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Finding Shelter in a Time of Crisis: A Process-Oriented Approach To Risk Management

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Finding Shelter in Time of Crisis: A Process-Oriented Approach To Risk Management

Research Paper No.

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Abstract

Success in financial markets rests on the effectiveness of a business's risk management strategy: manage risks well and profits follow; fail to manage risks and a crisis ensues. It has long been evident that inadequate enterprise risk management policies, or internal risk-reducing strategies, create perilous consequences for a business. The recent financial crisis illustrates that the often disparate regulatory guidance and multiplicity of regulators who influence enterprise risk management policies were ill-suited to address conflicts and weaknesses in risk management accountability and enforcement mechanisms.

During the crisis, a chorus of commentators demanded a federal solution to address the devastating economic effects caused, in part, by failed enterprise risk management policies at large, complex financial institutions and the threats of systemic risk that the wave of enterprise risk management failures engendered. In response to these demands, Congress enacted the Dodd-Frank Act. While the Act initiates significant reforms, Congress missed an important opportunity to implement truly effective enterprise risk mitigating measures.

This Article challenges the prevailing wisdom that emphasizes systemic risk oversight but neglects enterprise risk management policies at systemically significant financial institutions. This Article sets forth a comprehensive regulatory framework to address the limitations of a fragmented regulatory structure. Specifically, this Article proposes to align gatekeepers' accountability for risk management failures with broader social and normative expectations by developing a process-oriented, principles-based approach to regulate risk management. Process-oriented solutions evaluate corporate organizational and behavioral processes to enhance the effectiveness of risk management reforms. Such measures reduce the threat of future economic crises. The proposed framework offers a better solution to risk management concerns, encourages financial institutions and other businesses to internalize the negative externalities of their higher-risk business strategies, promotes corporate insiders' accountability for enterprise and systemic risk, reduces markets' vulnerability to future crises, and militates against the likelihood of another $700 billion federal bail-out.

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Finding Shelter in Time of Crisis:
A Process-Oriented Approach To Risk Management

Kristin Johnson*

"Too many … acted recklessly, taking on too much risk. . .
Like Icarus, they never feared flying ever closer to the sun."[1]

"All the incentives – profits, compensation, glory, and even job security – went in the direction of taking more and more risk, even if you half-suspected it would end badly."[2]

Introduction

Risk management is a critical factor in the stability and success of a business. For the last few years, domestic and international authorities committed unprecedented effort to develop policies to regulate systemic risk. Systemic risk, broadly defined, refers to the threat that the insolvency of one or more significant financial institutions may initiate a domino-effect of insolvencies destabilizing the domestic economy, and quite possibly, the global economy.[3] Commentators argue that, in 2007, the mere threat of systemic risk led to a contraction in credit markets, a decline in equity markets (with losses reaching over seven trillion dollars in U.S. equity markets and more than fifty trillion dollars in global equity markets)[4] and a deep and pervasive national economic recession.[5] Following the recent financial crisis, popular sentiment demanded that authorities identify the sources of systemic risk and adopt appropriate regulation to prevent or reduce the likelihood of future crises.

This Article argues that, in order to address systemic risk concerns *ex ante*, regulators of systemically significant financial institutions must adopt and enforce effective enterprise risk management regulations. Enterprise risk management or ERM refers to the strategies that

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[1] NAT'L COMM'N ON THE CAUSES OF THE FIN. AND ECON. CRISIS IN THE U.S., THE FIN. CRISIS INQUIRY REPORT (2011) [hereinafter FIN. CRISIS INQUIRY REPORT] at xix *available at* http://www.fcic.gov/report. Greek mythology chronicles the story of Icharus and his father Daedalus. In their effort to escape from the island of Crete, Daedalus constructed wings made of feathers and wax. Icharus, despite warnings, soared near the sun. The wax melted and he fell from the sky. The blue-ribbon commission compares Icharus's hubris to directors' and officers' decisions during the period leading up to the recent financial crisis. *See* JOSEPHINE PRESTON PEABODY, OLD GREEK FOLK STORIES TOLD ANEW 16–17 (Echo Library 2008) (1897).

[2] Joe Nocera, *Risk Mismanagement*, N.Y. TIMES MAG., Jan. 2, 2009, at MM24.

[3] *See* Michelle M. Harner, *Barriers to Effective Risk Management*, 40 SETON HALL L. REV. 1323, 1334–36 (2010); *see also* John D. McKinnon & Michael R. Crittenden, *Panel Rips Wall Street Titans*, WALL ST. J., Jan. 14, 2010, at A1; Joe Nocera, *Biggest Fish Face Little Risk of Being Caught*, N.Y. TIMES, Feb. 25, 2001, at B1.

[4] *See* Hernando de Soto, *Toxic Assets Were Hidden*, WALL ST. J., Mar. 25, 2009, at A13; Heather Landy, *The Stock Slump of 2008: Wrecking Ball to Wealth*, WASH. POST, Jan 11, 2009, at F05; Vikas Bajaj, *Market Limps into 2009 After a Bruising Year*, N.Y. TIMES, Jan.1, 2009, at A1.

[5] *In Depth Coverage of Global Financial Crisis*, FIN. TIMES, http://www.ft.com/indepth/global-financial-crisis (last visited Feb. 24, 2011); *U.S. Financial Crisis Has Global Fallout*, NAT'L PUBLIC RADIO, Sept. 28, 2009, *available at* http://www.npr.org/templates/story/story.php?storyId=95149054.

businesses employ to monitor, manage, and mitigate risks. For financial institutions, effective ERM policies improve the stability of their individual business but also ameliorate the threat of precipitating conditions that may lead to systemic risk.[6]

The prevailing view suggests that systemic risk is the linchpin of effective reform.[7] Theorists who adopt the prevailing view neglect ERM concerns, arguing that the internal affairs of corporations involve disputes about private wealth transfers.[8] Commentators describe the underlying conflicts within the corporation that fuel ERM concerns as illustrations of the classic agency problem. In essence, agency problems and agency costs refer to the long-explored conflicts between shareholders, who are the owners of corporations, and directors and executive officers, who manage the business and affairs of corporations.[9] The oversight of these corporate governance matters is often viewed as the province of the states. Moreover, the prevailing view assumes that federal interference in corporate governance is simply unwarranted.[10]

However, the prevailing view overlooks two critical issues. First, while systemic risk is important, the threat of systemic risk during the recent crisis emerged *after* expansive losses due to ERM failures at significant financial institutions.[11] Permitting private businesses' to transfer the costs or negative externalities of their activities to the public reduces social welfare and engenders sub-optimal outcomes.[12]

Second, the prevailing view characterizes ERM as a classic agency problem that illustrates the pervasive conflicts between the interests of shareholders and directors and officers.[13] Challenging that assumption, this Article argues that state corporate governance mechanisms inadequately regulate the conflicts between the shareholders' interests and the interests' of executive officers and directors at sophisticated, storied financial institutions. This Article argues that incentives for personal gain may motivate executive officers and directors to take risks that lead to market instability, if not market failure, massive economic losses, and other harmful spill-over effects that are antithetical to broader normative expectations.[14]

During the crisis, exposés teemed with stories of executive officers collecting unfathomable bonus compensation awards by disregarding risk exposure. [15] Angelo Mozilo, the CEO of Countrywide Financial, Inc., for example, earned $470 million in salary and bonus-compensation

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[6] *See infra* Part I.

[7] *See infra* Part I.

[8] *See* Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 229–35 (2009); Schwarcz, *Systemic Risk*, *supra note* **Error! Bookmark not defined.**, at 241–47.

[9] *See infra* Part I.

[10] Norman Veasey, *The Challenges for Directors in Piloting Through State and Federal Standards in the Maelstrom of Risk Management*, 34 SEATTLE U. L. REV. 1, 2, 12–13 (2010); Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 15, *available at* ssrn: http://ssrn.com/abstract=1673575.

[11] *See* CONG. BUDGET OFFICE, THE TROUBLED ASSET RELIEF PROGRAM: REPORT ON TRANSACTIONS THROUGH DECEMBER 31, 2008 (2009), available at http://www.cbo.gov/doc.cfm?index=9961; *see also*, Kristin N. Johnson, *Things Fall Apart: Regulating Credit Default Swaps*, 82 U. COLO. L. REV. 167 (2010).

[12] Johnson, *supra* note 11, at 175.

[13] Stephen M. Bainbridge, Caremark *and Enterprise Risk Management*, 34 IOWA J. CORP. L. 967, 969 (2009)

[14] *See, e.g.*, Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO L.J. 247 (2010); *see also* John D. McKinnon & Michael R. Crittenden, *Panel Rips Wall Street Titans*, WALL ST. J., Jan. 14, 2010, at A1; Joe Nocera, *Biggest Fish Face Little Risk of Being Caught*, N.Y. TIMES, Feb. 25, 2001, at B1.

[15] *See* T. Leigh Anenson & Donald O. Mayer, *"Clean Hands" and the CEO: Equity as an Antidote for Excessive Compensation*, 12 U. PA. J. BUS. L. 947 n.231–35 and accompanying text (2010); James R. Hagerty, *Mozilo's Pay Plunged 79%; He Still Made $10.8 Million*, WALL ST. J., Apr. 25, 2008, at B1; Gretchen Morgenson, *Stock Sales by Chief of Lender Questioned*, N.Y. TIMES, Oct. 11, 2007, at C1.

during the five year period leading to the financial crisis.[16] The creative risk taking measures at Countrywide led to the collapse of the business[17] and a chain reaction of subprime mortgage foreclosures that contributed significantly to the on-set of the recent financial crisis.[18]

This Article concludes that inextricable ties link ERM and corporate governance and, therefore, regulatory reforms must address both issues to reduce the threat of systemic risk. Recent regulatory reform indicates a movement away from the prevailing view. Congress's adoption of the most far-reaching and comprehensive set of financial market reforms enacted since the Great Depression, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) ,[19] demonstrates the federal government's rejection of the prevailing view. However, Dodd-Frank' s tepid, indirect measures fail to fill the gap between pre-existing regulatory efforts and effective risk management policies.[20]

This Article argues for a process-oriented, principles-based approach to enterprise risk management regulation. Part I offers a primer on enterprise and systemic risk. Exploring the development of state director and officer accountability standards, Part II argues that state standards permitted an untenable gap to develop between managers' liability for ERM decisions and normative expectations regarding risk management oversight. Part III analyzes Dodd-Frank's reform efforts. Part IV proposes solutions that complement existing ERM oversight approaches. Finally, Part V concludes.

I. Understanding Enterprise and Systemic Risk Management

To better understand risk management, this Part explores two risk management methods – credit derivatives, namely credit default swaps, and quantitative risk models. This Part explores the tensions between the promise and peril that ERM methods create. This Part demonstrates that these two risk management methods intended to mitigate risk ironically heightened risk exposure for large financial institutions during the recent crisis and accelerated the near collapse of prominent financial institutions. Section A of this Part considers the attributes of enterprise risk and systemic risk management. Section B explores two examples of ERM methods. Section C illustrates the limitations of these ERM methods.

A. Risk And Risk Management Methods

Risk broadly defined, refers to the potential for loss arising from uncertainty or unexpected outcomes.[21] When risks materialize, mundane effects, such as anticipated losses, may result, or a

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[16] *See* Hagerty, *supra* note 15.

[17] Countrywide shares declined from $45.26 per share in January 2007 to $4.25 in July 2008. Eric Dash & Gretchen Morgenson, *Troubled Giant in Home Loans Close to Rescue*, N.Y. TIMES, Jan. 11, 2008, at A1. Ben Protess, *From Ex-Chief, a Staunch Defense of Countrywide's Legacy*, N.Y. TIMES, Feb. 18, 2011, at B5.

[18] Gretchen Morgenson, *Lending Magnate Settles Fraud Case*, N.Y. TIMES , Oct. 15, 2010, at A1.

[19] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 376 (2010) (hereinafter "Dodd-Frank Act").

[20] *See, e.g.*, Harner, *supra* note 14; Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 32 IOWA J. CORP. L. 967 (2009).

[21] *See* PHILIPPE JORION, VALUE AT RISK: THE NEW BENCHMARK FOR MANAGING FINANCIAL RISK 3 (3d. ed. 2007).

business may experience devastating losses. Systemic risk, for example, refers to the threat that the aggregation of risks in the financial markets will lead to market disruption.[22]

Depending on the business strategy and the market in which a business operates, effective management of myriad risks determines a business's success.[23] The principle business activities of financial institutions often include lending, underwriting, securitization, and other higher-risk, leveraged activities.[24] While financial institutions certainly face risks common to all businesses, financial institutions' business activities engender unique risks, described as financial risks.[25] Several distinguishable risks comprise the group of risks described as financial risks, including credit, market, or operational risks.[26]

Three principle risks comprise the most frequently cited examples of financial risks. Credit risk refers to the probability that a creditor will default and fail to satisfy its debt obligations.[27] Credit risk commonly arises in a traditional borrower-lender model. When lender makes a loan to a borrower, the lender is exposed to credit risk until the borrower repays the loan. If during the term of the loan the borrower defaults, the lender will suffer the loss of the remaining principal and interest payments.[28] Within financial institutions, credit risk arises in this simple borrower-lender context; credit risk also arises in other, more complex contractual arrangements.[29]

Market risk describes the probability that a negative event may occur and result in a wide-spread decline in the value of an asset class, such as a decline in the value of the equity or debt securities market or the commodities markets.[30] Unlike credit risk, market risk management efforts involve predicting movements in the value of an entire asset class, rather than merely the credit quality of one's contract counterparties. Finally, operational risks relate to the systems and

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[22] *See* Roberta S. Karmel, *The Controversy Over Systemic Risk Regulation*, 35 BROOKLYN J. INT'L L. 823, 825 (2010); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L. J. 193, 198–204 (2008); Arthur E. Wilmarth, *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 90 OR. L. REV. (forthcoming 2011).

[23] Betty Simkins & Steven A. Ramirez, *Enterprise-Wide Risk Management and Corporate Governance*, 39 LOY. U. CHI. L.J. 571 (2008); *see also* U.S. DEP'T OF TREASURY, TREAS. NOTICE 2008-PSSFI1 (Oct. 4, 2008), *available at*, http://www.treas.gov/press/releases/reports/exec%20comp%20pssfi%20notice%20revised.pdf.

[24] *See, e.g.*, Bank of America Corp., Annual Report (Form 10-K), at 1 (Feb. 25, 2011); Citigroup Inc., Annual Report (Form 10-K), at 5 (Feb. 25, 2011) (same); JPMorgan Chase & Co., Annual Report (Form 10-K), at 54 (Feb. 28, 2011) (same).

[25] *See* Martin Lipton et al., *Risk Management and the Board of Directors*, WACHTELL, LIPTON, ROSEN & KATZ (WLRK) PUBLICATION 7–13 (2008), http://blogs.law.harvard.edu/corpgov/files/2008/11/risk-management-and-the-board-of-directors.pdf.

[26] *See* Simkins & Ramirez, *supra* note 23, at 580 n.67 (citing CHARLES W. SMITHSON, CLIFFORD W. SMITH, JR., & K. SYKES WILFORD, MANAGING FINANCIAL RISK 18–22 (1998)) ; Charles K. Whitehead, *Destructive Coordination*, 96 CORNELL L. REV. 323, 337 n.65 (2011) (citing JORION, *supra* note 19, at 75).

[27] *See* Johnson, *supra* note [XX], at [XX]; *see also* RENO GALLATI, RISK MANAGEMENT AND CAPITAL ADEQUACY 129–30 (2003) (citation omitted).

[28] Johnson, *supra* note 11, at 206; Douglas O. Edwards, Comment, *An Unfortunate "Tail": Incentivizing Better Risk; Management Practices After the Financial Crisis of 2007-2009*, 81 U. COLO. L. REV. 247, 300–04 (2010); Michael I. Overmyer, Note, *The "Foreign Private Adviser Exemption: A Potential Gap in the New Systemic Risk Architecture*, 110 COLUM L. REV. 2185, 2219–25 (2010).

[29] Johnson, *supra* note 11, at 168.

[30] *See* BASEL COMM. ON BANKING SUPERVISION, AMENDMENT TO THE CAPITAL ACCORD TO INCORPORATE MARKET RISKS (Apr. 1998), http://www.bis.org/publ/bcbsc222.pdf; INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS, Amendment to the Capital Accord to Incorporate Market Risks 1 (Apr. 1998), *available at* http://www.bis.org/publ/bcbs118.htm; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD 98-15323, RISK-BASED CAPITAL: REGULATORY AND INDUSTRY APPROACHES TO CAPITAL AND RISK (1998); HAL S. SCOTT & PHILIP A. WELLONS, INTERNATIONAL FINANCE, TRANSACTIONS, POLICY, AND REGULATION 252 (6th ed. 1999).

processes used to execute business strategic plans, such as the technology to execute electronically securities market trade requests.[31]

ERM describes the specific processes that directors and officers of a company adopt to identify, monitor, and manage the business's known risks in accordance with the business's risk preferences.[32] In other words, the executives determine where risks exist, communicate the risks to managers who make decisions about how to address risks, and managers articulate a policy for addressing the risks.[33] A plethora of ERM methods[34] assist firms' efforts to protect the assets and profits of their businesses through these risk-reducing or risk-mitigating devices.[35] The long history of ERM methods include strategies as obvious as purchasing insurance, selectively avoiding business opportunities subject to volatile price movements, or simply limiting leverage.[36] Market participants have employed ERM methods for several hundred years.[37] In recent years, financial product engineers began to develop nascent ERM methods to manage the increasingly sophisticated and complex risks that businesses face.

Identifying ERM failures requires careful review of events and consideration of risk management policies. Significant financial losses alone are inadequate to support the conclusion that a business's risk management policies failed.[38] Risk management failures arise in connection with the failure to implement or oversee appropriate ERM methods. Commentators identify six categories of risk management failures: mistakes arising from the inaccurate measurement of known risk, mistaken assumptions regarding the materiality of risks, failure to communicate risks to decision-makers, failure to monitor risks, failure to manage risks, and failure to employ appropriate risk models.[39] Addressing ERM concerns requires properly distinguishing risk management failures from other unfortunate events or decisions.

Section B examines ERM methods that contributed to risk management failures at systemically significant financial institutions during the recent financial crisis. Examination of these concerns offers valuable insight into the appropriate contours regulatory reform.

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[31] *See* Yossi Raanan et al., *Operational Risk Management: An Overview*, *in* OPERATIONAL RISK MANAGEMENT: A PRACTICAL APPROACH TO INTELLIGENT DATA ANALYSIS 20 (Ron Kenett & Yossi Raanan eds., 2010); ORG. FOR ECON. CO-OPERATION AND DEV., ADVANCES IN RISK MANAGEMENT OF GOVERNMENT DEBT 136 (2005); Johnson, *supra* note 11, at 210–12; Simkins & Ramirez, *supra* note 23, at 581.

[32] *See* COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, ENTERPRISE RISK MANAGEMENT—INTEGRATED FRAMEWORK: EXECUTIVE SUMMARY 1 (2004), *available at* http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf [hereinafter COSO Framework]; RISK AND INS. MGMT. SOC'Y, INC., THE 2008 FINANCIAL CRISIS: A WAKE-UP CALL FOR ENTERPRISE RISK MANAGEMENT 4, *available at* http://www.ucop.edu/riskmgt/erm/documents/2008fincrisis_wakeupcall.pdf [hereinafter RIMS report]; Kenneth A. Bamberger, *Technologies of Compliance: Risk and Regulation in a Digital Age*, 88 TEX. L. REV. 669, 691 (2010).

[33] *See* Rene M. Stulz, *Risk Management Failures: What Are They and When Do They Happen?*, 20 J. APPLIED CORP. FIN. 58, 58 (2008).

[34] A discussion of all of the ERM methods and best practice proposals is beyond the scope of this article. *See* Governor Susan Schmidt Bies, Member, Board of Governors of the Federal Reserve System, Keynote Address at the Fordham Journal of Corporate & Financial Law Symposium, *in* 8 FORDHAM J. CORP. & FIN. L. 81, 83 (2003).

[35] *See* RIMS report, *supra* note 31; PETER L. BERNSTEIN, AGAINST THE GODS: THE REMARKABLE STORY OF RISK 3-6, 57–75 (1996).

[36] *See* Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, And Complete Capital Markets*, 108 COLUM. L. REV. 231, 234.

[37] *See* Charles R.P. Pouncy, *Contemporary Financial Innovation: Orthodoxy and Alternatives*, 51 SMU L. REV. 505, 519–32 (1998).

[38] *See* Stulz, *supra* note 32, at 58.

[39] *See, e.g.*, *id.* at 60.

B. ERM Methods – A Double-Edged Sword

While historically businesses applied fragmented risk management policies to different business "silo," increasingly businesses applied more comprehensive, enterprise-wide strategies.[40] In the 1990s, risk managers began to disregard the "silo" approach and advocated for integrated, enterprise-wide ERM policies.[41] Nascent, sophisticated ERM methods offer promising benefits; yet, misguided application of these methods threatened to engender pernicious costs.

1. Credit Derivatives

Derivatives contracts are a risk-transferring ERM method with a history that dates back over several hundred years.[42] Derivatives contracts are bilateral contracts involving a party with exposure to the risk that an asset will decline in value.[43] Credit derivatives are derivatives contracts in which the referenced asset is a debt instrument.[44] There are two classes of credit derivatives –collateralized debt obligations and credit default swap agreements.[45]

In a credit default swap agreement, a party with risk exposure (a protection buyer) seeks to transfer a portion of that risk and enters into an agreement with a counterparty (a protection seller) who believes that value of the subject asset will not decline.[46] The agreement is referred to as a derivatives contract because the value of the agreement is derived from the asset referenced in the contract, or the reference asset.[47] The reference asset may be a loan, a portfolio of loans, a debt security or any debt asset. In the event that the reference asset declines in value or the issuer of the reference asset defaults, the protection seller agrees to pay the protection buyer a sum equal to the difference in the face value of the asset and the reduced market value of the asset.[48] After entering into the derivatives contract, the protection buyer faces reduced risk exposure. The protection seller receives a lump-sum or periodic premium for accepting the risk transfer.[49] Innovative development of derivatives contracts now allow market participants to enter into credit default swap agreements to reduce the risk of loss related to energy products, currency,

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[40] Simkins & Ramirez, *supra* note 23, at 577.
[41] Harner, *supra* note 14, at 1330.
[42] Simkins & Ramirez, *supra* note 23, at 577; *see also* Johnson, *supra* note11, at 192; RICHARD J. TEWELES & FRANK J. JONES, THE FUTURES GAME 6 (2nd ed. McGraw-Hill 1987). As early as the seventeenth century, Japanese market participants commonly employed futures contracts to hedge against loss exposures in rice markets. *See* Mark West, *Private Ordering at the World's First Futures Exchange*, 98 MICH. L. REV. 2574, 2577–78, (2000). Futures contracts for tulip bulbs created an asset bubble that consumed Dutch financial markets in the seventeenth century. MIKE DASH, TULIPOMANIA: THE STORY OF THE WORLD'S MOST COVETED FLOWER AND THE EXTRAORDINARY PASSIONS IT AROUSED 187–95 (Rachel Kahan ed., 1999). American derivatives contracts flourished in the 1800s. See Jonathan Lurie, Private Associations, Internal Regulation and Progressivism: The Chicago Board of Trade 1880—1923, as a Case Study, 16 AM. J. LEGAL HIST. 215, 219 (1972).
[43] *See* Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 2 (1996).
[44] Frank Partnoy and David A Skeel Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1021 (2006).
[45] Johnson *supra* note 11, at 200.
[46] *See id.* at 7 (explaining how risk is transferred in forwards contracts).
[47] *See* Johnson, *supra* note 11, at 128.
[48] Johnson, *supra* note 11, at 192; Romano, *supra* note 43, at 47.
[49] *See* Johnson, *supra* note [xxx], at 128 n.148.

precious metals, credit instruments, and equity and debt securities markets.[50] Naked credit default swap agreements permit protection buyers who do not even own the reference asset to enter into agreements as a means to reflect suspicions that a debt issuer is likely to default on its debt obligations.

Like collateralized debt obligations, credit default swaps also transfer risks. An illustration offers may prove useful. Imagine that an investor owns a bond (debt asset) issued by Boeing, Inc. that matures in ten years. If the bond holder becomes concerned that Boeing may default on its bond payment obligations, the investor enters into a credit default swap agreement. The agreement is a bilateral contract and its terms provide for the bondholder to obtain insurance-like protection against a decline in the value of the Boeing bond. If Boeing defaults, the bondholder's counterparty agrees to purchase the bond at face value, permitting the bondholder to avoid the loss of any remaining principle and interest payments due on the bond. In exchange, the counterparty receives compensation in the form of a lump sum or periodic payment from the bondholder. Credit default swaps reduce the market risk exposure related a decline in the value of the Boeing bond.

In addition to credit default swaps, market participants use collateralized debt obligations to transfer and mitigate risk exposure. Financial institutions create collateralized debt obligations by aggregating asset-backed debt obligations, such as residential mortgages. In a residential mortgage the house identified in the mortgage secures repayment of the principal and interest.[51] In collateralized debt obligation arrangements, financial institutions acquire bundles of residential mortgages, arrange them in packages, and distribute rights to the repayment obligations of the underlying mortgages through special investment vehicles. Driven by the fees of facilitating the debt repackaging, financial institution markets and distributes rights to the cash-flows of the special investment vehicles.[52] In packaging of the cash-flow rights, financial institutions sub-divide the repayment rights into classes or tranches and assign priority, or seniority with respect to the right to payments, to particular tranches.[53] Thus, the financial institution spreads risk across the market by removing individual debt assets from one market participant's portfolio and broadly distributing the risk exposure related to that subprime mortgage to many others through the bundling of many debt assets and the marketing of interests in the special investment vehicle.[54]

For years leading to the recent financial crisis, directors and executives emphasized the credit risk reduction benefits of credit derivatives while ignoring the credit risks these instruments created. For collateralized debt obligations, financial institutions that inventoried significant volumes of subprime mortgages to bundle and package into special investment vehicles faced massive losses when adjustable rate subprime mortgages reset at higher interest rates and borrowers began to default. In the context of credit default swap agreements, the owner of the debt asset referenced in the agreement began to seek immediate settlement as debtors defaulting

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[50] *See id.* at 128 n.147 (citing ROBERT E. WHALEY, DERIVATIVES: MARKETS, VALUATION, AND RISK MANAGEMENT 679–80, 687–88 (2006)); Romano, *supra* note 43, at 25, 47–50 (explaining options in oil and swaps in currency).
[51] *See e.g.*, Frank A. Gevurtz, *The Role of Corporation Law in Preventing a Financial Crisis: Reflections on In re Citigroup, Inc. Shareholder Derivative Litigation*, 23 PAC. MCGEORGE GLOBAL BUS. & DEV. L. J. 113, 117 (2010).
[52] *Id*.
[53] *Id*.
[54] Due to the collateralized debt obligations' complex structures, financial markets had difficulty pricing these instruments and, therefore, measuring and monitoring the risks related to these instruments posed unique challenges. In some instances, collateralized debt obligations contained slices of more than 100 different debt securities with varying levels of priority for repayment bundled together into a single security backed by mortgages or other debt receivables. Carrick Mollenkamp et al., *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, WALL ST. J., Nov. 3, 2008, at A1.

on their mortgages triggered the termination of credit default swap agreements that were tied to real estate assets.

Managers mistakenly assumed that these risk reducing measures were guarantees that eliminated exposure to the risk of loss.[55] In fact, assuming that credit default swaps *eliminate* the risk of loss for the owner of the debt asset ignores the risk that both the debt issuer and the counterparty to the credit default swap agreement may default on their payment obligations.

Financial institutions' miscalculation of the known risks related to credit derivatives and their failure to address these risks through ERM policies created a critical trigger in the development systemic risk during the recent crisis.[56] Defaults on subprime mortgages created a tidal wave of losses for financial institutions.[57] In an ironic twist, these errors undermined the risk-shifting benefits that credit derivatives offered and created crippling exposure to debilitating losses.

2. Quantitative Risk Models

In addition to risk mitigating financial products such as credit derivatives, quantitative models promised risk mitigating benefits. While derivatives offer an example of a classic ERM method, quantitative risk models represent a genuinely modern approach to ERM. Like derivatives, quantitative models offer great promise as an ERM method; yet, mistakes in the use of quantitative models or misguided assumptions regarding the strengths and weaknesses of quantitative models diminish their value.

Quantitative models use statistical and mathematical formulae to analyze historical data and to predict the risk of loss resulting from negative changes in the value of assets, portfolios, or an entire business unit's investments. Quite simply, these complex, mathematical models answer the question – how much might I lose on this particular investment?

Theorists began developing quantitative models in the 1950s.[58] Harry Markowitz published a seminal article in the Journal of Finance in 1952 introducing one of the earliest quantitative models.[59] Later models, such as the Value-at-Risk (VaR) model, became increasingly popular in the 1980s. VaR measures the potential loss in value of an asset or portfolio over an indicated period of time for a given confidence interval.[60] In other words, VaR measures the maximum

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[55] *See* Am. Ins. Grp., Annual Report (Form 10-K), at 94 (Mar. 1, 2007); William K. Sjostrom Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 957 (2009); Mollenkamp et al., *supra* note 54; Gretchen Morgenson, *Behind Biggest Insurer's Crisis, Blind Eye to a Web of Risk*, N.Y. TIMES, Nov. 3, 2008, at A1. Adam Davidson, *How AIG Fell Apart*, REUTERS.COM, (Sept. 18 2008), http://www.reuters.com/article/2008/09/18/us-how-aig-fell-apart-idUSMAR85972720080918.

[56] *See* Kristin N. Johnson, *From Diagnosing the Dilemma to Divining a Cure: Regulating Financial Markets*, 40 SETON HALL L. REV. 1299, 1308 (2010). The exposure to the mortgage markets forced the bankruptcy or the sale of major financial institutions. *See, e.g.*, *Lehman Brothers Files for Bankruptcy*, FIN. TIMES, Sept. 15, 2008, http://www.ft.com/cms/s/0/52098fa2-82e3-11dd-907e-000077b07658.html; Eric Dash, *Purchase of Merrill Fulfills Quest for a Bank*, N.Y. TIMES, Sept. 15, 2008, at A18 (describing the decline of Lehman Brothers and the acquisition of Merrill Lynch into Bank of America).

[57] Eric Dash, *Citigroup to Halt Dividend and Curb Pay*, N.Y. TIMES, Nov. 24, 2008, at A1.

[58] *See generally* Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952); HARRY M. MARKOWITZ, PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENT (1959).

[59] Id.

[60] GLYN HOLTON, VALUE-AT-RISK: THEORY AND PRACTICE, ACADEMIC PRESS (2003); *see also The Risks of Financial Modeling: VaR and the Economic Meltdown: Hearing Before the Subcomm. on Investigations and Oversight of the H. Comm. on Science and Technology*, 111th Cong. (2009) (statement of Richard Bookstaber), available at http://democrats.science .house.gov/Media/file/Commdocs/hearings/2009/Oversight/10sep/Bookstaber_Testimony.pdf. Stated differently,

loss that an investor may experience or downside risk exposure.[61] VaR is expressed as a dollar amount[62] and measures potential losses over a period of one day, several days, or several weeks.[63] Introducing the disciplines of math to investing, market participants argued, reduced irrational, egotistical, and emotional investment strategies. VaR engineers enjoyed international acclaim.[64]

Among VaR's many benefits, VaR models predict losses related to various asset classes, including equity or debt securities, commodities, credit portfolios, derivatives, and other investment instruments.[65] For financial institutions, VaR offers a method to determine the amount of capital and assets that the business should maintain in its reserves in order to satisfy regulatory capital standards.[66] Based on the information supplied by VaR's snapshot, risk managers may adjust their trading strategies and positions to reduce or enhance market exposure.

Reliance on VaR became so widespread that federal regulators adopted rules requiring disclosure of VaR in publicly-traded corporations' periodic filings.[67] The Securities and Exchange Commission and other financial institution regulators adopted risk reporting requirements requiring market participants to report VaR or an equivalent risk metric.[68] In 1999, the Basel Committee on Banking Supervision, an organization that establishes international banking standards, directed local banking regulators to adopt local banking guidelines employing VaR to calculate compliance with capital reserve requirements.[69]

Similar to the discoveries regarding risk management failures related to the use of credit default swaps, managers' cognitive biases stymied the effectiveness of VaR. Two problems exacerbated inaccuracies in VaR's risk metrics. First, VaR relies solely on historic events to

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"VaR is defined as an amount lost on a portfolio with a given small probability over a fixed number of days." Jon Danielsson & Casper G. De Vries, Value-at-Risk and Extreme Returns, 60 Annales d'Économie et de Statistique 239, 239 (2000). Theorist Carl Friedrich Gauss developed the original VaR, which measured portfolio risk along a normal distribution curve. Nocera, *supra* note [XX], at MM24. The normal distribution curve is a bell curve and the "pattern of normal distribution will cluster around those smaller changes toward the middle of the curve, while the less-frequent distributions will fall along the ends of the curve." *Id.* For example, a stock is more likely to gain or lose one point in a day than twenty points. *Id.* VaR provides an estimate of the range of possible gains and losses and is heavily used by U.S. financial institutions, particularly in light of SEC rulings requiring firms to disclose quantitative information regarding their derivatives' positions using VaR-style models. 17 C.F.R 210.4-08(n) (2009); Philippe Jorion, *In Defense of VAR*, DERIVATIVES STRATEGY, Apr. 1997, http://www.derivativesstrategy.com/magazine/archive/1997/0497fea2.asp.

[61] Jorion, *supra* note 60. VaR theorists explain VaR predicts that for a portfolio of stocks that is calculated to have a one-day 95% VaR of $1 million, then managers may conclude that there is a 5% probability that the portfolio will lose more than $1 million in the twenty-four hours following the calculation of VaR, assuming markets function in a normal manner and no trading occurs on the assets in the portfolio. *Id.*

[62] Jorion, *supra* note 60.

[63] *Id.*

[64] *See Nobel Prizes 1990*, NOBELPRIZE.ORG, http://nobelprize.org/nobel_prizes/economics/laureates/1990/.

[65] Jorion, *supra* note 60.

[66] Kenneth A. Bamberger, *Technologies of Compliance: Risk and Regulation in a Digital Age*, 88 TEX. L. REV. 669, 691, 701 (2010); Robert T. Miller, *Oversight Liability for Risk Management Failures at Financial Firms*, 84 S. CAL. L. REV. 47 (2010).

[67] The SEC was the first regulator to require disclosure using a quantitative model similar to VaR. SEC Accounting Policies for Certain Derivative Instruments, 17 C.F.R. § 210.4-08(n) (2009); SEC Financial Statements, 17 C.F.R. § 228.310 (2007); *see also* Richard Dale, RISK AND REGULATION IN GLOBAL SECURITIES MARKETS 78 (1996).

[68] *See* Capital Requirements for Market Risk, 60 Fed. Reg. 38,142 (proposed July 25, 1995) (to be codified at 12 C.F.R. pt.. 2)(noting the Federal Reserve's risk reporting requirement);

[69] *See* Adrian Blundell-Wignall and Paul Atkinson, *Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity*, OECD JOURNAL, 2010, *available at* http://www.webcitation.org/5q4GU5WGw (pre-publication version).

evaluate future probabilities of losses.[70] The model is only able to consider past events.[71] Second, and more troubling, VaR evaluates the distributions of probable outcomes around a mean.[72] In plain English, the models present two snapshots that depict a bell curve.[73] Within the bounds of the first snapshot, or the rise in the bell curve, analysis is meaningful because of the frequency of distributions or events that offer a basis for drawing rational conclusions. The second snapshot offers less statistical certainty.

To illustrate the first problem, consider the years leading to the recent financial crisis. The infrequency of steep declines in residential and commercial real estate values relegated these types of events to the second snapshot, or the tails of the bell curve. Therefore, VaR offered less useful predictive analysis regarding the rare or infrequent events that follow from a decline in housing prices. In light of the models' limitations, many were confounded by the banks effusive praise for and reliance on these quantitative models.[74]

Even more disconcerting, VaR's limits predicting rare and or extremely low probability events offer no guidance regarding the magnitude of losses that may result if unanticipated events occur.[75] As a result of their over-confidence in VaR models, market participants aggressively invested in real estate assets. When housing prices began to decline – that *rare* event, referred to as a "black swan" that hid in the "tail risk" of the second snapshot of the model, crippled individual financial institutions and threatened to destabilize the entire economy.

Second, VaR models rely on historical data. VaR may only assess probable future outcomes based on an evaluation of past events. Obviously, there are many reasonably foreseeable risks that have not yet occurred and that VaR fails to consider.

Further confounding VaR's usefulness, actors within financial institutions both failed to account for VaR's limitations and erred in selecting data that may have been useful to mitigate misunderstandings regarding VaR's predictions.[76] The latter issue exemplifies the classic agency dilemma. The effectiveness of VaR as a measure of risk exposure rests on the accuracy of the data and assumptions employed in the model. The integrity of managers who determine the underlying information and assumptions applied in a VaR's model is integral to the success of the model.[77] Managers' authority to determine these fundamental matters creates information asymmetries, meaning the managers have access to more information than shareholders or regulators relating to the accuracy of VaR. Simple errors in judgment weaken the predictive value of the models. Purposeful manipulation of VaR diminishes any realistic expectations that VaR offers a valuable measure of risk exposure. Section C describes illustrations of risk

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[70] *See* Whitehead, *Destructive Coordination*, *supra* note 23, at 364.

[71] *See id.*

[72] David Einhorn and Aaron Brown, *Cover Story: Point/Counterpoint: Private Profits and Socialized Risk*, GLOBAL ASSN. OF RISK PROF'LS, June-July 2008, at 10, *available at* http://www.garpdigitallibrary.org/download/GRR/2012.pdf (explaining VaR's shortcomings). In *Private Profits and Socialized Risk*, Einhorn criticized VaR, while Brown defends the usefulness of VaR.

[73] Theorists refer to the low probability events that represent less frequent distributions and occur on the ends of the distribution curve as "tail risks." *See* Einhorn and Brown, *supra* note 72, at 10.

[74] *See* e.g., Simkins, *supra* note 23.

[75] For example, consider a manager's decision to use the model in the summer of 2007 and applying a two-year historical look-back period to measure the risk that a real estate portfolio would decline in value. Nocera, *supra* note 22.

[76] *See* Andreas Krause, *Exploring the Limitations of Value at Risk*: *How Good is it in Practice?*, 4 J. OF RISK FIN. 19, 26 (2003).

[77] *See* Krause, *supra* note 76, at 30; Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 224–25 (2009).

management failures during the crisis involving misguided use of credit derivatives and quantitative models.

C. Legends of the Fall: The Classic Agency Dilemma, Executive Compensation, and Suboptimal Decisions

The narratives of AIG and Citigroup offer illustrate ERM failures arising from the use of credit derivatives and risk modeling methodologies, such as VaR. For both AIG and Citigroup, the credit derivatives businesses increased the institutions' earning in the years before the crisis, but increased risk exposure and ultimately, losses during the crisis.[78] As a result both Citigroup and AIG were overexposed to risks in the credit derivatives market and weaknesses of VaR's calculations regarding risk exposure.[79]

With a coveted position in the industry league tables for issuing collateralized debt obligations prior to the crisis, Citigroup amassed a $55 billion inventory in of collateralized debt obligations and the underlying debt assets, largely subprime mortgages.[80] From 2003 to 2005, Citigroup, tripled its offering of collateralized debt obligations, increasing its issuing total from $6.28 billion to $20 billion.[81] Citigroup received approximately $500 million in fees from this business in 2005.[82] When rising home loan default rates, foreclosures and declining residential real estate prices struck the collateralized debt obligation market in 2007 and 2008, Citigroup's failure to account for the possibility of widespread defaults and declining home prices led the firm to suffer over $65 billion worth of losses. Losses related to Citigroup's collateralized debt portfolio and subprime mortgage businesses climbed to twenty-one and forty-one cents on the dollar.[83]

AIG suffered similar losses related to its participation in the credit default swap market. In the early 2000s, AIG aggressively developed a position as a leading protection seller in the credit default swap market.[84] When calculating the risk on its credit default swap portfolio, AIG's senior executive officers accounted for the periodic payments that the company received from its credit default swap portfolio as premiums paid on insurance.[85] The senior executives at AIG treated the premiums like "free money."[86] In required public filings, AIG described for its $450 billion credit default swap portfolio[87] as creating "low risk exposure."[88] Consequently, in AIG's

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[78] *See e.g.,* Frank A. Gevurtz, *The Role of Corporation Law in Preventing a Financial Crisis: Reflections on In re Citigroup, Inc. Shareholder Derivative Litigation*, 23 PAC. MCGEORGE GLOBAL BUS. & DEV. L. J. 113, 117 (2010).

[79] *See* X. Ju & N.D. Pearson, *Using Value-at-Risk to Control Risk Taking: How Wrong Can You Be*, 1 J. RISK 5 (Winter 1999).

[80] League tables offer a ranking system for identifying the most financially successful business divisions at financial institutions in a particular year for a specific service or product.

[81] *See e.g.,* Eric Dash & Julie Creswell, *The Reckoning: Citigroup Saw No Red Flags Even as It Made Bolder Bets*, N.Y. TIMES, Nov. 23, 2008, at A1, *available at* http://www.nytimes.com/2008/11/23/business/23citi.html.

[82] *Id*.

[83] *See e.g.,* Frank A. Gevurtz, *The Role of Corporation Law in Preventing a Financial Crisis: Reflections on In re Citigroup, Inc. Shareholder Derivative Litigation*, 23 PAC. MCGEORGE GLOBAL BUS. & DEV. L. J. 113, 117 (2010).

[84] William Sjostrom, *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 952 (2009).

[85] *Id*. at 957. See M. Todd Henderson, Credit Derivatives are not "Insurance," 16 CONN. INS. L.J. 1 (2009).

[86] *Id.*; Anna Schecter et al., *The Executive Who Brought Down AIG*, ABC NEWS (Mar. 30, 2009), *available at* http://abcnews.go.com/Blotter/story?id=7210007&page=1 ("It is hard for us, and without being flippant, to even see a scenario within any kind of realm of reason that would see us losing $1 in any of those transactions." (quoting statement made by AIG executive Joseph Cassano at August 2007 AIG investor conference call)).

[87] Notional value refers to the total face value of the debt securities or loans protected by the credit default swap agreements. *See* BARRON'S FINANCIAL GUIDES: DICTIONARY OF FINANCE AND INVESTMENT TERMS 487–88 (8th

2007 annual report filed with the SEC, AIG reported a low "capital markets trading" VaR.[89] As one commentator notes, "managers who understand how VaR is computed, can game the measure to report superior performance, while exposing the firm to substantial risks."[90] AIG executives' decisions exemplified this strategy.

Commentators argue that directors and officers at Citigroup and AIG had incentives to ignore the disconcerting risks that materialized during the crisis. Reducing the appearance of risk improved the appearance of the business's balance sheet. With the illusion of less risk exposure outstanding, executives could reallocate capital reserves set aside to cover the losses related to defaults on debt assets to other investment opportunities.[91] Redirecting capital from risk reserves create opportunities to enhance a company's revenues and, thereby, increases the appearance of the company's profitability or value.[92] For publicly-traded companies, the increased value often translates into a higher equity share price.

In addition, executive officers had significant personal incentives to increase the firm's equity share prices. In many publicly-traded companies, and most large financial institutions, incentive-based executive compensation is awarded based on the movement of the company's equity share price.[93] A clear conflict of interest emerged between managers' self-interest in enhancing equity security prices and their decision-making processes regarding the use of credit default swaps to shift business risk and permit more liberal use of reserved capital.

Even if managers do not intentionally manipulate use of ERM methods such as credit derivatives, biases may limit their efforts to employ ERM practices. Overconfidence, for example, is one form of cognitive bias that influences executives' ability to think rationally about risks or the accuracy of risk measures, such as VaR. Armed with VaR's myopic and limited historical perspective on risk exposure, Citigroup and AIG's executives trusted financial models that registered the probability of a widespread default on home mortgages or a decline in the creditworthiness of credit default swap counterparties as remote events.[94] Both companies' executives enjoyed the lucrative compensation received as the fees poured into company coffers for underwriting collateralized debt obligations or credit default swaps.

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ed.). The notional value of a credit default swap is generally only a fraction of the full face value of the debt obligation. *See* Johnson, supra 11, at 215.

[88]*See* Sjostrom, *supra* note 84 at 953 –56.

[89]AIG, 2007 Annual Report (Form 10-K), at 124 (Feb. 27, 2008) [hereinafter AIG '07 Annual Report], *available at* http://idea.sec.gov/Archives/edgar/data/5272/000095012308 002280/y44393e10vk.htm.

[90] Aswath Damodaran, Value at Risk: Where is the Beef? 25 (unpublished manuscript) (*available at* http://pages.stern.nyu.edu/~adamodar/pdfiles/papers/VAR.pdf).

[91] *See* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1020 (2007); Timothy Geithner, President and Chief Exec. Officer of the Fed. Reserve Bank of N.Y., Credit Market Innovations and Their Implications, Address Before the 2007 Credit Markets Symposium (Mar. 23, 2007), *available at* http://www.newyorkfed.org/newsevents/speeches/2007/gei070323.html; *Risky Business - Credit Derivatives*, ECONOMIST, Aug. 20, 2005, at 56

[92] Lucian A. Bebchuk & Holger Spamann, Regulating Bankers' Pay, 98 GEO L. J. 247 (2010); James Fanto, *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV. 731, 739 (2009).

[93] Bebchuk, *supra* note **Error! Bookmark not defined.**, at 277.

[94] According to AIG's Annual Report, "[c]redit-related factors, such as credit spreads or credit default are not included in [AIG Financial Product Group's] VaR calculation." AIG '07 Annual Report, at124. AIG Financial Product Group is the division of AIG that agreed to enter into credit default swap agreements. Carrick Mollenkamp, *et al.*, *Behind AIG's Fall, Risk Models Failed to Pass Real World Test*, WALL ST. J., Nov. 3, 2008, at A1 (noting that the models developed by AIG did not address the potential losses if the debt assets in the credit default swaps declined in value or AIG's requirements to post collateral if housing market prices declined).

Over-confidence in VaR's predictive value did not align with the broader normative interests in avoiding a financial crisis.[95] The events leading to the crisis indicate executives' interests and long-term shareholders' interests in risk-taking do not always align, creating an example of the classic agency dilemma.[96] Incentives to enhance their own compensation led some Citigroup executives to aggressively acquire subprime mortgages to build collateralized debt obligations. Similarly, the executives at AIG's business division that grew the company's credit default swap portfolio to its behemoth size received lucrative compensation for the increased revenues associated with the agreements.[97] When both companies neared collapse, executives responsible for the credit derivatives business units' final million-dollar bonuses cashed-in their golden parachutes.[98]

This Part explored two ERM methods used to mitigate risk. While these methods demonstrate tremendous promise, mistakes and misguided use of these ERM methods may ironically instigate the very risks that the methods aim to prevent. The next Part considers state law approaches to agency issues arising in the context of ERM policymaking

II. State-Law Solutions to Risk Management Oversight

Corporate governance policies attempt to balance directors' and executive officers' accountability for corporate decisions with their authority to oversee the business of the corporation.[99] Section A of this Part argues that state statutory and common law are deferential to executives and directors and offer a weak mechanism for addressing conflicts related to ERM policies. Section B explains why state laws are and will likely remain friendly to executives and directors. This Part concludes that state corporate governance offers limited solutions for addressing ERM failures that arise from conflicts between directors' and executive officers' interests in ERM policies.

A. Fiduciary Duties – Directors' Oversight Liability

In a modern corporation, owners of the corporation, shareholders, do not manage the daily business and affairs of a business. State statutes grant directors the authority to manage the business of the corporation.[100] Typically, the board of directors of large corporations and almost all significant financial institutions include two classes of directors. Outside directors who have limited material relations to the company apart from their appointment to the board and inside directors who also serve as executive officers of the company and receive salary and other

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[95] *See e.g.*, Adam Nagourney, *Bracing for a Backlash Over Wall Street Bailouts*, N.Y. TIMES, Mar. 15, 2009, at A1; Nicholas von Hoffman, *AIG Bailout Sparks Taxpayer Anger*, THE NATION, Sept. 29, 2008.

[96] It is noteworthy that shareholders are not a homogeneous group. For a discussion of the divergent perspective of shareholders, see Johnson, *supra* note 11, at 188.

[97] *See* Edmund L. Andrews & Peter Baker, *A.I.G. Planning Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES, Mar. 14, 2009, at A1.

[98] *Id*.

[99] *See* STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 104 (2008); *See also* Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, 59 AM. J. COMP. L. 1, 8 (2011).

[100] *See* DEL. CODE ANN. tit. 8, § 141(a) (2010) (noting that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors"). The American Law Institute's Principles of Corporate Governance reflects similar designs. *See* AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 3.02(a)(2)-(3)(1992).

benefits from the company.[101] The board generally authorizes significant business polices, such ERM policies, and inside directors, executive officers who do not serve as directors, and employees execute business plans.[102]

Common law has long-described the relationship between directors and shareholders as a fiduciary relationship.[103] Courts characterize directors' fiduciary obligations as encompassing two duties, a duty of care, requiring directors to exercise case in avoiding harm to the corporation's interests, and a duty of loyalty, requiring directors to avoid self-dealing or, if conflicts of interest arise, to place the corporation's interests ahead of their own.[104]

Because of its prominent voice, Delaware's legal standards generally reflect the prevailing state law approach to corporate governance, including interpretation of directors' fiduciary obligations.[105] In recent years, however, Delaware courts have struggled to articulate clear standards explaining directors' liability for fiduciary obligations for corporate losses that arise from failed internal controls. Until the recent crisis, the oversight liability claims typically involved programs monitoring compliance with legal obligations or accounting policies.

In *Stone v. Ritter*, the Delaware Supreme court revisited its precedent examining director liability for corporate losses arising from inadequate oversight of a business's affairs.[106] In *Stone*, AmSouth Bancorporation's shareholders initiated claims arguing that directors breached their fiduciary duties by failing to monitor and detect employees' violations of federal and state banking laws. Responding to the persistent illegal activity and the resulting $50 million in fines and civil penalties, shareholders brought claims seeking to hold directors personally liable for these preventable corporate losses.

The *Stone* court began its analysis by inquiring about the appropriate characterization of the plaintiff's claims. Were plaintiffs' claims allegations that directors breached their duty of loyalty or their duty of care? In 1985, the Delaware Assembly amended its corporate governance statutes to add Section 102(b)(7) which permits shareholders to adopt clauses in their charters exculpating directors from duty of care claims *ex ante*.[107]AmSouth's charter included such a provision exculpating directors from duty of care claims.[108] Thus, the characterization of the shareholders claims would have been dispositive if the court described the claims as duty of care claims. The exculpation clause in AmSouth's charter precluded shareholders' claims. However, Section 102(b)(7) prohibits corporations from adopting language in their exculpation clauses that would limit directors' liability for the directors' failure to act in good faith or for breaches of their duty of loyalty. Therefore, if shareholders' claims alleged that directors' failed to act in good faith or breached their fiduciary duty of loyalty, the exculpating clause would not preclude shareholders' claims.[109]

Thus, the *Stone* court's analysis turned first to the issue of whether shareholders' claims should have been characterized as allegations that directors breached their duty of care, directors failed to act in good faith, or directors breached their duty of loyalty. To determine the

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[101] *See* tit. 8, § 141(e).
[102] Harner, *supra* note 12, at 48–49.
[103] *See* Pepper v. Litton, 308 U.S. 295, 306-07 (1939).
[104] FRANK GEVURTZ, CORPORATION LAW 278 (2d. West 2010).
[105] Mark Roe, *Delaware's Shrinking Half-Life*, 62 STAN. L. REV. 125, 133–35 (2009).
[106] *See* Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006).
[107] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2010).
[108] *Stone*, 911 A.2d at 369.
[109] *Id*.

appropriate characterization, *Stone* offered a curious interpretation of its previous decisions evaluating similar claims that directors' failed to comply with their oversight obligations.

The *Stone* court invoked its earlier decision in *Graham v. Allis-Chalmers Manufacturing Company* to explain the origin of oversight liability claims. The shareholders in *Graham* initiated derivative claims alleging that directors breached their fiduciary duties by failing to monitor, discover, detect, and prevent employees' illegal activities.[110] The shareholders argued that the corporation's payment of a substantial fine and four non-director employees indictment for violations of federal antitrust laws evidenced directors' failure to attempt to establish an internal reporting system to ensure compliance with antitrust laws.[111] However, the *Graham* court found that the directors had no actual knowledge of the illegal activities and explained that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."[112]

Stone next considered the Delaware Chancery Court's analysis of *Graham* in *In re Caremark*.[113] In 1994, Caremark International, Inc. ("Caremark") entered into a plea agreement with the Department of Justice and other federal agencies.[114] Caremark agreed to plead guilty to one felony count of mail fraud and to pay approximately $250 million in fines and penalties.[115] Responding to the significant fines and penalties, shareholders filed derivative lawsuits on behalf of the corporation seeking to recover the corporations' losses for its failure to comply with federal law.[116] The shareholders argued that directors' breached their fiduciary duties by allowing "a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance."[117]

Delivering the opinion in *Caremark*, Chancellor Allen interpreted *Graham* to mean that "absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf."[118] Directors do not have a duty to review fastidiously every detail of the corporation's operations.[119] However, the *Caremark* court concluded that *Graham* should not be read to mean that

> corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.[120]

Caremark then offered the critical connection between directors' oversight obligations and good faith. Chancellor Allen explained that a board must exercise good faith judgment in designing

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[110] *Id*.
[111] *Graham*, 188 A.2d at 127.
[112] Stone, 911 A.2d at 368 (citing *Graham*, 188 A.2d at 130 (emphasis added)).
[113] *In re Caremark Int'l Inc. Litig*., 698 A.2d 959, 960 (Del. Ch. 1996).
[114] *Id*.
[115] *Id*.
[116] *Id*.
[117] *Stone*, 911 A.2d at 368 (citing *Caremark*, 698 A.2d at 967).
[118] *Id*. at 967.
[119] *Id*.
[120] *Id*.

information and reporting systems that will provide the board with adequate and timely access to information regarding operations necessary for the directors to fulfill their oversight obligations.[121]

Caremark then explained that liability arises where directors know of employee misconduct and the board's failure to intervene is "sustained or systematic."[122] The standard of liability requires shareholders to demonstrate that directors "utter[ly] fail[ed] to attempt to assure a reasonable information and reporting system exist[ed]."[123] Shareholders who demonstrate directors' sustained, systematic, utter failure to implement a reasonable reporting system may argue that directors breached their obligation to act in good faith, a "necessary condition" to finding directors liable.[124]

After analyzing *Caremark*, *Stone* turned to its analysis in *In re Walt Disney & Co. Derivative Litig*., incorporated the final piece to the oversight liability puzzle.[125] *Disney* offered the applicable standard for acting in good faith, though its counter-intuitive, non-exhaustive list of examples describes behavior that cannot be deemed to constitute good faith [126] According to the *Disney* court,

> [a] failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.

When applied in the context of oversight liability, the third example in *Disney's* list of conduct that constitutes bad faith seems most relevant. The Stone court coupled *Disney's* good faith analysis with Caremark's monitoring analysis. Together the standards explain the type of conduct evidence that creates oversight liability.

In sum, shareholders must demonstrate that "(a) directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations" preventing directors from being informed of risks or problems that require their attention.[127] In addition, liability only follows if directors were aware of the fact that they were not discharging their fiduciary obligations. Directors may be liable if they consciously disregarding their responsibilities by failing to act where circumstances indicate a known duty to act or if they fail to act.

Reading Disney and Caremark together, the court opined that good faith is a "subsidiary element" or "condition" to alleging a breach of the duty of loyalty and a showing of good faith is required to assert a *Caremark* oversight liability claim.[128] Notwithstanding forty years of precedent analyzing oversight liability claims under the duty of care rubric, Stone subsumes oversight liability claims within the duty of loyalty framework. Why the sudden shift?

The reason for Stone's recharacterization of oversight liability claims is fairly clear. By describing oversight liability claims as duty of loyalty claims and requiring evidence that

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[121] *Id*.
[122] *Id*.
[123] *Id*.
[124] *Id*.
[125] *See* Anne Tucker Nees, *Who's The Boss? Unmasking Oversight Liability within the Corporate Power Puzzle*, 35 DEL. J. CORP. L. 199, 224–25 (2010).
[126] *See* In re Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. 2005).
[127] *Stone*, 911 A.2d at 370.
[128] *Id*.

directors failed to act in good faith, Stone resurrects oversight liability claims. Subsequent to the adoption of Section 102(b)(7) but prior to the *Stone*, it was unclear if the exculpation clauses that preclude shareholders' suits alleging a breach of directors' duty of care also precluded oversight liability claims. With its decision in Stone, the court indicates its sentiments that oversight liability claims offer an important mechanism in state corporation law's efforts to balance directors' accountability for corporate decisions and their authority to make those decisions.

Stone preserves shareholders' ability to use derivative suits to hold directors personally liable for corporate losses resulting from directors' failed oversight. While *Stone* resolved concerns regarding the viability of oversight liability claims generally, it was unclear whether *Stone* applied to shareholders' claims regarding a failure to oversee an important corporate issue resulting in significant losses if the issue was not subject to regulatory compliance. In other words, does *Stone* only apply if directors fail to comply with positive legal obligations. Having suffered significant losses when Citigroup nearly became insolvent during the recent crisis, Citigroup shareholders prepared to determine the limits of *Stone*.

B. The Case for Oversight Liability for Risk Management

In a novel claim initiated during the recent crisis, Citigroup, Inc.'s shareholders filed derivative suits seeking to apply *Caremark* and *Stone*'s oversight liability standard to corporate losses related to risk management policies that resulted in staggering financial losses. Prior to *In re Citigroup, Inc.*, courts imposed oversight liability in claims seeking to hold directors and officers liable for corporate losses resulting from failure to monitor compliance with existing federal or state law or failure to detect accounting irregularities.

Articulating their claims according to the standard for oversight liability adopted in *Stone*, *Citigroup* shareholders argued that directors and officers breached their fiduciary duties by (1) failing to adequately oversee and manage exposure to risk in the subprime mortgage market, and (2) failing to ensure adequate disclosure and financial reporting. Shareholders argued that directors ignored red flags that warned of the perilous consequences of wide-spread defaults in the subprime mortgage market, causing the company to experience devastating losses.[129] The opinion of the Chancery court addresses the claims in the context of defendant directors' motion to dismiss the claims.[130]

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[129] In re Citigroup S'holder Derivative Litig., 964 A.2d 106, 114 (Del. Ch. 2009).

[130] *Id.* at 112. *Citigroup* is a derivative suit brought by shareholders on behalf of the corporation seeking to enforce directors and officers fiduciary obligations. *Id.* at 111. Delaware requires plaintiffs bringing derivative suits to make demand on the board of directors, asking the directors to bring the claim and direct the litigation. Under Section 141(a) of Delaware General Corporations law, the board of directors exercises authority over the business and affairs of the corporation. *See* DEL. CODE ANN. tit. 8, § 141(a) (2008). The boards' authority includes the decision to initiate a law suit on behalf of the corporation. The procedural requirement for demand may be excused and plaintiff shareholders may proceed with their claims if they demonstrate that demand is futile. Common law provides that demand would be futile if plaintiffs may raise a reasonable doubt that "(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." Aronson v. Lewis, 473 A.2d 804, 814 (Del. 1983). Where shareholders' claims do not challenge a business decision, rather as was the case in *Caremark*, instead the complaint alleging that directors inaction breaches fiduciary obligations, then the plaintiff shareholders may demonstrate demand futility by pleading particularized facts that "create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment." Rales v. Blasband, 634 A.2d 927, 933–34 (Del. 1993). For a discussion of derivative suits and procedural obligations, see Frank Gevurtz, *The Role of Corporation Law in Preventing a Financial Crisis: Reflections on In re Citigroup, Inc. Shareholder Derivative Litigation*, 23 PAC. MCGEORGE GLOBAL BUS. & DEV. L. J. 113, 117 (2010).

Applying the *Caremark* standard affirmed in *Stone*, the *Citigroup* court examined the managers' decisions to determine if (a) directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee the operations of the systems.[131] As *Stone* clearly explained, shareholders had an obligation to demonstrate the directors knew that they were not discharging their fiduciary obligations or demonstrated a conscious disregard for their responsibilities by failing to act in the face of a known duty to act. As the court in *Citigroup* notes, "the test is rooted in concepts of bad faith; indeed a showing of bad faith is a necessary condition to director oversight liability.[132] Plaintiffs' ability to demonstrate either of these conditions offers evidence that managers were likely not informed of risks or problems that they are accountable to oversee and thus, are possibly liable for breaching their duty to monitor these matters.[133]

As the *Stone* court explained, the characterization of shareholders' claims significantly influenced the disposition of the litigation. Examining the claims, Chancellor Chandler explained that the shareholders' claims were merely assertions that directors' and officers' "failed to fully recognize the risks posed by subprime securities."[134] According to Chancellor Chandler, looking "past the lofty allegations of duties of oversight and red flags used to dress up these claims[,]" the shareholders claims aimed to hold directors personally liable "for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company."[135]

As a result of this characterization that shareholders claims merely question the merit of directors' and officers' business decisions, the court explains that the business judgment rule governs the analysis regarding liability. The business judgment rule is a rebuttable presumption that directors act on an informed basis, in good faith and in the honest belief that their actions are in the best interest of the company. The standard is highly deferential to prevent judges from engaging in hindsight bias. Therefore, rarely, if ever, are directors held liable for good faith business decisions when courts employ the business judgment rule. Moreover, even if shareholders' claims survived the high bar of the business judgment rule, Citigroup's charter contained an exculpation provision and absent evidence of bad faith as described in *Disney*, the provision served to preclude shareholders' claims.[136]

Notwithstanding its decision rejecting shareholders' claims on the grounds that the claims are properly characterized as duty of care claims subject to the business judgment rule and exculpated by Citigroup's charter, Chancellor Chandler examined shareholders' arguments that "red flags" identified in the complaint indicated defendants' failure to establish adequate oversight mechanisms or make a good faith effort to comply with the established oversight procedures.

Citigroup's shareholders argued that managers *knew* or *should have known* that certain business practices, particularly those relating to the bank's participation in the subprime mortgage market and the credit derivatives market, created the threat of debilitating enterprise risks.[137] As described in Part II, Citigroup had extensive exposure to the subprime mortgage

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[131] *Id.* at 123–24.
[132] *Citigroup*, 964 A.2d at 123 (citing *Stone*, 911 A.2d at 369).
[133] *Id.* at 123
[134] *Id.* at 124.
[135] *Id*.
[136] *Id*.
[137] *Id.* at 121–23.

market because of its sizeable collateralized debt obligation portfolio.[138] Citigroup amassed a $55 billion credit derivatives portfolio and ignoring warning by risk managers across the financial services industry about the dangers of these instruments. The resulting losses nearly collapsed the two-hundred year old financial institution.[139] Relying on the same facts to demonstrate both claims, shareholders presented an extensive enumerated list of "'red flags'. . . [that] should have given [directors and officers] notice of the problems brewing in the real estate and credit markets." [140] According to the shareholders' complaint, directors and officers ignored these warning in "pursuit of short term profit."[141]

According to the court, Citigroup's layered internal review policies and its long-standing executive risk management and credit committees undermined Citigroup plaintiffs' claims that the company lacked information systems and controls. [142] Citigroup plaintiffs' so-called red flags – media articles, economists' predictions about the market, credit rating agencies' decision to downgrade credit assets in Citigroup's portfolio or assets similar to those in Citigroup's subprime mortgage portfolio, continuing mark-downs of the value of Citigroup's portfolio offered no evidence of directors' intentional disregard of their oversight responsibilities.[143]

The reason for the careful review of the alleged red flags is not quite clear. Chancellor Chandler's earlier conclusions regarding the application of the business judgment rule and the exculpation clause each offered a reasonable basis for disposition of shareholders' claims. One commentator argues that Chancellor Chandler includes the discussion to "leave open the possibility that, in an appropriate case, a board might be subject to liability under Caremark for failing to monitor the corporation's business risk."[144] A signal that "Caremark claims founded on alleged failures by the board to monitor the company's business risk"[145] are not barred as a matter of law is critical to any potential for state corporate governance to offer any mechanism for shareholders to hold directors liable for risk-taking decisions.

In the absence of an open window for accountability claims under state corporate governance for ERM failures, there may be limited mechanisms for shareholders to hold directors accountable for their aggressive risk-taking decisions. When one couples the technological and innovative developments in financial products and conflicting interests related to executive compensation described in Part I with the Delaware courts' high bar limiting shareholders' ability to succeed in claims alleging ERM failures, the resulting accountability standard is sobering. As Chancellor Chandler notes

> "[t]he presumption of the business judgment rule, the protection of an exculpatory [Section] 102(b)(7) provision, and the difficulty proving a *Caremark* claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk."[146]

The lack of accountability for ERM failures leaves shareholders vulnerable to managerial abuses of authority. Moreover, noting that Congress and federal regulators are often reticent to adopt corporate governance measures, in the absence of an effective state corporate governance

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[138] *See supra* Part I.B. and C.
[139] *Citigroup*, 964 A.2d at 115 n.6.
[140] *Id.* at 124.
[141] *Id.* at 111.
[142] *See id.* at 127.
[143] *Id.* at 128.
[144] Robert T. Miller, *The Board's Duty to Monitor Risk After Citigroup*, 12 U. PA. J. BUS. L. 1153, 1159 (2010).
[145] *Id*.
[146] *Citigroup*, 964 A.2d at 125.

mechanism, shareholders may not have an appropriate tool through which they may obtain justifiable relief for aggressive, self-interested excessive risk taking by directors and officers.

C. State Law Standards Likely To Remain Manager-Friendly

1. Racing to the Bottom, Racing to the Top

Delaware courts do not operate in a vacuum; the relationship between Delaware courts and legislature with the businesses incorporated with the state influences the contours of Delaware's corporate law. Delaware adopts manager-friendly corporation law to appease its corporate constituents and dissuade them from moving to other states where corporation laws may offer more liberal accountability standards.

Scholars posit that a charter market race began in the late nineteenth century as states competed to attract business to incorporate in their jurisdictions.[147] Liberalizing accountability standards offers states a critical tool for attracting corporations to their jurisdiction. Directors typically make the decision regarding where the business incorporates or re-incorporates and a liberal or manager-friendly accountability standard makes a state more attractive to corporations. Directors typically elect to incorporate in states that strategically adopt management-friendly laws. Aware that directors are influenced by the rigor of state corporation law enforcing fiduciary liability and other significant governance matters, some scholars argue that the competition results in a race to the bottom.

Interpreting the competition, some theorists view the competition as engendering positive outcomes while others question the impact of competition.[148] William Cary, for example, posited that states' competitive efforts to adopt laws that increasingly favor management result in the erosion of shareholder protections and weaken shareholders' legal remedies to enforce managers' fiduciary obligations.[149] In contrast, Ralph Winter argued that charter competition is healthy. Competition invites states to craft innovative solutions to the conflicts that arise between shareholders and directors and officers. States, according to Winter, offer laboratories of experimentation creatively addressing difficult questions and offering a diverse solutions.

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[147] As the first state to commercialize its charter business, New Jersey, had an initial lead in the charter competition race. *See generally* Charles M. Yablon, *The Historical Race: Competition for Corporate Charters and the Rise and Decline of New Jersey: 1880-1910*, 32 J. CORP. L. 323 (2007). New Jersey became increasingly industrial and less concerned with managers' preferences. *Id*. As New Jersey legislation became increasingly restrictive, other states recognized the tension between corporate managers' preferences and New Jersey's indifference as an opportunity to gain a toehold in the market for corporate charters. *Id*.

[148] The state charter competition debate raises issues commonly discussed in literature examining the benefits or costs of state regulation of matters of national concern. Examples of other areas that influence or adopt arguments from the corporations charter competition debate include environmental protection law. *See e.g*., Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race to the Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1235 (1992); Daniel C. Esty, *Revitalizing Environmental Federalism*, 95 MICH. L. REV. 570, 633–34 (1996); *see* David A. Skeel, Jr., *Lockups and Delaware Venue in Corporate Law and Bankruptcy*, 68 U. CIN. L. REV. 1243, 1270–79 (2000); limited liability company law, *see* Larry Ribstein, *Statutory Forms for Closely-Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 396–403 (1995) (comparing the dynamics of competition for incorporations by public companies and competition for incorporations by limited liability companies); and tax law, *see* Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 380 (1996).

[149] See WILLIAM W. COOK, A TREATISE ON STOCK AND STOCKHOLDERS 1604–05 (3d ed. 1894) ("federalism in corporate law in the United States is driving some states to liberalize their corporate statutes"). *See, e.g.*, Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1441 (1992); Cary, *supra* note 156.

Moreover, theorists argue that investors know about the jurisdiction gaming and may "vote with their feet" by exiting businesses incorporated in states that lack well-balanced, efficient, and effective corporate governance limitations.[150]

Second, the benefits that states receive if they are successful in the corporate charter competition create incentives for states to remain competitive. Initial filing fees and annual franchise tax revenues can generate noteworthy financial incentives for states to compete.[151] According to one study, in 2005, Delaware obtained $523 million or one-fifth of the state's tax revenues from corporation franchise taxes. [152]

Third, the tax revenues also create incentives for policy makers to maintain manager-friendly corporate law standards.[153] Delaware's small bar is comprised of wealthy, well-connected lawyers.[154] The bar is very well-organized and often includes many members of the Delaware Assembly, including members who participate in the drafting of Delaware's state laws.[155] As a result of the organized, well-mobilized interest groups favoring liberal corporate governance standards in states like Delaware, theorists argue that the boundaries of corporate governance are subject to regulatory capture. Commentators contend that the Delaware bar, motivated by professional fees earned by local lawyers and administrators, participates and the highly-organized and wealthy lobby that strongly influences Delaware's statutory corporate governance provisions and by extension the courts' interpretations corporate governance standards.[156] The adoption of Section 102(b)(7) by the Delaware Assembly illustrates the concerns that trouble the critics of competition. The amendment permitting corporations to include exculpating provisions in their charters was a swift, unabashedly clear response to a Delaware Supreme Court decision imposing fiduciary liability on officers and directors.

2. With Only One Runner in the Race, Picking the Winner Is Easy

Theorists Marcel Kahan and Ehud Kamar recently challenged prevailing views that argue that the charter market is characterized by horizontal competition. Kahan and Kamar posit that

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[150] *See, e.g.*, Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 915 (1982); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 280–81 (1985); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

[151] *See, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 15–16 (1993); Bebchuk, *supra* note 149, at 1441; Black *supra* note 156, at 548-49; Cary, *supra* note 156; Coffee, *supra* note 156, at 650; Macey, *supra* note 156, at 195.

[152] Ehud Kamar, *Beyond Competition for Incorporation*, 94 GEO. L.J. 1725, 1744, n. 99 (citing An Act Making Appropriations for the Expense of the State Government for the Fiscal Year Ending June 30, 2005, S.B. 320, 142nd Gen. Assem., at 4, 19 (Del. 2004), *available at* http://www.state.de.us/budget/budget/fy2005/fy2005-sb320-budget-bill.pdf; STATE OF DEL., OFFICE OF THE GOVERNOR, POLICY AND FINANCIAL OVERVIEW: FISCAL YEAR 2005, at 12 (Jan. 29, 2004), http://www.state.de.us/budget/budget/fy2005/misc/FinancialOverview.pdf.

[153] Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 506 (1987).

[154] *Id*.

[155] *Id*.

[156] *See, e.g.*, ROMANO, *supra* note 150 at 15–16 (1993); Bebchuk, *supra* note 149, at 1441; Black, *supra* note 153, at 548–49; Cary, *supra* note 153, at 663; Coffee, *supra* note 153, at 650; Macey, *supra* note 153, at 195. *See also* Lucian Bebchuck & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L. J. 553, 588 (2002).

competition data misconstrues states' incentives to compete.[157] According Khan and Kamar, empirical evidence clearly indicates that one state's prominent voice in the articulation of corporate law dismantles the race debate and illustrates that states are not competing with each other in the charter market.[158]

Even if states are competing with one another, these theorists claim they are not competing with the clear frontrunner. Nearly fifty percent of businesses incorporate in Delaware.[159] Ninety-seven percent of publicly-traded businesses in America are incorporated in either Delaware or their home jurisdiction.[160] Eighty-five percent of businesses that change the jurisdiction of their charter reincorporate in Delaware.[161] Although the market turmoil that began in 2007 promoted some reform efforts,[162] as one theorist explains "firms either stay put in their home state or move to Delaware. There is no third state that corporate players regularly consider."[163] Professors Khan and Kamar argue that Delaware enjoys a near monopoly in the corporate charter market.[164] Dispelling the myth of horizontal competition, Kahan and Kamar argue that Delaware's substantial lead in the charter market race discourages other states from competing.

Whether there is a race or true competition, the influence of Delaware's statutory and common law precedent on states' approaches to corporate governance is indisputable. Thus, Delaware's prominence and its jurisprudence play a uniquely significant role in articulating the corporate governance standards applied to directors. Considering the recent *Citigroup* case and the ambiguity of the court's decision in light of Delaware's dominance, it is fairly safe to say that no other state is likely to adopt an accountability standard that creates lower hurdles for shareholders seeking to hold directors liable for ERM failures.

The *Citigroup* decision and regulatory capture of the states' policymakers suggest that no Delaware authority will likely act in a manner that does more than acknowledge the possibility of director accountability for ERM failures. For if Delaware courts should adopt a rule granting shareholders greater leniency in the pleading standards for claims alleging oversight liability for

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[157] *See* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L *See, e.g.*, ROMANO, *supra* note 160 at 15–16 (1993); Bebchuk, *supra* note 149, at 1441; Black, *supra* note 153, at 548–49; Cary, *supra* note 153, at 663; Coffee, *supra* note 153, at 650; Macey, *supra* note 153, at 195. *See also* Lucian Bebchuck & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L. J. 553, 588 (2002).. REV. 679, 684–85 (2002). Mark Roe, *Delaware's Shrinking Half-Life*, 62 STAN. L. REV. 125, 133–35 (2009).

[158] Kahan and Kamar, *supra* note 157, at 684–85.

[159] *See* Delaware Division of Corporations, CORP.DELAWARE.GOV, http://www.state.de.us/corp/index.htm (last updated Mar. 2011) ("More than 850,000 business entities have their legal home in Delaware including more than 50% of all U.S. publicly-traded companies and 63% of the Fortune 500"). Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 845 (1993) (stating that roughly half of the largest industrial firms are incorporated in Delaware).

[160] Roe, *supra* note 157, at 127

[161] *Id.*

[162] In 2008, a group of shareholder activists led by Carl Ichan approached the state of North Dakota and prompted the state to enact "the nation's most shareholder friendly corporate-governance law" prior to the adoption of the Dodd-Frank Act. Cari Tuna, *Shareholders Ponder North Dakota Law*, WALL ST. J., Dec. 8, 2009. The law offers a package of rules that companies that incorporate in North Dakota may adopt including annual election of all directors instead of the staggered boards popular among Delaware corporations, "requiring an annual shareholder advisory vote on executive pay [,] . . . naming a chairman who isn't an executive." *Id*. As a result, Delaware's actions are constrained by the potential competition in the market.

[163] Roe, *supra* note 157, at 127.

[164] *Id.* at 127 (noting that some "states have 'toe-holds'—holds on an important element for state competition, despite the fact that the state lacks the full panoply of what's needed to compete").

ERM failures, the legislature may quickly act to undercut the lenient standard. There are, of course, other sources of corporate law and in response to the crisis, it appears that Delaware's sensitivity to regulatory capture did not prevent the other sources from inquiring into the incentives that may have motivated aggressive risk-taking and business decisions that led to ERM failures. While an important source of corporate law, the states are not the only source of corporate law. The next Part explains that competition from federal lawmakers and regulators may dethrone Delaware from its coveted position as the king of the corporation law hill.

III. Well-crafted, Better-drafted?: Federal Regulation of Risk Management Through Disclosure and Substantive Corporate Governance Reforms

As a result of the limited state law mechanisms, this Part explores the ERM reforms that Congress implemented in response to the financial crisis. Section A contends that during periods of market disruption, Congress and federal regulators routinely adopt legislation designed to address the underlying issues and prevent future crises. Section B argues that legislation adopted to buttress several failing systemically significant financial institutions represented Congress's most pervasive corporate governance regulatory efforts. Section C contends that Congress's adoption of the Dodd-Frank Act converts the crisis-initiated reforms into permanent risk management.

A. Delaware's True Competition

If theorists who dismiss horizontal competition are accurate, does Delaware win the prize for being the most significant source of corporate governance, and if so, what are the normative implications of Delaware's victory? Federal lawmakers and regulators represent Delaware's true competition in the race to asset preeminent corporate governance policies.[165]

History indicates that the federal government typically intervenes in the corporate governance sphere during periods of market disruption or pervasive fraud scandals.[166] Indeed, until after the stock market crash of 1929 leading to the New Deal response, Congress had rarely intervened in states' regulation of corporations.[167] The pervasive fraud that instigated a crisis of confidence and lead to the stock market crash, also prompted Congress to adopt the Securities Act of 1933 ("Securities Act") and the Exchange Act of 1934 ("Exchange Act").[168] These two acts and their mandatory disclosure obligations comprise the centerpiece of federal securities regulations. Prior to the adoption of federal securities laws, state legislatures enacted local laws to prevent fraud in connection with the securities transactions in their respective jurisdiction.[169]

Drafters of the Exchange Act included Section 14 among the statute's provisions in an effort to address perceived imbalances in the relationship between shareholders and directors and officers who manage the corporation. Section 14 permits shareholders to include proposals in

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[165] Mark J. Roe, *Washington and Delaware as Corporate Lawmakers*, 34 DEL. J. CORP. L. 1, 17 (2009).
[166] Cox, Hillman, Lagevoort, Securities Regulation
[167] Roberta Romano, , *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance* , 114 YALE L.J. 1521, 1585 (2005).
[168] *See generally* Securities Act of 1933, 15 U.S.C. § 77(a)-(aa) (2011); Securities Exchange Act of 1934, 15 U.S.C. § 78(a)-(oo) (2011).
[169] Cox, Hillman, Lagevoort, Securities Regulation

annual proxy statements delivered to all shareholders in advance of the annual shareholder meeting.[170] For decades after the adoption of Section 14, Congress's foray into the corporate governance was limited. The accounting scandals at Enron, Worldcom and Tyco marked a watershed moment in the government's reach into corporate governance.[171] Adopting the Sarbanes-Oxley Act (SOX) in 2002,[172] Congress enacted a wave of disclosure reforms and expressly supplanted states' authority related to certain elements of corporate governance.

SOX purposefully enhanced the mechanisms at shareholders disposal under federal law for enforcing directors' and officers' accountability for corporate oversight of accounting policies and their responsibility to develop internal controls to detect accounting irregularities. Section 301 of SOX requires the board of directors of publicly-traded corporations to appoint an audit committee and empower the committee to appoint an auditor, to oversee the auditor's execution of its duties, and to adopt whistleblower-like policies for reporting of questionable accounting practices.[173] The audit committee must be comprised of only independent board directors.[174] Congress unapologetically announced its intentions to intrude in the corporate governance sphere with these few non-disclosure reforms intended to influence the balance of power between shareholders and directors and officers.

B. Federal Risk-Management Reforms

The recent financial crisis evoked many similar popular sentiments regarding financial market participants, but one significant element distinguished the events of the market disruption and created a stumbling block for reformers.[175] The ERM failures, errors and mistakes that initiated the recent crisis did not reflect the intentional deception of the accounting scandals. Yet, one common thread runs through both the accounting scandals and the events of the recent crisis. Long-term shareholders' interests and directors' and officers' interests were not aligned with regard to risk management policies.

1. Emergent Reforms Adopted During the Crisis

At the height of fear and panic during the crisis Congress hurriedly adopted emergency systemic risk and risk management reforms. On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act (EESA) [176] and the granted the Department of Treasury (Treasury) the authority to create the Troubled Asset Relief Program (TARP) to purchase "toxic"

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[170] BERLE & MEANS, *supra* note 29.
[171] *See* Romano, *supra* note 167; William S. Laufer, *Illusions of Compliance and Governance*, 6 CORP. GOVERNANCE 239, 239 (2006); Cindy A. Schipani, *The Future of the Attoyney-Client Privilege In Corporate Criminal Investigations*, 34 DEL. J. CORP. L. 921, 922–24 (2009); Joseph Nocera, *For All Its Cost, Sarbanes Law Is Working*, N.Y. TIMES, Dec. 3, 2005, at C1.
[172] Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified as scattered sections of 11, 15, 18, 28 & 29 U.S.C.) (2006).
[173] Sarbanes-Oxley Act § 301, 15 U.S.C. § 78j–l (20011).
[174] *Id*.
[175] David Wessel, *Blasting the Bailout Blues*, WALL ST. J., May 13, 2010, at A2; Andrew Ross Sorkin, *Extreme Makeover Wall Street Edition*, N.Y. TIMES, Apr. 1, 2010, at F1.
[176] Emergency Economic Stabilization Act of 2008 § 101(a)(1), Pub L No 110-343, 122 Stat. 3765 [hereinafter EESA].

assets from financial institutions.[177] The Treasury promptly changed the focus of TARP from purchasing poorly-performing debt instruments to direct capital investments.[178] Under the Capital Purchase Program ("CPP"), Treasury purchased non-voting, senior preferred shares and equity warrants convertible into shares of the TARP recipients' common stock.[179]

Through the programs' conditions, Congress imposed four corporate governance reforms on TARP recipients.[180] The reforms limit compensation arrangements to prevent senior executive officers (SEOs) from taking unnecessary and excessive risks that threaten the viability of the financial institution; require TARP recipients to recover bonus compensation paid to an SEO based on earnings, gains or financial disclosures determined to be materially inaccurate ("clawback"); prohibit golden parachute payments to any SEO while TARP obligations remain outstanding; and limit tax deductibility of executive compensation for TARP recipients who receive exceptional assistance.[181]

Concerns about the interplay between the issues escalated in early 2009 when TARP recipients announced intentions to pay out record bonuses from a pool of assets that commingled federal funds and the businesses revenues. Citigroup, after suffering more than $27.7 billion in losses and soliciting the government for $45 billion in TARP financial assistance, announced intentions to pay 738 employees bonuses of at least $1 million in the same year that the financial institution reported over.[182] Despite being the recipient of $170 billion in federal assistance, AIG also agreed to pay $165 million in "performance bonuses" to the company executives.[183] On February 17, 2009, Congress swiftly responded, amending the EESA and adopting the American Recovery and Reinvestment Act ("ARRA").[184] Congress pressed further into the substantive elements of corporate governance and adopted several reforms that would become the most controversial provisions in the Dodd-Frank Act.

The EESA and the ARRA faced one significant limitation in their efforts to initiate permanent reforms to address the imbalances between long-term shareholders interests and the directors' and executive officers' incentives to engage in risk taking. The reforms had a clear sunset provision that limited their influence to the period of time that a TARP recipient's repayment obligations remained outstanding. To ensure that long-term influence of reforms related to the incentives that instigated the recent financial crisis, Congress adopted the fourth major pillar in the federal securities regulatory regime.

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[177] *See* Lori Montgomery & Paul Kane, *Bush Enacts Historic Financial Rescue: House Passes Plan By Wide Margin, But Stocks Keep Falling*, WASH. POST, Oct. 4, 2008, at A1.

[178] U.S Dep't of Treas., *Treasury Announces TARP Capital Purchase Program Description*, Oct. 14, 2008, *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp1207.aspx.

[179] American Recovery and Reinvestment Act of 2009, Pub. L. 111-5, § 7001(a)(2) (codified at 12 U.S.C. § 5221(a)(3) (2011)) [hereinafter ARRA].

[180] *Id. at* § 111(b)(1).

[181] EESA, *supra* note 176, at § 111(b)(2)(C); *see also* 73 Fed. Reg. 62,205, at §§ 30.8, 30.9.

[182] ANDREW M. CUOMO, NO RHYME OR REASON: THE 'HEADS I WIN, TAILS YOU LOSE' BANK BONUS CULTURE 5 (2009), *available at* http://www.ag.ny.gov/media_center/2009/july/pdfs/Bonus%20Report%20Final%207.30.09.pdf.

[183] Edmund L. Andrews & Peter Baker, *A.I.G. Planning Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES, Mar. 14, 2009, at A01, *available at* http:// www.nytimes.com/2009/03/15/business/15AIG.html. The bonus announcements instigated a tremendous public backlash.

[184] American Recovery and Reinvestment Act, Pub. L. 111-5, 123 Stat. 115 (codified in scattered sections of 12 U.S.C.) [hereinafter ARRA].

2. The Dodd-Frank Act: Federal Corporate Governance Reform of Risk Management Oversight

On July 21, 2010, Congress enacted the Dodd-Frank Act.[185] One of the most sweeping regulatory acts adopted in the last seventy years, the Dodd-Frank Act enhances disclosure-oriented and substantive elements of corporate governance and securities regulation. The Dodd-Frank Act provisions impact not only TARP recipients, but certain financial institutions as well as al companies subject to Exchange Act periodic reporting requirements and all systemically significant institutions and financial institutions.[186] The reforms comprise a rare shift in the relationship between shareholders and the executive officers and directors of the companies subject to the legislation.[187]

a. Disclosure-Oriented, Stakeholder-Centered Reforms

In many respects the risk management reforms adopted in the Dodd-Frank Act are consistent with traditional approaches to securities regulation. Several provision of the Dodd-Frank Act emphasize the importance of disclosure in reducing the asymmetries of information between executives and officers, whose positions offer intimate knowledge of a business's strengths and weaknesses, and existing shareholders or potential investors. Among the more controversial disclosure provisions, Section 956 of the Dodd-Frank Act requires financial institutions to disclose incentive-based executive compensation arrangements and prohibits incentive-based executive compensation arrangements that encourage excessive risk taking or that may lead to a material financial loss.[188]

Consistent with the statute's risk-mitigating objectives, Dodd-Frank amends Section 14 of the Exchange Act and enhances proxy statement disclosure obligations for reporting companies.[189] While the Exchange Act required certain general executive compensation disclosures prior to the adoption of the Dodd-Frank Act, the newly introduced reforms require reporting companies to disclose the relationship between the company's equity shares' performance and the CEO's compensation ("pay versus performance").[190] Moreover, the reforms also require a description of the median annual compensation of all employees compensation (excluding compensation paid to the CEO), the annual total compensation paid to the CEO, and a ratio comparing the latter two measures.[191] Additional amendments to Section 14 enhance the disclosure obligations related to incentive-based executive compensation arrangements related to a merger or acquisition.

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[185] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong.,-(2010) [hereinafter Dodd-Frank Act].

[186] There are three types of companies subject to the periodic reporting requirements in the Securities Exchange Act of 1934. Companies whose securities trade on a national securities; companies with more than $10 million in assets and a class of equity securities held by at least 500 persons; and companies who filed a registration statement under Section 5 of the Securities Act of 1933 that has become effective. Security and Exchange Act of 1934, Section 12(b),(g); Rule 12g-1; and 15(d). The term "reporting company" describes any company that is subject to reporting requirements under federal securities law.

[187] *See generally* Dodd-Frank Act, *supra* note 185.

[188] Dodd-Frank Act, *supra* note 185, at § 951(a)(i) (codified at 15 U.S.C. § 78 (n)(i)).

[189] Dodd-Frank Act, *supra* note 185, at § 953(a)(i) (codified at 15 U.S.C. § 78 (n)(i)).

[190] Dodd-Frank Act, *supra* note 185, at § 953(a)(i) (codified at 15 U.S.C. § 78 (n)(i)).

[191] Dodd-Frank Act, *supra* note 185, at § 953 (codified at 15 U.S.C. § 78n(i)).

Acknowledging the increasingly significant role of derivatives in financial markets, Section 955 amends Section 14 of the Exchange Act to require reporting companies to disclosure the companies policy regarding employees, executives and directors' use of derivatives or other financial products designed to hedge their exposure to a decline in the value of the company's share.[192] In addition, requires companies to disclose whether the company permits one person to serve as CEO and chairman of the board of directors.[193] Finally, reporting companies must disclose whether the company has adopted policies to recover incentive-based compensation awarded on the basis of accounting statements that contain errors which enhanced the relevant compensation awards. [194]

On the one hand, the reforms offer great promise.[195] Managing the incentives of executives through executive compensation policies offers a critical tool in the successful management of financial institutions' risk exposure.[196] When compensation arrangements are structured without sufficient care the arrangements may create incentives for executives and other employees to engage in imprudent and excessive risk-taking that is inconsistent with the long term health of the business.[197] The enhanced disclosure mandates patently indicate that regulators perceive disclosure to offer an effective deterrent to compensation policies that intentionally incite executives' to take excessive risks. The disclosures also reduce the asymmetries of information and agency costs that commonly stymie investors informed participation in financial markets. The disclosures strengthen the integrity of the market place and coupled with the other benefits foster greater stability and militate against systemic risks.

On the other hand, the reforms are quite obviously limited in comparison to the magnitude of the recent crisis. The reforms completely disregard significant organizational realities. There are three classes of insiders - inside directors who are both directors and executive officers of the company, executive officers and employees. Reforms should have addressed the conflicts between the interests of each of these groups and shareholders' interests.

For example, the executive compensation disclosure reforms may influence conflicts of interest between executives and shareholders regarding risk taking. However, the board of directors generally adopts formal risk management policies and sets the parameters for executives' actions. While there are inside directors who occupy a seat in the board room and are best positioned to influence ERM policies to enhance their chances of increasing compensation, these individuals are typically not the majority of the of the members of the board. The majority of the members of the board of directors of companies whose securities are publicly-traded, including the large systemically significant financial institutions, are independent.

Moreover, Congress's election to increase disclosure requirements is not without costs. Compliance with disclosure reforms is expensive. Commentators note that say-on-pay votes significantly increase corporations' proxy expenses and add to the already noteworthy time managers commit to preparation of reporting companies' proxy statements and annual reports. An entire body of literature critiques the expenses of SOX and the threat that the expenses

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[192] Dodd-Frank Act, *supra* note 185, at § 955 (codified at 15 U.S.C. § 78 (n)(i)).
[193] 15 U.S.C. § 78n-2
[194] 15 U.S.C. § 78j-4.
[195] For a more comprehensive discussion of the mandatory disclosure debate, see Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669 (1984).
[196] Proposed Rule to Implement Section 956 of the Dodd-Frank Act *available at* http://www.sec.gov/spotlight/doddfrank956proposedruledraft.pdf
[197] Proposed Rule to Implement Section 956 of the Dodd-Frank Act *available at* http://www.sec.gov/spotlight/dodd-frank/956-proposedrule-draft.pdf.

created for the competiveness of the U.S. securities markets.[198] In addition, disclosure requirements are subject to inherent limitations. Disclosure is subject to manipulation and little evidence supports the assumption that additional disclosure enhances an investor's decision-making process. Fortunately, Congress had a second tool available to address risk management concerns, substantive corporate governance reforms.

b. Much Ado About Nothing: Substantive Governance Reforms

Many of the disclosure mandates in Dodd-Frank are accompanied by a parallel substantive corporate governance reform that changes a structural or organizational element of corporate governance. For example, the incentive-based disclosure requirement in Section 956 also prohibits financial institutions from adopting incentive-based compensation policies that encourage excessive risk taking or that may lead executives to take risks that lead to material financial losses.

The "say-on-pay" mandate accompanying executive compensation disclosures in Section 951 requires reporting companies to include a resolution in their annual proxy statements that grants shareholders the authority to participate in an advisory, non-binding vote on executive compensation awards. [199] In addition, reporting companies must include a resolution indicating whether votes on the say on pay resolutions will occur every one, two, or three years and a resolution on the frequency of the say-on-pay votes at least once every six years. [200] Finally, Section 951 requires a non-binding, advisory shareholder vote on any golden parachute arrangements related to mergers and acquisitions.[201]

In addition to the express voting rights, the reforms require companies subject to the Act to appoint only independent directors to the compensation committees of the board of directors. Compensation committees are expressly authorized by the statute to determine the salaries of executives, the board of directors and all of the other employees of the company.[202] The statute directs national securities exchanges to revise their listing criteria to require that compensation committee members include only independent directors.[203]

Accompanying disclosure requirements related to clawback policies, Section 954 requires companies whose shares are listed on a national exchange to adopt "clawback" policies. The policies allow recovery of income from any current or former executive officer if the company is required to restate its accounting disclosures due to material non-compliance with federal financial reporting obligations for the three-year period following the date the financial disclosures are filed.[204]

Proxy access granted to shareholders under Section 971 represents one of the most controversial substantive reforms adopted in Dodd-Frank.[205] The SEC's recently adopted Rule

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[198] INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (DEC. 2006).
[199] The Securities Exchange Act of 1934, § 14A(c), 48 Stat. 881(1934) [hereinafter Exchange Act].
[200] 15 U.S.C. § 78n-1 (2011).
[201] Exchange Act, *supra* note 199, at § 14A(b)(1).
[202] *See generally* 15 U.S.C. § 78j-3.
[203] 15 U.S.C. § 78j-3(f).
[204] 15 U.S.C. § 78j-4(b)(2) (2011).
[205] The provision also allows the SEC to exempt certain companies from the proxy access requirements. In re Motion of Business Roundtable and the Chamber of Commerce of the United States of America, Order Granting Stay, Securities Act of 1933 Release No. 9149, Securities Exchange Act of 1934 Release No. 63031, Investment

14a-11 now requires companies to include shareholders' nominees along with the incumbent directors and managements' nominees for the board of directors.[206] The final Rule 14a-11 allows shareholders to nominate board candidates for election if the shareholder owns at least three percent of the company's shares and has continuously owned at least three percent of the company's shares for the prior three years. While companies subject to the rule are not able to opt-out, the proposed rule does not apply if a company's bylaws or state law prohibits shareholders from nominating directors. Under the proposed rule, shareholders would be able to nominate the greater of one nominee or up to 25% of the total board seats.[207]

Commentators express skepticism about how effectively Dodd-Frank's substantive reforms will improve enterprise risk management. The shareholder-centric substantive provisions influence the overall balance of power between shareholders and directors and officers. It is unclear, however, that these reforms will impact risk management in the manner that Congress anticipates or even reform the substance of the specific corporate governance issues identified in the statute.

For example, presumably, say-on-pay votes give shareholders a prominent voice in determining executive compensation – an area identified as troublesome because of the risk-taking incentives that compensation creates. Yet, the say-on-pay vote is merely advisory and nonbinding; thus, it does not genuinely shift authority over executive compensation to shareholders. In this respect, the provision is largely symbolic.

Moreover, empirical studies cast further doubt on the efficacy of say-on-pay reforms. Empirical studies evaluating say-on-pay vote policy adopted in other jurisdictions suggest that increasing shareholder participation rights does not necessarily lead to more meaningful shareholder participation.[208] Jeffrey Gordon's study examining the effects of "say-on-pay" arrangements in the U.K. suggests that the influence of shareholder approval votes on executive compensation is limited, at best. Though there is some evidence that the introduction of say-on-pay votes encourage the growth of long-term incentive compensation plans, generally shareholders almost always approve proposed executive compensation packages.[209] It is even less clear that say-on-pay votes yield the most critically presumed benefits – enhanced risk management oversight.

Moreover, examination of the requirement that the members of compensation committees include only independent board members also fails to represent a radical requirement and offers little evidence of the presumed risk reduction benefits. In the first instance, the national securities exchanges already introduced listing standards that provide for listed companies ensure that the majority of members of the compensation committee or all of the members are independent.[210]

Company Act of 1940 Release No. 29456 (Oct. 4, 2010), *available at* http://www.sec.gov/rules/other/2010/33-9149.pdf.

[206] A shareholder must own at least 3 percent of the company's shares at the time that she proposes director nominees and she must have owned 3 percent of the company's shares for the period beginning three years prior to the submission of the nominees and the submission of the director nominees for inclusion in the proxy statement.

[207] Under the proposed Rule 14a-18, a shareholder must file a Schedule 14N with the SEC no earlier than 150 days and no later than 120 days prior to the anniversary of the mailing date for the company's definitive proxy statement in the previous year.

[208] Stephen M. Bainbridge, *Is 'Say On Pay' Justified?*, 32 REGULATION 42, 45 (2009).

[209] David McCann, *Say What? The Battle Over Executive Comp*, CFO.COM, (June 4, 2008), http://www.cfo.com/article.cfm/11485334/c_2984338/?f=archives.

[210] *See* New York Stock Exchange, Listed Company Manual § 303A.01(2009), *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F; NASDAQ; NASDAQ Listing Rule § 5605(d) (2009), *available at*

Section 303A.01 of the New York Stock Exchange Listed Companies Manual requires listed companies to appoint a compensation committee comprised entirely of independent directors. Under Section 5605(d) of the NASDAQ listing standards only a compensation committee that is wholly independent or majority independent may determine executive compensation.[211] Moreover, the exchange rules also offer detailed explanations regarding the committees' responsibilities. Thus, the exchanges had already adopted these provisions that Dodd-Frank Act announces as federal regulation of corporate governance.[212]

Professor Lisa Fairfax offers thoughtful reflections regarding the elusive definition of "independence" and the significant biases that limit directors from acting in a manner that is genuinely consistent with a theoretical definition of independence.[213] Moreover, the results of empirical studies regarding the influence of independent directors support and reject, depending on the specific issue examined, the conclusion that independence matters.[214] More importantly for addressing the causal factors underlying the recent financial crisis, there is no evidence to suggest that the independent compensation committee will ensure better risk management.[215]

The proxy access reforms offer are similarly disappointing. Presumably adopting proxy access presumably allows shareholders to exercise greater authority in electing directors who appoint managers. Considering empirical studies that examine individual shareholders' participation in director elections in comparison to the influence of shareholder-activists, institutional investors, and labor-affiliated groups reveals the weaknesses in the statute's premises.[216] Empirical studies suggest that in contests, incumbent directors will grant concession to shareholders in order to retain their board seats. Moreover, proxy campaigns are expensive and difficult to mount. As a result, even if shareholders under the Dodd-Frank Act will have access to nominate directors, the probability that shareholders will succeed in getting their candidates elected presents another set of challenges.[217] It is unlikely that shareholders will succeed in getting enough candidates elected to capture a majority or even a significant minority of seats on the board. Shareholders selective targeting of directors also suggests that their efforts will not prompt a removal of the entire board in any given election or even a significant number of incumbent directors. Commentators expect proxy access to have only an indirect impact on risk management.[218]

As one commentator notes, the adoption of long-debated reforms that will likely have limited impact on the relationship between shareholders and directors and executives of the company

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http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_2&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F.

[211] NASDAQ; NASDAQ Listing Rule § 5605(d) (2009), *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_2&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F.

[212] Dodd-Frank Act, *supra* note 185, at § 952.

[213] Lisa Fairfax, *The Uneasy Case for Inside Directors*, 96 IOWA L. REV. 127, 175 (2010).

[214] *See* Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 924-26 (1999); Eliezer M. Fich & Lawrence J. White, *CEO Compensation and Turnover: The Effects of Mutually Interlocked Boards*, 38 WAKE FOREST L. REV. 935, 936 (2003). Idalene F. Kesner, Bart Victor & Bruce T. Lamont, *Board Composition and the Commission of Illegal Acts: An Investigation of Fortune 500 Companies*, 29 ACAD. MGMT. J. 789, 794-96 (1986).

[215] Sanjai Bhagat & Bernard Black, *supra* note 214 at 923.

[216] Edward Rock and M. Khan & Kahan & Rock. *supra* note 157.

[217] Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 678, 688–694 (2007).

[218] Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 IOWA J. CORP. L. 309, 332–334 (2011).

render Dodd-Frank's reforms uneventful. Thus, "there is nothing even remotely radical about anything in these" reforms.[219]

This Part explored the reforms adopted in the EESA, the ARRA and the Dodd-Frank Act that aim to improve risk management. The efforts in the reforms are laudable, but the real question is whether they will genuinely reduce financial institutions exposure to excessive risk taking and the broader financial markets exposure to systemic risk. The next Part offers a model for improving the efficacy of the reforms through existing but underexplored channels.

IV. Regulating Enterprise Risk Management

The temptation in times of crisis is to assume that regulation will address the causal factors and prevent subsequent crises. The measures introduced in the Dodd-Frank Act offer limited reforms to financial institutions' enterprise and systemic risk oversight. In large part, the reforms myopically focus on managing the conflicts that incentive-based compensation creates, an indirect means of addressing the underlying, causal factors that contributed to the recent financial crisis. This Part examines a process-oriented, principles based approach to risk management reform.

A. A Proposal for Process-Oriented, Principles-Based Reform

A process-oriented approach to risk management regulation offers a valuable method for addressing ERM failures and militates against the threat of systemic risk. Imposing governing guidelines in a series of reforms best enhances financial institutions risk management capabilities. These principles-based reforms offer regulators agility and improve the likelihood that financial institutions will identify and respond to excessive risk taking by directors, officers and employees, the most important corporate insiders involved in risk-taking and risk management.

Four tiers of regulation influence corporate governance. Corporate governance is traditionally the province of states. For over seventy-five years, the federal government has imposed disclosure obligations and increasingly in recent years substantive corporate governance obligations on corporations whose securities trade in national securities markets.[220] Self-regulatory organizations, such as national securities exchanges regulate corporations whose securities are publicly-traded through their membership criteria.[221] Finally, contractual arrangements govern the relationship between shareholders, the owners and residual claimants in corporations, and directors and officers who manage the business and affairs of corporations.

Effectively addressing risk management at large, complex financial institutions requires careful consideration of the interplay among the four tiers of regulation and the two decision-making spheres that steer the corporation's fate. Building upon the strengths of each tier of regulation and guarding against the dangers of each of the spheres of decision making improves the efficacy of an institution's risk management policy. This Part discusses in turn the methods that regulators in each tier may employ to promote best practices in financial institutions' risk regulation efforts.

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[219] *See, e.g.* Nocera, supra note 75 (explaining that "there is nothing even remotely radical about anything in these bills.").
[220] Exchange Act, *supra* note 199, at § 4.
[221] Id. at § 19.

1. Group Decisionmaking

Group decision-making as described in this Article refers to instances in which decisions are made by several insiders and outside directors, directors who do only receive remuneration from the corporation for their service as directors and who are not employees. The importance of directors acting as a group is well-established in finance and legal theory. The Second Restatement of Agency notes that directors are not agents of the corporation and therefore may not act alone on the corporation's behalf.[222] The Model Business Corporations Act reinforces this interpretation. As organizations, businesses rely on group processes for several reasons.[223] Experimental psychologists and economists' research regarding group decisionmaking explains that groups are typically better at making decisions than individuals. Reviewing the literature, Stephen Bainbridge argues that

> groups appear to outperform their average member consistently, even at relatively complex tasks requiring exercise of evaluative judgment. . . . Accordingly, it seems fair to conclude that group decisionmaking often is preferable to that of individuals. . . Corporate law's strong emphasis on collective decisionmaking by the board thus seems to have a compelling efficiency rationale.[224]

For a business to gain the best outcome when a task is assigned, it may be difficult to identify the individual who will outperform the peer group in advance of the task. A group decisionmaking process gains the benefits of the strongest member(s) of the group without the necessity of having to identify the strongest member at the outset.

2. Tiers of Regulatory Authority

Four authorities regulate the board of directors. Each of these authorities influences aspects of the board's decisionmaking processes. Structuring regulation in a manner that leverages the benefits of group decisionmaking offers a valuable mechanism to improve ERM oversight.

Federal Regulation

Directors exercise an indisputably important role in steering an enterprise. Typically, the board accomplishes this role through various group decisionmaking processes. Early federal efforts to regulate corporate governance reflect an understanding of the board's important role in decisionmaking and the significance of group decisionmaking processes. Later reform efforts continue to reflect this perspective. Section 14 of the Exchange Act's efforts to facilitate shareholder proxy access, SOX's board reforms, and Dodd-Frank's corporate governance reforms reflect the assumption that the composition of the board creates a valuable check on the influence of inside directors and executive officers on the internal policies that govern the affairs of the corporation. The mandate requiring that only independent directors should serve on these committees, however, is unsupported by evidence and contested by careful review of the empirical data and the literature.

To the extent that state and federal authorities intervene in the development of corporate governance, substantive reforms should consider addressing the limitations of group decision-

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[222] Restatement (Second) of Agency 14C cmt. b (1958).
[223] Model Bus. Corp. Act Ann. 8.20 cmt. (1984 & Supp.).
[224] Stephen Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1

making. The federal government has a long history regulating businesses whose activities engender significant risks to social welfare. Typically, the government adopts regulatory guidelines that set forth minimum internal control standards related to the business and outline appropriate responses to crises. The oil and natural gas industry, the nuclear energy industry and the oversight of the food and drug industries offer examples of areas of the law where the government has adopted express regulations establishing operational guidelines. [225]

Considering the benefits of group decision-making in the context of the government's traditional approach to regulation of businesses that may engender significant negative externalities, this Article proposes that the government concentrate risk management reforms on the development of positive law. Businesses respond to positive law obligations by establishing internal controls and policies that facilitate compliance. These controls and policies involve internal networks and committees and capture the benefits of group decisionmaking with the business.

Regulators should determine compliance with the proposed federal risk management regulations using a principles-based regulatory approach.[226] Historically, the SEC adopt rules applicable to reporting companies or companies whose securities are publicly-traded and applies the rules in a manner described as rules-based regulation. Compliance with rules in a rules-based regime requires strict adherence to the letter of the standard.[227] In contrast, in a principles-based regime, compliance inquiries evaluate regulated entities decisions and activities on the basis of their consistency with the normative intentions of the standard. [228]

Banking regulation currently offers this type of approach but securities regulation has continued to resist introducing principles-based regulatory oversight. In the banking industry, regulatory capital requirements, or legal obligations regarding the capital and assets that the institutions must hold in their reserves to satisfy short and long term obligations, serve as federally established limits enforced through regulators assessment of banks compliance with the intended purpose of the guidelines.[229] Each bank is unique and treated as having a unique balance sheet, which means that the regulation is applied by considering the goals of the capital requirements in the context of the specific entity subject to regulation.[230] Dodd-Frank reinforces the value of this approach by strengthening capital requirements applied to the banking industry.

In the context of securities regulators oversight of risk management, a principles-based review of the proposed federal risk management regulation would have assisted regulators in detecting miscalculations of VaR during the crisis. The use of financial models has been problematic because there is no substantive review of the models or the divergent and erroneous

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[225] *See, e.g.*, Natural Gas Act, 15 U.S.C. § 717 (2006); Natural Gas Policy Act, Pub. L. No. 95-621, 92 Stat. 3350 (codified as amended in scattered sections of 15 U.S.C.); National Energy Conservation Policy Act, Pub. L. No. 95-619, 92 Stat. 3206 (codified as amended in scattered sections of 42 U.S.C).

[226] Nan S. Ellis & Lisa M. Fairchild, *The NYSE Response to Specialist Misconduct: An Example of the Failure of Self-Regulation*, 7 BERKELEY BUS. L.J. 102, 148 n.313 (2010); *See generally* Yesnia Cervantes, *"Fin-Rah": A Welcome Change: Why the Merger was Necessary to Preserve U.S. Market Integrity*, 13 FORDHAM J. CORP. & FIN. L. 829, 857 (2008); Cristie L. Ford, *New Governance, Compliance, and Principle-Based Securities Regulation*, 45 AM. BUS. L.J. 1 (2008); James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625 (2007). *See also* John H. Walsh, *Institution-Based Financial Regulation: A Third Paradigm*, 49 HARV. INT'L L. J. 381, 382 (2008).

[227] *See* Park, *supra* note 261, at 634–35..

[228] *Id.* at 635–37.

[229] Wilmarth, *supra* note 3.

[230] *Id.*

data employed in connection with the models.[231] A better understanding of these models and the imposition of standards that facilitate the development of internal controls or committees within financial institutions as well as enhancing the expertise of regulators monitoring VaR results will significantly enhance ERM. The current regime requiring mere disclosure of VaRs results are subject to manipulation in large part because the SEC has not developed expertise in interpreting quantitative models and their results. More careful regulation of VaR or other quantitative risk models and the application of well-articulated standards regarding the use of financial models, the federal government may facilitate better risk management regulation.

State Regulation

Whereas bright-line rule-based regulation allows regulated entities to predict with greater certainty the types of activities that will violate the relevant standards, such regulations also facilitate arbitrage – parties seeking loopholes in the standards and safely evading regulation by acting within the loopholes. A principles-based approach permits regulators to apply regulation in a broader manner and reach activities that violate the intent of regulation. A principles-based approach is particularly important in evaluating compliance with risk management regulations because applying one-size fits all standards may be difficult. Regulation of risk management requires granting regulators the flexibility necessary to root out disconcerting behaviors.

States are already equipped to enhance risk management regulation by leveraging group decisionmaking. *Citigroup* created an opportunity to acknowledge shareholders' ability to bring derivatives suits against directors and officers alleging that their failures to carry out risk management oversight obligations breaches of their fiduciary duties. Interpreting *Stone* and *Caremark* to impose an obligation on directors and officers to monitor risk management in good faith creates personal liability for directors and officers for ERM. In addition, such an interpretation considers risk management in a manner consistent with directors' and officers' obligations to monitor compliance with positive law obligations.

As *Caremark* noted, the inquiry rests on whether directors and officers, in good faith, establish internal controls and other systems designed to detect risk management failures. As one commentator notes, this interpretation would be consistent with the *Caremark's* principle and intent to apply personal liability where directors and officers sustained or systemic failure to attend to a known risk creates significant corporate losses.[232] As the *Caremark* court explained, any reasonable director's execution of his duties to the corporation related to the business's compliance with positive law obligations would seek to create internal controls and committees.[233] The group decisions at the management level that that influences the structure of the internal and oversight of risk management will enhance risk management, thereby reducing the company's risk exposure.

[231] *See supra* notes 79 through 86 and accompanying text.
[232] Bainbridge, *supra* note 14.
[233] *In re Caremark Int'l Inc. Litig*., 698 A.2d 959, 970–73 (Del. Ch. 1996).

Self-Regulatory Organizations

SROs may also enhance risk management oversight at financial institutions through the regulatory framework of their listing criteria.[234] During the recent financial crisis, many of the largest and most sophisticated financial institutions that suffered significant distress and received TARP recipients were companies whose securities are publicly-traded on national securities exchanges.[235] The exchanges, as SROs, have the authority to adopt rules governing their members. With increasing frequency, and, based on federal mandates under SOX and Dodd-Frank, the SROs adopt rules affecting principles of corporate governance. SOX, for example directs SROs to adopt audit committees and requires independent directors' participation in the board. Dodd-Frank, similarly directs SROs to adopt compensation and independent director participation obligations. These process-oriented, group decisionmaking reforms offer some relief from risk management concerns, the SROs have the authority and capacity to design more narrowly-tailored reforms.

SROs represent are particularly well-situated to adopt specific ERM reforms because of their knowledge and expertise. Under Section 19 of the Exchange Act, SROs exercise important rule-making authority.[236] Their standards apply to companies who elect to list their securities on the exchange.[237] Through the listing criteria and regulations for listed companies, the SROs impose obligations on their members. Indeed, SROs frequently lead in developing regulation to address significant concerns that face financial markets, including corporate governance reforms. For example, as noted in Part III, SROs had adopted requirements regarding the composition of compensation committees well before Congress adopted Dodd-Frank. SROs' continuing engagement with listed companies and agility allows for more rapid development of regulation in response to industry concerns.

SROs may use their rule-making authority and flexibility to adopt process-oriented rules that emphasize group-decision making.[238] Many trade organizations and independent risk management research groups offer a plethora of suggestions regarding best practices and organizational approaches to enhance risk management. For example, in 2009, several industry groups proposed risk management practices that may be adopted. The Committee of Sponsoring Organisations of the Treadway Commission ("COSO") published a paper describing specific, comprehensive ERM practices that business may adopt to reduce exposure to ERM failures. Among the proposals, COSO suggested that management should meet regularly to discuss risk-management philosophy and risk appetite; understand enterprise risk-management practices; review portfolio of risks in relation to risk appetite; and be apprised of the most significant risks and related responses. These proposals utilize group decisionmaking to identify and address risk

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[234] *See e.g.*, NYSE LISTED COMPANY MANUAL, NYSE.COM, http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?searched=1&selectednode=chp_1_2_2&CiRestriction=102&manual=%2Flcm%2Fsections%2Flcm-sections%2F (last visited Mar. 14, 2011).

[235] For a list of TARP recipients, including the various large publicly-traded financial institutions, *see* Matthew Ericson et al., *Tracking the $700 Billion Bailout*, N.Y. TIMES, http://www.nytimes.com/packages/html/national/200904_CREDITCRISIS/recipients.html (last visited Mar. 14, 2011).

[236] Exchange Act, *supra* note 199, at § 19.

[237] *See supra* note 270 for listing standards.

[238] Lori A. Richards, *Director, Office of Compliance Inspections and Examinations U.S. Securities and Exchange Commission*, Speech at NYSE Regulation Second Annual Securities Conference (June 20, 2006), *available at http://www.sec.gov/news/speech/2006/spch062006lar.htm*.

management concerns. The Organisation for Economic Co-operation and Development offers similar emphasizing "the transmission of information is through effective channels, a clear corporate governance issue."[239] Finally, Risk and Insurance Management Society, Inc. offers suggestions regarding practices relating to quantifiable and unquantifiable risks. SROs are well-positioned to evaluate these policies and impose effective ERM regulations.[240]

Contractual Governance

Finally, the relationship between shareholders and directors and officers is, at its core, a contractual relationship. Many theorists argue that adjusting the contractual agreement between executives and directors offers a useful mechanism to address conflicts between the interests of directors and executives and the interests of shareholders.

Notwithstanding the challenges of collective bargaining and their lack of sophistication, Kelli Alces argues that shareholders may be better off seeking to impose and enforce contractual obligations protecting perceived fiduciary obligations than relying on courts.[241] Extending this argument to the development of an effective mechanism for instituting reforms in ERM policies that rely on group decisionmaking practices, there are contractual mechanisms that may improve ERM. In the context of executive compensation, Dodd-Frank imposes limits on financial institutions' ability to adopt executive compensation arrangements that encourage excess risk taking. A provision in corporate charters imposing fiduciary obligations on directors and executives holding them personally liable for risk management failures accomplishes shareholders' goals in the post-crisis derivative litigation in a single step.

Contractual provisions within compensation arrangements may also help improve ERM policies. Boards may negotiate with executives to tie incentive-based awards to risk-adjusted returns rather than merely the performance of the corporation's equity securities. In other words, employees would be eligible for compensation rewards based on their ability to improve the performance of the company relative to the amount of risk that the company faces in connection with the business activity that increased its equity share price.

For example, Joseph Cassano, the former AIG executive who acted as director of the division that acquired the company's devastating credit default swap portfolio. Cassano received rewards as the division collected premiums for agreeing to offer protection against the default by the issuer of the debt security identified in the credit default swap. The revenue streams increased as the size of AIG's credit default swap portfolio grew. A risk-adjusted compensation award would have corrected Cassano's compensation based on the risk exposure that the increased credit default swap portfolio created for AIG. In addition, boards may negotiate contractual provisions in formal compensation agreements that include express clawbacks permitting the company to recover compensation if the company discovers errors in its risk assessment that change perceptions regarding the profits that motivated a compensation award.

B. The Limitations of Group Decisionmaking

[239] Grant Kirkpatrick, The Corporate Governance Lessons from the Financial Crisis, Fin. Market Trends, Feb. 2009, at 4, available at http://www.oecd.org/dataoecd/32/ 1/42229620.pdf.
[240] THE 2008 FINANCIAL CRISIS: A WAKE-UP CALL FOR ENTERPRISE RISK MANAGEMENT 3 (Bill Coffin ed., 2009), available at http://www.RIMS.org/ERMwhitepaper.
[241] Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 IOWA J. CORP. L. 239, 279 (2009).

Financial institutions and other businesses receive valuable benefits from employing group decisionmaking techniques. However, a group-decision making approaches face obvious limitations. This Section explores the limitations that challenge the use of group decisionmaking approaches to address ERM concerns.

First, group decisionmaking processes are vulnerable to cognitive biases.[242] Confirmation bias, or the tendency to accord merit or value to events that confirm a group's decision, may impede objective evaluation of complex issues. As the group attempts to determine an appropriate course of action related to the set of complex issues, on an unconscious level, they find evidence confirming the group's proposed course of action and disregard evidence that is contrary to the group's decision.

Second, group decisionmaking processes may invite herding, or a tendency for individuals participating in a group decisionmaking process to imitate the decisions of other members in the group disregarding information in their possession or their own judgment that is contrary to the group's opinion.[243] Theorists also describe herding as a response to bounded rationality and information asymmetries.[244] Where individuals in a group conclude that they have less or less-useful information they may elect to free ride on the information offered by another group member who is perceived as better informed.[245] As the description of herding suggests, the presumptions in herding can lead the group to sub-optimal decisions.

Third, structural bias may lead board members to develop amicable relationships that impede their ability to objectively evaluate the suggestions of other board members.[246] Board members are generally close-knit groups that share strong social, if not familial, ties.[247] Their interactions and affiliations outside of the board room may color their engagement and the rigor of debate within the board room.[248] As a result, structural bias may limit the effectiveness of group decision making.

Notwithstanding the significant concerns that cognitive biases, herding and structural biases engender, group decisionmaking processes represent a viable approach to enhancing ERM and reducing systemic risk concerns. Awareness of the concerns regarding group decisionmaking and introduction of organizational models and structural processes to address the concerns offers a useful method of reducing the effects of the concerns. Moreover, these concerns can be reduced through the use of outside consultants that can vet strategies, policies and ideas outside of the internal management group of board committee considering a particular course of action.

In addition, the concerns raise issues that are critical to address ERM failures and other corporate concerns. There is often a gap between legal academics' approach to business concerns and the approach posited by academics in business and finance. Ignoring this gap exacerbates the likelihood of many issues, including the concerns related to group decisionmaking. A thoughtful

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[242] Stephen Bainbridge, *Why a Board? Group Decision Making in Corporate Governance*, 55 VAND. L. REV. 31 (2002).

[243] Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior, and Cognitive Biases*, 74 Wash. U. L.Q. 347, 348, 353-56 (1996); *See generally* Peter H. Huang, *Herd Behavior in Designer Genes*, 34 WAKE FOREST L. REV. 639, 645-53 (1999); *See generally* OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 37 (1996).

[244] Kahan & Klausner, *supra* note 243, at 353-56.

[245] Bainbridge, *supra* note 243, at 52.

[246] *See* Lisa Fairfax, *Uneasy Case for the Inside Director*, IOWA L. REV. 127, 148-49 (2009); Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323, 341, 352-57 (2007); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 831 (2004).

[247] *See* Fairfax, supra note 246, at 148-49.

[248] *Id*.

incorporation of organizational and behavioral theories from finance literature would offer valuable insight for lawyers assisting boards with policies that enhance ERM policies. A comprehensive consideration of the board, its functions, the insiders described in Part II above and the outside directors is the key to developing effective, sustainable ERM policies.

V. Conclusion

This Article demonstrates that regulation of policies that businesses or enterprises adopt to identify, monitor, and mitigate risks, comprises a critical element in any effective strategy to reduce systemic risk. Systemically significant financial institutions suffered staggering losses due to failures related to these internal risk management policies; the grave circumstances created by the crisis illustrate the importance of regulating enterprise risk management or ERM. The prevailing view focuses narrowly on systemic risk and overlooks the valuable benefits engendered by adopting effective risk management reforms. When we consider the costs of ERM failures, it becomes clear that adopting a myopic view of risk regulation may prove costly.

State fiduciary obligations generally introduce effective mechanisms designed to balance directors' and officers' authority over internal corporate affairs with their accountability for such decisions. However, this Article reveals that state law has so narrowly interpreted the fiduciary duties of directors and officers that very little misconduct by these managers of the corporation is actionable. As illustrated by a wave of shareholder litigation arguing that directors and officers should be held accountable for massive financial losses during the recent financial crisis, ERM oversight is not explicitly captured on the short list of misconduct. The low threshold for escaping fiduciary liability under state law permits private businesses to shift their negative consequences, or negative externalities, of their risk taking activities to the public. When the costs of these negative externalities required the government to deploy over $700 billion dollars to stabilize the economy, federal regulators promptly intervened.

Comprised of disclosure requirements and, in more recent years, corporate governance reforms, federal securities regulation endeavors to address ERM failures. The recently adopted Dodd-Frank Act introduces reforms that acknowledge that directors' and executives' incentives to take excessive risks with a company's assets and capital may not align with shareholders' interests in exposing the company to higher-risk business activities. In the end, however, federal approaches to ERM oversight focus too narrowly on disclosure, executive compensation, and independent directors' participation in executive compensation decisions. While federal reforms may curtail some less-desirable behavior, a more effective approach remains underexplored.

This Article suggests that a comprehensive approach to risk management regulation is necessary to reduce ERM failures and the deleterious role of ERM failures in creating systemic risk. Drawing on the strengths of each of the four spheres of authority that influence corporate governance – state authorities, federal authorities, self-regulatory agencies, and private contractual arrangements – this Article offers a more effective solution to ERM concerns. In the absence of eliminating the conflicts between executive officers and directors' incentives and shareholders' interest in ERM, implementing effective systems and controls may serve to curb some abuses of authority. Ultimately, aspirational standards may enable regulators to impose agile standards that evolve to align risk management regulation with normative expectations.