies increased six-fold in real terms between 1980 and 2003.[38] There similarly was a substantial increase in the size of the U.S. stock market

34 Matt Murray, *Critical Mass*, WALL ST. J., Feb. 8, 2001, at A1.

35 Xavier Gabaix, *The Granular Origins of Aggregate Fluctuations*, 79 ECONOMETRICA 733, 734 (2011).

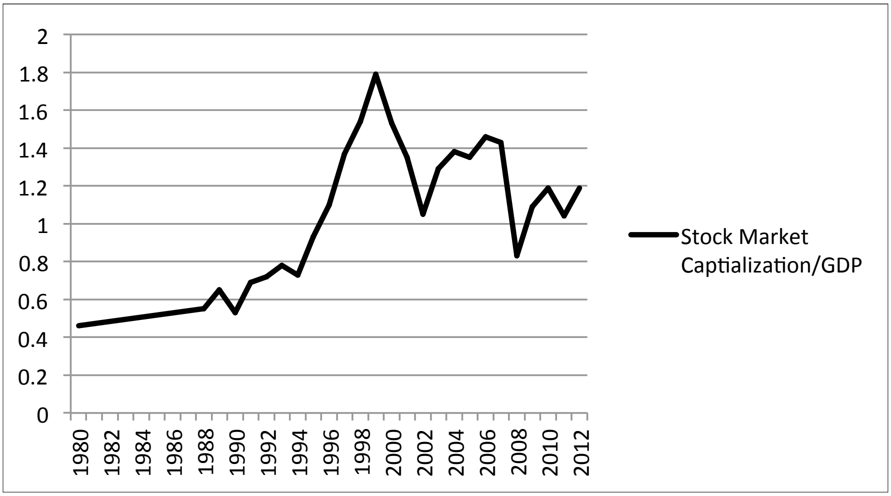
36 Compiled from *2005 Full List*, FORTUNE 500, http://money.cnn.com/magazines/fortune/fortune500_archive/full/2005 (last visited Sept. 18, 2013). Adjustments for inflation were made using CPI via *The Annual Consumer Price Index for the United States, 1774-2013*, MEASURING WORTH, http://www.measuringworth.com/uscompare/ (last visited Sept. 18, 2013).

37 Marianne Bertrand, *CEOs*, 1 ANN. REV. ECON. 121, 137 (2009).

38 Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q.J. ECON. 49, 72, 94 (2008) (reporting additionally that the increase was even more substantial for the top one hundred firms).

relative to the economy, even making allowances for the "bear" markets associated with the dot.com stock market crash and subsequently the financial crisis, as shown in Figure 2. With more being at stake for investors, it is not surprising that bolstering managerial accountability through improved corporate governance moved on to the priority list.

Figure 2: Value of All Listed U.S. Stocks/GDP, 1980-2012[39]



C. Deregulation

Deregulation likely was an additional catalyst for corporate governance's rise to prominence and its subsequent staying power.[40] In the United States, deregulation commenced during the Jimmy Carter administration with the airline and trucking industries, moved into full swing under Ronald Reagan in areas such as oil and gas and antitrust enforcement, and continued in the 1990s with electricity and telecommunications.[41] This process likely intensified potential managerial agency cost problems and the adoption of more rigorous corporate governance was a logical counter-reaction.[42]

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39 Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the 20th Century*, 69 J. Fin. Econ. 5, 15 (2003); *Data*, The World Bank, http://data.worldbank.org/indicator/CM.MKT.LCAP.GD.ZS (last visited Feb. 17, 2014).

40 Prahalad & Doz, *supra* note 16, at 20 (explicitly drawing attention to deregulation as a factor contributing to the growing importance of CEOs).

41 Skeel, *supra* note 21, at 119-20, 198.

42 Kole & Lehn, *supra* note 6, at 421, 425.

All else being equal, senior executives running a company in an industry that is heavily regulated will have less discretion than their counterparts in industries that do not face such restrictions.[43] As the twentieth century drew to a close, deregulation caused constraints on the development of pricing schemes, distribution patterns and innovative products to unravel and the removal of regulatory "safety nets" introduced substantial downside risk for lagging firms.[44] Deregulation correspondingly should have increased the importance of the managerial function in a wide range of firms. At the same time, by inducing increased instability in the business environment, it would have increased the costs of observing managerial performance, thereby enhancing the value of governance mechanisms designed to keep potentially wayward executives in check.[45] The corporate governance movement plausibly developed as at least a partial counterweight to higher agency costs that deregulation potentially engendered.

There is a literature that, consistent with the foregoing logic, treats corporate governance and regulation as substitutes.[46] The point cannot be pressed too hard, however, in this particular context. This is because corporate governance will not necessarily be a mere afterthought when companies are tightly regulated. Firms in highly regulated industries in fact often have more robust corporate governance than their counterparts in unregulated industries.[47] Regulatory pressure stands out as a plausible explanation why. "Safety-first" regulators, knowing they cannot oversee day-to-day operations of regulated firms, could well successfully exhort those firms to upgrade corporate governance and internal monitoring systems to reinforce constraints that regulation imposes.[48]

D. The Public Company Financial Revolution

A "financial revolution" that U.S. public companies experienced as the twentieth century drew to a close likely was an additional catalyst for corporate

43 Sydney Finkelstein & Brian K. Boyd, *How Much Does the CEO Matter? The Role of Managerial Discretion in the Setting of CEO Compensation*, 41 Acad. Mgmt. J. 179, 181 (1998); Donald C. Hambrick & Eric Abrahamson, *Assessing Managerial Discretion Across Industries: A Multimethod Approach*, 38 Acad. Mgmt. J. 1427, 1429 (1995).

44 Kole & Lehn, *supra* note 6, at 421.

45 *Id.* at 421, 423.

46 David A. Becher & Melissa B. Frye, *Does Regulation Supplement or Complement Governance?*, 35 J. Banking Fin. 736, 738 (2011).

47 *Id.* at 737.

48 *Id.* at 736.

governance's rise to prominence and subsequent staying power.[49] Due to a wave of financial innovation, business enterprises in this era could take advantage of a wide range of new techniques to finance their existing operations, fresh acquisitions and expansion plans.[50] By one estimate, public companies in the United States deployed seventy-six different varieties of innovative securities between 1970 and 1997 to raise over 1.7 trillion dollars from domestic capital markets.[51] One byproduct was an increase in corporate indebtedness, with the liabilities of the nonfinancial business sector climbing from 68% of GDP in 1970 to 129% in 2007.[52]

The financial revolution that occurred in the closing decades of the twentieth century had significant implications for executives in publicly traded companies. As Randall Thomas argued in 2004, "[t]he opportunities for American executives expanded tremendously."[53] The changed circumstances were illustrated dramatically by upstarts in various industries mounting serious challenges to incumbents previously unassailable due to financial advantages accruing to successful "first-movers" in their particular industrial sector.[54]

While improved access to finance would have given executives of public companies increased room to maneuver, debt increases risk.[55] The financial

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49 Raghuram G. Rajan & Luigi Zingales, *The Influence of the Financial Revolution on the Nature of Firms*, 91 Am. Econ. Rev. 206, 209 (2001) (arguing that with the financial revolution that had been occurring "we would also expect changes in the emphasis of governance").

50 Raghuram G. Rajan & Luigi Zingales, Saving Capitalism from the Capitalists 68 (2003).

51 Kenneth A. Carow, Gayle R. Erwin & John J. McConnell, *A Survey of U.S. Corporate Financing Innovations: 1970-1997*, J. App. Corp. Fin., Spring 1999, at 55, 68.

52 Simon Johnson & James Kwak, 13 Bankers: The Wall Street Takeover and the Next Financial Meltdown 68 n.41 (2010); *see also* Robin Greenwood & David Scharfstein, *The Growth of Finance*, J. Econ. Persp., Spring 2013, at 3, 21, 24 (indicating that the value of credit extended to companies grew from thirty-one percent of GDP in 1980 to fifty percent in 2007).

53 Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven*, 57 Vand. L. Rev. 1171, 1228 (2004); *see also* Sydney Finkelstein, Donald Hambrick & Albert Cannella, Strategic Leadership: Theory and Research on Executives, Top Management Teams, and Boards 30 (2009) ("Beyond the obvious trend of deregulation . . . societal and economic trends . . . have expanded the choices for senior executives.").

54 Rajan & Zingales, *supra* note 50, at 36-41; *see also id.* at 70-72, 77-79 (indicating that technology often accelerated the process by allowing new entrants to replicate the specialized resources of first-movers with minimal fuss).

55 Johnson & Kwak, *supra* note 52, at 68.

revolution that U.S. public companies experienced correspondingly should have magnified concerns shareholders would have had that management might squander the new opportunities available. This in turn should have increased investor receptivity to the idea that corporate governance had a beneficial role to play in reducing agency costs. Hence, an important collateral effect of the liberating but potentially disruptive finance revolution that public companies experienced may well have been to help to foster and sustain corporate governance's rise to prominence.

E. A New Corporate Governance Equilibrium

1. The mid-1980s to 2002: Partial Adjustment

Taken together, the growth of companies, deregulation and a financial revolution meant that as the twentieth century drew to a close executives of U.S. public companies were operating with a discretion unavailable to their post-World War II counterparts. Executives correspondingly had scope to create (and presumably destroy) value in a way that they did not have previously. A bolstering of corporate governance was an obvious potential corrective. While executives of U.S. public companies were operating with enhanced managerial discretion, this could be countered if mechanisms were in place that ensured that the right people were hired, that those in charge were suitably incentivized, and that underperformers were required to move on.

There indeed was a marked strengthening in corporate governance that more than sufficed to ensure that corporate governance would not remain a mere 1970s fad. From the mid-1980s through the 1990s, boards were strengthened, executive pay was restructured to align pay more closely with performance, and shareholders became increasingly willing to step forward to influence managerial turnover.[56] The *Economist* observed in 1999 that a spate of CEO dismissals occurring in the early 1990s had "change[d] the balance of power between shareholders and boards at big American firms" and suggested that "incompetent chief executives in large companies (were) rarer than they were in 1990."[57] Economists Bengt Holmstrom and Steven Kaplan struck a similar chord in a 2001 survey of corporate governance, saying that "since the mid-1980s, the U.S. style of corporate governance had reinvented itself" and predicting that "a more market-oriented corporate governance than existed up to the early 1980s is here to stay."[58]

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56 Cheffins, *supra* note 10, at 9.

57 *Thank You and Goodbye*, Economist, Oct. 30, 1999, at 91.

58 Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, J. Econ. Persp., Spring 2001, at 121, 140, 141.

While improvements in corporate governance should have helped to keep executives on their toes, there was a counter-trend in the form of CEOs moving to the forefront in an unprecedented manner. This was Prahalad and Doz's "more visible corporate leadership."[59] As we have seen, the new style of corporate leadership was evident in the 1980s,[60] as talented executives realized that investors responded favorably to companies with bold, charismatic CEOs and were relaxed about managerial stars being paid very well.[61]

The era of the "celebrity" or "imperial" CEO[62] developed fully in the midst of U.S. corporate prosperity in the 1990s. By 1999 matters had progressed to the point where, as the *Economist* observed, "[m]any investors in America . . . believe that bosses have more influence over their companies than they used to . . . ."[63] The *Economist* itself seemed to agree, saying in an editorial the same year that "[a]n able chief executive has extraordinary power to make or break a company."[64] The upshot, as Rakesh Khurana said in his 2002 book *Searching for a Corporate Savior*, was that the definition of an effective CEO had changed "from that of competent manager to charismatic leader."[65] It would seem, therefore, that whatever additional discipline improved corporate governance might have imposed on U.S. public companies, senior executives continued to have substantial discretion available to them.

2. Scandals, SOX and the Retreat of the Imperial CEO

The celebrity CEO of the 1990s would soon face a challenge that further entrenched corporate governance. Alan Greenspan, chairman of the Federal Reserve of the United States from 1987 to 2006, said in congressional testimony in 2002 that in public companies the chief executive was "the fulcrum of governance."[66] He made this observation just as corporate scandals affecting Enron, WorldCom and various other prominent U.S. public companies in the early 2000s were making favorable assessments of U.S. corporate governance such as Holmstrom and Kaplan's seem somewhat naive. Corporate governance,

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59 *Supra* note 17 and accompanying text.

60 *Supra* notes 22-24 and related discussion.

61 Smith & Walter, *supra* note 22, at 106-07.

62 On the terminology, see Gideon Haigh, Fat Cats: The Strange Cult of the CEO 85 (2004); and Smith & Walter, *supra* note 22, at 110.

63 *The Best . . . and the Rest: A Survey of Pay*, Economist, May 8, 1999, at 14.

64 *Firing the Boss*, Economist, Oct. 30, 1999, at 17.

65 Rakesh Khurana, Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs 71 (2002).

66 Andrew Hill, *A Tarnished Icon of the American Way*, Fin. Times, July 22, 2002, at 21.

however, did not stand still, and the changes in turn brought the era of the imperial CEO to an end, arguably heralding a fresh corporate governance equilibrium.

The Sarbanes-Oxley (SOX) Act of 2002,[67] which was the primary regulatory response to the corporate governance scandals occurring at the beginning of the 2000s, imposed various new governance-related requirements on publicly traded companies. Moreover, according to former SEC chairman Arthur Levitt, the scandals that prompted SOX's enactment accelerated "a cultural change in corporate America" oriented around tougher boards and increasingly active shareholders.[68] Levitt indeed claimed in 2005 in the wake of dismissals of CEOs at well-known public companies such as Hewlett-Packard and Disney that the days of "the autocratic, muscular CEO" were gone — "[t]he imperial CEO [was] no more."[69]

There was widespread agreement at the time that Levitt's assessment was on the mark. A *Financial Times* columnist said in 2005 that corporate scandals occurring as the decade had opened "marked the beginning of the end of the imperial chief executive."[70] Robert Dilenschneider, founder of a public relations firm with clients comprising one-third of the Fortune 500,[71] argued the same year that "[w]hat's needed now is a different kind of CEO: Men and women who shed the trappings of imperial power (and) work with their boards of directors."[72]

The consensus that the corporate scandals of the early 2000s and SOX's enactment had prompted "a governance revolution"[73] was sustained thereafter. According to a 2007 *Wall Street Journal* article entitled *After the Revolt*, the CEO dismissals occurring in the mid-2000s represented a "new, post-revolutionary generation of power in corporate America" exemplified by CEOs "on shorter leashes, more beholden to their boards of directors."[74] Greenspan observed in a chapter on corporate governance in a 2007 memoir that "the autocratic-

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67 Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745.

68 Arthur Levitt, *The Imperial CEO Is No More*, Wall St. J., Mar. 17, 2005, at A16.

69 *Id.*

70 Joshua Chaffin, *Exit the Emperor Bosses, Leaving a Legacy of Prudence*, Fin. Times, Mar. 19, 2005, at 11.

71 Richard Lee & Olivia Just, *Q&A with Robert Dilenschneider*, Stamford Advocate, Feb. 17, 2012, http://www.stamfordadvocate.com/news/article/Q-A-with-Robert-Dilenschneider-3336510.php.

72 Robert L. Dilenschneider, *When CEOs Roamed the Earth*, Wall St. J., Mar. 15, 2005, at B2.

73 John Plender, *It's the Revolution, Stupid*, Fin. Times, Mar. 21, 2005, at 20.

74 Alan Murray, *After the Revolt*, Wall St. J., May 5, 2007, at A1.

CEO paradigm appears to be the only arrangement that allows for effective functioning of the corporation," but conceded that "[i]n the aftermath of the Enron and WorldCom scandals, the power of the corporate CEO has been diminished and that of the board of directors and shareholders enhanced."[75]

By 2010 the reorientation of U.S. corporate governance away from celebrity CEOs had reached the point where Marcel Kahan and Ed Rock could characterize U.S. CEOs as "Embattled."[76] This coincided with a general maturation of corporate governance in U.S. public companies. As Omari Simmons argued in a 2013 law review article, "[o]ver the past thirty years, corporate governance, despite occasional bumps, has undoubtedly improved."[77] Arguably, then, in the wake of the corporate scandals and legislative reforms of the early 2000s, there was a reasonably fully executed transition from an equilibrium oriented around the constrained form of capitalism in place during the managerialist heyday of the 1950s and 1960s in favor of an equilibrium suited to the more freewheeling market conditions that emerged thereafter.[78] The rise of corporate governance and its continued prominence stand out as legacies of this process.

III. Corporate Governance Comes to the Fore — The Case of Banks

A. Why Banks Merit Independent Analysis

We have now seen that in U.S. public companies generally the corporate governance scandals of the early 2000s combined with SOX to dethrone previously imperial CEOs. Deficient corporate governance at U.S. financial firms has been identified as a potential cause of the financial crisis.[79] There

75 Alan Greenspan, The Age of Turbulence: Adventures in a New World 429, 436 (2007).

76 Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 Tex. L. Rev. 989, 989 (2010).

77 Omari Simmons, *The Corporate Immune System: Governance from the Inside Out*, 2013 U. Ill. L. Rev. 1131, 1135.

78 *Cf.* James C. Woolery, *Bridging the Chasm Between Boards and Shareholders*, Wall St. J., Oct. 10, 2013, at A17 (arguing that with boards being "extremely cautious" and seeking "steady shareholder returns," cash balances were at an all-time high).

79 Christopher M. Bruner, *Corporate Governance in a Time of Crisis*, 36 J. Corp. L. 309, 316 (2011) ("Government officials and taxpayers reeling in the wake of this catastrophe have naturally sought to determine why the crisis occurred, and who is to blame. Unsurprisingly, bank boards and officers have found themselves in the crosshairs . . . ."); Simone M. Sepe, *Regulating Risk and*

is something of a paradox here. How could it be that deficient corporate governance contributed to the financial crisis when market and regulatory trends were resulting in more robust scrutiny of corporate executives?

It is possible to resolve the paradox by taking into account similarities and differences between banks and nonfinancial companies. As we will see now, trends that ensured corporate governance's late twentieth-century prominence were evident in banks. Part IV below indicates, however, that banks were different in ways that may have contributed to the onset of the financial crisis.

It is not entirely clear whether the foregoing diagnosis of the interrelationship between corporate governance, banks and the financial crisis is correct. There is empirical evidence indicating that prior to the financial crisis on average publicly traded banks were no worse governed than nonfinancial public companies.[80] Also, in general terms the U.S. system of corporate governance performed tolerably well under difficult conditions as the crisis loomed.[81] Nevertheless, it does appear that a post-Enron/SOX corporate governance "pass" that major banks received did offer scope for powerful CEOs to run their firms in ways that contributed to the onset of the financial crisis.

B. Bigger Banks

Corporate governance became entrenched as part of U.S. corporate life in the manner it did as the twentieth century drew to a close partly because more was at stake, which in turn meant that managerial accountability should have become a higher priority. One way in which this occurred was that major publicly traded companies became considerably larger along various dimensions.[82] This trend was, if anything, more pronounced with financial firms over the same period. The size of the financial sector grew markedly, comprising 8.3% of U.S. GDP in 2006 as compared with 4.9% in 1980.[83] Similarly, the financial services industry generated forty percent of total domestic corporate profits in 2007 as compared with ten percent in the early

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Corporate Governance in Banks, 62 EMORY L.J. 327, 327 (2012) (arguing that for those wondering what prompted the aggressive risk-taking by U.S. banks that reputedly helped to precipitate the financial crisis, "[o]ne popular answer points to the failure of bank governance").

80 Renée Birgit Adams, *Governance and the Financial Crisis*, 12 INT'L REV. FIN. 7, 27 (2012).

81 Cheffins, *supra* note 10, at 61.

82 *See supra* Section II.B.

83 Greenwood & Scharfstein, *supra* note 52, at 3.

1980s, and the industry's share of stock market value grew from six percent to nineteen percent over the same period.[84]

The financial sector was not simply getting bigger. In addition, the dominant firms — the ones most likely to be prominent publicly traded corporations — were more than keeping pace. The assets of the six largest U.S. commercial banks increased fourfold as a proportion of GDP between 1994 and 2009.[85] Likewise, among companies large enough to be part of the S&P 500 stock market index, the market value of financial firms amounted to 22.3% of the S&P 500 in early 2007 as compared to 8.8% in 1989 and 13% in 1999.[86]

C. Deregulation

Deregulation, as was the case with the emergence of bigger firms, not only likely contributed to the growing prominence of corporate governance between the 1970s and the 2000s,[87] but also probably was a more pronounced trend with banks than it was generally. In response to widespread banking failures occurring during the Great Depression, the U.S. federal government put in place a regulatory regime which prioritized eliminating risk and ensuring banking stability.[88] By virtue of the Banking Act of 1933,[89] supplemented by the Bank Holding Company Act of 1956[90] and other measures, the commercial

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84 *What Went Wrong?*, Economist, Mar. 22, 2008, at 91, 92; Arthur E. Wilmarth, *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 Conn. L. Rev. 963, 1003 (2009); *cf.* Nat'l Comm'n on the Causes of the Fin. & Econ. Crisis in the United States, The Financial Crisis Inquiry Report 64 (2011) (indicating that financial sector profits were fifteen percent of corporate profits in 1980, thirty-three percent in 2003, and twenty-seven percent in 2006).

85 Charles W. Murdock, *The Big Banks: Background, Deregulation, Financial Innovation, and Too Big to Fail*, 90 Denv. U. L. Rev. 505, 543 (2012).

86 *Still Vulnerable*, Economist, Apr. 19, 2008, at 8500; William W. Bratton & Michael W. Wachter, *The Case Against Shareholder Empowerment*, 158 U. Pa. L. Rev. 653, 717 (2010).

87 *See supra* Section II.C.

88 Michael Klausner, *An Economic Analysis of Bank Regulatory Reform: The Financial Institutions Safety and Consumer Choice Act 1991*, 69 Wash. U. L.Q. 695, 695 (1991); Michael Taylor, *The Search for a New Regulatory Paradigm*, 49 Mercer L. Rev. 793, 795 (1998).

89 Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162.

90 Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 134.

banking industry became one of the most heavily regulated sectors of the U.S. economy.[91]

An important way in which banking was regulated was to cordon banks off from market forces by barring potential competitors, such as securities firms, from engaging in core aspects of banking. [92]Concomitantly, banks were largely precluded from carrying out business activities unrelated to banking, meaning in this context taking deposits and making loans. [93]Banks were also protected from competition within their own industry.[94] Bank charters were rationed by state and federal bank regulators and the Banking Act of 1933 authorized the Federal Reserve Board to impose ceilings on rates of interest payable on bank deposits.[95] Moreover, the 1933 and 1956 legislation supplemented preexisting federal and state laws designed to ensure that banking remained geographically fragmented.[96]

With strict regulation in place, for nearly fifty years after the enactment of the Banking Act of 1933 the United States experienced an era of "boring" banking.[97] Commercial banking was characterized by stable profits and a very low failure rate,[98] with an average of fewer than six banks among thousands failing per year between 1942 and 1980.[99] Bankers were said to follow a 3-6-3 business model, borrowing at three percent, lending at six percent, and

91 Ross N. Dickens & George Philippatos, *The Impact of Market Contestability on the Systematic Risk of US Bank Stocks*, 4 Applied Fin. Econ. 315, 315 (1994).

92 Helen A. Garten, *Regulatory Growing Pains: A Perspective on Bank Regulation in a Deregulatory Age*, 57 Fordham L. Rev. 501, 516-17 (1989); Klausner, *supra* note 88, at 695.

93 Garten, *supra* note 92, at 509-10; Klausner, *supra* note 88, at 696, 698-703.

94 Robert E. Litan, American Finance for the 21st Century 26 (1998); Klausner, *supra* note 88, at 695, 720.

95 Garten, *supra* note 92, at 511 (interest rate restrictions); Michael C. Keeley, *Deposit Insurance, Risk, and Market Power in Banking*, 80 Am. Econ. Rev. 1183, 1185 (1990) (charter restrictions); Klausner, *supra* note 88, at 695.

96 Davis, *supra* note 20, at 109; Klausner, *supra* note 88, at 695, 698, 703-05. For a summary of the contribution of the 1933 and 1956 banking legislation in this regard, see Robert E. Litan, What Should Banks Do? 26-27, 29-30 (1987).

97 Johnson & Kwak, *supra* note 52, at 62-63; Murdock, *supra* note 85, at 513.

98 Garten, *supra* note 92, at 508-09.

99 James R. Barth, Tong Li & Wenling Lu, *Bank Regulation in the United States*, 56 CESifo Econ. Stud. 112, 117-18 (2010) (providing data on the total number of commercial banks at five-year intervals from 1940 to 1980, with the lowest figure being 13,503 in 1960); Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-Market Receivership*, 60 Brooklyn L. Rev. 1295, 1330 (1995) (numbers of failures).

golfing by three o'clock.[100] George Moore, who led the worldwide expansion of First National City Bank (later Citibank and Citigroup) in the 1950s and was chairman of the board from 1967 to 1970, said in his 1987 memoir that "banking is the surest, safest, easiest business I have seen or known."[101]

Investment banking, though riskier than commercial banking, was also subject to constraints in the decades following the Depression that meant firms were run along conservative lines.[102] Investment banks were not regulated for safety and soundness in the same way as commercial banks.[103] Still, the provisions in the 1933 banking legislation that came to be known as the Glass-Stegall Act reduced considerably the freedom of action of investment banks by prohibiting any entity carrying out securities underwriting from engaging in deposit banking.[104] The organizational form that investment banks deployed also fostered prudence.

For a number of decades following the enactment of Glass-Stegall, investment banks were general partnerships where the partners were personally liable for debts of their firms.[105] The fact that partners' personal wealth was at stake if things went seriously awry fostered a conservative mindset.[106] For instance, Goldman Sachs's first business principle was that their clients' interests came first, with its partnership structure encouraging bankers to be "greedy, but long-term greedy."[107] The organizational structure of investment banks also imposed limits on growth. As partnerships they lacked sufficient permanent capital to underwrite every major transaction they could theoretically work on and to expand operations in a systematic way in what was a highly cyclical industry.[108] This all began to change in 1970 when the New York Stock Exchange

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100 Johnson & Kwak, *supra* note 52, at 53; Klausner, *supra* note 88, at 725, n.106; Murdock, *supra* note 85, at 513.

101 George S. Moore, The Banker's Life 146 (1987).

102 Johnson & Kwak, *supra* note 52, at 62.

103 Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 Seattle U. L. Rev. 1173, 1177 (2010).

104 Banking Act of 1933, § 21, Pub. L. No. 73-66, 48 Stat. 162.

105 Hill & Painter, *supra* note 103, at 1177.

106 *Id.*; Nat'l Comm'n on the Causes of the Fin. & Econ. Crisis in the United States, *supra* note 84, at 61 (quoting Peter Solomon, a former Lehman Brothers partner, as saying that "[s]ince they were personally liable as partners, they took risk very seriously"); Murdock, *supra* note 85, at 513.

107 Mary Kissel, *How the Banker Went to Vegas*, Wall St. J., Oct. 10, 2013, at A15.

108 Charles R. Geisst, The Last Partnerships: Inside the Great Wall Street Money Dynasties 6-7, 227, 314-15 (2001); Terry Robards, *Wall St. Watches and Hopes, as Bache Offers Shares*, N.Y. Times, Sept. 12, 1971, at F2 (discussing

repealed a rule precluding its members from being publicly owned.[109] Prompted initially by the need to finance back-office computerization required due to rapidly growing transaction volume,[110] over the next two decades most major investment banks went public, thus marking the end of the partner liability regime that helped to foster conservatism among such firms.[111]

Change was also afoot with commercial banks. During the 1970s and 1980s it was becoming increasingly evident that "the legal regime originally designed to protect the banking industry by walling competitors out of the banks' profitable preserve had begun instead to trap banks within a shrinking market."[112] Investment banks, mutual funds and the finance arms of major industrial and commercial companies took advantage of rapidly evolving technology to develop innovative financial products that provided stiff competition for banks' deposit and loan services.[113] Bank customers began leaving in droves, evidenced by a massive outflow from bank accounts sparked by the high inflation and rising interest rates of the 1970s.[114]

To permit banks to counteract the shift to deposit substitutes, Congress largely phased out interest-rate controls during the early and mid-1980s.[115] Additional bank deregulation soon followed. In 1994, Congress put in place a national framework for interstate banking, culminating a process various states had begun in the late 1970s.[116] Similarly, the 1999 Gramm-Leach-

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reasons for Bache & Co., then the nation's second-largest brokerage house, going public).

109 Alan D. Morrison & William J. Wilhelm, Investment Banking: Institutions, Politics, and Law 278 (2007); Hill & Painter, *supra* note 103, at 1177.

110 Morrison & Wilhelm, *supra* note 109, at 237-38, 277-78.

111 Nat'l Comm'n on the Causes of the Fin. & Econ. Crisis in the United States, *supra* note 84, at 62; Christopher M. Bruner, *Conceptions of Corporate Purpose in Post-Crisis Financial Firms*, 36 Seattle U. L. Rev. 541, 549 (2013); Hill & Painter, *supra* note 103, at 1177.

112 Klausner, *supra* note 88, at 696.

113 *Id.* at 727.

114 *Id.*; Litan, *supra* note 96, at 34-35; Canova, *supra* note 99, at 1309-10; Arthur E. Wilmarth, *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. Ill. L. Rev. 217, 239-40.

115 Litan, *supra* note 96, at 35; Canova, *supra* note 99, at 1310, 1315-16, 1319-20; Wilmarth, *supra* note 114, at 239-40.

116 Barth, Li & Lu, *supra* note 99, at 123-24, 126-27; Kevin J. Stiroh, *How Did Banking Holding Companies Prosper in the 1990s?*, 24 J. Banking Fin. 1703, 1706-07 (2000).

Bliley Act[117] was the key final chapter in a dismantling of barriers between commercial and investment banking, as it expressly permitted the creation of full-service financial holding companies.[118]

Deregulation duly helped to transform the formerly "boring" banking sector. Banks responded to the unleashing of market forces by engaging in an unprecedented wave of consolidation resulting in the number of banks falling from almost 15,000 in 1980 to under 8000 in 2008.[119] Larger banks, for their part, moved into new lines of business with the intention of creating financial "supermarkets" that could provide a full range of financial services to customers.[120] Hence, just as deregulation provided for executives of U.S. companies generally expanded managerial latitude to which corporate governance theoretically could operate as a beneficial corrective, the partial unshackling of banks meant that governance should have moved up the agenda with financial firms.

D. "Bright New Finance"

A late twentieth century finance "revolution" that U.S. public companies experienced expanded opportunities available to American executives and in so doing likely helped to bring corporate governance to prominence.[121] The financial landscape for banks similarly changed markedly, and in ways that should have increased managerial latitude and thereby made governance a higher priority. Major investment banks experienced a pronounced financial transformation due to converting themselves into publicly traded firms, which greatly facilitated their access to capital.[122] Moreover, leading investment banks, which were already highly leveraged by 2000, became more so as the financial crisis approached. While prosperous large nonfinancial companies rarely have equity representing less than thirty percent of assets,[123] the equivalent

117 Gramm-Leach-Bliley Act of 1999, Pub. L. 106-102, 113 Stat. 1338.

118 Barth, Li & Lu, *supra* note 99, at 127-30; Roberta S. Karmel, *Is the Public Utility Holding Company Act a Model for Breaking Up the Banks That Are "Too-Big-to-Fail"?*, 62 Hastings L.J. 821, 834-35 (2011); Wilmarth, *supra* note 114, at 318-20, 331.

119 Barth, Li & Lu, *supra* note 99, at 130; Lawrence G. Baxter, *Betting Big: Value, Caution and Accountability in an Era of Large Banks and Complex Finance*, 31 Rev. Banking Fin. L. 765, 791-92 (2011); Wilmarth, *supra* note 84, at 972-76.

120 Johnson & Kwak, *supra* note 52, at 85-86.

121 *See supra* Section II.D.

122 *Supra* notes 110-111 and accompanying text.

123 Anat Admati & Martin Hellwig, The Bankers' New Clothes: What's Wrong with Banking and What to Do About It 30 (2013).

figure for the largest U.S. investment banks fell from 3.7% in 2000 to just 2.8% in 2007.[124]

The largest U.S. commercial banks also became increasingly highly leveraged as the financial crisis approached, with equity representing 6.6% of assets in 2000 but only 4.5% in 2007.[125] This trend, however, needs to be put into context. Corporations vary widely with respect to their use of debt and banks pretty much universally have less equity relative to assets compared to nonfinancial firms.[126] Hence, even during the conservative 3-6-3 banking era, U.S. banks had equity levels hovering around six percent of assets.[127] Moreover, in contrast with the trend for the largest banks, on an aggregate basis leverage became less pronounced in the banking sector as the financial crisis approached. Likely due to the introduction of laws requiring regulators to intervene when banks failed to meet specified minimum capital requirements, among commercial banks generally equity represented nearly ten percent of assets by the mid-2000s.[128]

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124 Derived from data provided by Viral Acharya, Irvind Gujral, Nirupama Kulkarni & Hyun Shon, *Dividends and Bank Capital in the Financial Crisis of 2007-2009*, at 11 (Nat'l Bureau of Econ. Research, Working Paper No. 16896, 2011). On a 2004 deregulatory move by the SEC that helps to explain the trend, see John C. Coffee, *Systematic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 Colum. L. Rev. 795, 818 (2011); and Murdock, *supra* note 85, at 521-22.

125 Derived from data provided by Acharya, Gujral, Kulkarni & Shon, *supra* note 124, at 11.

126 Admati & Hellwig, *supra* note 123, at 30; Stergios Leventis, Panagiotis Dimitropoulos & Stephen Owusu-Ansah, *Corporate Governance and Accounting Conservatism: Evidence from the Banking Industry*, 21 Corp. Governance 264, 266 (2013).

127 Viral Acharya, Hamid Mehran, Till Schuermann & Anjan Thakor, *Robust Capital Regulation* 17 (Fed. Reserve Bank of N.Y., Staff Report No. 490, 2011). While Acharya, Mehran, Schuermann and Thakor indicate that the equity level held steady at six percent from the late 1940s to the early 1990s, other sources indicate that leverage in fact increased at various banks between the mid-1970s and mid-1980s. *See* Garten, *supra* note 92, at 534; Keeley, *supra* note 95, at 1184-85.

128 Acharya, Mehran, Schuermann & Thakor, *supra* note 127, at 17 (providing data and citing the impact of the Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. Law 102-242, 105 Stat. 2236). For a summary of the minimum capital regime the 1991 legislation introduced, see Mathias Dewatripont & Jean Tirole, The Prudential Regulation of Banks 62-63 (1994). Banking regulators in the United States in fact first introduced rudimentary across-the-board capital rules for banks in the early 1980s and bolstered regulation as the 1980s drew

Though with commercial banks there was no uniform trend regarding leverage, a corporate finance-related reconfiguration still marked the end of the cautious 3-6-3 era. Banking was already moving out of the "boring" category by the late 1980s, with national commercial banks ranking thirty-sixth out of seventy industries in a study measuring managerial discretion by reference to industry characteristics such as market growth, capital intensity, product differentiability, and demand instability (variation in growth rates).[129] During the 1990s numerous major banks adopted increasingly aggressive strategies with assets they held and with loans they made, meaning they had a riskier asset/liability mix even when equity capital was being boosted.[130] The process continued apace in the 2000s, with the "megabanks" that were emerging during this era making increasingly risky loans, engaging heavily in the manufacturing of securities (securitization) and bolstering trading of complex financial assets.[131] As William Bratton and Michael Wachter observed in 2010, "[s]uch a change in business strategy meant a move to greater expected returns and greater risk."[132]

The *Economist* characterized the changes to banking fostered by deregulation and financial innovation as the replacement of "traditional banking" with "bright new finance."[133] From a corporate governance perspective, a key corollary of this shift was that, as was the case with the corporate finance

to a close to implement an international risk-based accord promulgated by the Basel Committee. *See* Garten, *supra* note 92, at 536; Wilmarth, *supra* note 114, at 457-58.

129 *See* Hambrick and Abrahamson, in a 1995 paper, ranked managerial discretion in seventeen industries on the basis of ratings by academics, ratings by security analysts, and objective industry data compiled between 1985 and 1989. Hambrick & Abrahamson, *supra* note 43, at 1431-35. Hambrick and two different coauthors subsequently extended the analysis to fifty-three additional industries, including national commercial banking, but only relied on objective industry data in so doing. *See* Finkelstein, Hambrick & Cannella, *supra* note 53, at 29-30.

130 Wilmarth, *supra* note 114, 445; *cf.* Allen E. Berger & Loretta J. Mester, *Explaining the Dramatic Changes in Performance of US Banks: Technological Change, Deregulation, and Dynamic Changes in Competition*, 12 J. Fin. Intermediation 57, 84 (2003) (indicating that a lower incidence of bank failures in the 1990s as compared with the 1980s suggested that banks became less risky).

131 Johnson & Kwak, *supra* note 52, at 86; Bratton & Wachter, *supra* note 86, at 720.

132 Bratton & Wachter, *supra* note 86, at 720.

133 *When Fortune Frowned: A Special Report on the World Economy*, Economist, Oct. 11, 2008, at 10 (paraphrasing Paul Volcker's reference to a "bright new financial system").

revolution affecting nonfinancial companies, top executives of investment and commercial banks would have had greater managerial latitude than their counterparts immediately following World War II. Given this, and given that banks were getting bigger and operating in an increasingly deregulated environment, "bright new finance" logically should have been accompanied by more robust corporate governance.

Corporate governance indeed did grow in prominence with U.S. banks as the twentieth century drew to a close. The proportion of board seats held by outside directors of large bank holding companies was higher than it was for industrial companies.[134] Banks substantially increased their use of incentive-oriented executive compensation.[135] Boards and institutional shareholders also began taking more aggressive measures to discipline poorly performing bank executives.[136] David Skeel even observed in 1999 that "[m]ore than ever before, the governance of U.S. banks . . . has come to resemble the governance of other U.S. firms."[137]

Skeel did not go so far as to claim that corporate governance arrangements in banks had become functionally identical to those in nonfinancial firms. Instead, he said that "it would be a mistake to conclude that bank . . . governance will soon look just like nonfinancial firm governance."[138] This was a prudent concession. This is because, even if the corporate governance movement had a substantial impact on the banking sector, the corporate governance of banks and nonfinancial companies continued to differ in significant ways prior to the financial crisis,[139] and differ in ways that may have contributed to the onset of the crisis.

As we will see in the remainder of the Article, with respect to the financial crisis the key distinction between banks and other public companies was timing. Generally speaking, U.S. companies were chastened by the corporate governance scandals of the early 2000s and changes that SOX introduced. In contrast, banks enjoyed a corporate governance "free pass" primarily due to delivering robust financial results in comparison to other companies. This meant that senior executives at banks retained discretion to run their firms

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134 Renée Adams, *Is Corporate Governance Different for Bank Holding Companies?*, FRBNY Econ. Pol'y Rev., Apr. 2003, at 123, 129 tbl. B, 131.
135 David A. Skeel, *The Market Revolution in Bank and Insurance Firm Governance: Its Logic and Limits*, 77 Wash. U. L.Q. 433, 447 (1999).
136 Wilmarth, *supra* note 114, at 291-92.
137 Skeel, *supra* note 135, at 433.
138 *Id.* at 448.
139 Adams, *supra* note 80, at 27.

withdrawn from other executives and arguably deployed this in a sufficiently counterproductive fashion to help set the stage for the financial crisis.

IV. Pre-Financial Crisis Corporate Governance: How Banks Differed

A. Persistence of the Imperial CEO

The Enron and WorldCom debacles and the 2002 enactment of SOX largely eclipsed the "imperial CEO" who initially had achieved prominence in U.S. public companies in the 1980s.[140] Matters were different with financial companies, where powerful, charismatic CEOs remained a prominent feature throughout the mid-2000s. One example was Stan O'Neal, chief executive of Merrill Lynch from 2002 to 2007, who drove the company to make large, ill-advised bets on mortgage securities that imperiled its future and fuelled the mortgage boom that helped to precipitate the financial crisis. O'Neal had an autocratic leadership style fostered by his hiring of a youthful management team that lacked the experience or stature to challenge him.[141]

O'Neal was by no means exceptional. Chuck Prince, who became Citigroup's CEO in 2003 and its chairman of the board in 2006, was described in 2005 by *American Banker* magazine as the "king within the walls of Citigroup"[142] to whom Citigroup's board reputedly was "willing to give more and more rope."[143] In 2007 the *New York Times* characterized Jimmy Cayne, chief executive and chairman of the board of Bear Stearns just prior to its hastily engineered rescue in March 2008 by J.P. Morgan, as a throwback "to an earlier era of Wall Street partnerships tightly controlled by the towering will and stubborn dictates of their managing partners."[144] Angelo Mozilo, cofounder of mortgage lender Countrywide Financial and chief executive when the company was sold to Bank of America at a financial crisis-related knockdown price in early 2008,

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140 *Supra* notes 68-72 and accompanying text.

141 Greg Farrell, Crash of the Titans: Greed, Hubris, the Fall of Merrill Lynch, and the Near Collapse of Bank of America 64-65 (2010); *see also* Susanne Craig, Randall Smith & Serena Ng, *Merrill Aims to Raise Billions More*, Wall St. J., July 29, 2008, at A1 (discussing the nature of Merrill Lynch's mortgage bets).

142 *The A Listers*, Am. Banker, Mar. 2005, at 43.

143 David Enrich, *For Rubin Pressure's On*, Wall St. J., Nov. 5, 2007, at C1.

144 Landon Thomas, *Not a Jolly Season for Top 2 Bankers*, N.Y. Times, Dec. 21, 2007, at 1. On the rescue, see Jeff Madrick, Age of Greed: The Triumph of Finance and the Decline of America, 1970 to the Present 384-85 (2011).

had a managerial style that provided scope for a "friends of Angelo" list that afforded politicians access to loans under favorable terms.[145] He was also described in a 2000 *Forbes* article as "the Rommel of the mortgage business" and "[t]he bad boy of the mortgage industry."[146]

Mozilo and Richard Fuld, chairman and chief executive of Lehman Brothers from 1994 until its September 2008 bankruptcy that amounted to "ground zero" of the financial crisis, were both included in *Barron's* 2007 list of the world's thirty best CEOs. *Barron's* said of Fuld that he "brings passion and competitiveness that are powerful even by (Wall) Street standards."[147] Fuld was also described in a 2009 book on the firm's collapse as "King Richard" who "turned Lehman's board of directors into a kind of irrelevant lower chamber."[148]

The post-Enron/SOX persistence of the imperial CEO in the banking sector had potentially significant implications, with excessive deference to powerful chief executives standing out as a potential cause of the financial crisis. As the crisis played out, one charge levelled against financial companies and their corporate governance was that boards had been too complacent about risks that management was running, with *American Banker* magazine suggesting in a 2008 cover story that "[a]t far too many banks . . . the attitude was to let the good times roll when executives should have been nibbling their fingernails down to the quick."[149] Another criticism was that boards missed the plot when setting executive pay, arguably contributing "to the mortgage boom and financial bust by encouraging their celebrity CEOs to take risks so they could make even bigger numbers."[150] Charges levelled against governance in financial firms are, moreover, not merely of historical interest. A *Financial Times* columnist argued in 2012 that "if the U.S. again places its trust in the autocratic instincts of a new generation of corporate leaders, it will lay the foundation for the next (financial crisis)."[151]

Why did financial companies get what appeared to be a mid-2000s corporate governance "free pass" in the form of tolerance of freewheeling celebrity CEOs? As we will see next, the regulatory terrain applicable to banks is a possible

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145 *A Case of Note*, Economist, Sept. 28, 2013, at 79.

146 Bernard Condon, *Last Man Standing*, Forbes, Nov. 27, 2000, at 108.

147 Andrew Bary, *The World's Best CEOs*, Barron's, Mar. 26, 2007, at 37, 42.

148 Larry MacDonald, A Colossal Failure of Common Sense: The Incredible Inside Story of the Collapse of Lehman Brothers 97, 224 (2009).

149 Glen Fest, *Risk Without Reward*, Am. Banker, Feb. 2008, at 26.

150 Keith Epstein, *CEO Pay: The Steroids Era*, Bus. Week, Mar. 08, 2008, http://www.businessweek.com/stories/2008-03-08/ceo-pay-the-steroids-erabusinessweek-business-news-stock-market-and-financial-advice.

151 Andrew Hill, *Baby Steps Won't Fix Broken US Governance*, Fin. Times, July 12, 2011, at 12.

explanation, though ultimately not a persuasive one. Other distinctive features of banks could have played a role, particularly a bias that bank shareholders may have had in favor of managers "rolling the dice." What was probably most important, however, was that financial companies delivered robust shareholder returns in comparison to other firms, thereby insulating them, at least temporarily, from the corporate governance pressures their nonfinancial counterparts encountered.

B. Regulation

Regulation and corporate governance are potentially substitutes,[152] with careful oversight by regulators arguably reducing the need for boards and shareholders to monitor management closely. Correspondingly, to the extent that regulators supervise bank management rigorously, such oversight could render corporate governance scrutiny superfluous.[153] Perhaps, then, the corporate governance "free pass" was issued to banks in the years immediately preceding the financial crisis because of an implicit assumption that regulation was ensuring that executives were not going off the track.

Direct oversight of governance arrangements has traditionally not been a feature of U.S. banking regulation.[154] Nevertheless various features of the regulatory scheme applicable to banks extend implicitly into the corporate governance realm.[155] As early as 1933, federal banking law authorized the removal of directors of banks operating under federal jurisdiction who had

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152 *Supra* note 46 and accompanying text.

153 Hugh Grove, Lorenzo Patelli, Lisa M. Victoravich & Pisun Xu, *Corporate Governance and Performance in the Wake of the Financial Crisis: Evidence from US Commercial Banks*, 19 Corp. Governance 418, 419 (2011) ("[R]egulatory oversight is considered to be an active monitoring force, which might limit the incentives of boards or blockholders to monitor."); Jens Hagendorff, Michael Collins & Kevin Keasey, *Board Monitoring, Regulation, and Performance in the Banking Industry: Evidence from the Market for Corporate Control*, 18 Corp. Governance 381, 382 (2010) ("To the extent that regulators monitor bank management, the need for independent boards to monitor diligently and effectively is reduced . . . .").

154 John D. "Jay" Cornet, *Bank Governance: An Independent Director's Perspective*, 7 N.C. Banking Inst. 1, 2 (2003) ("Despite significant bank regulations, few regulations directly address governance issues.").

155 Michael E. Murphy, *Assuring Risk Management in Banking: The Corporate Governance Dimension*, 36 Del. J. Corp. L. 121, 126 (2011) ("Banking laws and regulations have frequently extended into the domain of corporate governance.").

engaged in unsafe or unsound banking practices.[156] In 1989 the authority to suspend and remove top management was enhanced, with action being permitted upon determination of substantial financial loss or damage or financial gain or other benefit.[157] Moreover, pursuant to a legislative mandate introduced in 1991 requiring federal banking regulators to develop standards to maintain safety and soundness in the banking sector, banks were put under an onus to set up internal control systems so as to improve the ability of managers to monitor their bank's activities and to ensure compliance with the law.[158] Reforms introduced in 1991 also provided regulators with the power to dismiss officers and directors of seriously undercapitalized banks.[159]

While deregulation was a key trend in the banking sector as the twentieth century drew to a close,[160] due in part to the rules relating to the disciplining of directors and officers U.S. laws governing risk-taking by banks remained strict by international standards.[161] Moreover, U.S. banks continued to be more heavily regulated than nonfinancial public companies, and in ways that were potentially relevant for corporate governance. James Fanto observed in a 2006 article contrasting the regulation of management of banks and publicly traded companies operating in other sectors:

> The picture of regulation of bank management that emerges . . . is one of all-encompassing oversight . . . . Historically, in stark contrast to bank management, officers and directors of a typical public company were subject to little substantive regulatory oversight. . . . The selection of and standards for officers and directors are essentially industry and market issues . . . .[162]

Though regulation remained a significant feature of the banking industry during the 2000s and can theoretically substitute for robust corporate governance, on balance it is unlikely that the regulatory regime under which U.S. banks

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156 Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 Geo. Wash. L. Rev. 175, 188 (1995) (citing the Banking Act of 1933, ch. 89, § 30, 48 Stat. 162, 193-94).

157 Michael P. Malloy, Principles of Bank Regulation 357 (3d ed. 2011).

158 James Fanto, *Paternalistic Regulation of Public Company Management: Lessons from Bank Regulation*, 58 Fla. L. Rev. 860, 875 (2006).

159 *Id.* at 882.

160 *Supra* notes 115-120 and accompanying text.

161 Hagendorff, Collins & Keasey, *supra* note 153, at 385 (scoring the U.S. and a dozen Western European countries on a 12-point scale and giving the United States, together with the United Kingdom and Belgium, the highest score of "9").

162 Fanto, *supra* note 158, at 886.

were operating explains their mid-2000s corporate governance free pass. In general terms, as we have seen, regulation and corporate governance can, depending on the stance regulators take, work in tandem rather than being of substitutes.[163] Moreover, during the mid-2000s a number of the highest-profile financial firms, such as the five leading investment banks (Morgan Stanley, Goldman Sachs, Merrill Lynch, Lehman Brothers, and Bear Stearns),[164] were not subject to the banking laws that impinged on directors and officers of commercial banks.

Even with commercial banks that were subject to the full panoply of bank regulation, it was well-known that they were operating in a riskier, more adventurous way than their 3-6-3 forerunners, implying that corporate governance should not have been a mere afterthought. The *Economist* said of U.S. banks in 2000 that "bank managers, long thought of as sober sorts, have, in effect, tried all sorts of ways to turn banking into a high-growth business. They have bought other banks, slashed costs, gone into pastures new and taken more risk, in many different guises."[165] Or as David Skeel said in 1999, "[t]hese are not your father's financial intermediaries . . . ."[166] Hence, to the extent that financial firms received a corporate governance free pass while managerial discretion was being curtailed more generally post-Enron/SOX, it does not appear that the reason was that regulation rendered corporate governance superfluous.

C. Distinctive Corporate Governance Features of Banks

Regulation aside, financial companies differ from their nonfinancial counterparts in various ways that can impact on corporate governance.[167] Banks, for instance, tend to be more opaque, in the sense that the quality of bank assets is usually

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163 *Supra* notes 47-48 and accompanying text.

164 On the five investment banks standing out from the rest and on their identity, see *Paradise Lost: A Special Report on International Banking*, Economist, May 17, 2008, at 4; and *When Fortune*, *supra* note 133, at 6.

165 *The Bigger They Are*, Economist, Oct. 28, 2000, 115, at 116.

166 Skeel, *supra* note 135, at 433.

167 The specifics of corporate governance of financial companies only attracted attention somewhat belatedly. *See* Jonathan Macey & Maureen O'Hara, *The Corporate Governance of Banks*, FRBNY Econ. Policy Rev., Apr. 2003, at 91, 91 (arguing that despite corporate governance moving to center stage "quickly and decisively . . . very little attention has been paid to the corporate governance of banks").

less observable than is the case with nonfinancial companies,[168] which in turn makes it more difficult to monitor managerial decision-making.[169] In addition, banks have key creditors (depositors) whose incentives to monitor are attenuated as compared with conventional creditors because deposit insurance provides a safety net.[170] Moreover, banks of a substantial size can, due to interconnectedness with key aspects of the financial system, quite easily become "too big to fail" and shareholders in such firms, being confident of a bailout, have incentives to lobby managers to "roll the dice" to exploit the lower cost of capital such banks enjoy.[171]

These differences, while pertinent in a general sense to the corporate governance of banks, seemingly should not have set the stage for a mid-2000s "free pass" for bank executives. Instead, along each dimension the distinctions between banks and nonfinancial companies imply that bank executives would have scope to engage in counterproductive risk-taking unavailable to their nonfinancial counterparts. Logically, then, boards of banks should have been vigilant monitors rather than dispensers of a "free pass" to management.

The shareholder angle merits further consideration, however, particularly because various prominent figures in the corporate governance field said shareholders helped to cause the financial crisis.[172] While shareholders in a bank likely to be rescued will be particularly susceptible to a "gung ho" managerial style, all bank shareholders will have a bias in favor of high-risk/high-return strategies because they will have a capped downside due to limited liability

168 Leventis, Dimitropoulos & Owusu-Ansah, *supra* note 126, at 265-66; Donald P. Morgan, *Rating Banks: Risk and Uncertainty in an Opaque Industry*, 92 Am. Econ. Rev. 874 (2002).

169 Leventis, Dimitropoulos & Owusu-Ansah, *supra* note 126, at 266.

170 *Id.*; George J. Benston et al., Perspectives on Safe & Sound Banking: Past, Present and Future 17-19 (1986).

171 Admati & Hellwig, *supra* note 123, at 143-45; John C. Coffee, *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 Cornell L. Rev. 1019, 1053 (2012); *cf.* Mark J. Roe, *Structural Degradation Due to Too-Big-to-Fail Finance*, 162 U. Pa. L. Rev. 1419. 1445-46 (2014) (acknowledging the connection between the "too big to fail" phenomenon and excess leverage as part of a general exploration of corporate governance problems associated with very large, complex financial firms).

172 Bernard S. Sharfman, *How the Strong Negotiating Position of Wall Street Employees Impacts the Corporate Governance of Financial Firms*, 5 Va. Bus. L. Rev. 349, 351-52 (2011) (citing examples); *see also* Coffee, *supra* note 124, at 810-12; Sepe, *supra* note 79, at 378-80.

and will capture the full upside if all goes well.[173] There is empirical evidence implying that boards of at least some banks counterproductively deferred to risk-preferring shareholder preferences as the financial crisis approached. The departure point is a "management insulation index," developed by Daniel Ferreira, David Kershaw, Tom Kirchmaier, and Edmund Schuster to measure how readily a majority coalition of shareholders could capture control of bank boards.[174] Their research indicates that, based on this index, U.S. banks which were susceptible to shareholder pressure prior to the financial crisis were prone to engage in potentially risky nontraditional banking activities, such as investment banking and the trading of complex securities, and were appreciably more likely to be bailed out when the financial crisis hit. Correspondingly, bank shareholders may have endorsed whatever governance "free pass" executives enjoyed as the financial crisis approached.

D. Stock Market Outperformance

While shareholder preferences may have contributed to the "free pass" that bank executives seemingly received as the financial crisis approached, financial outperformance was an even more important reason why the post-Enron/SOX corporate governance trends affecting U.S. public companies generally had a muted immediate impact on financial companies. The corporate governance of publicly traded companies is more likely to be subject to critical scrutiny when financial results are poor.[175] Conversely, top executives of companies that are performing well are likely to be granted substantial latitude,[176] and banks fell into the latter category during the early and mid-2000s.

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173 Benston et al., *supra* note 170, at 176; Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 Nw. U. L. Rev. 1205, 1210 (2011).

174 Daniel Ferreira, David Kershaw, Tom Kirchmaier & Edmund Schuster, *Shareholder Empowerment and Bank Bailouts* (Working Paper, 2012), *available at* http://ssrn.com/abstract=2170392.

175 *See, e.g.*, Sridhar Arcot, Valentina Bruno & Antoine Faure-Grimaud, *Corporate Governance in the UK: Is the Comply or Explain Approach Working?*, 31 Int'l Rev. L. & Econ. 193, 199 (2010); Iain MacNeil & Xiao Li, *Comply or Explain: Market Discipline and Non-Compliance with the Combined Code*, 14 Corp. Governance 486, 492 (2006) (indicating that among companies with substandard corporate governance, measured by reference to compliance with a corporate governance code applicable to all companies with a primary listing on the London Stock Exchange, shareholders were much more likely to impose pressure on companies to comply after periods of poor performance).

176 *Supra* note 31 and accompanying text.

In contrast to many U.S. public companies, banks generated strong shareholder returns as the dot.com stock market boom ended and scandals such as Enron rocked corporate America. The corporate governance free pass duly followed. According to a July 2008 *American Banker* article describing how weak financial results that banks had been delivering over the previous year had prompted greater vigilance among directors, "the passage of that reform legislation (SOX) coincided with an extended run of profitability in the banking industry, and discussions about the consequences of weak corporate governance were mostly theoretical."[177] Or as a stock market analyst said of bank directors at the same time, they "realize they now have to be on top of things, have to be the ones who make sure management is actually accounting for risk . . . . Of course, that always should have been the case, but at least they are stepping up now."[178] Even shareholders otherwise inclined to lobby for corporate governance reform seemed prepared to cut banks slack post-Enron, with the number of instances where bank shareholders made filings with the SEC indicating an intention to engage in activism falling by nearly one-third in 2002-2005 as compared with 1997-2001.[179]

The stock market performance of financial companies between 2000 and 2007 reveals why discussions of weak corporate governance were largely "theoretical" prior to the financial crisis. While the S&P 500 dropped nearly fifty percent between March 2000 and September 2002 as the "dot.com" bull market went into reverse and corporate scandals hit,[180] share prices of banks in the S&P 500 actually increased, as shown in Figure 3. Bank shares then continued to perform well for the next five years, while the stock market overall was struggling to recover ground lost during the 2000-2002 bear market.

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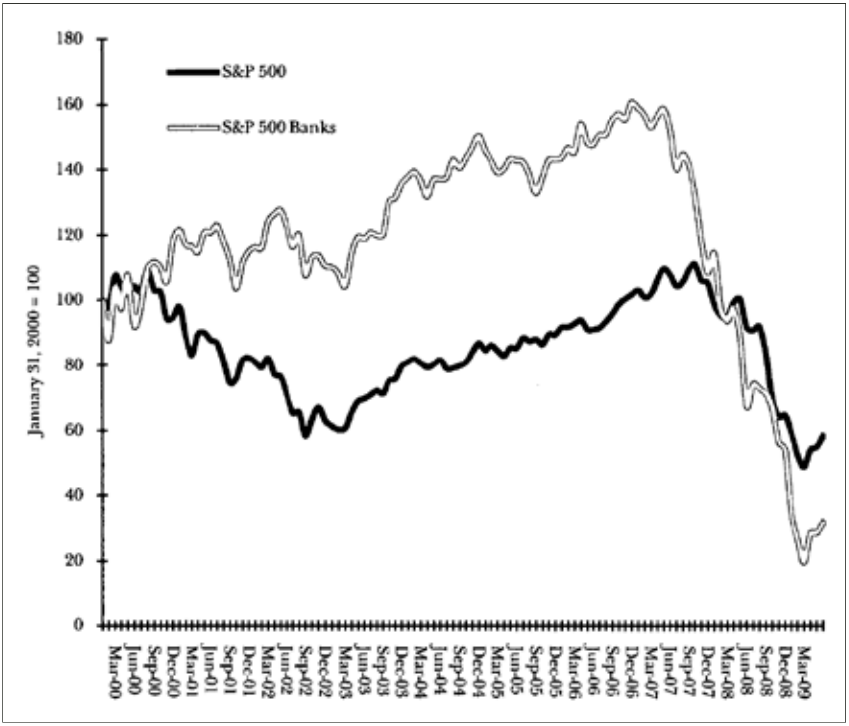
177 Kevin Dobbs, *Crisis Casts Bank Boards as Activists*, AM. BANKER, July 14, 2008, at 1.

178 *Id.* (quoting Richard X. Bove, an analyst at Ladenburg Thalman & Co.).

179 Raluca A. Roman, *Shareholder Activism in Banking* 42 (Working Paper, 2013) (indicating 421 instances between 1997 and 2001, an average of 84.25 per year, as compared with 238 between 2002 and 2005, an average of 59.5).

180 Cheffins, *supra* note 10, at 10.

Figure 3: S&P 500/S&P 500 Banks, 2000-2009[181]



The stock market outperformance by banks that likely insulated bank executives from post-Enron/SOX governance scrutiny was backed up by solid financial results. Profits that financial companies generated increased an average of 13.8% annually in the decade ending in 2006, compared with 8.5% for nonfinancial companies.[182] The underlying difficulty was sustainability. Banks could prosper during the mid-2000s because loan growth was strong and defaults were uncommon due to a reasonably stable economy, rising asset prices, and low interest rates.[183] However, financial sector growth was racing ahead of the real economy, leaving banks highly vulnerable. In 2008 the *Economist* likened the financial services industry to the resilient but hapless Looney Tunes cartoon character "Wile E. Coyote, running over the

181 Bratton & Wachter, *supra* note 86, at 718.

182 Wilmarth, *supra* note 84, at 1003.

183 *Still Vulnerable*, *supra* note 86; Bratton & Wachter, *supra* note 86, at 720; *see also Bouncing Back*, Economist, Dec. 3, 2005, at 91 (indicating that recent loan-loss rates for U.S. banks were the lowest on record).

edge of a cliff," explaining that the industry had "defied gravity by using debt, securitisation and proprietary trading to boost fee income and profits."[184] When the fall came the corporate governance free pass was emphatically over. Correspondingly, just as the corporate governance scandals of the early 2000s set the stage for a new corporate governance equilibrium for nonfinancial companies, as the next Part of the Article indicates, the financial crisis moved governance up the agenda for banks.

V. Bank Corporate Governance and the Financial Crisis: Towards a New Equilibrium

A. In the Midst of the Crisis

In 2006, a robust housing boom that the United States had been experiencing ended abruptly and mortgage defaults grew dramatically.[185] In 2007, notable financial companies such as Citigroup, Wachovia, Bank of America, Morgan Stanley, Lehman Brothers and Bear Stearns were in a seriously weakened state due to the deeply troubled U.S. mortgage market.[186] As Figure 3 indicates, share prices of banks began to fall in mid-2007, a few months prior to the beginning of the "bear" market that would be associated with the financial crisis. In 2008, the bottom fell out, as share prices of financial companies in the S&P 500 declined nearly sixty percent.[187]

The onset of the financial crisis ended whatever corporate governance free pass executives of financial companies had enjoyed. The June 2008 *American Banker* article that indicated that corporate governance concerns had been largely theoretical in the banking sector after the enactment of SOX observed "No longer."[188] There was, for instance, strong criticism of generous executive pay arrangements of various financial companies embroiled in the crisis.[189] Also, while shareholders generally eschewed publicly challenging bank executives as the financial crisis mounted, perhaps being fearful of making a bad situation worse,[190] 2008 was the year between 1994 and 2010

184 *What Went Wrong?*, *supra* note 84.
185 Johnson & Kwak, *supra* note 52, at 157.
186 David Faber, And Then the Roof Caved In: How Wall Street's Greed and Stupidity Brought Capitalism to Its Knees 166 (2009).
187 Cheffins, *supra* note 10, at 17.
188 Dobbs, *supra* note 177.
189 Cheffins, *supra* note 10, at 41-44.
190 *Id.* at 47.

with the highest number of instances where bank shareholders made filings with the SEC indicating an intention to engage in activism.[191]

Boards also stepped up to the plate. Amidst growing criticism of directors of financial companies and various recommendations by shareholder advisory firms to clients to vote against nominations to board seats that banks proposed,[192] boards began orchestrating managerial turnover at a rapid clip. Chuck Prince was a prominent casualty. In November 2007 he resigned under pressure as Citigroup's CEO and chairman of the board and Citigroup split the role of CEO and chairman thereafter, with the implicit mandate of the chairman being to monitor carefully the new CEO's performance.[193] More generally, of the fifteen financial companies sufficiently adversely affected by the onset of the financial crisis to be removed from the S&P 500 during 2008 (Citigroup was not one of these), seven fired their CEOs in the months before removal and other senior executives were replaced at three other such firms.[194]

B. Aftermath

The end of the corporate governance free pass for financial firms did not forestall the subsequent economic pain the financial crisis would deliver. The stock market swoon continued during the opening months of 2009, with the S&P 500 bottoming out in March after a decline of nearly fifty-five percent from October 2007.[195] The U.S. economy shrank by four percent in the year following the October 2008 collapse of Lehman Brothers, and the unemployment rate more than doubled from the beginning of the recession (4.8%) to October 2009 (10.2%).[196]

In the wake of the financial crisis, the corporate governance free pass was not about to be restored. Instead, governance practices in banks received heightened attention.[197] The imperial CEO who featured prominently in leading financial companies in the mid-2000s was a noteworthy casualty. A columnist for the *Globe & Mail*, a leading Canadian newspaper, picked up early on the point. Writing in early 2009, he observed that historians would

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191 Roman, *supra* note 179, at 42 tbl. 1 (103 instances in 2008; the total did not exceed a hundred in any other year).

192 Cheffins, *supra* note 10, at 34-35; *Paradise Lost*, *supra* note 164, at 19.

193 Dobbs, *supra* note 177.

194 Cheffins, *supra* note 10, at 21, 37-39.

195 *Historical Prices*, Yahoo Fin., http://finance.yahoo.com/q/hp?s=%5EGSPC&a=09&b=3&c=2007&d=01&e=17&f=2014&g=m (last visited Feb. 17, 2014).

196 Johnson & Kwak, *supra* note 52, at 182-83.

197 Group of Thirty, Toward Effective Governance of Financial Institutions 12 (2012); Grove, Patelli, Victoravich & Xu, *supra* note 153, at 418.

be able to "carbon-date that extinct species known as the celebrity CEO" to hearings of the House Financial Services Committee, where members of the Committee grilled chief executives of the eight largest financial firms in the United States.[198]

Subsequent events confirmed the demise of the celebrity CEO in the banking sector. The *Wall Street Journal* suggested in a 2012 article that "[t]he financial industry may be going through the same transformation witnessed by corporate America when imperial CEOs á la Jack Welch (General Electric CEO from 1981 to 2001) . . . gave way to more understated and more socially aware figures . . . ."[199] The newspaper returned to the theme in 2013, saying that "[l]arge banks, burned by years of scandal, often with swashbuckling CEOs at the helm, are turning to new bosses who sport well-polished veneers of boringness."[200] Even J.P. Morgan Chase, whose CEO and chairman of the board Jamie Dimon was labelled in 2012 the "last star CEO,"[201] responded in 2013 to criticism of Dimon's power by appointing two new independent directors and by designating a "lead independent director" with power to call board meetings and a mandate to guide consideration of CEO succession.[202] As for why the change might be good for banks, the Group of Thirty, an international think tank comprised of central bankers and senior bank executives, said in a 2012 report on effective corporate governance:

> Given a choice between a very good CEO and a "star" CEO, the former is preferable to the latter. Very good CEOs tend to get the job done reliably, without undue fanfare . . . . Star CEOs, by contrast, may conflate the institution's success with their personal goals . . . and they may start to believe their own press.[203]

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198 Sinclair Stewart, *Let Us Prey*, Globe & Mail, Mar. 27, 2009, at 42. On the identity of those testifying, see Stacy Kaper, *Spotlight on 8 CEOs, and Pandit Grabs It*, Am. Banker, Feb. 12, 2009, at 1.

199 Francesco Guerrera, *Wall Street Chiefs Set a New Agenda*, Wall St. J., Feb. 28, 2012, at C1.

200 Max Colchester, *Today's Bank Chiefs Can Spin a Yawn*, Wall St. J., Aug. 12, 2013, at C1.

201 John Gapper, *JP Morgan's Fiasco Exposes the Myth of an Imperial CEO*, Fin. Times, May 17, 2012, at 9.

202 Tom Braithwaite, *JP Morgan Acts to Curb Dimon's Board Power*, Fin. Times, Sept. 10, 2013, at 20; Dan Fitzpatrick & Joann S. Lublin, *JP Morgan Juices Up Director's Job*, Wall St. J., Sept. 10, 2013, at C1.

203 Group of Thirty, *supra* note 197, at 38.

Arthur Levitt, when he drew attention to the mid-2000s "cultural change in corporate America"[204] involving a shift away from celebrity CEOs, attributed the trend primarily to market factors rather than regulation. He said that while SOX and related reforms "corrected some of the more egregious structural problems of the 1990s, they are not what are driving this shake-up."[205] Levitt identified major institutional shareholders and the media as the primary forces pushing boards "to demand a very different kind of leadership from senior management."[206]

Matters were different with the post-financial crisis switch by banks away from "star" CEOs to a more "boring" managerial approach. Shareholder pressure did help to prompt J.P. Morgan Chase to bolster the independent element on its board of directors.[207] Nevertheless, the shift to a less flamboyant post-financial crisis managerial style by major banks was not primarily a market-driven corporate governance trend. Perhaps this was because bank shareholders have reasons to prefer bank executives to be gung ho.[208] Whatever the reason, it was regulatory pressure that prompted banks to retreat from their freewheeling pre-financial crisis ways.

J.P. Morgan Chase's 2013 boardroom reforms were prompted as much by an effort to shore up its relations with regulators as to placate shareholders,[209] with the bank being responsive to change because it was facing the threat of massive financial penalties for alleged post-financial crisis infractions.[210] Morgan Stanley reoriented itself for similar reasons. According to a 2013 report in the *Wall Street Journal*, the firm "upended its culture and ethos . . . forging a business that more closely resembles the banking industry's old model of eschewing risky bets and collecting reliable fees," with a key change being that "50 full-time government regulators [were] now stationed at Morgan Stanley" who were "prowl[ing] the office floor looking for land mines . . . ."[211] There were no such regulators at Morgan Stanley as late as 2008.[212]

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204 *Supra* note 68 and accompanying text.
205 Levitt, *supra* note 68.
206 *Id.*
207 Braithwaite, *supra* note 202.
208 *Supra* note 173 and accompanying text.
209 Fitzpatrick & Lublin, *supra* note 202.
210 *Jamie Dimon Stepping Down Isn't Good Enough*, N.Y. Post, Oct. 7, 2013, http://nypost.com/2013/10/06/jamie-dimon-stepping-down-isnt-good-enough/.
211 Aaron Lucchetti & Julie Steinberg, *Life on Wall Street Grows Less Risky*, Wall St. J., Sept. 10, 2013, at C1.
212 *Id.*

Regulatory-driven post-financial crisis overhauls such as Morgan Stanley's reputedly were commonplace in major U.S. financial firms.[213] This is not surprising given that the 2010 Dodd-Frank Act vested regulators with various new powers to restrain risk-taking by banks that might be too big to fail.[214] For instance, the legislation provided for the establishment of a new Financial Stability Oversight Council that was provided with a mandate to identify banks that could create a threat to financial stability.[215] The Council was in turn provided with the power, acting in tandem with the Federal Reserve, to subject such firms to enhanced supervision and to require them to raise fresh capital and operate in accordance with leverage restrictions.[216] The Federal Reserve weighed in as well in 2012. It issued a supervisory letter providing guidance on its approach to risk-focused supervision of large financial firms that identified corporate governance as one pillar of its approach and spelled out various steps boards should take to provide the sort of effective corporate governance that would need to be in place for firms to be sustainable under economic, operational or legal stresses.[217]

While the Federal Reserve identified the bolstering of corporate governance as an aspect of its supervision of large financial firms, corporate governance reform was not a feature of the key bank-specific provisions in the Dodd-Frank Act, namely those focusing on bank holding companies (Title VI), non-bank financial companies (Subtitle I(C)), the Financial Stability Oversight Council (Subtitle I(A)), and orderly liquidation of "too big to fail" financial companies targeted by the Act (Title II).[218] The legislation did contain a subtitle entitled "Strengthening Corporate Governance" with provisions instructing the SEC to introduce rules to assist dissident shareholders seeking to use the corporate

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213 *Id.*

214 Coffee, *supra* note 171, at 1050, 1059; Jonathan R. Macey & James P. Holdcroft, *Failure Is an Option: An Ersatz-Antitrust Approach to Financial Regulation*, 120 Yale L.J. 1368, 1390 (2011) ("What the Dodd-Frank Act does instead is increase regulators' discretion and power.").

215 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203, § 111.

216 Baxter, *supra* note 119, at 845-46; Coffee, *supra* note 171, at 1059.

217 Letter from Bd. of Governors of the Fed. Reserve System, to the Officer in Charge of Supervision at Each Reserve Banks, and to Domestic and Foreign Large Fin. Inst. 3-5 (Dec. 17, 2012), *available at* http://www.federalreserve.gov/bankinforeg/srletters/sr1217.htm.

218 The only reference to "governance" in the sections of the Act addressing these themes is in section 210(h)(2)(F), which deals with the powers of the entity responsible for orderly liquidation of too-big-to-fail banks to set up a bridge financial company.

proxy machinery to nominate directors and imposing reporting requirements on companies that had failed to split the roles of chief executive officer and chairman.[219] These provisions, however, were applicable to all issuers falling under the SEC's jurisdiction, not just financial companies. Moreover, most of the provisions in the subtitle of the Dodd-Frank Act dealing with the "hot button" corporate governance topic of executive compensation[220] applied to all publicly traded companies subject to SEC jurisdiction rather than just financial companies.[221]

Given the effort made to liberalize proxy access for dissident stockholders and given that key executive compensation reforms focused on the introduction of a shareholder "say on pay" vote and the mandating of additional disclosure to investors,[222] empowering shareholders stands out as the predominant theme in the Dodd-Frank Act provisions dealing with corporate governance.[223] Ironically, corporate governance reforms of the sort that Dodd-Frank introduced potentially run counter to the shift toward "boring" banks that regulators appeared to be promoting. To the extent that the Dodd-Frank Act reforms empower shareholders of banks, this enhances their ability to pressure bank executives to pursue high-risk strategies that regulators seem to oppose,[224] particularly because banks' primary creditors — the depositors — have little incentive to impose a check on shareholder-backed risk-taking due to deposit insurance that the Federal Deposit Insurance Corporation provides.[225]

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219 Dodd-Frank Act, subtit. IX(G), encompassing §§ 971-972.

220 Leo E. Strine, *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 Bus. Law. 1079, 1082 (2008).

221 Dodd-Frank Act, subtit. IX(E), encompassing §§ 951-957. Section 956, which requires disclosure of executive pay arrangements to regulators, was an exception as it only applies to "covered financial institutions."

222 *Id.* § 951 (shareholder voting on executive compensation); *id.* § 953 (disclosure).

223 Bruner, *supra* note 79, at 319-20 (emphasizing the shareholder orientation of the Dodd-Frank corporate governance reforms); Coffee, *supra* note 171, at 1049 ("Dodd Frank partly sided with traditional corporate governance reformers, enacting much of their standard agenda to enhance shareholder power."); Sepe, *supra* note 79, at 380 ("The measures introduced by the Dodd-Frank Act aim at empowering shareholder voice.").

224 *See supra* note 173 and accompanying text (discussing bank shareholder preferences for high-risk/high-return strategies); Bruner, *supra* note 79, at 321-22; Coffee, *supra* note 171, at 1049, 1055; Sepe, *supra* note 79, at 380-81.

225 *Supra* note 170 and accompanying text; *see also* Robert P. Bartlett, *Making Banks Transparent*, 65 Vand. L. Rev. 293, 303-04 (2012); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 Geo. L.J. 247, 255-57 (2010);

Conclusion

This Article has picked up on Ronald Gilson's 1996 cue[226] and examined with respect to corporate governance how and why existing institutions responded to a changing array of challenges. In so doing, the Article has engaged with issues thus far largely unaddressed in the corporate governance literature and thereby provided fresh historically-related insights into the development of corporate governance. This Article's key contributions have been twofold. The first has been to explain by reference to dramatic changes affecting the manner in which U.S. public companies conducted business why corporate governance, despite its belated arrival, became much more than a 1970s fad.

The Article's second major contribution has been to describe how and why as compared to nonfinancial companies the corporate governance chronology was altered in a potentially crucial way for banks. Due to deregulation, improved access to finance, and to companies simply getting bigger, corporate governance began to matter more in U.S. public companies as the twentieth century drew to a close. Increased emphasis on boardroom monitoring, performance-related executive pay and shareholder activism duly followed. Shortly following major corporate scandals occurring during the early 2000s and the 2002 enactment of the Sarbanes-Oxley Act, a new corporate governance equilibrium appeared to coalesce, with formerly high-flying celebrity CEOs being put on appreciably shorter leashes.

Similar trends affected the financial services industry, with corporate governance achieving a higher profile during an era of "bright new finance" marked by the emergence of larger banks, deregulation, and technological change. Due in large measure, however, to stock market outperformance, leading banks were issued a mid-2000s corporate governance "free pass" that arguably helped to set the stage for the financial crisis. Only in the wake of the 2008-2009 economic meltdown that U.S. banks arguably helped to precipitate did large financial companies shift to "boring" mode and ditch the imperial CEO model eschewed generally by U.S. public companies after the corporate governance upheavals of the early 2000s.

The analysis provided here is by no means definitive. The Article has shown that the star CEOs who rose to prominence as the twentieth century drew to a close had their wings clipped post-Enron/SOX with nonfinancial companies and after the financial crisis with major banks. On the other hand, the intriguing question whether the financial crisis would have been as severe

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Kose John, Hamid Mehran & Yiming Qian, *Outside Monitoring and CEO Compensation in the Banking Industry*, 16 J. Corp. Fin. 383, 385 (2010).

226 *Supra* note 6 and accompanying text.

as it was if bank executives had not been given a corporate governance free pass in the mid-2000s has been left open.

The Article's analysis of *why* celebrity CEOs had their wings clipped when they did is also by no means definitive. We have seen with banks that in the wake of the financial crisis regulators eager to reduce risk took the lead. In contrast, Arthur Levitt, with the "vast cultural change" he said was occurring in boardrooms and executive suites of nonfinancial companies in the mid-2000s, attributed the change primarily to pressure from major institutional shareholders and the media.[227] It is unclear whether Levitt's assessment of the potency of market-oriented agents of change is fully on the mark. For instance, prior to the financial crisis passivity in fact was the default option for major institutional stockholders, with pension funds and mutual funds being reluctant to do more than vote against management proposals which shareholder advisory services opposed.[228]

It is beyond the scope of this Article to go further in assessing the contribution of potential agents of change. The Article has nevertheless offered fresh insights concerning the interrelationship between corporate governance and the financial crisis, and has identified factors that brought corporate governance to prominence in banks and public companies more generally. In so doing it has provided a fresh departure point for future historically-oriented research on corporate governance.

227 *Supra* note 206 and accompanying text.

228 Cheffins, *supra* note 10, at 13.