Federalizing Fiduciary Duty: The Altered Scope of Officer Fiduciary Duty Following Orderly Liquidation Under Dodd-Frank

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Introduction

The financial crisis of 2008 ushered in a new era of regulatory reform in the United States. The failure of several large banks prompted Congressional scrutiny of the U.S. bank regulatory system. Many critics highlighted the government's failure to intervene to prevent Lehman Brothers' insolvency, which resulted in economic turmoil not yet resolved.[1] Against this backdrop, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in July 2010.[2]

Dodd-Frank mandates institutional changes to minimize economic instability and establishes regulatory processes to guide the government's response to future bank failures. At the heart of the regulation is the Orderly Liquidation Authority,[3] which outlines a federal resolution process for "systemically significant" financial companies.[4] The Orderly Liquidation Authority gives the Federal Deposit Insurance Corporation ("FDIC") authority to liquidate a failed financial company after the Secretary of the Treasury has determined that government receivership is necessary.

As part of this new regime, Dodd-Frank federalizes the fiduciary duties of officers and directors at large financial institutions that are liquidated under Dodd-Frank. Historically, state law has set the fiduciary duties of bank directors and executives. For example, it is a general principle of corporate law that the business judgment rule is the default standard for evaluating director conduct because it is the chosen rule in nearly every state. By enacting Dodd-Frank, the federal government has altered the traditional scope of fiduciary duty during the resolution process. Section 207 narrows director fiduciary duty by guaranteeing that a director will be immune for his or her decision to consent to government receivership.[5] In implementing Section 210(s), the FDIC has moved in the opposite direction, promulgating a claw-back rule that broadens fiduciary duties for bank executives at failed financial institutions.[6]

While federal encroachment in state corporate law is not a new occurrence, these regulations cut deeply into state prerogatives and will have far-reaching effects for director and executive behavior. To be sure, federal courts and the federal government are free to displace state law; however, the internal affairs doctrine has tra-

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[1] *See The Orderly Resolution of Lehman Brothers Holdings Inc. under Dodd-Frank*, 5 FDIC Quarterly 31 (2011) ("The disorderly and costly nature of the LBHI bankruptcy. . . contributed to the massive financial disruption of late 2008.").

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, PUB. L. No. 111-203, 124 Stat. 1376 (2010).

[3] *Id.* at tit. 2

[4] *Id.* at §716, 124 stat. at 1260. This is a category of companies introduced in the Dodd-Frank Act that is subject to enhanced regulation due to the high risk such companies pose to the US financial system if they fail.

[5] *Id.* at §207

[6] *Id.* at §210

ditionally provided a dividing line for permissible federal intervention.[7] The doctrine provides that the states govern internal corporate affairs, while federal regulators (such as the SEC) govern external corporate affairs, such as securities trading.[8] This line has not always been maintained. For example, SEC regulation of proxy statements substantially intruded into the internal governance of corporations. Fiduciary duty, however, lies at the core of state law governing corporate affairs, and thus is usually left free from federal interference.

Although financial regulation often sets federal policy for state and federally chartered banks, the new and controversial Dodd-Frank rules go beyond previous federal legislation in displacing state standards of fiduciary duty. For example, Sarbanes-Oxley[9] reforms were largely limited by established state law principles based on "a policy decision to not affect a major 'paradigm shift' in the allocation of law making authority between the federal government and the states."[10] That decision is consistent with previous regulations and federal court decisions which restrained from federalizing officer duty (or altering its scope). For example, the expansion of Rule 10b-5 litigation may have transformed state fraud claims into federal causes of action (resulting in greater resort by shareholder litigants to federal courts), but the scope of fiduciary duty remained unchanged. [11] And while rules that compel disclosure may strengthen fiduciary duties in ways that state law cannot, the disclosure rules do not alter the standard of care. For this reason, the FDIC claw-back rule represents a deeper incursion into state law than ever before.

Part I of this paper discusses Section 207 of Title II of the Dodd Frank Act. This provision immunizes directors from liability for "acquiescing or consenting" to the appointment of the FDIC as receiver.[12] Thus, the provision guarantees that directors will not be subject to lawsuits that challenge their decision to consent to the re-

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[7] Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 598 (2003).

[8] *See, e.g.*, CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 91 (1987) ("It thus is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares.").

[9] Sarbanes-Oxley Act of 2002, PUB. L. No. 107-204, 116 Stat. 745 (2002).

[10] Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbannes-Oxley Act: A Morality Tale for Policymakers Too*, 22 GA. ST. U. L. REV. 251, 290 (2005). *But see* Lyman P.Q. Johnson and Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1150 (2004) (arguing that SOX, although it does not specifically address director and officer fiduciary duties, will modestly preempt this area and will prove to be influential even where it does not preempt). While SOX may have redefined and clarified what counts as breach of fiduciary duty, its provisions do not expressly preempt state law claims in order to facilitate cooperation with regulators, nor do they displace the state law standard of care for the entities that it regulates.

[11] *See Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977); Richard W. Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991, 1000 (1976).

[12] Dodd-Frank, *supra* note 2, at §207.

[12] Dodd-Frank, *supra* note 2, at §207.

ceivership. While a narrow grant of immunity is certain, courts may choose to read the provision broadly in order to preclude suits that are closely related to the director's decision to consent. Section 207 therefore reduces the scope of a director's fiduciary duty in order to facilitate cooperation with federal regulators. This grant of immunity, coupled with existing pressure to succumb to regulatory pressure (which is quite high), makes it unlikely that a director will choose to contest the Secretary's decision. Thus, the judicial review provision, which was heralded as an important check on expansive regulatory power, may prove to be an empty concession.

Although Section 207 minimizes the role of the judiciary and deprives plaintiffs of certain state law claims, the provision creates beneficial incentives for directors to work cooperatively with government regulators. In addition, the preemption of claims does not appear to be a particularly severe displacement of state law, as it does not require state courts to alter the standard of care for a breach of fiduciary duty or switch the common law burden allocation.

By contrast, the FDIC has expanded fiduciary duties for bank executives in implementing Section 210(s) of Orderly Liquidation Authority. Part II of this paper discusses FDIC Rule 380.7, which allows the FDIC to claw back up to two years of compensation from current and former senior executives and directors who are found "substantially responsible" for the failure of the financial institution.[13] The rule, which applies in civil actions as well as administrative proceedings, significantly departs from state law standards, which govern state and nationally chartered banks. Significantly, the rule adopts a presumption of substantial responsibility for executives at failed institutions based on their executive status. Further, the rule alters the common law burden allocation, in which the claimant bears the burden of proof. The presumption can be rebutted only if the executive demonstrates that he or she acted in a prudent manner or did not cause the failure. Consequently, the rule creates a federal duty of reasonable care for bank executives and requires courts to depart from the traditional standard of care under the business judgment rule.

It is not clear, however, that the FDIC rule would survive close judicial scrutiny. While Dodd-Frank Section 210(s) gives the FDIC authority to claw-back two years of compensation from culpable individuals, Section 210(s) does not permit the FDIC to create a rule that departs from state law. Indeed, a close reading of Dodd-Frank reveals that Congress intended state law to govern claw-back proceedings. Thus, courts will not give *Chevron* deference to the FDIC's interpretation, and the rule is unlikely to survive an Administrative Procedure Act ("APA") challenge.

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[13] Orderly Liquidation Authority Provisions under Title II of Dodd-Frank, 76 Fed. Reg. 21626, 41629 (July 15, 2011).

I. Immunity for Directors under Section 207 of Dodd-Frank

Title II of Dodd-Frank, known as the Orderly Liquidation Authority, allows the Secretary of the Treasury to appoint the FDIC as receiver for failing or failed financial companies when its default would threaten financial stability. Previously, the FDIC had authority to act as receiver only for federally insured commercial banks. Thus, Dodd-Frank gives the FDIC the power to act as a receiver for financial institutions that previously would have been within the jurisdiction of bankruptcy courts.

Section 207 of the Orderly Liquidation Authority provides that directors will not be liable for consenting or acquiescing to the Secretary's receivership determination. Thus, Section 207 guarantees that a director will be immune from all suits, likely state claims alleging breach of fiduciary duty, which challenge his or her decision to consent to the receivership. While such suits are rare (and have not been successful[14]), the provision eliminates the possibility, providing substantial reassurance for directors at failed financial companies. In addition, the provision might be a source of immunity for antecedent events. For example, a court could interpret the provision broadly in order to find suits related to the decision to consent (likely breach of fiduciary duty claims) preempted by Section 207. Consequently, the Orderly Liquidation Authority reduces the scope of a director's fiduciary duty in order to facilitate cooperation with his or her regulators. The provision may also immunize federal securities claims against directors, as will be explained.

In Section 202, Congress allows the board of directors to seek judicial review of the Secretary's decision, and thus attempts to preserve a supervisory role for the judiciary. Supporters of Title II touted the judicial review function as an important safety valve for the legislation. Senator Dodd explained that "the new liquidation authority Senator Shelby and I crafted should be used very rarely. . . .We have put in some very high hurdles to trigger its use, including judicial review."[15] However, this statement is false—the judicial review function does not constitute a significant hurdle to liquidation for two reasons. First, as critics of Dodd-Frank often point out, the

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[14] While shareholders have sued directors for breach of fiduciary duty after the financial company is brought into federal receivership, no director has ever been held liable for consenting to FDIC receivership, or even for putting a financial holding company into bankruptcy. For example, in *In re Bridgeport Holdings, Inc.*, the shareholders of a liquidated trust sued the former directors and officers, alleging that they breached their duty of due care because they had failed to pursue all viable options before filing for bankruptcy. *In re Bridgeport Holdings, Inc.*, 388 B.R. 548, 559 (D. Del. 2008). The Delaware Bankruptcy Court dismissed the suit, finding that the directors were entitled to the protection of the business judgment rule. 388 B.R. 548 (D. Delaware 2008).

[15] 156 Cong. Rec. S3569, S3624 (daily ed. May 12, 2010) (Senate Consideration of S. 3217), *reprinted in* DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: A LEGISLATIVE HISTORY (William H. Manz, ed.).

scope of judicial review is limited.[16] The District Court is not permitted to evaluate the Secretary's decision on the merits, and it may only review the Secretary's finding that the institution is a financial company in default or in danger of default.[17] Second, practical considerations suggest that the judicial review provision will have less significance than its critics anticipated. Even absent an explicit grant of immunity, directors often bow to regulatory influence. And Section 207 will only increase this outcome. Thus, the presence of Section 207 nearly guarantees that directors will never choose to contest the Secretary's decision in federal court.

Thus, Dodd-Frank greatly alters the liquidation framework for systemically significant financial institutions, minimizing the role of the judiciary and preempting certain state law claims. And while Section 202 introduces a judicial check on the use of the Liquidation Authority, practical considerations render the provision an empty concession.

A. The Resolution Authority

According to the Treasury Department, the 2008 failure of Lehman Brothers and subsequent economic turmoil exposed the need for financial regulation to "fill a void" and provide for the organized and predictable resolution of large financial companies.[18] As such, Dodd-Frank contains provisions that would guide the gov-

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[16] Kenneth Scott, DODD-FRANK: RESOLUTION OR EXPROPRIATION?1-3 (2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1673849 (arguing that the narrowness of the judicial review provision could lead to the invalidation of Title II);
Brent J. Horton, *How Dodd-Frank's Orderly Liquidation Authority For Financial Companies Violates Article III of the United States Constitution*, 36 IOWA J. CORP. L. 869, 886 (2011). (faulting the "extremely deferential standard of review" and the "limitation on the scope of the review.")

[17] *See* Douglas G. Baird and Edward R. Morrison, *Dodd Frank for Bankruptcy Lawyers* 12 (2011) (unpublished manuscript) (*available at*: http://www.law.northwestern.edu/jep/symposia/documents/Baird_Dodd-Frank_for_Bankruptcy_Lawyers.pdf)

[18] In a March 2009 press release introducing the Resolution Authority, the Treasury Department explained, "The legislative proposal would fill a significant void in the current financial services regulatory structure and is one piece of the comprehensive regulatory reform strategy that would mitigate systemic risk." Press Release, U.S. Dep't of the Treasury, Treasury Proposes Legislation for Resolution Authority (Mar. 25, 2009), *available at* http://www.streetinsider.com/Economic+Data/Treasury+Proposes+Legislation+For+Resolution+Authority/4511759.html. *See also* Orderly Liquidation Authority Provisions of Dodd-Frank, 76 Fed. Reg. 4208 (January 25, 2011) ("Prior to the enactment of the Dodd-Frank Act, Public Law 111-203, 12 U.S.C. 5301 et seq. on July 21, 2010, there was no common or adequate statutory scheme for the orderly liquidation of a financial company whose failure could adversely affect the financial stability of the United States. Instead, insured depository institutions were subject to an FDIC-administered receivership under applicable provisions of the Federal Deposit Insurance Act, insurance companies were subject to insolvency proceedings under individual State's laws, registered brokers and dealers were subject to the U.S. Bankruptcy Code and proceedings under the Securities Investor Protection Act, and other companies (including the parent holding company of one or more insured depository institutions or other financial companies) were eligible to be a debtor under the U.S. Bankruptcy Code. These

ernment's response to future failures. The Orderly Liquidation Authority formalized the resolution process, giving the FDIC the power to act as receiver of financial institutions whose failure would pose systemic risk.[19] Dodd-Frank makes clear that the creditors and shareholders will "bear the losses of the financial company" and instructs the FDIC to maximize the value of the company's assets, mitigate risk, and minimize losses as well as moral hazard.[20]

Congress modeled the resolution process after existing bank receivership proceedings, adopting elements of both the Federal Deposit Insurance Act ("FDIA") and the Bankruptcy Code.[21] The liquidation proceeding is quasi-administrative with only limited judicial review of certain decisions, similar to existing FDIA provisions for commercial bank receivership.[22] However, the Orderly Liquidation Authority significantly alters traditional resolution processes in two ways.

First, Dodd-Frank broadens the scope of the FDIC's powers, allowing the FDIC to resolve systemically significant financial institutions, or "financial companies," whose insolvency was previously addressed in bankruptcy court. The term "financial companies" is broadly defined to include bank holding companies[23] and nonbank financial companies supervised by the Board of Governors of the Federal Reserve ("Board of Governors").[24] The term also includes nonbank financial compa-

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disparate insolvency regimes were found to be inadequate to effectively address the actual or potential failure of a financial company that could adversely affect economic conditions or financial stability in the United States. In such a case, financial support for the company sometimes was the only viable option available for the Federal government to avoid or mitigate serious adverse effects on economic conditions and financial stability that could result from the company's failure.")

[19] *See* Dodd-Frank *supra* note 2, at §§ 203(a)(1), 204(a)(1) and 210(a)(9)(E). Dodd Frank allows for the liquidation of "failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard." The provisions specifically provide for liquidation, not reorganization of the bank.

[20] *See Id.* at § 204 ("It is the purpose of this title to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard.") *See generally* Paul E. Lee, *The Dodd-Frank Act Orderly Liquidation Authority: A Preliminary Analysis and Critique – Part I*, 128 BANKING L. J. 771 (2011).

[21] Under the FDIA, the FDIC acts as a receiver for insured depository institutions and is given broad powers to resolve insured depository institutions. *See* Baird & Morrison, *supra* note 14, at 29 ("To a very large extent, Title II is consistent with the basic principles of bankruptcy law. The terminology is different, but this is not a matter of substance. Its basic features and ambitions are the same.")

[22] Lee, *supra* note 17 at 779. *See* FDIC RESOLUTIONS HANDBOOK, Chapter 7 at 7 ("...[t]he primary advantage is that the FDIC, in administering the assets and liabilities of a failed institution as its receiver, is not subject to court supervision, and its decisions are not reviewable except under very limited circumstances.") *Available at* http://www.fdic.gov/bank/historical/reshandbook/ch7recvr.pdf.

[23] Dodd-Frank *supra* note 2, at §§ 102(a)(1) & 12 U.S.C. § 1841(a).

[24] *Id.* at § 102(a)(4).

nies that are "predominantly engaged in financial activities"[25] and thus may include hedge funds and private equity funds.[26]

Second, Dodd-Frank grants the FDIC ample authority to liquidate the failed institution. The FDIC is given the power to sell assets "without obtaining any approval, assignment, or consent with respect to such a transfer" unless the transaction raises antitrust issues.[27] Further, the FDIC may create a "bridge financial company," which would be owned and controlled by the FDIC.[28] As Professors Baird and Morrison point out, "[t]his concentration of power in the hands of one agency. . .is a marked departure from prevailing bankruptcy law."[29]

The Liquidation Authority will only apply after the Secretary of the Treasury has determined, with support from the FDIC and the Federal Reserve, that taking action is necessary to avoid or mitigate seriously adverse economic effects.[30] The Secretary of the Treasury may make this determination only after finding that a company is in default or in danger of default, that no private sector options are available, and that the company's default would seriously harm the United States economy. However, Title I of Dodd-Frank requires FDIC involvement much earlier, giving the FDIC enhanced supervisory authority at the earliest sign of trouble:[31] for example, Title I mandates that systemically significant institutions create resolution plans or "living wills" and submit these plans to the FDIC.[32] And the FDIC intends its su-

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[25] *Id.* at §§ 102(a)(4)(A)(ii) & 102(a)(4)(B)(ii). These are activities that the Federal Reserve Board identifies pursuant to the Bank Holding Company Act. These activities may evolve over time, and explicitly include: "providing financial, investment, or economic advisory services" and "insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker." Most importantly, financial activities include "lending, exchanging, transferring, investing for others, or safeguarding money or securities." 12 U.S.C. §1843(k)(4)(A).

[26] Dodd-Frank *supra* note 2, at § 201(a)(11)(iv).

[27] *Id.* at § 210(a)(1)(G).

[28] *Id.* at § 210(h)(5)(A), §210(h)(2)(G).

[29] Baird & Morrison, *supra* note 14, at 3.

[30] *See* Dodd-Frank § 203(b).

[31] *See, e.g.*, Dodd-Frank *supra* note 2, at §166, ("Early Remediation Requirements"), ("The Board of Governors, in consultation with the Council and the Corporation, shall prescribe regulations establishing requirements to provide for the early remediation of financial distress of a nonbank financial company...")

[32] Section 165 of Dodd-Frank provides for enhanced supervision standards for systemically important financial institutions, which include bank holding companies with assets of greater than $50 billion and companies designated as systemic by the Financial Stability Oversight Council. Section 165(d) of Dodd-Frank requires these institutions to report living wills, or plans "for rapid and orderly resolution in the event of a material financial distress and failure." On October 17, 2011, the Board of Governors of the Federal Reserve System approved a final rule requiring certain large bank holding companies, non-US banks with US banking operations, and systemically significant nonbank financial companies to periodically submit to the Federal Reserve and FDIC comprehensive plans for the rapid and orderly resolution of the company under the Bankruptcy code in the event of failure. *See* Resolution Plans Required, 12

pervisory authority to be hands on. In a report describing the hypothetical liquidation of Lehman Brothers under Title II, the FDIC explained that absent an "early private sector solution," the FDIC would need "to establish an on-site presence to begin due diligence and plan for a potential Title II resolution."[33] During this time, the FDIC would gather information about the institution's structure, organization, and other key operations in order to facilitate potential rescue efforts. However, the report also emphasized that government receivership would be a last resort for the bank, and that the FDIC would encourage the board of directors to accept the best private sale it could "non-withstanding its dilutive nature."[34]

If the Secretary determines that FDIC receivership is necessary, Dodd-Frank requires that the Secretary of the Treasury make this proposal to the board of directors. If the directors do not consent, the Secretary must petition the United States District Court for the District of Columbia for an order authorizing the appointment.[35] Thus, judicial review is triggered if the directors do nothing. However, the scope and scale of the review is quite limited. The court is required to act within twenty-four hours and must assess whether the Secretary's determination is "arbitrary and capricious."[36] Moreover, the District Court may only consider whether the financial company is in default or is in danger of default and whether the institution is a "financial company." If the court fails to act, the Secretary's petition is automatically granted. And while the decision is appealable, there is no stay of the decision pending appeal, and the court of appeals must also use the arbitrary and capricious standard.[37] Con-

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C.F.R. Part 381 (Oct. 17, 2011), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20111017a1.pdf.

[33] *The Orderly Resolution of Lehman Brothers Holdings, Inc. under Dodd-Frank, supra* note 1, at 41

[34] *Id.* at 42 ("... [V]irtually any private sale would yield a better return for shareholders than the likely negligible proceeds shareholders would receive in an FDIC receivership, as equity holders have the lowest priority claims in a receivership...The preferred outcome under the Dodd-Frank Act is for a troubled financial company to find a strategic investor or to recapitalize without direct government involvement or the FDIC being appointed receiver. To that end, the recommendation and determination prescribed by section 203(a)(2)(E) and (b)(3) of the Dodd-Frank Act, respectively, concern the availability of a viable private sector alternative. Requiring a troubled financial company to aggressively market itself pre-failure helps to ensure that exercise of the orderly resolution authority in Title II is a last resort.")

[35] *Supra* note 2, *id.* at § 202(a)(1)(A)(i), ("Judicial Review") ("If the board of directors (or body performing similar functions) of the covered financial company does not acquiesce or consent to the appointment of the Corporation as receiver, the Secretary shall petition the United States District Court for the District of Columbia for an order authorizing the Secretary to appoint the Corporation as receiver.")

[36] *Supra* note 2, *id.* at § 202 (a)(1)(A)(iii) (The court, "after notice to the covered financial company and a hearing in which the covered financial company may oppose the petition, shall determine whether the determination of the Secretary that the covered financial company is in default or in danger of default and satisfies the definition of a financial company under section 201(a)(11) is arbitrary and capricious.").

[37] *Id.* at § 202(a)(1)(B).

sequently, it is highly unlikely that the board would be able to overturn the Secretary's decision, and this is the only time that judicial review is available. While critics of the Orderly Liquidation Authority have faulted the Title II judicial review provision on these grounds, practical considerations ensure that a director will almost never choose to contest the Secretary's decision.

B. The Consent Provision

Section 207 of Dodd-Frank provides that directors will be immune for their decision to consent to government receivership. It reads, "The members of the board of directors (or body performing similar functions) of a covered financial company shall not be liable to the shareholders or creditors thereof for acquiescing in or consenting in good faith to the appointment of the Corporation as receiver for the covered financial company under section 203."

The consent provision was introduced in the earliest draft of Dodd-Frank, where it immediately followed the judicial review provision.[38] No legislative history exists to shed light on the reason for its inclusion. Congress presumably included the provision in order to facilitate director acquiescence to the receivership decision by eliminating personal liability for the decision to consent. Speedy resolution of a bank requires immediate director acquiescence—any delay could have adverse consequences for the United States economy.

However, it would be unusual for the government to seek receivership against the wishes of the financial company's board of directors. Government receivership is an expensive and complicated process, and the government would strongly prefer a private sector solution. Despite the complexity of the default determination, it is unlikely that the board of directors would disagree with the government's conclusion that a bank is in default or in danger of default.[39] And historically, regulators have had much influence over director decision-making, especially at federally regu-

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[38] *See* "Improvements to Supervision of Financial Firms," the July 22, 2009 version of the Dodd-Frank Act. The initial consent provision read: "SEC. 1206. DIRECTORS NOT LIABLE FOR ACQUIESCING IN APPOINTMENT OF CONSERVATOR OR RECEIVER. The members of the board of directors (or body performing similar functions) of a covered bank holding company shall not be liable to the covered bank holding company's shareholders or creditors for acquiescing in or consenting in good faith to— (1) the Secretary's appointment of an Appropriate Federal Regulatory Agency as conservator or receiver for the covered bank holding company under section 1204; or (2) an acquisition, combination, or transfer of assets or liabilities under section 1209." § 1209 gave the "appropriate regulatory agency" powers to acquire, combine, and transfer the assets and liabilities of the failed bank.

[39] Of course, if the board did disagree that the financial institution was in default or in danger of default, or if it believed the decision was arbitrary and capricious, they could refuse to give their consent. But this outcome is extremely unlikely, both due to the fact that the government would strongly prefer to find any other private sector solution and also because the scope of the review is limited.

lated institutions.[40] The regulatory influence would be substantial in this context: if a director wished to contest the government receivership, he or she would be forced to fight the Secretary, the Federal Reserve, and the FDIC simultaneously.

Although director cooperation appears likely, the fact that Congress included the immunity provision suggests that Congress believed it would provide necessary encouragement. Liability is a large concern for directors at failed financial companies.[41] The number of shareholder class actions filed against financial institutions in the past few years is at an all-time high,[42] and such suits are much more likely to be brought after bank liquidation. Congress might have anticipated that the threat of liability could create director resistance.[43] And while a limited interpretation of Section 207 would not substantially alter the outcome, a court may interpret the provision broadly to encompass related events. In such cases, Section 207 would substantially facilitate director cooperation.[44]

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[40] Regulators exert much influence over director decisions. For example, the AIG board of directors forced out Hank Greenberg after Elliot Spitzer and other regulators began investigating the CEO for misconduct. *See* RON SHELP, FALLEN GIANT (2d ed. 2009). The Marsh & McLennan board also caved to regulatory pressure and forced out CEO Jeffrey Greenberg following a Spitzer investigation; Kulbir Walha & Edward E. Filusch, *Eliot Spitzer: A Crusader Against Corporate Malfeasance or a Politically Ambitious Spotlight Hound? A Case Study of Eliot Spitzer and Marsh & McLennan*, 18 Geo. J. Legal Ethics 1111 (2004-2005). In both cases, the CEO was ultimately not found to have violated the law. In addition, a bank's decision to merge with a failing bank is heavily influenced by regulators. Regulatory pressure was largely responsible for Bank of America's acquisition of Merrill Lynch in 2008, as well as Wachovia's decision to acquire Wells Fargo; *see* Robert. C. Pozen and Charles E. Beresford, "Bank of America Acquires Merrill Lynch (A)," Harvard Business School Case 310-092; David Enrich & Dan Fitzpatrick, *Wachovia Chooses Wells Fargo, Spurns Citi*, WALL ST. J., (Oct 4, 2008), *available at* http://online.wsj.com/article/SB122303190029501925.html.
For further examples of regulatory pressure and its influence on board decision-making, see David M. Barnes, Note, *Shotgun Weddings: Director and Officer Fiduciary Duties in Government Controlled and Partially-Nationalized Corporations*, 63 VAND. L. REV. 1419 (2010); Jennifer E. Bethel & Stuart L. Gillian, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. 29 (2002).

[41] Although the liquidation would result in the termination of the board, this prospect is not likely to substantially affect the regulators' decision to take the bank into receivership. Directors are often part-time employees who often earn less in their job as director than they had in previous positions.

[42] *Securities Class Action Filings – 2009: A Year in Review*, 2010 CORNERSTONE RESEARCH

[43] In addition, the board of directors has a large equity stake in the firm and thus would have strong financial incentives to resist the takeover. Even without liability, the directors will incur reputational costs if the financial institution is taken into federal receivership. Perhaps Congress intended that Section 207 would offset these factors.

[44] Director and officer insurance policies (known as D&O) are increasingly used to protect directors. These policies allow directors to exercise their business judgment without the threat of personal liability. Such protection is most important during bankruptcy, when the financial institution will not be able to indemnify directors for lawsuits and claims targeting a director's personal assets. And such suits are most likely following liquidation. Thus, an airtight insurance policy would have a similar incentive effect as Section 207. However, Section 207 remains influential at the margins. While an insurance policy protects a director's personal

C. The Scope of the Consent Provision

Section 207 preempts state and federal claims that attack a director's good faith decision to consent to the government receivership.[45] By its terms, Section 207 does not extend immunity to events that are clearly antecedent to the receivership decision. However, separating antecedent events from the decision to consent is not always a simple task. Consequently, courts may interpret Section 207 to immunize state breach of fiduciary duty suits as well as federal securities claims that challenge events that are closely related to the decision to consent. Therefore, a director who is subject to shareholder and creditor suits following liquidation will likely use Section 207 to defend against such suits.

First, directors may claim that the decision to consent to the receivership appointment occurred over an extended timeline. The FDIC has emphasized that it will begin planning for liquidation "when a bank's problems appear to be severe enough to potentially cause it to fail," which may begin several months prior to the institution's default.[46] Thus, the FDIC will monitor financial institutions closely and establish an "on-site presence" at the first signs of trouble. Establishing an on-site presence may signal that government receivership is an option for the bank.[47] Consequently,

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assets, the shareholder will still get damages and therefore will still be inclined to bring suits. But Section 207, which bars any recovery, may discourage shareholders from bringing suits. In addition, bankruptcy has the potential to complicate D&O issues. For a discussion of these issues, see Paul A. Ferrillo, *Directors and Officers Liability Insurance in Bankruptcy Settings – What Directors and Officers Really Need to Know* (April 30, 2010), *available at* http://www.weil.com/files/Publication/bc0784b3-c723-4e0a-994a-8256df4a958b/Presentation/PublicationAttachment/8b3370e9-7227-4fe5-94dd-893a244d5683/WeilBriefing_BFR_April30_10_v3%20(2).pdf.
Further, many insurance policies do not offer full coverage—some do not protect directors for their defense costs and others will only partially reimburse damages. For policies that offer less than full coverage, or policies that may be compromised in the event of default, Section 207 will provide substantial reassurance that in the event of liquidation, when the threat of suit is much greater, directors will not be forced to compensate shareholders and creditors for their losses. Of course, in the event that the director does not have D&O insurance, Section 207 will be the primary means for a director to protect against suits that challenge good-faith decisions made prior to liquidation.

[45] In this context, "good faith" means "honesty in fact in the conduct or transaction concerned." Uniform Commercial Code § 1-201(19). Thus, as long as the director was not acting fraudulently or in an attempt to injure the company to secure personal benefit, the decision would be "in good faith." *See* Guaranty Trust Co. of New York v. International Steam Pump Co., 231 F. 592 (2d Cir. 1916) ("...the record satisfies me that the directors acted in good faith when they concluded that a receivership was inevitable and that this course was determined upon, not to injure the company, nor to gain advantage for any particular class of security holders, but to save the business and plant as a going proposition."). For a discussion of the various interpretations of good faith in Delaware law, *see* Sean J. Griffith, *Good Faith Business Judgment, A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005).

[46] The Orderly Resolution of LBHI under Dodd-Frank, 5 FDIC QUARTERLY 1, 5 (2011).

[47] Of course, establishing an on-site presence could have negative signaling effects. The FDIC mentions this consequence, but contends that allowing the FDIC to have a continu-

bank directors may claim that the decision to consent to the receivership did not occur at a single point in time, but was under consideration by the board for many months as they evaluated options with the regulators. The directors may point to the regulatory presence as evidence of a prolonged decision-making process and characterize individual decisions that occurred during this time as part of a single, integrated decision. The integrated decision defense, in its broadest construction, would immunize proximate prior events that served as steps leading to the ultimate receivership resolution.

For example, courts may use Section 207 to immunize shareholder suits that allege that the directors engaged in an imprudent merger immediately before the bank went into government receivership. In such a case, the court may view the merger as part of a two-step strategy that would either save the bank or force it to obtain help from the government. The directors would get immunity for considering and pursuing such alternatives, which were reviewed within the context of deciding whether it was necessary and advisable to go into receivership. This defense could be raised for all decisions made in an attempt to avoid FDIC takeover, such as the decision to raise capital, terminate workers, or make optimistic statements.[48]

Second, FDIC supervision may exonerate directors for actions taken immediately prior to the resolution. The FDIC has made clear that it will encourage banks to seek private solutions and engage in aggressive marketing in order to avoid government takeover.[49] This encouragement and subsequent supervision would make it much more difficult for plaintiffs to establish that directors had bad intent or were grossly negligent in engaging in such activities.

For example, a director might be sued for statements that optimistically describe the future of the failing bank. To give rise to a cause of action under Rule 10b-5, a defendant must have made, with scienter, a material omission or misrepresentation connected with the purchase or sale of a security.[50] It will be difficult for a plain-

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ous on-site presence for resolution planning would reduce the signaling effect. *See Orderly Resolution of LBHI under Dodd-Frank, supra* note 1, at 11.

[48] The SEC would resist any retroactive application of Section 207 that would eliminate federal securities claims.

[49] The FDIC encourages earnest marketing with the goal of finding a private sale. *See Orderly Resolution of LBHI under Dodd-Frank, supra* note 1, at 12 ("Forcing Lehman to more earnestly market itself to a potential acquirer or strategic investor well in advance of Lehman's failure would serve several other goals, even if such private sector transaction were unsuccessful.").

[50] Rule 10b-5, promulgated pursuant to the Securities Exchange Act of 1934. The rule provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

tiff to establish intent to defraud if the bank directors were working hand in hand with the regulators. And a director could defend against a Rule 10b-5 suit by claiming that he bowed to government pressure despite his own sincere belief that the bank would be saved; thus, his initial optimism was genuine. Similarly, a director could raise a proximate cause defense, alleging that the receivership decision proximately caused the shareholder and creditor losses. He would contend that he would have been able to take necessary steps to prevent shareholder losses absent regulatory pressure to consent to the receivership.[51]

Executives have already attempted to defend against financial crisis lawsuits by pointing to their regulators. Michael Perry, the former chief executive of IndyMac Bancorp, which failed in 2008, has involved the Office of Thrift Supervision ("OTS") in defending against an SEC suit for fraud and misleading investors.[52] Perry alleged that the OTS directed and approved of contested filings, and that this approval negates any inference of scienter. [53] Further, he claimed that former OTS regional director Darrel W. Dochow "specifically directed" Mr. Perry to backdate IndyMac's report to regulators in order to make the bank appear well capitalized.

Such arguments are likely to continue to be advanced. And Section 207, with its express grant of immunity, will almost certainly be used to defend against suits following Title II liquidation. While it is unlikely that courts will extend Section 207 in large measure, the express language of the statute allows for a generous interpretation. No limiting language precedes the "for acquiescing in or consenting . . . to the appointment" portion of the provision. Notably, the provision does not include the term "solely," a term that is used fifty-nine times in the Dodd-Frank Act.[54] If Con-

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(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
17 C.F.R. § 240.10b-5 (2011).

[51] It is worth noting that a broad reading of Section 207 may pit the director's personal interest against his duty to the shareholders. However, it is doubtful this would rise to a forced breach of duty of loyalty. The receivership would only be an option if the bank was genuinely insolvent and was unable to find a private sector solution. Consequently, consenting to government control would be the only viable option for the director. And of course, the immunity provision is constrained by the limits of good faith, which would arguably exclude self-interested decisions. Decisions made at the insistence of the regulators (even with subsequent immunization from personal liability) cannot be bad faith decisions by definition—if they were, the immunity provision would be self-defeating.

[52] U.S. Sec. and Exch. Comm'n, *Litigation Release No. 21853*, U.S. SEC. AND EXCH. COMM'N (Feb. 11, 2011), http://www.sec.gov/litigation/litreleases/2011/lr21853.htm.

[53] Wells Submission on Behalf of Michael W. Perry at 32, Indymac Banccorp, Inc., (LA-3517), *available at* http://graphics8.nytimes.com/packages/pdf/business/june-1-2010.pdf.

[54] *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L.

gress had intended to ensure that the preemptive effect of the statute was limited to the decision to consent, Congress likely would have used "solely" or other restrictive language. The broad construction may encourage courts to give broad effect to the pre-emptive language.

Further, the Supreme Court has recently affirmed its willingness to extend express preemption beyond the terms of the state to eliminate state causes of action. In *Cippolene v. Liggett Group,* the Court found common law damage claims for fraudulent misrepresentation preempted by the Public Health Cigarette Smoking Act of 1969, a statute that regulated cigarette labels.[55] The statute included a preemption provision but did not mention state claims. However, the Court emphasized that Congress' enactment of an express preemption provision eliminated the need "to infer congressional intent to pre-empt state laws . . . ."[56] In identifying the domain that Congress expressly pre-empted by the statute, the Court compared the language of the Act with an earlier enactment and determined that the comparatively broad language of the current Act extended the preemptive scope of the law. Despite legislative history that demonstrated that Congress was primarily concerned with preempting positive enactments by States, the Court found that the Act reached beyond these enactments to preempt certain common law claims. Thus, all claims predicated on a legal duty disclaimed by the statute were preempted.

In Section 207, Congress explicitly preempted state law claims that challenge the decision to consent to receivership. As we have seen, this decision is rarely an isolated event. And the broad language of the provision supports the conclusion that events that precede but are reasonably related to the consent decision may also be preempted.

Consideration of Congress' overall purpose in enacting Title II further supports a broad reading. Section 207 offers protection for directors in order to encourage acquiescence when the Treasury determines that such cooperation is necessary. But even before the ultimate decision is made, bank directors must cooperate with the FDIC in order to ensure success of the liquidation process. Common law suits that challenge director decisions made while under close FDIC supervision may reduce a director's incentive to follow regulator suggestions.[57] If a narrow construction

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No. 111-203, § 739, 124 Stat. 1729 (2010) (discussing legal certainty for swaps: "No hybrid instrument sold to any investor shall be void, voidable, or unenforceable, and no party to a hybrid instrument shall be entitled to rescind, or recover any payment made with respect to, the hybrid instrument under this section or any other provision of Federal or State law, based *solely* on the failure of the hybrid instrument to comply with the terms or conditions of section 2(f) or regulations of the Commission." (emphasis added)) .

[55] Cipollone v. Liggett Grp., 505 U.S. 504, 527 (1992).

[56] *Id.* at 517 (quoting Cal. Fed. Savings & Loan Ass'n. v. Guerra, 479 U.S. 272, 282 (1987)).

[57] Note that Section 207 does not protect a director against suits that attack his or her

of Section 207 would discourage director cooperation, a court might find it necessary to preempt incompatible common law suits that challenge events connected to the decision to consent.

The Supreme Court has not hesitated to preempt state law claims that stand as an obstacle to a regulatory objective.[58] In *Geier v. American Honda Motor Co.*, the Court found state claims preempted, even in the presence of an express savings clause, when such claims would upset the regulatory scheme established by federal law.[59] The Supreme Court has further emphasized that "a liability award 'can be, indeed is designed to be, a potent method of governing conduct and controlling policy.'" [60] Thus, a court may preempt related claims when doing so would comport with federal policy objectives.

Preemption of certain common law claims following liquidation is also consistent with Congress' determination that shareholders and creditors will "bear the losses of the financial company."[61] In a May 2010 Senate Hearing, Senator Dodd explained, "the new liquidation authority is intended to be an emergency exception to bankruptcy when necessary to protect . . . the overall stability of the United States, and not to protect irresponsible creditors. . .it provides for orderly wind-down of large complex financial institutions, while still forcing shareholders to be wiped out, culpable management to be fired, and creditors to bear losses. . . ." This purpose departs substantially from bankruptcy proceedings, where courts strive to minimize shareholder and creditor losses.

Thus, it is likely that courts will find state law claims pre-empted when such claims challenge events that are reasonably related to the consent decision. In addition, courts may find federal securities claims preempted due to the presence of substantial federal regulation. In *Marine Bank v. Weaver*, the Supreme Court indicated that the securities laws should be construed narrowly where pervasive bank regulation already exists.[62] The Court came to a similar conclusion in *Credit Suisse v. Billing*,

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decision that prevented the need for government takeover. Thus, if a director engages in a shotgun merger, which causes large losses for shareholders and debtholders (but also avoids liquidation), they will be vulnerable to suits alleging breach of fiduciary duty.

[58] "[W]e think this sort of litigation would exert an extraneous pull on the scheme established by Congress, and it is therefore preempted by that scheme." Buckman Co. v. Plaintiffs' Legal Comm., 531 U.S. 341, 352 (2001).

[59] In *Geier*, plaintiff was injured in an accident while driving a car that did not have passive restraints, which were required under Federal Motor Vehicle Safety Standard (FMVSS) 208. The Court held that her lawsuit conflicted with the objectives of FMVSS 208, and was thus pre-empted by the Act. *See* Geier v. American Honda Motor Co., 529 U.S. 861, 886 (2000).

[60] Riegel v. Medtronic, Inc., 552 U.S. 312, 324 (2008) (quoting *Cipollone*, 505 U.S. at 521).

[61] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 204(a)(1), 124 Stat. 1454 (2010).

[62] Marine Bank v. Weaver, 455 U.S. 551, 558 (1982).

where it held that pervasive administrative regulation could displace an express antitrust claim.[63] The financial institutions that are subject to the Orderly Liquidation Authority are heavily regulated. Therefore, *Marine Bank* and *Credit Suisse* would support overriding Rule 10b-5 claims or other federal securities claims that are related to the decision to consent to receivership.[64]

While Section 207 expressly immunizes claims that challenge a director's decision to consent to federal receivership, it remains to be seen how far courts will extend the provision to eliminate suits based on antecedent events. Courts employ a presumption against preemption, and often construe immunity provisions narrowly.[65] However, the presumption did not prevent the Supreme Court from extending express preemption beyond the terms of a statute in order to preempt common law suits when such suits challenged a failure to act that was not required under federal

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[63] Credit Suisse Securities v. Billing, 551 U.S. 264, 275-76 (2007) ("This Court's prior decisions also make clear that, when a court decides whether securities law precludes antitrust law, it is deciding whether, given context and likely consequences, there is a 'clear repugnancy' between the securities law and the antitrust complaint—or as we shall subsequently describe the matter, whether the two are 'clearly incompatible.' Moreover, *Gordon* and *NASD*, in finding sufficient incompatibility to warrant an implication of preclusion, have treated the following factors as critical: (1) the existence of regulatory authority under the securities law to supervise the activities in question; (2) evidence that the responsible regulatory entities exercise that authority; and (3) a resulting risk that the securities and antitrust laws, if both applicable, would produce conflicting guidance, requirements, duties, privileges, or standards of conduct. We also note (4) that in *Gordon* and *NASD* the possible conflict affected practices that lie squarely within an area of financial market activity that the securities law seeks to regulate.")

[64] This argument could be coupled with the "integrated decision" argument. See *supra* note 48. Imagine that a director, in filling out a securities law disclosure statement, describes several options that the board was pursuing, including the receivership. In doing so, he excludes material facts necessary to make the disclosure statements not misleading. The directors might argue that they are immune from subsequent Rule 10b-5 claims because their statements pertained to the decision to enter receivership and the factors that went into it. And the court might accept this argument by finding that the securities laws are "clearly incompatible" with the Dodd-Frank regulation.

[65] Cipollone v. Liggett Grp., 505 U.S. 504, 523 (1992). Even in the face of statutory immunity, shareholders may find a way to use the events related to immunization as part of their overall demonstration of a breach of fiduciary duty. This is similar to the situation in antitrust law when the Noerr-Pennington defense for lobbying the government is invoked. In such cases, the Supreme Court has held that the plaintiffs can refer to government lobbying as evidence of illegal concerted behavior, even though liability cannot be based on the lobbying itself. Through the Noerr-Pennington antitrust immunity doctrine, the Supreme Court has carved out an antitrust exemption for joint efforts to influence governmental action. *See generally* Eastern R.R. Presidents Conference v. Noerr Motor Freight, Inc., 365 U.S. 127 (1961); United Mine Workers v. Pennington, 381 U.S. 657 (1965) (Concerted efforts to influence public officials do not violate the antitrust laws even if they are part of a broader scheme that violates the Sherman Act.) If this were to occur, the value of the immunity would be reduced. And if the immunity provision eliminates a substantial number of suits against directors, executives may become the targets for shareholder and creditor litigation.

law.[66] And the presumption against preemption did not stop the Supreme Court from eliminating state causes of action in the face of an express savings clause when federal policy required.[67]

Although the scope of Section 207 immunity is subject to debate, it is clear that the provision will only add to existing pressure for directors to acquiesce to financial regulators. Accordingly, the judicial review provision will have little practical value—directors will not likely choose to challenge the Treasury Secretary's decision.

II. Presumption of Substantial Responsibility for Executives

The FDIC has recently adopted a "claw-back" rule that provides for the recoupment of executive compensation following Title II liquidation.[68] Rule 380.7 authorizes the FDIC to claw-back executive compensation received within two years of the FDIC's receivership appointment if the executive is "substantially responsible" for the failure.

The rule departs from state law in two significant ways. First, the claw-back rule incorporates a presumption of substantial responsibility for executives at the failed financial company. The presumption applies to all executives with policy-making responsibility, regardless of actual misconduct. Thus, the job title presumption alters the common law burden allocation, in which the claimant bears the burden of proof. Second, an executive can rebut the presumption by proving that he or she acted prudently or did not cause the failure. Accordingly, the FDIC rule departs from the default gross-negligence standard required under the business judgment rule. The claw-back rule therefore creates a new federal duty of reasonable care for executives, who must prove that they acted prudently in order to avoid being presumed responsible for a bank's insolvency.

Importantly, Rule 380.7 is not limited to administrative actions—the FDIC intends that the burden shift and heightened standard of care will apply in any civil action. While the FDIA grants the FDIC substantial discretion over its own administrative actions, explicit Congressional authorization is required before the FDIC may alter the standard of care and shift the procedural burden in its own litigation.

A close examination of Dodd-Frank reveals that the FDIC lacked Congressional authority to displace state law, which governs both state and nationally char-

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[66] *Cipollone*, 505 U.S. at 524.

[67] *See* Geier v. American Honda Motor Co., 529 U.S. 861, 869 (2000).

[68] While the language of the FDIC rule includes directors as well, the provision should apply principally to executives. Under Section 207, directors who consent to the decision to be put into receivership will not be liable for that decision. As has been demonstrated, directors will often consent to the decision, and thus, will be immunized from the claw-back provision. Avoiding a penalty under the claw-back rule would provide additional motivation for a director to consent to the receivership appointment.

tered banks. There is no evidence that Congress authorized the burden shift or the heightened standard of care—instead, it appears that Congress intended that the FDIC would follow state law when it promulgated the claw-back rule. Consequently, the rule would be unlikely to survive an APA challenge.

Congress intended that the claw-back rule would hold responsible individuals accountable after a bank failure.[69] However, a rule that presumes culpability for individuals on the basis of executive status may have unintended adverse consequences for financial institutions. The overbroad terms of the rule may deter executives from remaining in or taking a position at a troubled financial institution. In addition, the altered standard of care may deter executives from exercising business judgment during periods of financial distress—in the very moments when the bank management should be given leeway to pursue options that might prevent default.

A. The Rule

Under Rule 380.7, the FDIC can claw back up to two years of compensation from current and former senior executives and directors who are found "substantially responsible" for the failure of the financial institution.[70] The rule displaces state law in two significant ways. First, the claw-back rule establishes that executives will bear the burden of proof. The rule provides that a senior executive or director will be presumed to be substantially responsible for the failure if: i) the senior executive or director had responsibility for the "strategic, policymaking or company-wide operational decisions of the covered financial company" (this includes the CEO, CFO, president, and chairman of the board of directors); ii) the senior executive or director is found by a court to have violated his or her duty of loyalty; or, iii) the senior executive or director is removed from his or her position by the FDIC because he or she is substantially responsible for the failure of the covered financial company.[71] A senior executive or director can rebut this presumption by showing that he or she acted "with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances," or that his or her actions did not cause a loss that materially contributed to the failure of the covered financial company.[69] This presumption does not apply to senior executives and directors hired during the two-year period prior to the FDIC's appointment as receiver to prevent further deterioration of the financial condition of the company.

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[69] The FDIC has echoed this sentiment. *See* Fed. Reg., *supra* note 15, at 4209 (emphasizing that it intends to ensure that "management, directors, and third parties who are responsible for the company's failing financial condition will be held accountable.").

[70] Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 41626, 41628 (July 15, 2011).

[71] *Id.* at 41640.

[69] *Id.* at 41641.

Thus, the FDIC rule adopts a presumption of substantial responsibility in three situations. The last two include legitimate grounds for shifting the burden of proof. In the second situation, executives will be presumed to be substantially responsible when they have breached their duty of care or duty of loyalty. This includes gross incompetence, bad faith, and self-interest violations. The third category is a tautology: it presumes substantial responsibility when the FDIC removes an executive because he or she is substantially responsible for the failure of the company. It is reasonable to adopt a presumption of substantial responsibility for individuals in these two categories. But the rule goes further—the first category presumes substantial responsibility if "the senior executive or director had responsibility for the strategic, policy-making or company-wide operational decisions." This category can include executives at failed banks who have not breached their fiduciary duties. Accordingly, a court would be required to adopt the presumption in situations even where an executive is not personally responsible for the bank failure. Thus, the claw-back rule presumes substantial responsibility solely on the basis of executive position.

In addition, an executive may rebut the presumption by proving that he or she acted prudently and did not cause the failure. Consequently, the rule sets a negligence standard of care for executive fiduciary duty: a senior executive or director is substantially responsible for the failure if the officer did not conduct "his or her responsibilities with the same degree of skill and care [as] an ordinarily prudent person," and as a result caused a loss that materially contributed to the failure of the covered financial company."[72]

The FDIC rule requires a higher standard of care for executives than the applicable state standard under the business judgment rule. The FDIC explains, "The standard of care that will trigger section 210(s) is a negligence standard; a higher standard, such as gross negligence, is not required."[73] Thus, the standard departs from the business judgment rule, in which liability "is predicated upon concepts of gross negligence."[74]

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[72] *Id.* The FDIC characterizes this standard as a negligence standard. However, the language suggests that this is a version of the "prudent man rule," which is almost exclusively applied to trustees of investments. Courts apply the prudent man rule not just with reference to an ordinary individual but to a similar expert with the training and skill expected of a fiduciary. The claw-back standard is a slightly watered down version of the prudent-man standard, but it is still a significant departure from the business judgment standard.

[73] *Id.* at 46131.

[74] "[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (later reversed on other grounds). The traditional formation of the business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Id.*

B. Background

The government has previously imposed claw-back rules in various forms.[75] The use of a claw-back mechanism emerged as a response to public outrage over rising executive compensation levels. As Professors Fried and Bebchuk have documented, "pay without performance" has contributed to public unease over executive compensation.[76] The AIG executive compensation scandal of 2009 provides an example- months after AIG's failure, evidence of multi-million dollar bonuses, paid out of federal funds, surfaced, prompting a public outcry and a rapid Congressional response.[77] Other firms, such as Goldman Sachs, have voluntarily chosen to adopt a "brake provision" that would require executives to forfeit all incentive pay not yet vested in the event of a Title II receivership.[78]

Dodd-Frank Section 210(s) authorizes the FDIC to promulgate a claw-back rule to be used after Title II liquidation. The first version of the FDIC rule was published in the *Federal Register* on October 19, 2010. Neither the original proposed rule nor the interim final rule included provisions that addressed the recoupment of executive compensation. On March 15, 2011, the FDIC Board issued for public comment a second proposed rule that introduced the claw-back provision and the rebuttable presumption. The FDIC received 21 comments in response to the proposed rule. Most of the comments were submitted by financial industry trade associations, while others were submitted by insurance trade associations, clearing and settlement companies, a committee of bankruptcy attorneys, law and business school faculty, and a group of law school students.[79] Many commentators objected to the use of a rebuttable presumption of substantial responsibility for executives.[80]

In the second proposed rule, the FDIC justified the use of a presumption by demonstrating that presumptions are consistently used in regulatory practice. The FDIC explained,

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[75] *See* Sarbanes-Oxley Act of 2002 §304, 15 U.S.C. §7243(a) (2006); Emergency Economic Stabilization Act of 2008, sec. 111, §111(b)(3)(B) 122 Stat. 3765, 3776 (2008) (to be codified at 12 U.S.C. §5221(b)(3)(B)) (applicable only to recipients of assistance under the Troubled Asset Relief Program (TARP) that have not repaid the Treasury).

[76] *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 8 (2004).

[77] Randall Smith & Liam Pleven, *Some Will Pay Back AIG Bonuses*, WALL. ST. J., Mar. 19, 2009, at A1 (describing how certain members of AIG's Financial Products group – responsible for a great deal of the losses – had received bonuses, but that some, under mounting public pressure, had decided to repay them). In response, Congress sought to impose a retroactive marginal taxation rate of 90 percent on the bonuses. H.R. 1586, 111th Cong. (2009) (enacted).

[78] Susanne Craig, *Goldman Adopts 'Brake' Provision on Bonuses*, N.Y. TIMES, Dec 23, 2010, *available at* http://dealbook.nytimes.com/2010/12/23/goldman-adopts-brake-provision-on-bonuses/.

[79] Fed. Reg., *supra* note 67, at 41627.

[80] Fed. Reg., *supra* note 67, at 41631.

> The Office of the Comptroller of the Currency ("OCC") uses rebuttable presumptions to determine when an individual's acquisition of bank stock will result in the acquisition by that individual of the power to direct the bank's management or policies. 12 CFR 5.50. The Social Security Administration uses presumptions to establish total disability. 20 CFR part 410. At common law, the existence of certain facts, such as exclusive control in negligence cases or disparate impact in discrimination cases, is viewed as sufficient to require some form of rebuttal evidence.[81]

Both the American Insurance Association ("AIA") and the American Bankers Association ("ABA") criticized the FDIC's justification for the presumption. The AIA distinguished the FDIC presumption from the examples used by the FDIC. The OCC presumption applies only when an individual files a notice with the OCC under the Change in Bank Control Act. Thus, the presumption is narrowly focused, and was incorporated to help evaluate an individual's request for OCC approval of a proposed acquisition of bank shares. The Social Security Administration rule is also distinguishable -the rule places the burden of proof on the agency in order to help the claimant, contrary to the claw-back presumption, which helps the agency at the expense of the executive.[82]

The ABA letter also pointed to the irregularity of using presumptions in this context:

> Presumptions are appropriate where direct, particularized evidence is not efficiently obtainable, which is why they are used in the other contexts cited in the [proposed rule]. Thus, presumptions are used in Social Security black-lung disability cases, where multiple confounding medical factors may make it impossible to prove with certainty exactly how a coal miner contracted a lung disease, or in employment-discrimination cases, where the true motive of the employer is often unascertainable.[83]

By contrast, the FDIC rule shifts the burden in order to help the agency recoup compensation despite the fact that the FDIC would have no trouble obtaining evidence about individual responsibility.

The FDIC largely ignored these concerns and promulgated the final rule without altering the rebuttable presumption or offering a clear justification for the burden shift. Instead, it relied on Dodd-Frank as authority for the rule:

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[81] Memorandum from James R. Wigand and Michael H. Krimminger to the FDIC Bd. of Directors (Mar. 9, 2011), *available at* www.fdic.gov/news/board/10MarNo5.pdf.

[82] *Id.*

[83] Letter from Mark Zingale, Kenneth E. Bentsen, Jr., Wayne Abernathy & Richard M. Whiting to Robert E. Feldman, Executive Secretary at the FDIC (May 23, 2011), *available at* http://www.fdic.gov/regulations/laws/federal/2011/11c11Ad73.PDF.

> The statutory language of the Dodd-Frank Act provides for the recoupment of compensation from current or former senior executives or directors of covered financial companies when they have not performed their duties and responsibilities. The use of rebuttable presumptions for those individuals under the limited circumstances in the Proposed Rule is aligned with the intent shown in the statutory language; thus, the presumptions remain unchanged in the Final Rule.[84]

Although it did not alter the presumption, the FDIC did clarify that the final rule set a negligence standard of care for recoupment proceedings.[85] The final rule requires that an executive or director be found substantially responsible "if he or she failed to conduct his or her responsibilities with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances." While this articulation borrows language from the "prudent-man" standard of care, which is often used in the context of trustees making investment decisions, it resembles a negligence standard in substance.

The FDIC further clarified that the rule was not limited to administrative proceedings, and "the FDIC as receiver may commence an action to seek recoupment and has a 'savings clause' to preserve the rights of the FDIC as receiver to recoup compensation under all applicable laws."[86] Thus, the rule allows the FDIC to shift its burden and hold an executive to a negligence standard of care in any civil action.

C. APA Challenges

Both the burden shift and new standard of care will likely be challenged under the APA, which governs the way in which administrative agencies may propose and establish regulations. The Supreme Court has granted administrative agencies broad discretion to flesh out statutory powers. However courts will not give *Chevron* deference to administrative rules when Congress has shown a different intention.[87]

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[84] Fed. Reg., *supra* note 67, at 41631.

[85] The FDIC explained, "The revision clarifies that the standard of care that will trigger section 210(s) is a negligence standard; a higher standard, such as gross negligence, is not required." Fed. Reg., *supra* note 67, at 41629.

[86] Fed. Reg., *supra* note 67, at 41629.

[86] Fed. Reg., *supra* note 67, at 41629.

[87] *See, e.g.*, Richard J. Pierce, Jr., *Chevron and its Aftermath: Judicial Review of Agency Interpretations of Statutory Provisions*, 41 VAND. L. REV. 301 (1988). In *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), the Supreme Court upheld the EPA's interpretation of the Clean Air Act, adopting a two part test: 1) "First, always is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court as well as the agency, must give effect to the unambiguously expressed intent of Congress." 2) "If, however, the Court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction of the statute . . . . [I]f the statute is silent or ambiguous with respect to the

Thus, the claw-back rule is not likely to survive an APA challenge.

The FDIC relied on Section 210(s) of Dodd-Frank as authority for the rule. Section 210(s) permits the FDIC to recover compensation from any senior executive or director deemed to be "substantially responsible" for the failure of the covered financial company.[88] However, the language of 210(s) further undermines the legitimacy of the FDIC rule and proves that Congress did not authorize the burden shift or the altered standard of care.[89] The statute emphasizes that Congress intended to

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specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." *Id.* at 842-43.

[88] It is somewhat odd that the FDIC relied exclusively on Dodd-Frank as authority for the claw-back rule when the FDIA accords the agency broad receivership powers—Congress has entrusted the FDIC with virtually complete responsibility for resolving failed federally insured depository institutions and has conferred expansive powers to ensure the efficiency of the process. Under the FDIA, the FDIC has the flexibility to employ a number of remedies when it resolves federally insured institutions. It may remove officers and directors, order salary reimbursement, and levy civil money penalties of up to $1.1 million per day when certain conditions are met. *See* Jeffrey L. Portis, *FDIC's Powers After a Bank Failure*, 65 U. DET. L. REV. 259, 259 (1988). None of these remedies requires proof of negligence or gross negligence, nor is the business judgment rule available as a defense. Instead, the FDIC must prove that practices were "unsafe and unsound," and in the case of large penalties ($1 million or greater), there must have been a knowing violation or a breach of duty. *See* FED. DEPOSIT INSURANCE CORP., RISK MANAGEMENT MANUAL OF EXAMINATION POLICIES § 14.1 (2005), *available at* http://www.fdic.gov/regulations/safety/manual/section14-1.html. Accordingly, the FDIC may order the reimbursement of executive salaries at failed commercial banks so long as the FDIC can prove that the reimbursement would correct conditions resulting from unsafe and unsound banking practices. *See* 12 U.S.C.A. § 1818 (2010). In light of these broad administrative powers, the FDIC might have claimed that the negligence standard and presumption shift are reasonable implementations of existing law in order to justify the claw-back rule.
However, there are two problems with this argument. Dodd-Frank gives the FDIC resolution authority over financial companies that were not previously under the purview of the FDIA. The FDIA clearly could not apply to nonbank financial firms. And for institutions within FDIA authority, the FDIC would have preferred to rely on Dodd-Frank rather than prove unsafe and unsound practices. The standard is unclear and is often fought over in litigation. Further, the FDIA grants the FDIC broad powers to resolve failed insured depository institutions in its own administrative actions. By contrast, the claw-back rule allows the FDIC to seek the recoupment of compensation through the court system.

[89] Dodd-Frank § 210(s):
Recoupment of Compensation From Senior Executives and Directors.—
(1) In general.—The Corporation, as receiver of a covered financial company, may recover from any current or former senior executive or director substantially responsible for the failed condition of the covered financial company any compensation received during the 2-year period preceding the date on which the Corporation was appointed as the receiver of the covered financial company, except that, in the case of fraud, no time limit shall apply.
(2) Cost considerations.—In seeking to recover any such compensation, the Corporation shall weigh the financial and deterrent benefits of such recovery against the cost of executing the recovery.
(3) Rulemaking.—The Corporation shall promulgate regulations to implement the requirements of this subsection, including defining the term 'compensation' to mean any financial remuneration, including salary, bonuses, incentives, benefits, severance, deferred compensation, or golden parachute benefits, and any profits realized from the sale of the securities of the

permit recovery only in cases where the executive is personally "substantially responsible for the failed condition of the covered financial company." "Responsible" requires individual culpability and causation, and "substantially" would require heavy involvement, not peripheral association with the bank failure. Further, Congress used "responsible" without "substantially" in sections of Dodd-Frank that call for the removal of directors and officers, which reveals that Congress meant to apply a higher standard for executives in recoupment cases.[90]

In addition, the claw-back rule does not provide a satisfactory explanation for its use of the presumption or the negligence standard of care, nor did the FDIC perform any cost-benefit analysis in connection with the adoption of the rule. An agency must justify its actions with a description of the logical basis and purpose of the rules it promulgates.[91] The Supreme Court "insist[s] that an agency 'examine the relevant data and articulate a satisfactory explanation for its action.'"[92] The D.C. Circuit has required that an agency accompany a new rule with a persuasive statement of reasons that address competing considerations.[93] Increasingly, the absence or inadequacy of cost-benefit assessments has become the basis for vacating administrative rules.[94] And the FDIC has emphasized in its own policy statements that it ex-

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covered financial company.
Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(s), 124 Stat. 1514 (2010) (to be codified at 12 U.S.C. § 5390).

[90] *See* Letter from Mark Zingale, Kenneth E. Bentsen, Jr., and Wayne Abernathy, Richard M. Whiting to Robert E. Feldman, Executive Secretary at the FDIC, page 11 (May 23. 2011), available at http://www.fdic.gov/regulations/laws/federal/2011/11c11Ad73.PDF, ("Sections 206(4) and 206(5) of Dodd-Frank call for the removal of directors and officers who are 'responsible' for the failed state of the covered company. By contrast, Section 210(s) calls for the clawback of the salaries of those directors and officers who are 'substantially responsible' for such a failure. Congress clearly meant to apply a higher standard in cases of recoupment, as compared to the standard applied in cases of removal.")

[91] *See* 5 U.S.C. § 557(c)(3)(A) (requiring an agency's adjudicative decision to be "accompanied by a clear and satisfactory explication of the basis on which it rests."). *Barren Creek Coal Co. v. Witmer*, 111 F.3d 352, 356 (3d Cir. 1997), *citing Cotter v. Harris*, 642 F.2d 700, 704–05 (3d Cir. 1981).

[92] *F.C.C. v. Fox Television Stations, Inc*, 556 U.S. 502, 513 (2009), *citing Motor Vehicle Mfrs. Assn. of United States, Inc. v. State Farm Mut. Automobile Ins. Co.*, 463 U.S. 29, 43 (1983).

[93] *See generally* Chamber of Commerce of the United States v. SEC, 412 F.3d 133 (D.C. Cir. 2005). In this case, Judge Ginsberg held that the SEC's failure to consider the costs of the conditions that it imposed in its new rule violated its duty to consider whether the rule was consistent with the public interest. Judge Ginsberg further held that the SEC's failure to consider suggested alternatives to an independent chairman condition in its rule violated the APA.

[94] *See* Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011). The Office of the Inspector General ("OIG") recently released a report assessing the FDIC's cost-benefit work in connection with the adoption of three Dodd-Frank rulemakings. The OIG concluded that the FDIC met its burden because it "worked jointly with other financial regulatory agencies to ensure a coordinated rulemaking effort; performed quantitative analysis of relevant data; considered alternative approaches to the extent allowed by the legislation; requested comment from

pects a cost-benefit assessment to accompany the issuance and review of rules.[95] By these standards, the FDIC's justification, which merely pointed to Dodd-Frank Section 210(s) as authority for the rule, was grossly inadequate.

The FDIC's choice to create a rule that applies in any civil action further undermines its decision to depart from state law. State law governs both state and nationally chartered banks,[96] even when an agency is party to the litigation. In *O'Melveny & Myers v. FDIC*, the FDIC claimed that federal law should determine the outcome of the case because it was appointed receiver of the failed financial institution subject to the litigation under FIRREA, a federal statute.[97] In rejecting this argument, the Supreme Court explained that where Congress has promulgated a comprehensive and detailed statute, the court must presume that state law rather than federal common law governs matters unaddressed by the federal statute.[98] The Court conclusively put an end to the application of federal common law to banks in *Atherton v. FDIC,* where it held that state law applied to all federally chartered banks.[99] Section 210(s) does not displace this established doctrine.

Other federal statutes that grant the FDIC authority to pursue claims against directors have used state law as a baseline. For example, FIRREA, which was passed in the midst of the savings and loan crisis, established gross negligence as a national minimum standard for director liability.[100] But the statute only allowed the FDIC to pursue claims against directors under a stricter liability standard if it would be permissible under state law. Thus, the FDIC should have first determined that the clawback rule standard of care was within the bounds of state law absent Congressional authorization to do otherwise. Congress did not indicate that it intended for the

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the public on numerous facets of the rules; and, where applicable, included information about the analysis that was conducted and assumptions that were used in the text of the proposed rule." By contrast, the FDIC did not accompany the clawback rule with any qualitative analysis of the rule's effects. *Evaluation of the FDIC's Economic Analysis of Three Rulemakings to Implement Provisions of the Dodd-Frank Act*, Office of the Inspector General, Report No. EVAL-11-003, *available at* http://www.fdicoig.gov/reports11/Eval-11-003-508.shtml.

[95] *Statement of Policy on the Development and Review of Regulations*, No. 5157, 63 Fed. Reg. 25157 (1998) ("Prior to issuance, the potential benefits associated with the regulation or statement of policy are weighed against the potential costs.").

[96] A national bank is a citizen for diversity purposes only of the state of its main office. Wachovia Bank v. Schmidt, 546 U.S. 303, 318 (2006)..

[97] O'Melveny & Myers v. FDIC, 512 U.S. 79, 85-88 (1994).

[98] 12 U.S.C. § 1821(k).

[99] *See* Atherton v. FDIC, 519 U.S. 213 (1997) ("There is no federal common law that would create a general standard of care applicable to this case . . . Normally, a federal court may fashion federal common law rules only upon a specific showing that the use of state law will create a significant conflict with, or threat to, some federal policy or interest . . . [H]ere . . . the FDIC is acting only as a receiver of a failed institution; it is not pursuing the government's interest as a bank insurer.")

[100] 12 U.S.C. § 1821(k).

claw-back rule to depart from state law in Section 210(s), nor did the FDIC adequately justify its decision to do so.

1. Congress Did Not Authorize the Presumption of Culpability for Executives.

It is unlikely that the presumption of culpability and the burden shift would survive an APA challenge. The FDIC's burden shift displaces state law, which Congress presumptively intends to follow unless it clearly states the opposite.[101] And Dodd-Frank did not give the FDIC the authority to eliminate its own burden of proof in bank insolvency actions.

Under federal and state common law, the burden of proof is on the claimant, especially when fraud or breach of fiduciary duty are concerned. (The claimant seeking fraud damages has to offer proof by "clear and convincing evidence."[102] The burden for a civil case is usually "by a preponderance of the evidence."[103]). And the traditional procedural rule requires the claimant to bear the burden of proof. The claw-back burden shift is thus in conflict with the traditional procedural rule. It also conflicts with the express allocation of burdens in the APA, which bind the agency in its own administrative proceedings.[104] The APA burden arguably states Congress' expectations for administrative proceedings of all kinds, even when the claim is made in federal court.

An analysis of Dodd-Frank further demonstrates that Congress did not intend the burden shift. Congress established presumptions in other sections of the Orderly Liquidation Authority, which suggests that it would have done so in Section 210(s) if it had wanted to.[105] Further, Congress recently passed two other statutes

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[101] *See* 2 Sutherland Statutory Construction § 36:9 (7th ed). ("A strong presumption exists against preemption. Consequently, preemption can only be found if the federal law clearly evinces a legislative intent to preempt the state law, or there is such direct and positive conflict that the two acts cannot be reconciled or consistently stand together.")

[102] *See* Fed. R. Civ. P. 9.

[103] 37 Am. Jur. 2d Fraud and Deceit § 493.

[104] The APA provides, "[E]xcept as otherwise provided by statute, the proponent of a rule or order has the burden of proof." 5 U.S.C. § 556(d). The Supreme Court has said that an agency "cannot allocate the burden of persuasion in a manner that conflicts with the APA." Director, Office of Workers' Compensation Programs, Dept. of Labor v. Greenwich Collieries, 512 U.S. 267, 281 (1994).

[105] Dodd-Frank Wall Street Reform and Consumer Protection Act § 210(a)(11)(H)(ii)(I), 124 Stat. 1376, 1473: "The covered financial company is presumed to have been insolvent on and during the 90-day period immediately preceding the date of appointment of the Corporation as receiver. . ."; § 210(a)(12)(D), *id.* at 1474: "Presumption of Insolvency: For purposes of this paragraph, the covered financial company is presumed to have been insolvent on and during the 90-day period preceding the date of appointment of the Corporation as receiver"; § 626(d)(2), *id.* at 1640: "PERMISSIBLE CORPORATE REORGANIZATION.—The formation of an intermediate holding company as required in subsection (b) shall be presumed to be a permissible corporate reorganization as described in

that allow for the recoupment of compensation without adopting presumptions.[106] If a statute that allows for the recoupment of compensation justifies the presumption, it surely would have been attempted before. Or, put another way, the authors of the legislation failed to mention presumptions in each such case, which means that it could not have been necessary to carry out the intent of the legislation.

Thus, Congress explicitly addressed the issue in question: it did not give the FDIC authority to shift the burden, and the federalism canon requires that an agency presume Congressional intent to follow state law absent explicit instructions to the contrary. Given the longstanding historical practice of placing the burden of proof on the claimant under both federal and state common law, as well as the APA allocation of the burden, it is not likely that a court would accept a burden shift imposed in the agency's own litigation proceeding.

The FDIC rule would also fail at *Chevron* step two. Absent clear Congressional intent, a court may overturn any rule that is "arbitrary or capricious in substance, or manifestly contrary to the statute."[107] Switching the burden of proof is arbitrary and capricious in this context, and is unlikely to survive judicial scrutiny.

As a general rule, presumptions do not shift the burden of proof. Instead, a presumption in a civil case imposes the burden of production on the party against whom it is directed, but does not shift the burden of persuasion.[108] Thus, a civil presumption places the burden of going forward with the evidence on the party against whom it operates.[109] However, the FDIC rule shifts the burden of persuasion: it only allows the executive to "rebut" the legal "presumption" of misconduct "by showing" that he acted in a non-negligent fashion or that he did not materially contribute to the economic losses. Shifting the burden of persuasion is radical, and is subject to greater scrutiny. And the claw-back rule clearly shifts the burden of production and the burden of persuasion on two issues that would otherwise be the burden of the govern-

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section 10(c)(9)(D)"; § 1412, *id.* at 2145: "Section 129C of the Truth in Lending Act is amended by inserting after subsection (a) (as added by section 1411) the following new subsection: '(b) PRESUMPTION OF ABILITY TO REPAY.— "(1) IN GENERAL.—Any creditor with respect to any residential mortgage loan, and any assignee of such loan subject to liability under this title, may presume that the loan has met the requirements of subsection (a), if the loan is a qualified mortgage.'"'

106 Emergency Economic Stabilization Act, 122 Stat. 3765 (2008), does not mention presumptions; American Recovery and Reinvestment Act, 123 Stat. 115 (2009), does not mention presumptions. Further, the legislative history does not mention presumptions in the context of the recoupment of executive compensation.

107 United States v. Mead Corp., 533 U.S. 218, 227 (2001).

108 "In a civil case, unless a federal statute or these rules provide otherwise, the party against whom a presumption is directed has the burden of producing evidence to rebut the presumption. But this rule does not shift the burden of persuasion, which remains on the party who had it originally." Fed. R. Evid. 301.

109 31A C.J.S. Evidence § 214.

ment.

It is not easy to rationalize a burden switch in circumstances such as these. As the comment letters point out, courts may endorse a presumption of liability if circumstances support an inference of misconduct. For example, if there is evidence of bad faith or a conflict of interest, the business judgment rule does not apply. Instead, the fairness rule authorizes a burden shift to the directors or executives in such cases.[110] By contrast, the FDIC rule is sweeping—any executive could be presumed substantially responsible on the basis of his or her position, even absent evidence of conflict or misconduct.

Presumptions or inferences are sometimes used because one side has unique access to information (but, again, such presumptions shift the burden of coming forward, not the burden of persuasion, as this rule does). During Title II liquidation, the executives who are presumed responsible have no special inside information about their performance. The Orderly Liquidation Authority holds failing financial institutions to strict reporting requirements.[111] When the FDIC is appointed receiver of a failed financial institution, it gains access to records showing assets, liabilities, and all bank transactions.[112] Consequently, the FDIC will have access to all information relevant to a determination of executive performance. Nor would the bank executives have a unique financial advantage—the government has a wealth of resources and expertise to bring to bear in such lawsuits.

Thus, the presumption is unlikely to be sustained. Instead, a reviewing court might use the surplusage canon of interpretation to avoid incongruous results. As discussed, the test for rebuttable presumption incorporates three categories. The first includes all individuals with responsibility for the strategic, policymaking, or company-wide operational decisions of the financial company, and consequently renders the second two categories superfluous. In order to avoid this absurd result, a court might read the first part of the regulation as a preamble to the rule instead of a separate basis for shifting the burden of persuasion. This would lend credibility to the

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[110] "Under the business judgment rule, the burden is on the party challenging the decision to establish facts to rebut the presumption. Where the business judgment rule does not apply, the burden shifts to the directors to prove the 'entire fairness' of the transaction." 3A Fletcher Cyc. Corp. § 1036. In *In re S. Peru Copper Corp. S'holder Derivative Litig.*, 30 A.3d 60, 87 n.72 (Del. Ch. 2011), Chancellor Strine cautioned against a broad construction of the fairness rule: "Unless there are facts suggesting that the directors consciously approved an unfair transaction, the bad faith preference for some other interest than that of the company and the stockholders that is critical to disloyalty is absent. The fact that the transaction is found to be unfair is of course relevant, but hardly sufficient, to that separate, individualized inquiry."

[111] *See* The Orderly Resolution of LBHI under Dodd-Frank, 5 FDIC Q. 1, 5 (Early Release, 2011).

[112] *See* Michael B. Kent, Jr., *The Court Giveth, and Congress Taketh Away*, 116 Banking L.J. 214 (1999).

presumption of substantial responsibility, which would then be employed when the executive was found to have breached his duty of care or duty of loyalty, or when the FDIC had already removed the executive for misconduct.

2. Congress Did Not Authorize the Altered Standard of Care.

Applying a *Chevron* analysis to the negligence standard used in the claw-back rule results in a similar conclusion: Congress did not intend for the FDIC to depart from the state law standard of care. Again, the federalism canon of interpretation requires the FDIC to refrain from displacing state law unless Congress has made a clear statement to the contrary.[113] Section 210(s) does not include a "clear and manifest" indication that Congress intended the FDIC to supersede the state law standard of care.[114] Consequently, the FDIC impermissibly encroaches on state law, which governs both state and nationally chartered banks, by creating a new federal standard of fiduciary duty for bank executives in insolvency cases. Without some indication that Congress intended the FDIC to impose a heightened standard of care, the FDIC rule fails at *Chevron* step one.

The business judgment rule is the default standard of review governing breach of fiduciary duty in the majority of states.[115] Under the rule, courts will not second-guess a business decision absent evidence of a conflict or bad faith.[116] By contrast, a prudent man rule is not the test for fiduciary duty for bank directors or executives in any state. A negligence standard also departs from the default standard of care in most jurisdictions.[117]

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[113] The Court adopted a powerful federalism interpretation: "If Congress intends to alter the usual constitutional balance between the States and the Federal Government, it must make its intention to do so unmistakably clear in the language of the statute." *Gregory v Ashcroft*, 501 U.S. 452, 460 (1991), *citing Atascadero State Hospital v. Scanlon*, 473 U.S. 234, 242 (1985).

[114] "Where ... the field which Congress is said to have pre-empted" includes areas that have "been traditionally occupied by the States," congressional intent to supersede state laws must be "clear and manifest," *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977), *citing Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947). *See also* United States v. Shimer, 367 U.S. 374, 383 (1961) ("It has long been recognized that many of the responsibilities conferred on federal agencies involve a broad grant of authority to reconcile conflicting policies. Where this is true, the Court has cautioned that even in the area of pre-emption, if the agency's choice to pre-empt 'represents a reasonable accommodation of conflicting policies that were committed to the agency's care by the statute, we should not disturb it unless it appears from the statute or its legislative history that the accommodation is not one that Congress would have sanctioned.'").

[115] *See generally* William Meade Fletcher, 3A Fletcher Cyc. Corp. § 1036 (2012). *See also* Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 457 (Del. Ch. 2011) ("Delaware has three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny, and entire fairness. The business judgment rule is the default standard of review.").

[116] *See generally* 3A Fletcher Cyc. Corp. §1036.

[117] The business judgment rule is "both a procedural guide for litigants and a substantive rule of law." Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989).

An examination of traditional FDIC policy further confirms that the claw-back negligence standard is an outlier. The FDIC has preferred not to second-guess the business judgment of the board, following an internal policy of pursuing outside director claims when the facts suggest grossly negligent conduct.[118] In FDIC Examiner Anton Valukas' report on the failure of Lehman Brothers, Mr. Valukas concluded that although the many business decisions "may have been in error," they did not support claims against the officers and directors: "Ultimately, the Examiner concludes that while certain of Lehman's risky decisions can be described in retrospect as poor judgment, they were within the business judgment rule and do not give rise to colorable claims."[119]

A court might also find that personal liability is an arbitrary and capricious remedy because the FDIC, the Federal Reserve, and the Treasury largely determine which banks fail. During the financial collapse of 2008, some banks were "bailed out" because they were too big to fail. Smaller banks were sold in shotgun marriages or liquidated.[120] Although the Orderly Liquidation Authority claims to eliminate the government bail out solution for failed banks, it is clear that the government heavily influences the resolution process. It is irrational to make bank executives personally liable for two years' salary, a substantial forfeiture, when the results are largely the product of government decision-making.

The claw-back rule is also overbroad in its use of a heightened standard of care. It is not tailored to situations in which the FDIC has evidence of executive conflict or bad faith. Instead, the claw-back rule alters the standard of care for all executives who have policymaking authority and who wish to demonstrate that they were not substantially responsible for the failure. This includes directors who have not breached their duty of loyalty or duty of care, or directors who have acted appropriately under the legal standard. And bank insolvency, which could be the product of government policy or bad economic conditions, does not by itself support an inference of director misconduct.[121] Accordingly, imposing a heightened standard of care

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[118] Fed. Deposit Ins. Corp., The FDIC and RTC Experience, Managing the Crisis 266, 275 n.11 (1998) ("...directors and officers are generally protected from liability if they have acted in good faith and with due care, and if they have made fully informed business decisions within the scope of their authority and without personal interest or self-dealing.")

[119] *In re Lehman Brothers Holdings Inc.*, Report of Anton R. Valukas, Examiner, *available at* http://lehmanreport.jenner.com/VOLUME%201.pdf, 22.

[120] Hank Greenberg, former AIG CEO has sued the Treasury for its allegedly discriminatory treatment of AIG during the government takeover. The lawsuit contends that the terms of the government's assistance to AIG were substantially less favorable than the terms of the government's assistance to Citigroup. Gretchen Morgenson, *Greenberg Sues U.S. Over A.I.G. Takeover,* N.Y. Times, Nov. 21, 2011, *available at* http://www.nytimes.com/2011/11/22/business/greenberg-sues-us-over-aig-takeover.html.

[121] During good times, bad management may cause bank failures. But the financial crisis of 2008 was largely the product of systemic economic problems and inadequate govern-

lacks a rational basis. For these reasons, the claw-back rule is unlikely to survive an APA challenge.

The altered fiduciary standard has the potential to drastically impact litigation outcomes, even more so than a burden switch. Under the business judgment standard, courts generally will not question an executive's business decisions because the quality of a business decision cannot always be judged by its results.[122] Business decisions are inherently risky, and may fail for reasons other than executive misconduct. As such, personal liability for a decision that produces bad results would discourage executives from entrepreneurial risk taking.[123] Consequently, this claw-back rule will likely deter bank executives from using their business judgment when engaging in rescue efforts. Executives may be dissuaded from "aggressive marketing" or from seeking private sector solutions that would pose losses for shareholders because such a strategy may be viewed as unreasonable. Thus, the rule may increase the likelihood of government receivership.

However, advocates of the rule may contend that this deterrent effect is beneficial in the context of large financial institutions. Due to federal deposit guarantees and the possibility of a federal bailout, executives at systemically significant financial institutions may be induced to engage in risk-taking behavior that is socially suboptimal. In other words, because bank executives privatize the gains from risk-taking but socialize the losses, moral hazard exists. But Dodd-Frank, which purports to end "too big to fail," lessens this concern. Further, a judicially imposed negligence standard is not the best way to discourage risk taking by bank executives. Most business decisions incur the risk of a bad outcome, and it would be difficult for a court to distinguish entrepreneurial risk taking from imprudent behavior. For one, a court reviewing these issues is poorly situated to judge executive conduct. In hindsight, many decisions will appear unreasonable. In addition, the determination is complex and subject to error. Thus, the substantial risk that an executive's actions would be erroneously viewed as unreasonable would over-deter executives from exercising

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mental policies. *See generally* FDIC Report, History of the Eighties—Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s, vol. 1, *available at* http://www.fdic.gov/bank/historical/history/3_85.pdf.

122 Mark J. Roe, *Corporate Law's Limits*, 31 J. Legal Stud. 233, 243 (noting, "Conventional corporate law does little, or nothing, to directly reduce shirking, mistakes, and bad business decisions that squander shareholder value. The business judgment rule is, absent fraud or conflict of interest, nearly insurmountable in America, insulating directors and managers from judges and freeing them from legal scrutiny."). *See also* Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051–52 (Del. Ch. 1996), ("There is a theoretical exception to [the business judgment rule] that holds that some decisions may be so 'egregious' that liability . . . may follow even in the absence of proof of conflict of interest or improper motivation. The exception, however, has resulted in no awards of money judgments against corporate officers or directors in [Delaware.]").

123 *See generally*, 3A Fletcher Cyc. Corp. § 1037.

their business judgment. Finally, the FDIC rule does not solve the executives' moral hazard problem; because the claw-back rule is capped at the two-year period preceding the receivership, it would be difficult for the court to adequately calibrate the penalty required to offset the risk taking behavior. Thus, the executive would still take risks when the benefits exceed actual costs.

A better solution, which has been proposed by Professor Bebchuk and Professor Spamann, would be to alter compensation structures that currently insulate directors from the downside to risk taking behavior. Paying executives with a broader segment of firm assets, such as preferred stock and outstanding bonds, would expose executives to "a broader fraction of the negative consequences of risks taken," thereby reducing incentives for excessive risk taking without involving the courts.[124] And if the promise of bank liquidation (and the accompanying job loss and threat of liability) is not enough to discourage directors from excessive risk taking, firms could follow in the footsteps of Goldman Sachs by voluntarily adopting a "brake" provision in the event of a receivership.

Finally, the claw-back rule may also dissuade experienced individuals from serving as executives at troubled financial companies. The Delaware Supreme Court recently cautioned against expanding liability into the area of executive compensation for this reason. In *In re The Goldman Sachs Group, Inc. Shareholder Litigation*, the Court explained that expansive liability "could potentially chill the [ability of corporations to retain the] service of qualified directors." The court further emphasized, "'oversight duties under Delaware law are not designed to subject directors . . . to personal liability for failure to predict the future and to properly evaluate business risk.'. . . Good faith, not a good result, is what is required of the board."[125]

Thus, the rule will motivate talented executives to leave troubled institutions as problems become insurmountable.[126] And although the presumption does not apply to executives that were hired during the two years prior to government receivership, the rule may impact executives who are hired to bring about recovery that may take more than two years to accomplish. For these reasons, the claw-back rule is likely to have perverse consequences for distressed financial companies, making it more difficult for management to engage in successful rescue efforts.

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[124] Lucian Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 Geo. L.J. 247, 284 (2010).

[125] In re Goldman Sachs Group, Inc. Shareholder Litigation, 2011 Del. Ch. LEXIS 151, 76 (Del. Ch. 2011), *citing In re Citigroup*, 964 A.2d 106, 131 (Del Ch. 2009).

[126] This effect will be less pronounced with an altered compensation scheme. While the executive may be paid with a greater fraction of firm assets, he or she may also be compensated accordingly for taking on additional risk.

Conclusion

The Orderly Liquidation Authority alters the scope of fiduciary duty during the resolution process. Section 207 narrows director fiduciary duty by guaranteeing that a director will be immune for his or her decision to consent to government receivership. In implementing Section 210(s), the FDIC has moved in the opposite direction, adopting a regulation that expands fiduciary duties for bank executives. These provisions seem to reflect divergent policy judgments. But there are different purposes at work.

Section 207 creates beneficial incentives for directors to work cooperatively with government regulators. Director cooperation is necessary for the resolution process to function smoothly. And while this provision, coupled with existing regulatory influence, renders the prospect of judicial review unlikely, a judicial check on regulatory power has limited practical importance in this context. The Orderly Liquidation Authority contains inherent safeguards to prevent abuse of regulatory power. For example, the government's incentives are aligned with the board of directors—both the government and the management consider government receivership to be a last resort. In addition, Congress restricted the FDIC's resolution power to systemically significant institutions, which ensures that the FDIC's expanded powers are limited to the cases in which immediate regulatory action is necessary. The events of the financial crisis of 2008 demonstrate that a rapid resolution of systematically significant institutions is necessary to promote economic stability and the judicial process is not well suited to resolve these issues in a timely manner. The complexity of the Secretary's determination suggests that any meaningful review of the decision would require more than twenty-four hours of deliberation.

Dodd-Frank's departure from bankruptcy law in certain sections of Title II also appears well calculated. For example, Congress intended that shareholders and creditors would not be given priority following liquidation. This outcome was designed to ensure that the costs of liquidation would be borne by the shareholders and creditors, instead of taxpayers.

The claw-back rule prescribed in Dodd-Frank also creates beneficial incentivizes for executive behavior. The rule envisioned by Congress would secure a higher level of executive responsibility by forcing culpable executives to give up two years of compensation.

But the FDIC rule, which adopts a presumption of responsibility based on executive status without considering individual misconduct, may have unintended adverse consequences for financial institutions. Courts use the business judgment rule because they are unable to evaluate the quality of a business decision based on hindsight. The FDIC rule, which turns on adverse outcomes, creates negative incentives for executives at financial institutions. As the ABA explained in its comment let-

ter, "such a rule could encourage a revolving door of senior executives and directors seeking to avoid recoupment, a situation that would undermine, rather than promote, stability. . . ."[127] And by requiring executives to demonstrate that they acted prudently to avoid a substantial penalty, the rule will discourage executives from assuming positions in troubled financial institutions. While the drafters of Dodd-Frank hoped to deter excessive risk taking at financial institutions, the rule sweeps too broadly by inviting the judiciary to evaluate all business decisions under a negligence standard (absent an indication of individual misconduct). Of course, courts may choose to interpret the rule narrowly by refusing to depart from the state law standard of care and burden allocation, allowing a presumption of guilt only after fiduciary misconduct has been demonstrated.

As Professor Clark has demonstrated, massive corporate law-reforms often depend on a bandwagon effect.[128] The Dodd-Frank Act, an extensive piece of legislation that triggered an outpouring of new implementing regulations, was passed quickly by an administration and Congress controlled by a single political party. The rallying cry at the time was that "a crisis is a terrible thing to waste." But economic waste also derives from mistaken prescriptions in such broad-scale regulatory efforts, and it is predictable that courts and future Congresses will be called upon to address policy errors such as the burden-shifting standard discussed here.

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[127] Mark Zingale et al., letter to Robert E. Feldman, Executive Secretary at the FDIC, May 23, 2011, http://www.fdic.gov/regulations/laws/federal/2011/11c11Ad73.PDF.

[128] Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbannes–Oxley Act: A Morality Tale for Policymakers Too*, 22 Ga. St. U. L. Rev. 251, 308–09 (2005).