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Non-Shareholder Voice in Bank Governance: Board Composition, Performance and Liability

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Abstract

Starting from the well-evidenced fact that banks with shareholder-focussed corporate governance fared worse in the financial crisis than those without, this paper considers various initiatives and proposals to re-orient board rules in relation to banks. The paper considers three type change. First, increased influence over board composition and behaviour without granting new rights of board representation to any group of persons. In this section we look at influence for the general public interest in bank stability via an increased role for bank supervisors in the selection and monitoring of bank directors and significant bank executives, and at an increased role for long-term creditors, in particular bondholders. The former is partly already in place and for the latter we suggest ways in which changes could be made, mainly via contract. Second, we look at influence via board representation, mainly for creditors but also for the public interest. We are sceptical about the scale of the benefits such representation is likely to afford and point out some of the costs of these proposals. Finally, we look at enhanced liability, whether regulatory, criminal or civil. There are many proposals for change in this area, some very far-reaching. We doubt the benefits of enhanced criminal liability, but think that more enforcement effort, especially in the regulatory field, but also as to civil liability, would yield positive results.

Keywords: Corporate Governance of banks, role of debt-holders and creditors, civil and criminal liability of bank directors, fit and proper, bank supervision, board composition, enforcement

JEL Classifications: G21, G3, K22

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Non-Shareholder Voice in Bank Governance:

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Paul Davies* and Klaus J. Hopt**

Survey

Abstract

Starting from the well-evidenced fact that banks with shareholder-focussed corporate governance fared worse in the financial crisis than those without, this paper considers various initiatives and proposals to re-orient board rules in relation to banks. The paper considers three type change. First, increased influence over board composition and behaviour without granting new rights of board representation to any group of persons. In this section we look at influence for the general public interest in bank stability via an increased role for bank supervisors in the selection and monitoring of bank directors and significant bank executives, and at an increased role for long-term creditors, in particular bondholders. The former is partly already in place and for the latter we suggest ways in which changes could be made, mainly via contract.

Second, we look at influence via board representation, mainly for creditors but also for the public interest. We are sceptical about the scale of the benefits such representation is likely to afford and point out some of the costs of these proposals. Finally, we look at enhanced liability, whether regulatory, criminal or civil. There are many proposals for change in this area, some very far-reaching. We doubt the benefits of enhanced criminal liability, but think that more enforcement effort, especially in the regulatory field, but also as to civil liability, would yield positive results.

I. Bank Governance and Corporate Governance

There is widespread agreement in the academic literature that banks which had 'good' corporate governance suffered bigger losses in the financial crisis at the end of last decade than those banks with less good corporate governance.[1] 'Good' governance for the purpose of these studies means governance based on the UK-US model which became dominant in corporate law in the three or four decades leading up to the crisis. The theory behind this model is that the welfare of society is best promoted by managers who run the company in the interests of the shareholders who, as residual claimants on the company's revenues, have the strongest incentive to improve the operational efficiency of the company. Corporate law should favour shareholders, not because shareholders are deserving from a distributional point of view, but because the welfare of society as a whole will thereby be maximized. From this theory it follows that the rules relating to the selection, functions and accountability of the members of the board should be such as to promote the shareholders' interests.[2] Thus, the board should contain a substantial proportion of "independent" directors, it should focus a significant proportion of its effort on monitoring the activities of the management, and it should be accountable to the shareholders (though the theory does not define precisely the level at which that accountability should be pitched). The findings of the post-crisis studies clearly represent a major challenge to this theory, but one confined to the banking (or, possibly, the wider financial) sector. Professor Cheffins has argued that, outside the financial sector, the institutions of corporate governance operated "tolerably well" in the crisis.[3] Nevertheless, the studies of the performance of banks in the crisis clearly create a major puzzle. They suggest that there is a tension between good corporate governance, as conventionally understood, and the stability of the banking system. The purpose of this paper is to explore the implications of these studies for the corporate governance of banks.

There are three main groups of explanations about what went wrong with bank governance in the crisis: monitoring failures, accountability failures and incentive failures. To some degree these explanations overlap and they are certainly not mutually exclusive. Monitoring failure can be attributed to the inherent difficulty of supervising the complex activities of a bank, especially given the opacity of its balance sheet, ie the difficulty of judging the quality of the bank's assets.[4] A bank loan is an asset, but its value depends on

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[1] This literature is summarized and analysed in J Armour et al, *Principles of Financial Regulation* (OUP, 2016) ch 17. The leading studies are A Beltratti and R Stulz, "The Credit Crisis around the Globe: Why Did Some Banks Perform Better? (2012) 105 *Journal of Financial Economics* 1; D Erkins, M Hung and P Matos, "Corporate Governance in the 2007-2008 Financial Crisis" (2012) 18 *Journal of Corporate Finance* 389; M Becht, P Bolton and A Röell, "Why Bank Governance is Different" (2012) 27 *Oxford Review of Economic Policy* 437.

[2] Although the opposite is often stated, there is nothing in this theory which assumes that the shareholders' interests are to be assessed on a short-term basis.

[3] Brian Cheffins, "Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500" (2009) 65 *The Business Lawyer* 1. He argues further that a major problem within banks was the failure to follow one general corporate governance good practice, ie the continued existence in banks of an "imperial" CEO: "The Corporate Governance Movement, Banks and the Financial Crisis" (2015) 16 *Theoretical Enquiries in Law* 1.

[4] Becht et al, above n 1, at 438.

the creditworthiness of the counterparty, which may be difficult to track over time. The value of a financial asset held by the bank may depend heavily on the liquidity of the market for the relevant class of asset and, except for 'plain vanilla' financial assets traded on deep and liquid markets, market liquidity may be highly volatile. The inherent difficulty of judging the value of the bank's businesses could be heightened by the stress in conventional corporate governance on the independence of directors, who, as outsiders, might not have the firm- or industry-specific understanding necessary to evaluate such information about the bank as was available to the board. Finally, the board might have trusted that overall risk management was something the regulator was taking care of, through regulatory capital requirements. Except in relation to the potential competence of independent directors, the monitoring story is not strongly related to the shareholder-focussed model of corporate governance: whatever the interests the board perceives itself as there to promote, running a bank from the board looks like a tough job.

The accountability failure does bring the standard model of corporate governance more clearly into focus. An assumption underlying the standard UK-US theory is that the company is exposed to all or substantially all the costs of carrying on its business. If there are costs of the company's activities which are borne by others and not the company ("negative externalities"), then management accountable to shareholders is likely to adopt policies which are excessively risky in relation to those particular costs. As the financial crisis showed, the costs to third parties of a general bank crisis are extremely large, even if banks are bailed out, and likely would have been larger had the banks not been bailed out.[5] In the case of bail-out, taxpayer expenditures may subsequently be recouped through a re-sale of the bank to the private sector, though there is no guarantee of that,[6] and in any event the public finances are likely to be distorted by the bail-out.[7] Bail-out is, in fact, a forced investment which would not have been made by a market investor. Whether the bank is bailed out or not, the costs to businesses and households of the reduced availability of credit are likely to be substantial and are not costs for which any legal system makes the failing banks liable. It can be argued that, if the bank shareholders are diversified, they will absorb the externality costs through a diminution in the value of their holdings in non-bank sectors, and that therefore the shareholders have an incentive to constrain excessive risk-taking by bank management. However, diversified shareholders are even less well-placed than board members to monitor bank management effectively, whilst concentrated shareholders do not have the incentive to do so, precisely because they are not exposed to the costs of externalities.

The incentive failure was arguably the result of the move in the 1990s by banks, along with non-financial companies, away from predominantly fixed-pay arrangements to

[5] The financial crisis of 2007-9 is estimated to have cost $15 trillion in lost production (about one-fifth of the world's annual output) and to have led to a substantial increase in unemployment. State efforts to mitigate the crisis led in the Eurozone to a sovereign debt crisis which worsened the economic impact of the crisis in the countries affected.

[6] At one end of the spectrum, the US Treasury made a substantial nominal profit on its bail-out and subsequent sale of AIG (an insurance company, not a bank), whilst at the other the UK Government at the time of writing still holds its 70% stake in Royal Bank of Scotland, whose share price is remains below the acquisition price.

[7] Sometimes to the extent of rendering the state unable to finance its overall operations without itself being bailed out.

"performance" pay, especially to rewards linked to the grant of share-options. It is debated whether this move was an application of the standard UK-US model in order to incentivize managers to be less risk-averse and to promote the interests of the shareholders or whether it was an expression of managerial greed, contrary to the interests of the shareholders.[8] In either case, managers were incentivized to focus on the bank's share price over the period of the option grant, irrespective of any longer-term risks that behaviour incurred for the bank. It is true that, when the crash came, managers suffered heavy losses through the destruction of the value of the bank shares then held by them, but research has shown that this loss was outweighed by the bonuses and proceeds from share sales which had occurred in the period before the crash.[9]

Since the financial crisis there has been a welter of corporate governance reforms for banks. By and large, these have received a bad academic press.[10] The purpose of this paper is to consider the arguments for and against reforms which aim to make bank boards more sensitive to the risks of negative externalities in the bank's operating model. We look at mechanisms for increasing the influence on the board of two groups likely to suffer from the negative externalities of board failure, namely, society at large (taxpayers and those harmed by the loss of access to credit) and, in the post-crisis world, creditors. We have a cross-cutting division of these mechanisms into those which involve board influence short of representation and those which posit representation on the board. Thus, in Section II we analyse the influence financial supervisors bring to bear on board composition and behaviour falling short of supervisory representation on the board. This mechanism is substantially in place, at least in many jurisdictions. In Section III we look at potential reforms which would increase the influence on the board of long-term debt holders, but again without giving them representation rights. We then turn to board appointment rights (Section IV) for both supervisors and creditors. It is a common critique of the post-crisis bank governance reforms that they have not given sufficient weight to creditors' interests.[11] However, our analysis is more supportive of that critique in relation to influence short of representation rights than via representation and, even then, predominantly through market mechanisms. Finally we turn to reforming the civil and criminal liabilities of board members so as to increase their sensitivity to non-shareholder interests. (Section V).

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[8] L Bebchuk and J Fried, *Pay without Performance* (Harvard U P, 2004)

[9] L Bebchuk, A Cohen and H Spamann, "The Wages of Failure" (2010) 27 *Yale Journal of Regulation* 257; S Bhagat and P Bolton, "The Financial Crisis and Bank Executive Compensation" (2014) 25 *Journal of Corporate Finance* 313. What these studies do show, however, is that bank executives were no better at predicting the crisis than anyone else; otherwise, they would have sold out entirely.

[10] For example, L Enriques and D Zetzsche, *Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirement Directive*, ECGI Law Working Paper N° 249/2014 (suggesting in particular that new bank board diversity requirements are ill-adapted to increase the board's expertise in monitoring the development of the bank's assets); Christoph Van Der Elst, *Corporate Governance and Banks: How justified is the match?* ECGI Law Working Paper 284/2015 (suggesting that post-crisis reforms have not accurately identified the peculiarities of bank governance).

[11] See Becht et al, above n 1 at 438 ("To make bank governance more effective it might be necessary to experiment with deeper reforms, such as allowing for creditor representation on boards."); Van Der Elst, ibid, at 32 ("Probably there is no other industry where stakeholder governance is so pivotal. Debt holders and public interest have no voice in the bank governance system and should be represented by the legislator and the regulator.")

We do not analyse the reforms which have upgraded the role and status of risk committees and risk officers,[12] though we think these reforms are potentially valuable. This is because, without further reform, the board and (ultimately) the shareholders remain in charge of risk strategy. The board may be better informed about risk but not necessarily more risk-averse; the board may have more "known unknowns" and fewer "unknown unknowns" (an important result), but its risk appetite may be unchanged. A more radical governance strategy is one which provides influence on the board to a group whose risk appetite is likely to be better aligned with the level which is socially optimal.

II. Supervisory Approval of Bank Directors and Senior Managers

Prudential supervisors are one obvious representative of the interests of society as a whole and a potential source of risk-averse influence on boards, since the prudential supervisor's principal goal is the safety and soundness of the banking system. That influence could be exogenous to the board, deriving, for example, from the capital and liquidity controls which are the traditional tools of bank supervision or from more recently devised tools of macro-prudential supervision. However, it is also possible to give the prudential supervisor a direct influence upon board appointments and composition (falling short of appointment *rights*). It is this form of influence which we analyse in this section.

If the consent of the supervisor (via a veto right) is needed for an appointment to the board and for its continuation, then the director is likely to become sensitive to the views of the supervisor on the proper level of risk-taking (and other elements of the bank's business strategy) as well to those of the shareholders. In addition, the approval mechanism could form the basis for the identification of those whom the supervisor would hold responsible for regulatory failures on the part of the bank. Depending on the rigour of the administrative liability rules, they could effectively supplement the standard company law rules on directors' liability. As we discuss in Section V, the standard rules tended not to generate liability for action or inaction in the crisis, because those rules are concerned to limit the risk of judicial hindsight bias by placing high hurdles before claimants.[13] However, before the crisis, it was also the case that regulation imposing responsibility on individuals was often lacking.[14]

[12] Directive 2013/36/EU (OJ L 176/338), Art 76 (hereafter "CRD" or "CRD IV").

[13] The classic example is the Delaware decision, *In re Citigroup Ltd* (2009) 264 A 2d 106 (Del Ch), where shareholder against directors for failing to monitor the bank's risks arising out of loans to the sub-prime market was unsuccessful because the standard for liability was bad faith. Even in jurisdictions where liability is based on some form of negligence, judgments in favour of plaintiffs are difficult to achieve.

[14] See the letter from Lord Turner, then chair of the Financial Services Authority (UK), published in the *Financial Times* (8 December, 2010), defending the FCA's decision not to take enforcement action against individuals in relation to the Royal Bank of Scotland's ill-fated takeover of ABN-Amro, on the grounds that the acquisition was "highly risky but breached no regulation." However, he also made the case for regulatory reform to induce bank boards to make a different and more cautious risk/return trade-off than would be acceptable in non-financial companies, precisely because of the size of the social losses associated with bank failure. A fuller version of the letter is available at: http://www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2010/1208_at.shtml (accessed 16 December, 2017). However, the CEO of the RBS at the time of its collapse, Sir Fred

A rather basic framework for regulatory approval of bank directors is laid out in the CRD. Art 13 requires, as a condition of initial approval of the bank, that the members of a bank's management body be of "sufficiently good repute and possess sufficient knowledge, skills and experience to perform their duties," while art 91(1) requires that condition to be met "at all times" by the members for the time being of the "management body" – a term which embraces the one-tier and both tiers of a two-tier board. In addition, art 98(7) requires the regulator's annual supervisory review to "include governance arrangements of institutions, their corporate culture and values, and the ability of members of the management body to perform their duties." This framework clearly leaves a large number of significant decisions to be taken by national governments and lower-level regulators.

1. *The United Kingdom*

We look first at the development of this framework in the UK, where popular anger at the failure of any senior bankers to be subject to significant sanctions for pre-crisis managerial actions led to regulatory reform which goes well beyond what the CRD requires. In fact, "fit and proper" person tests for bank managers are of long-standing in national banking regulation, as are codes of conduct applying post appointment, requiring competence in the discharge of the duties of the office. However, as the Financial Services Authority admitted in 2008, its prior practice had been to concentrate on the honesty and integrity of board members rather than their competence, and in practice it had rarely investigated the post-appointment conduct of individuals.[15] After the crisis it introduced an ex ante interview process for future senior bank appointments and, as to past conduct, it stated that "we have made a strategic decision to investigate more individuals."[16]

Despite this statement of intent, the FSA and its successors (PRA and FCA) proved able to bring successful regulatory proceedings against few high-level bankers involved in the failures which occurred in UK banks prior to the financial crisis.[17] In 2013 the Parliamentary Committee on Banking Standards heavily criticized the existing regulatory regime as it applied to top bank appointments. "In principle, it is the means by which the regulator can control those who run banks, but in practice it makes no attempt to set clear expectations for those holding key roles. It operates mostly as an initial gateway to taking up a post, rather than serving as a system through which the regulators can ensure the continuing exercise of individual responsibility at the most senior levels within banks."[18] The approval system was reformed the same year in the Financial Services (Banking

Goodwin, did agree to give up part of his pension and his knighthood was removed by the Queen. So, he suffered some financial loss and his reputational loss was high, but came at the end of his career.

15 Financial Services Authority (UK), *The approved persons regime – significant influence function review*, Consultation Paper 08/25, December 2008, para 2.2.

16 Ibid.

17 For details of the limited successes see A Kokkinis, *Corporate Law and Financial Instability* (Routledge, 2018) 130-133. After the crisis, the FSA was split in two, with its functions divided between a Prudential Regulatory Authority (PRA) and a Financial Conduct Authority (FCA). Since the interest of this paper is with the stability of the banking system, we are primarily concerned with the PRA's rules.

18 House of Lords and House of Commons, Parliamentary Commission on Banking Standards, *Changing banking for good*, First Report of Session 2013–14, June 2013, vol II, para 564 (HL Paper 27-II; HC 175-II).

Reform) Act 2013, mainly by way of amendments to the Financial Services Act 2000, with the aim of making the holders of top bank appointments more accountable to the regulators.

For the purposes of this paper, there are three significant features of the reformed regime for "senior management functions" in banks, ie functions which involve "a risk of serious consequences for the [bank] *or for businesses or other interests*" in the UK.[19] First, the application to the regulator for approval as a senior manager must be accompanied by a "statement of responsibilities", ie "a statement setting out the aspects of the affairs of the [bank] which it is intended that the person will be responsible for managing in performing the function."[20] A job title alone is not enough.[21] This provides a basis for a more thorough-going vetting process than a mere job title. Second, in addition to liability for personal breaches of the conduct rules made by the regulator, a senior manager is liable under the regulatory system for breaches of any requirement by the bank where that manager "was at that time responsible for the management of any of the [bank's] activities in relation to which the contravention occurred" and the manager did not take reasonable steps to avoid the breach occurring or continuing.[22]

Clearly, the statement of responsibilities operates so as to define ex ante the manager's area of accountability. The senior manager is potentially liable for action by subordinates which put the bank in breach of the regulations, even though the manager was unaware of the action.[23] For example, a senior manager, into whose area of responsibility interest-rate reporting falls, is exposed to administrative penalties for rate manipulation carried out by subordinates of which s/he was not aware, if the regulator can show that the manager was negligent in allowing that behaviour by the subordinates to occur.[24] As initially formulated, there was a "presumption of responsibility", ie the burden of disproving negligence was on the senior manager. Before the legislation came into force, however, it was re-formulated

[19] Financial Services Act 2000, s 59ZA (emphasis added) – a clear recognition of negative externalities. There is also a separate regime, not discussed in this paper, for annual bank certification as fit and proper of those carrying out "significant harm functions", ie where the function carries the risk of significant harm to the bank or its customers, but not to interests outside the bank and those who deal with it (ss 63E and F).

[20] S 60(2A). It is up to the bank how it allocates responsibilities.

[21] Subsequent significant changes to the responsibilities must be notified to the regulator with such information as the regulator requires (s 62A). It appears that such changes do not automatically trigger a new approval process but the regulator could take the initiative to impose conditions on the existing authorization under s 63ZB.

[22] S 66B(5).

[23] S 36 of the 2013 Act creates a new criminal offence, carrying imprisonment for up to seven years, for a senior manager whose conduct or omissions cause the bank the fail, the standard of liability being somewhere between gross negligence and recklessness. This is discussed further in Section V.

[24] For some indication of how the regulator will approach this task, see PRA, Supervisory Statement SS28/15,
Strengthening individual accountability in banking, May 2017. This policy document specifically excludes escape from individual responsibility because the impugned decision was a collective one. "The Duty of Responsibility recognises that individual Senior Managers should be held accountable for their individual contributions to collective decisi ons and their implementation insofar as those contributions are in scope of their Senior Manager responsibilities." (para 2.67)

as a "duty of responsibility", ie the burden of proof of negligence lies on the regulator.[25] This may prove a significant weakening of the provision, but more will probably turn on how the courts calibrate negligence in this area and whether they take the overall reform as a signal that they should require a higher standard of care from senior bank managers.[26]

The third feature which is relevant to this paper, but which is not a novel feature of the revised regime introduced by the 2013 Act, is that the concept of a "senior manager" is not congruent with that of a director of the bank. The senior manager definition, which has been established by the prudential regulator, excludes "plain vanilla" non-executive directors, ie those who do not perform any of the following roles: chair of the board, senior independent director or chair of the audit, risk or remuneration committees.[27] "Standard" NEDs thus do not require prior approval of the regulator, do not have to provide a statement of responsibilities and are not subject to the duty of responsibility.[28] Even those NEDs within the senior manager regime are not expected to take on executive responsibilities, and so their statement of responsibilities and potential exposure to liability are expected to be less extensive than those of executive managers.[29] By contrast, some senior non-board managers are brought within the regime, broadly those immediately below the board, because of their control of key business areas.[30] In some cases those managers might not actually be employed by the bank in question, but elsewhere in the banking group. Overall, this is a highly functional definition of senior management. It does not map onto the distinction between executive and non-executive directors because some (but not all) non-executive directors are within the regime, whilst it extends to managers who are not on the board at all.

2. *The Euro Area*

For "significant" banks the fit and proper purpose test is applied by the European Central Bank acting as the Single Supervisor.[31] However, the powers which the ECB possesses in relation to any particular bank are those which the national regulator has and thus vary from member state to member state, subject to the modest degree of harmonization brought about by the CRD and European Banking Authority guidelines. Moreover, the ECB's powers are limited to the initial approval and subsequent monitoring of the appointee's compliance with the fit-and-proper test. Disciplinary action for non-performance of the appointee's functions is a matter for the national regulators, subject to the ECB's 'nuclear option' of

[25] See s 66B(6), repealed by the Bank of England and Financial Services Act 2016, s 25(3)(f) and (g), before it entered into force. The reasons put forward for the change were disputed in the legislative debates on the 2016 Act.
[26] See *Pottage v FSA*, Upper Tribunal, 2012 (FS/2010/33) for a pre-reform decision where the regulator failed in its attempt to impose a penalty on an individual on the grounds that that person had done enough to address the problems in the bank of which he was or should have been aware.
[27] PRA and FCA, *Approach to non-executive directors in banking*, PRA CP15/5 and FCA CP7/15, February 2015. Within its sphere the FCA also treats the chair of the nomination committee as a senior manager.
[28] However, they are subject to a less intensive regime of regulatory approval, in order to comply with the CRD requirements. See SS 28/15, above n 20, para 4.11.
[29] Ibid, para 2.9.
[30] Para 1.19.
[31] Regulation (EU) No 468/2014 of the European Central Bank (ECB 2014/17), Arts 93 and 94 (SSM Framework Regulation).

removing the approved person from the board.[32] Finally, the ECB, at least initially, took the view that its powers were confined to members of the 'management body', ie to the directors (whether on a single or two-tier board): they did not extend to non-board senior managers but, on the other hand, do embrace all non-executive directors.[33]

The recently adopted EBA and ESMA *Guidelines on the assessment of the suitability of members of the management body and key function holders*[34] take matters a bit further forward, as the title of the guidelines indicate. These bring in "key function holders" as well as members of the management body and are likely to influence the ECB's actions in the future, since the guidelines are addressed to it as single supervisor as well as to national competent authorities. It was controversial in the public debate when the draft guidelines were consulted upon whether the European regulatory authorities had power to bring key function holders within the scope of the guidelines, since the CRD refers to a fit and proper test only in relation to members of the management body. The regulators, however, took the view that the general language in arts 74 and 88 of the CRD gave them sufficient cover for the extension of the guidelines in this way.[35] As adopted, the guidelines extend to "the heads of internal control functions and the CFO, where they are not members of the management body, and, where identified on a risk-based approach by CRD-institutions, other key function holders. Other key function holders might include heads of significant business lines, European Economic Area/European Free Trade Association branches, third country subsidiaries and other internal functions."[36] However, the guidelines do not touch on administrative sanctions for breaches of the guidelines.

III. Debt-holders and bank board influence

Possible additional or alternative sources of caution in relation to bank board decision-making are the holders of bank debt. Clearly, where that debt takes the form of deposits, it would be futile (for coordination reasons) and counter-productive (because depositors can easily "run" on the bank by withdrawing their deposits) to seek to increase the influence of depositors on the board. However, holders of long-term bank debt (bonds or notes) are in a position where it is difficult for them to run,[37] and so they might in principle be interested in mitigating their risks through influence on the board. If that influence can be brought to bear (see below), it is likely to be in favour of caution, since bond-holders have no strong interest in the pay-offs from risk-taking, assuming that, when the risky decision is taken, the bank is still in a position to meet its commitments under the bond.[38]

[32] Council Regulation (EU) No 1024/2013, art 16(2)(m) (OJ 2013 L 287/63).
[33] The ECB's procedures are set out in ECB, *Guide to fit and proper assessments*, May 2017. The procedures are not remarkably different from those of the PRA in the UK.
[34] September 2017, in force from 30 June, 2018.
[35] *Guidelines*, p 88.
[36] Ibid, p 20.
[37] They can normally sell their debt, but the price will reflect the market's concerns about the bank's current state.
[38] If this is not the case, the bondholders may be more in favour of risk than shareholders, since the creditors will be the first to benefit from the upside of the decision.

It is true, of course, that in the crisis bond-holders did not suffer the downside of excessive risk-taking by bank managers, because the banks, largely, were bailed out by states (taxpayers) before they went into liquidation, and it is only in liquidation (or its equivalent) that, in the absence of special regulation, debt-holders absorb losses (in terms of having their formal contractual claims reduced or eliminated). However, the search post-crisis for bank resolution procedures which will shift the cost of saving banks away from taxpayers has led to "bail-in" mechanisms which, if successful, will impose losses on long-term debt-holders in resolution (before taxpayers are called on) and, by the same token, will increase the sensitivity of bond-holders to pre-resolution risky behaviour on the part of bank managers. Under the Financial Stability Board's recommendations, internationally active banks are required by 2022 to have "total loss absorbing capacity" ("TLAC") equal to a minimum of 18% of their risk-weighted assets, ie substantially in excess of the Basel minimum capital requirements.[39] The purpose of TLAC is to ensure that, in resolution, significant banks are capable not only of absorbing the losses they have incurred, but also of being recapitalized and thus restored to viability (together with adjustments to their businesses). To this end, it is a crucial requirement of the FSB scheme that a substantial part of TLAC – a minimum of one third is stipulated – should consist, not of equity, but of long-term debt. Debt, unlike equity, will still be available at the point of resolution to recapitalize the bank, via write-off or conversion into equity.[40]

There is considerable debate about whether bail-in will in fact work in the way that the FSB envisages and even whether bail-out is socially more acceptable than bail-in. However, for the purposes of this paper, that is not the central issue. The question is whether there will be in future a quantity of bank debt in issue which faces a realistic chance of being wiped out or converted in resolution. For example, it matters not from this perspective that bail-in will sometimes turn out not be sufficient to reorganize the bank and the state steps into complete the task, provided bail-out occurs *after* the long-term debt has been wiped out. Nor does it necessarily matter whether the resolution of the bank takes place via a reorganization of its capital structure (for which bail-in is a particularly helpful tool) or via a sale of its viable businesses, whether via a bridge bank or not, or via the transfer of its non-performing assets to a "bad bank" through the asset separation tool. Provided that in the case of a sale of the viable businesses, the debt holders are left behind in the transferor or, in the case of a "bad bank", they transfer with the assets, the debt holders will absorb losses and thus have incentives to monitor the management of the bank. However, it would

[39] FSB, *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution: Total Loss-absorbing Capacity (TLAC) Term Sheet*, November 2015, Term Sheet 4. In addition the TLAC must amount to a leverage ratio of 6%, as calculated on the Basel basis. Minimum capital requirements count towards the TLAC requirement, except for capital required to meet regulatory buffers (eg capital conservation or counter-cyclical capital buffers). For the implementation of these recommendations in the EU see Commission proposal to amend the CRR (COM(2016) 850 final) and EBA, *Final Report on MREL: Report on the Implementation and Design of the MREL Framework*, December 2016 (EBA-Op-2016-21). In EU terminology TLAC has become MREL: "minimum requirements for own funds and eligible liabilities".

[40] Ibid, Term Sheet 6(f). See also Davies, Paul L., "The Fall and Rise of Debt: Bank Capital Regulation after the Crisis", *Oxford Legal Studies Research Paper No. 53/2015*. Available at SSRN: https://ssrn.com/abstract=2670052 or http://dx.doi.org/10.2139/ssrn.2670052. For a review of the literature in the area of bail-in and corporate governance, see E. Martino, *Law & Economics of Banks Corporate Governance in the Bail-in Era*, https://ssrn.com/abstract=3100703.

undermine the prospect of creditor monitoring were bail-out without debt-holders incurring losses to survive the BRRD reforms, which seems unlikely, but not wholly impossible, in the case of GSIBs.[41]

One market reaction to the increased riskiness of bank bonds is for investors to increase the rate of interest required to induce them to purchase these securities. Nobody is obliged to buy bank bonds if the terms of issue are unattractive. However, this merely leads to a reformulation of our question: will banks (to reduce their cost of capital) and lenders (to mitigate risks) find it mutually beneficial to establish governance rights for creditors which aim to manage the risk to which the creditors are exposed?[42] This will depend on the likely effectiveness of such rights, a condition which embraces both the size of the benefits conferred on creditors by the governance arrangements and the costs, to both creditors and banks, of providing these benefits.

There are a number of possible governance arrangements which could be set up. At the most traditional end of the spectrum, bondholders could take one or more seats on the bank board in a non-executive capacity. However, given the increased responsibilities and potential liabilities of even non-executive bank directors, it is unlikely that this would be attractive to bond-holders. Their primary aim is to secure the performance of the obligation attached to the securities: a governance arrangement targeted on that goal and which does not expose bond-holders to responsibility for the general conduct of the bank's business is likely to be more attractive to them. Alternatively, legislation could mandate creditor representation on boards. We discuss this in Section IV.

However, there exists an established, largely contractual mechanism, to give creditors influence over management strategy, without requiring board representation. When the bank itself acts as a lender, whether on its own or in a syndicate, it will normally insert extensive "covenants" into the loan agreement, ie contractual provisions which require the consent of the bank to borrower decisions which might substantially alter the risk to which the bank is subject in making the loan. When the borrower wishes to take one of these steps, the consent requirement creates an opportunity for the bank to negotiate with the borrower about the terms on which the change may be implemented – the sanction for non-agreement being, normally, an obligation to repay the loan at that point. The conventional wisdom in corporate finance is that in the case of publicly-traded bonds the range of covenants is much narrower than in private loans. In particular, covenants requiring lender consent to strategic

[41] The recent example of the use of the "not in the public interest" exception to bail-in in the case of the Italian regional banks, however questionable, is not, we suggest, a strong pointer in the direction of a general relaxation of the BRRD system, since these banks were not systemically important.
[42] Tröger has argued that, given the uncertainties surrounding the bail-in process, accurate pricing of bail-in bonds may be difficult (T. H. Tröger *Too Complex to Work: A Critical Assessment of the Bail-in Tool under the European Bank Recovery and Resolution Regime*, SAFE Working Paper No. 179 2017). This may increase the attractiveness of covenants. Although inserted at the time of issuance of the debt, the rigour of the debt-holders' use of their powers under the covenants can vary subsequently, as information about the resolution authorities' use of their powers is revealed after issuance.

business decisions by the borrower are rare, being common only in relation to changes in the ownership of the borrower or similar major restructurings.[43]

This caution in relation to covenants in public debt is typically attributed to the collective action problems of dispersed, public bond-holders, ie the costs involved in getting them to decide how to respond to situations where their consent is required. The extent of the collective action problem in relation to bail-in bonds is worth a moment's reflection. It is unlikely that retail investors will be substantial holders of the bonds – indeed, they may be discouraged or prohibited by regulation from purchasing them. Regulation is also likely to direct institutional purchases to institutions which are outside the banking area and can suffer loss on the bonds without jeopardizing their own viability. The most likely candidates are insurance companies, pension funds and certain types of hedge fund, ie sophisticated investors well able to assess the costs and benefits of contractual protection. They will need, no doubt, a mechanism for coordinating their response to breaches of covenant, but the coordination problem does not appear overwhelming.

A potential coordination mechanism already exists in public bond issues in the shape of a "trustee" or some differently named representative of the bondholders who has power under the trust deed to act on behalf of the bondholders. However, for reasons primarily of cost the trustee's duties are limited and normally confined to receiving and passing-on information and to taking action when instructed to do so by a sufficient majority of the bond-holders.[44] In fact, the term "trustee" in relation to corporate bond issues is really a misnomer, for, unlike a trustee under standard trust, the bond trustee is not invested with a broad discretion which it is under a duty to exercise in the best interests of the bond-holders. For a trustee to be invested with more pro-active powers on behalf of the bond-holders would require a change in the trustee's duties and remuneration structure.

However, such a change could be brought about largely by contract and possibly without any legislative changes. In 1999 a group of US scholars published an article showing how this could be done in a US legal context, which is not enormously different from that employed for bonds not issued under New York law.[45] Under their scheme, the trustee would actively acquire information about the borrowing company; monitor compliance with the bond terms; renegotiate covenants when the company seeks an amendment; and decide whether and what kind of enforcement action to take when a covenant is breached.[46] Clearly, a trustee with these duties would need to have a sophisticated understanding of all aspects of the business of banks and would command a correspondingly higher remuneration than is paid currently to bond trustees.

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[43] L. Hornuf, M. Reps and S. Schäferling, "Covenants in European investment-grade corporate bonds" (2015) 10 *Capital Markets Law Journal* 345.

[44] For an example of the reluctance of trustees to act even when properly instructed by the requisite majority of bondholders see *Concord Trust v Law Debenture Trust Corporation plc* [2005] UKHL 27. The court commented that the issuers had "terrified the trustee into declining to accept the apparently mandatory obligation to the bondholders imposed by [the contract] and into acting as, in effect, their surrogate in the current proceedings."

[45] Y Amihud, K Garbade and M Kahan, "A New Governance Structure for Corporate Bonds" (1999) 51 *Stanford Law Review* 447.

[46] At p 470.

That cost might come to be seen by both bondholders and banks as one worth paying if the price of and risk attached to bail-in bonds was reduced by an amount which exceeded the cost of the trustee's extra remuneration. This is particularly likely in the case of investors who aim to hold the bonds until maturity (insurance companies, pension funds); perhaps less so in the case of those whose business model involves trading in the bonds (hedge funds). However, the advantage of a contractual model is that it can be adjusted to meet the needs of different types of investor. The model described above could be adjusted so as to put more decisions in the hands of the investors and fewer in the trustee, for example. New issues of bonds could contain covenants reflecting the experience of investors under prior issues. Different contemporaneous issues of bonds could come with different covenant packages, designed to appeal to different classes of investor.

Moving away from bond covenants, a third mechanism for investor protection makes use of the remuneration systems for rewarding bank executives, especially the variable part of such systems. In this arrangement, high-powered incentives for bank managers to achieve certain goals are deployed for the protection of bank creditors (rather than to promote the interests of shareholders alone). This protection might operate in a negative or a positive form, ie it might create disincentives for remuneration arrangements which carry risks for bank creditors or it might create incentives to adopt remuneration systems which promote the interests of creditors. As with covenants, the present factual position does not reveal strong forms of either set-up, but they might become more important in the future.

As to the negative arrangements, there are some provisions in CRD IV which supervisors could make use of to this end. Art. 92(2)(a) requires the competent authorities to ensure that banks' "remuneration policy is consistent with and promotes sound and effective risk management", whilst Art 104(1)(g) empowers them "to require institutions to limit variable remuneration as a percentage of net revenues where it is inconsistent with the maintenance of a sound capital base." Both powers could be used by supervisors to require the removal of elements from remuneration systems which are likely to generate risks to the safety and soundness of banks and thus to the bondholders. Much will depend on what use supervisors make of these powers.[47] The most famous control in CRD IV over risk-inducing variable remuneration does not rely on supervisory judgment. This is the cap on bonus levels, set at twice the level of the fixed remuneration (subject to shareholder consent).[48] Whilst the cap is there to "avoid excessive risk taking",[49] it is likely to be a blunt instrument, discouraging effort as often as it discourages improper risk taking. Whether the trade-off is worthwhile is a matter of judgment. The cap might appear less important in controlling excessive risk taking were supervisors to make active use of their discretionary powers.[50]

The positive use of incentives to promote bondholder protection has been advocated by Bebchuk and Spamann, essentially by linking bankers' variable rewards, not just to the performance of equity but to the performance of a wider set of the bank's securities, including its bonds.[51] This idea finds a somewhat pale reflection in CRD IV. Apart from

[47] The EBA guidelines, above n 34, are not specific on this issue.
[48] Art 94(1)(g).
[49] CRD IV, recital 65.
[50] Alternatively, with the cap in place, supervisors may regard it is relieving them of the responsibility to make active use of their discretionary powers.
[51] L Bebchuk and H Spamann, "Regulating Bankers' Pay" (2010) 98 *Georgetown Law Journal* 247.

the general provisions in Article 92, the CRD does not require that the performance criteria for rewards to bank managers should take any particular form. Subject to Art 92, the performance criteria are set by the bank. The bank bodies which set the criteria are accountable predominantly to the shareholders and so they may not be particularly receptive to the Bebchuk/Spamann proposal – though, as noted above, it might be in the interests of the shareholders in some case to offer debt investors remuneration schemes which take account of their interests. Art. 95 of CRD requires the remuneration committee of significant banks to have the primary responsibility for proposing remuneration schemes and to be composed of non-executive directors. It does not stipulate that those executives shall be chosen other than in the standard way, ie normally by the shareholders, directly or indirectly; though where national law requires employee representation at board level, the committee must contain at least one employee representative.[52] The employees' interests are likely to be better aligned with those of the creditors than are the shareholders'. The dominance of the shareholders in remuneration setting has been underlined by the recent amendments to the Shareholder Rights Directive.[53] Art 9a now provides that the shareholders must be given a vote, either advisory or binding, on the remuneration policy of a listed company. Consequently, both bodies within the company primarily concerned with setting performance criteria are shareholder-oriented. For the reasons given in Section I of this paper, increasing the influence of shareholders over remuneration schemes in banks seems the wrong way to go.

When, however, the remuneration committee moves on from setting the criteria for an award to defining the nature of the award itself, it will find that there is constraining language in the CRD. Art. 94(1)(l) provides that at least 50% of the award shall consist of a "balance" of shares and "where possible . . . other instruments which can be fully converted to [equity] or written down", both equity and the "other instruments" being subject to a retention period of at least three years. This language raises the prospect of bank managers being rewarded in bail-in bonds as well as in equity and, over the retention period, building up a significant holding of debt securities in the bank. The EBA *Guidelines*[54] place some emphasis on this provision. "Where possible" is interpreted as a simple availability question: has the bank issued bail-in debt instruments in sufficient quantities to make them available for reward purposes? In the EBA's view, where "institutions are primarily wholesale funded, or rely to a large extent on additional Tier 1, Tier 2 or bail-in-able debt to meet their capital requirements" (ie the standard case under the FSB's recommendations), then the EBA expects debt instruments subject to write down/conversion to be available.[55]

This still leaves the question of the "balance" between shares and debt in the award, a matter on which the CRD is not clear. Here the *Guidelines* require that "institutions should be able to demonstrate that they have taken into account the interests of shareholders, creditors, bondholders and other stakeholders when setting the balance between different instruments."[56] Again, the impact of this approach in practice will turn on the rigour of the

[52] See further Section IV below.
[53] Directive (EU) 2017/828.
[54] Above, n 39, §15.4.
[55] Para 253.
[56] Para 255.

supervisory scrutiny of the choices which remuneration committees, beholden to shareholders, have actually made. Even if bail-in debt becomes a significant element in the awards made to bank managers, it is not clear how heavily that will constrain their risk choices if the performance criteria are not focussed on the interests of bank creditors.

IV. Composition of the Board of the Banks

One of the conclusions to be drawn from our analysis in Section I might be to change the composition of the boards of the banks[57] by giving interested non-shareholders a say or even a seat in the board. This has, indeed, been proposed as a reform agenda, though the proposals vary considerably in their content and details.

1. *Indirect representation of the creditors' interests in the board:* Seen from a comparative perspective, it seems advisable to consider first the experience made in countries with labour codetermination in the board of the corporation. As to this one must distinguish between the German half/half codetermination and the more common one-third parity codetermination in many other European countries.

(a) Let us first look at the German experience with the "full" (quasi-parity) co-determination that gives the labour side half of the seats in the boards of major corporations, including banks.[58] Politically this kind of labour codetermination is still controversial, in particular because it is fully mandatory and does not leave any possibility for agreements between the capital and the labour sides as is foreseen in the Statute of the European Company.[59] Labour unions praise codetermination and government parties, whether Social-democrats or Christian-democrats, agree or in any case do not want to touch it. The trade unions even advocate the German model as being an "export article" and ignore that there is little sympathy abroad, at least for the half-half model, as demonstrated again by the recent regulatory discussion in the UK. It is true that from German industry there are no (longer) strong complaints; one has grown accustomed to it and there is no hope for change. Empirical evidence on the pros and cons of labour codetermination is available,

[57] CRD IV is of primary importance for bank regulation; so is Solvency II for insurance regulation. Many aspects of corporate governance of banks have parallels or may be even identical ones, for corporate governance of insurance firms. Cf. P. Manes, "Corporate governance, the approach to risk and the insurance industry under Solvency II", in: M. Andenas, R. G. Avesani, P. Manes, F. Vella, P. R. Wood, eds., *Solvency II: A Dynamic Challenge for the Insurance Market*, Bologna 2017, ch. IV, p. 93; M. Siri, "Corporate Governance of Insurance Firms After Solvency II", in: P. Marano, M. Siri, eds., Insurance Regulation in the European Union, Solvency II and Beyond, Palgrave Macmillan 2017, ch. 7, p. 129.

[58] German Act on Codetermination of the Workers of 4 May 1976. For details see M. Habersack, M. Henssler, P. Ulmer, *Mitbestimmungsrecht*, 3d ed. 2013.

[59] See the plea for reform by Arbeitskreis "Unternehmerische Mitbestimmung", "Entwurf einer Regelung zur Mitbestimmungsvereinbarung sowie zur Größe des mitbestimmten Aufsichtsrats", *Zeitschrift für Wirtschaftsrecht (ZIP)* 2009, 885. Similarly S. Thomsen, C. Rose, D. Kronborg, "Employee representation and board size in the Nordic countries", *European Journal of Law and Economics* 42 (2016) 471 at 488: indirect support to sceptics, "employee representation as cost factor rather than a contribution to value creation".

though scarce and with contradictory findings.[60] Most of the evidence relates to the works council codetermination, which is more or less generally considered to have positive effects. As to board room codetermination there are both positive and negative effects. On the positive side codetermination played an important role after the German reunification and has helped to bring about the necessary fundamental changes in a way that was compatible with labour interests. Similar effects are to be found when enterprises are in financial difficulties and lay-offs become necessary. On the cost side there is the slowing down of the decision making process; the limited focus on wages and jobs, even in times of stiff competition; the fighting off of takeovers in lockstep with the management and thereby a reduction of the disciplinary effects of takeovers on management; and finally the attempt to keep jobs in Germany and accordingly the contribution to creeping protectionism. In crises and in particular bank crises, labour joins management in exerting pressure on government for rescue by the state. Altogether it seems that the board members from the labour side simply promote labour interests, not the interest of other creditors or stakeholders,[61] though more recently – as membership in trade unions shrinks – the German trade unions are trying to play also the role of defenders of consumers and the environment. As to the aftermath of the financial crisis, as far as known, there is no evidence that corporations with labour codetermination fared better than corporations without it. This suggests that introducing or strengthening labour in the boards of banks is not a solution for better bank governance. As to Germany at least, this would be incompatible with the German constitution because the present codetermination at quasi-parity already preserves a difficult balance between shareholders' (constitutional) rights and those of labour.

(b) While the German half/half codetermination is an outlier internationally, mandatory labour codetermination at one-third parity or with just one or some labour representatives in the board is relatively common in Europe. In this context one might think of giving labour a specific role solely in the remuneration committee of the boards of banks. Under present German law it is legally unnecessary to have one or more members of the labour side in each committee, including the remuneration committee. The idea would be that labour representatives could functionally act like independent directors, not as far as their own interests are concerned,[62] but as to the remuneration of management and board members. But there is the negative experience in the Mannesmann/Vodafone case, in which an illegal post-merger premium was given to the former chairman of the management board by the chairman of the supervisory board, Josef Ackermann, with the consent of or at least

[60] See the summarizing article by U. Jirjahn, "Ökonomische Wirkungen der Mitbestimmung in Deutschland: Ein Update", *Schmollers Jahrbuch* 131 (2011) 3-57; K. Pistor, "Corporate Governance durch Mitbestimmung und Arbeitsmärkte", in: P. Hommelhoff, K. J. Hopt, A. v. Werder, eds., *Handbuch Corporate Governance,* 2d ed. 2009, p. 231.

[61] This is the widely held belief. But see recently K. Lopatta, K. Böttcher, R. Jaeschke, "When labor representatives join supervisory boards: empirical evidence of the relationship between the change to parity codetermination and working capital and operating cash flows", *Journal of Business Economics* (2018) 88:1.

[62] As to the controversy whether labour representatives are "independent" see K. J. Hopt, M. Roth in *Großkommentar zum Aktiengesetz,* 5th ed., 2018, article 100 comments 176 et seq. Under the majority rule, neither the worker representatives who are working at the corporation nor trade union members are independent.

no opposition from the spokesman of the labour side in the board.[63] Most recently, it is interesting to note that German trade unions have taken a stand against a stronger form of shareholders say on pay, and this for obvious reasons. Such a reform, which is due when the European Shareholders Rights Reform Directive comes to be transposed, would reduce the role of the codetermined boards considerably. Yet it may be that, under this threat and as a response to frequent criticism of the role of labour in the remunerations excesses in the last years, the trade unions and the labour representatives in the boards will become more sensitive regarding to increase the remuneration of management.

(c) Apart from labour codetermination, one might think of one or more independent directors who would be entrusted with taking care of the public interest, including or even primarily the interests of the stakeholders. The idea of a public interest director was advocated for major companies and banks after World War II as well as after major bank crises in several countries already in the last century.[64] More recently it has been suggested to provide for a corporate social responsibility director.[65] Yet it is hard to define what the public interest is since it is so broad. If one looks at the recent discussion on ESG (environmental, social and governance) criteria, it is doubtful whether such a representative in charge of raising these general public concerns would be able to – and also actually would – raise the particular concern of systemic risk of banks in the board of a specific bank, and if he or she did so it is doubtful whether the systemic risk would prevail among all the other public interests.[66]

2. *Direct representation of the creditors' interests in the board:* If indirect representation is not a satisfactory solution, direct representation of the creditors, in particular long-term creditors, on the board of the banks might help. This has actually been advocated, though only in more general terms and without more details.[67] Different forms of such a special creditor representation in the board of banks are conceivable in parallel to the above-mentioned labour representation. The problems that arise relate to their role in the board, the compatibility with labour representation and the possible electors.

The role of representatives of the creditors in the board is not self-evident. For labour representation it is commonly accepted, at least under German law, that all board members have the same legal rights and duties. This means that they are legally bound to act in the interest of the corporation, whether this interest is conceived as the long-term shareholders' interest or a different form of general stakeholder interest, as traditionally in Germany

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[63] K. Pistor, "The Mannesmann Executive Compensation Trial in Germany", in C. J. Milhaupt, K. Pistor, *Law and Capitalism,* 2008, p. 69.
[64] H. Krüger, "Öffentliche Elemente der Unternehmensverfassung", in: H. Coing, J. H. Kaiser, *Planung V,* 1971, p. 56 et seq.. Cf. also K. J. Hopt, *Der Kapitalanlegerschutz im Recht der Banken,* 1975, at p. 208 et seq. under the aspect of investor protection, p. 209 et seq., 212 et seq., 233.
[65] E. Rehbinder, "Unternehmenspublizität im Zeichen sozialer Verantwortung der Unternehmen", in *Festschrift für Baums,* 2017, p. 959.
[66] As to the negative Irish experience with public interest directors see B. Clark, G.E. Henderson, "Directors as Guardians of the Public Interest: Lessons from the Irish Banking Crisis", Journal of Corporate Law Studies 16 (2016) 187.
[67] For example J. Hagendorff, "Corporate Governance in Banking", in: A. N. Berger, P. Molyneux, J. O. S. Wilson, eds., *The Oxford Handbook of Banking,* 2d ed., 2015, p. 139 at p. 155; M. Becht, "The Governance of Financial Institutions in Crisis", in: S. Grundmann et al., *Festschrift für Hopt,* 2010, vol. , p. 1615 at 1625 et seq.

where the management board has the right and the duty to pursue the interests of the shareholders, the creditors and the public (common good) simultaneously.[68] While in practice it is clear that the labour directors will voice particularly the interests of labour, the impact of labour codetermination depends on the number of seats, ie in Germany half of the seats in major corporations and one third in other companies.

The role of directors in committees, for example in the remuneration committee or the risk committee, is more specific. Since creditor representatives are supposed to have an eye on risk, in particular systemic risk, they could make a contribution in such a committee, possibly also in other committees such as the nomination committee. In this context it is interesting to note that the presence of independent directors in audit and risk committees seems to have led to better results in the financial crisis.[69]

A major problem of creditor representation in the board would be the compatibility of creditor representation with labour codetermination. It is politically untenable to diminish the present status of labour codetermination in the board, certainly in Germany, but probably also in other countries with existing (one-third parity) labour representation. Yet splitting up the shareholder side that is already under pressure to have more diversity would be problematic. In Germany, more specifically, the carefully balanced equilibrium between capital and labour in the board[70] would be destroyed.[71]

A third question is who should elect such creditors' representatives. Having them elected by the general depositors and small creditors is hardly conceivable, since these persons do not have an incentive nor the capability to make a meaningful election, quite apart from the practical problems of such an election, which would be much more difficult than for the general shareholders. This may be different for long-term bondholders who have an incentive to take into consideration the systemic risk,[72] at least if in the future bail-in legislation will not only be enacted, but also followed in practice as envisaged in the European Union.[73] A more secondary question is who should represent these bondholders, whether it should be one or more of them or possibly a trustee (or some differently named representative of the bondholders).[74] What is clear is that such a trustee would need to have a particular qualification and the necessary legal powers to act.[75]

In any case it seems clear that the representatives of other banks that are creditors themselves are not the ones who should be considered in this context. Bank representation

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[68] Section 76 of the Stock Corporation Act and the majority of the commentaries, see for example J. Koch in U. Hüffer, J. Koch, *Aktiengesetz,* 13th ed. 2018, article 76 comments 28 et seq.: plurality of interests, weighing of interests by the managing board.

[69] Y.-H. Yeh/H. Chung/C.-L. Liu, "Committee Independence and Financial Institution Performance during the 2007-08 Credit Crunch: Evidence from a Multi-country Study", *Corporate Governance: An International Review* 19 (2011), 437.

[70] German Constitutional Court, 1 March 1979 (Labor Codetermination Decision), *Decisions of the Constitutional Court* vol. 50, p. 290.

[71] Already under the present law more mandatory diversity requirements are criticized because of this German particularity.

[72] Above s. III.

[73] The recent Italian banking crisis and the experience with the near-failure of the Monte dei Paschi in Siena gives a rather dim outlook on this.

[74] Above s. III.

[75] Above s. III.

on bank boards has traditionally been a common feature in German boards,[76] though in the wave of demutualization this kind of representation has decreased considerably before and after the financial crisis.[77] Experience shows that the representatives of (major) banks in the boards of other banks did not take specific care of the interests of all other stakeholders. Their incentive to monitor increased only after the financial crisis, while before it was negligible because of the fact that their own creditor interests were generally covered by their own securities and pledges. More importantly, the experience with the financial crisis showed that these bank representatives did not see the systemic risks or did not take them into consideration sufficiently.[78]

3. *Representation of the creditors' interests in the board by bank regulators:* If the problems of the specific role, the conflict with labour representation and the election of creditor representatives cannot be coped with, one might think of having the bank regulator itself sitting on the board of the banks. At first sight this seems the best solution, because already now it is the task of bank regulators to be mindful of the creditors' interests and more specifically the systemic risk which traditionally has not or has inadequately been considered by the bank boards.[79] This would be in line with and take further the suggestion made above concerning the role of the bank supervisor in approving or dismissing bank directors and senior managers.[80] Yet there are two objections, a more formal and a more fundamental one.

The first objection is that in many jurisdictions with developed bank regulation, the bank supervisors already have a de facto power or even a legal right[81] to attend important meetings of the board of the bank if they consider it necessary to obtain the information they need for fulfilling their supervisory task. Since the bank supervisors are in a position to enforce what they deem to be necessary, it would not add much to this task to give them a regular seat and a voice in the board.

More fundamental is a second objection. Having the supervisors sitting as regular board members would raise serious role conflicts for the supervisors. On the one side they would participate in the day to day decision-making process that is up to the board. On the other hand they have to fulfil their supervisory tasks. It is hard to combine both. The supervisors are not supposed to run the bank themselves; this is not a part of their legal authority nor are they fit to do so. Giving them such a role would entail the consequence that the supervisors would have to face accountability and even liability, a consequence which the German legislature, for instance, has excluded by rejecting state liability for negligent supervision, but which is a real threat in other countries.[82] By the same token the supervisory task might be endangered since regular board membership of bank supervisors

[76] K. Johansen/S. Laser/D. Neuberger/E. Andreani, "Inside or outside control of banks? Evidence from the composition of supervisory boards", *European Journal of Law and Economics* 43 (2017) 31.
[77] W.-G. Ringe, "Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG", *The American Journal of Comparative Law* 63 (2015) 493
[78] Above s. I note 9.
[79] Above s. I.
[80] Above s. II.
[81] For Germany article 44 section 4 of the Bank Supervision Act (KWG).
[82] For example German Financial Services Supervisory Act (FinDAG) 2002, article 4 section 4: The supervisory agency acts only in the public interest.

would in the end amount to supervising their own participation in the board's activities. It is hard to see how this role conflict between active participation in the board and supervisory control over the board could be solved.

4. *Board in Bank Groups:* The problems of good bank governance may be most relevant in the context of bank groups and, indeed, in most countries there is special bank group legislation which is administered and enforced by the various national or supranational regulators and which presents particular challenges for the supervision of financial conglomerates.[83] Apart from the area of antitrust and recent tendencies in corporate social responsibility and human rights, the traditional separation system is still maintained, ie the parent and each subsidiary are separate legal persons and their creditors have rights only against their respective partner and not against the parent or other members in the group. For banks it has been observed that there is empirical evidence that bank companies with a controlling shareholder (or a parent) did worse than others that had dispersed ownership or were not members of a group.[84]

The problem regarding the regulation of bank groups in general and bank governance in particular cannot be treated here in more detail. Under the aspect of the composition of the bank board, it suffices to see that there is not a special board of the group as such, though in practice the board of the parent may sometimes function like one. Creating such a group board besides the board of the parent would either change the separation system or lead to a difficult doubling of boards and their rights and duties. It is better to deal with the board problems of each bank-group-member board idnvidually.

As to the composition of the board of the parent, the question of the representation of creditors is even more complex than in corporations that are independent, since then the problem arises of how to take into consideration the creditors of the subsidiaries. Similar questions arise, though practically with much less relevance, for the eventual representation of the creditors in the boards of bank subsidiaries.

Apart from this, all group law problems that exist for non-banks arise also and some more severely for bank groups. The strategy which is most often used and may be comparatively more successful is full transparency in the group, in particular in bank groups.[85] This transparency is not only relevant for the shareholders and stakeholders as in non-bank groups, but also and very much so for the bank regulator.

As to more substantive strategies, a group-wide internal risk management is indispensable, for banks considerably more than for non-banks.[86] For risk management it is vital for the board and the risk managers to get a "complete view of the whole range of risks of the

[83] Cf. Basel Committee on Banking Supervision, Guidelines, Corporate governance principles for banks, July 2015, Principle 5 p. 22 et seq: Governance of group structures; idem, Joint Forum, Principles for the supervision of financial conglomerates, September 2012. Cf. J.-H. Binder, A. Glos, J. Riepe, eds., *Handbuch Bankenaufsichtsrecht,* 2018, § 5: Grundsätze der konsolidierten Aufsicht über Gruppen.
[84] K. J. Hopt, "Corporate Governance of Banks and Other Financial Institutions After the Financial Crisis", *Journal of Corporate Law Studies* 2013, 219 at 239 et seq., see also supra note 1.
[85] J. Armour et al., *Principles of Financial Regulation,* 2016, at p. 389.
[86] J. Armour et al., loc. cit., at p. 378; J.-H. Binder et al., loc. cit., § 11 II.

institution".[87] Accordingly the internal information flow[88] within the group, in particular from management to the board and from the board of the subsidiary to the board of the parent, is key. The legal difficulties and controversies in this respect are well-known.[89] But a rule that would make mandatory the inclusion of the central risk officer on financial institutions boards would be too intrusive.[90] It should be up to the bank how it organizes its internal risk management in the bank and in the group, provided it works.

As to incentives, compensation-related consequences may be more effective than liability. Under CRD IV the material risk-takers are not only employees of the parent: rather, all employees of EU-based groups may be encompassed, even if they work outside the EU.[91]

V. Liability of Bank Directors and Other Key Function Holders

Legislators use civil liability as the standard incentive for good behaviour also for board members. More recently there is a tendency in economic law also to use criminal liability indiscriminately for all manners of violations, not only for those involving intentional conduct and grave fault. Traditionally, for directors the duty of care and the duty of loyalty are distinguished, whether or not they are combined as fiduciary duties owed towards the corporation. As to the duty of care, the business judgment rule gives the directors a so-called safe haven in order to avoid that they shy away from taking decisions that involve risk but might nevertheless be in the interests of the corporation and its shareholders. In some countries, as for example in Germany, the business judgment rule is codified; in other countries the rule is applied either expressly or de facto by the courts and in legal scholarship. The liability of directors is usually only towards their corporation (internal liability) and only under special circumstance towards shareholders, creditors and third parties (external liability). In most countries liability provisions for directors are fully or at least partly mandatory; mere self-regulation and market discipline are not enough.

As we have seen before, this traditional structure of incentives for directors may not work well for banks because it neglects the systemic risk of banks and the particular dangers for depositors and other (consumer) bank clients that do not exist for non-banks, or not to the same degree. In order to remedy this liability structure, several alternatives are discussed: regulatory duties, criminal responsibility and more severe civil liability. As we shall see, all options have their pros and cons, though regulatory duties may be preferable, but what counts in the end is their stricter enforcement.[92]

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[87] Article 76(5) CRD IV.

[88] This is to be distinguished from transparency and disclosure to third parties or the general public.

[89] K. J. Hopt/M. Roth in *Großkommentar zum Aktiengesetz*, 5th ed., 2015, article 93 comments 288 et seq. and article 116 comments 203 et seq.

[90] Contra A. Kokkinis, *Corporate Law and Financial Instability* (Routledge 2018), p. 188 et seq.

[91] Art. 92(1) CRD IV on remuneration policies. Up to 25 per cent of variable compensation may be discounted for the purposes of the cap at a rate that the supervisors may set, J. Armour et al., loc. cit., at p. 386. See also Art. 94(1)(g)(iii).

[92] As to the theory and problems of directors' liability there is a wide and controversial international discussion, cf. ; P. C. Leyens, M. C. Faure, "Directors' and Officers' Liability: Economic Analysis", ECGI Law Working Paper No, 376/2017, November 2017; H. Spamann, "Monetary Liability for Breach of the Duty of Care?" ECGI Law Working Paper No. 300/2015, September 2015, under 5: a

1. *Regulatory duties of care and loyalty:* As a response to the financial crisis, legislators and regulators have created or intensified a host of regulatory duties of care and loyalty for directors and to a lesser degree for key function holders in the bank. The best example is the lengthy catalogue in the European Capital Requirements Directive CRD IV, which by now has been or is being transformed into national law in many member states. This catalogue is constantly being refined by regulators, for example the European Banking Authority EBA, the European Securities and Market Authority ESMA, the German Federal Financial Supervisory Agency (BaFin) and, at the origin of this development, the Basel Committee on Banking Supervision.[93] These regulatory duties imitate and stiffen the civil and corporate law duties of directors to a considerable degree, but they do not give shareholders and creditors standing to sue and to ask for damages. [94] Instead, enforcement is solely up to regulators. The incentive for directors to obey is great since the regulator may not only enforce compliance but ultimately has the power to remove the directors, as we discussed in Section III.

How well this works in practice is not yet fully clear; much depends on the quality, the information and the enforcement energy of the regulator. The mechanism may vary considerably among different states, even EU member states, though efforts are under way to harmonize enforcement by national regulators. There are also other criticisms. As occurs often after a crisis, legislators and regulators react too late and then too much. The newly introduced regulatory duties go very far, perhaps too far. In any case, they are much too detailed and tend to involve the regulatory agencies in activities that should be up to the board. This might diminish the self-initiative of the directors and lead to too much bureaucracy rather than to better management and control. The explanatory note of the German BaFin for members of the management and supervisory boards under bank supervisory law amounts to 50 pages.[95] Furthermore it is feared that the extensive regulatory duties that may or may not be apt for banks and financial institutions might spill over to the civil and corporate law duties of directors even though the specific risks and regulatory purpose do not exist there.[96] John Armour and others have rightly observed that distinguishing regulatory and private law duties is an obscure task.[97] Still, regulatory duties are commonly used and have been very considerably broadened after the financial crises by CRD IV and the ensuing national transformation into member state supervisory law.

cost-benefit analysis tends to disfavour liability apart from specific situations. G. Wagner, "Organhaftung im Interesse der Verhaltenssteuerung – Skizze eines Haftungsregimes", *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR)* 178 (2014) 227.

[93] Basel Committee on Banking Supervision July 2015, International Association of Insurance Supervisors November 2015, Swiss FINMA September 2016, German BaFin November 2016, Financial Stability Board April 2017, Joint ESMA and EBA Guidelines 26 September 2017 etc.

[94] See most recently J.-H. Binder, "Der Aufsichtsrat von Kreditinstituten drei Jahre nach dem "Regulierungstsunami" – eine Bestandsaufnahme", *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* 2018, 88.

[95] German BaFin, "Merkblatt zu den Mitgliedern von Verwaltungs- und Aufsichtsorganen gemäß KWG und KAGB", 4 April 2016.

[96] As to the relationship between corporate law and bank supervisory law J.-H. Binder, loc. cit., *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* 2018, 88 at 116 et seq.

[97] J. Armour et al., loc. cit., at p. 389 bottom and note 90. See also I. H.-Y. Chiu, "Regulatory Duties for Directors in the Financial Services Sector and Directors' Duties in Company Law: Bifurcation and Interfaces", ssrn 4 August 2015, *Journal of Business Law* 2016, 465.

One of the major advantages is the possibility of quick, flexible and, if need be, harsh enforcement by the supervisors, see infra 4. Therefore strengthening bank governance by regulatory duties may be the best way to go.[98]

2. *Criminal responsibility of bank directors:* One of the suggestions for better incentives of bank board members and managers has been to hold them criminally responsible for their acts and omissions.[99] In Germany several criminal cases against former bank directors are pending. Most prominent is the case of the HSH Nordbank, a public bank of the two German states (Bundesländer) of Hamburg and of Schleswig-Holstein. The directors of this bank had engaged the bank in 2007 in highly risky credit default swap transactions (so-called Omega 55 transactions), which ultimately led to a loss of 145 Mio. Euro. The directors defended themselves by stating (i) that the purpose of the complicated transaction, which contained a repo guarantee by a foreign bank, was to free the balance sheet from high outstanding debts in order to prepare the bank for going public, (ii) that the transaction was prepared by the bank's personnel and hired lawyers in London and (iii) that the internal credit and risk committees had signalled approval. The facts are highly complicated and need not be described here in detail. In any case the first instance court acquitted these directors after many months of trial in a long ruling of more than 300 pages on the ground that they had acted negligently, but without gross negligence. The German Bundesgerichtshof[100] reversed the acquittal in a widely observed judgment on the ground that, in essence, gross negligence is not necessary for the criminal offense of "Untreue" under section 266 of the Penal Act. Since the lower court had found that the directors had not acted within the "free haven" of the business judgment rule – basically by not fully living up to their duty of information – they may be criminally liable even for simple negligence. The case is now back at first instance for more fact-finding. The maximum penalty under article 266 is five years of imprisonment.

In the UK, the Financial Services (Banking Reform) Act (2013) section 36 provides for a new criminal offence for senior bank managers whose reckless misconduct causes their firm to fail.[101] This section is much more specific than the German one. Four elements must be fulfilled. The senior manager must take, or agree to the taking of, a decision as to the way in which the business of a group institution is to be carried on. He or she must be aware of the risk that the implementation of the decision may cause the failure of the group institution. The incriminated conduct must fall far below what could reasonably be expected of a person in the same position. And the implementation of the decision must

[98] J.-H. Binder, loc. cit., *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* 2018, 88 at 123. Contra A. Kokkinis, loc. cit., p. 170, 181.
[99] Criminal proceedings have been instituted after the financial crisis in a number of countries, apart from Germany and the UK (there against the former CEO and three other former top executives of Barclays Capital). This has occurred, for example, in the USA, Greece and in particular Iceland, where the CEOs, other top and former CEOs and even majority shareholders of the three largest failed banks were convicted of fraud and market manipulation. See S. Schwartz, A. Jones, J. Yan, "Responsibility of Directors of Financial Institutions", in: D. Busch, G. Ferrarini, G. van Solinge, eds., *Corporate Governance of Financial Institutions: Law, Conduct, and Culture,* ch. 4 B 3, forthcoming.
[100] German Bundesgerichtshof, decision of 12 October 2016, *Zeitschrift für Wirtschaftsrecht (ZIP)* 2016, 2467.
[101] Financial Services (Banking Reform) Act 2013 Chapter 33 Section 36. Above s. II note 23.

have caused the failure of the group institution. The maximum penalty is seven years of imprisonment.

In Germany the decision of the Bundesgerichtshof was hailed by the financial press and by a number of criminal law professors, but it was severely criticized by others, both civil and criminal law experts. According to the criticism, the penal law senate of the Bundesgerichtshof disregarded the corporate law concept of the business judgment rule. Pursuant to this corporate law concept, the fact that the conditions of the business judgment rule have not been met just means that the director has been negligent, but not necessarily grossly negligent. In other words, according to the Bundesgerichtshof directors may be criminally liable for any, even only slightly negligent actions or omissions in the course of their management. This is indeed too strict. Criminal law is not made for sanctioning every management mistake but should step in only at a later stage, namely if there is intentional or at least grossly negligent misbehaviour. This is also true for banking and should not be changed even for systemic banks or more generally for systemic risks. Civil and criminal liability must not be applied side by side in the same way; instead the latter must come in only for more serious cases. Furthermore, on the procedural side, the criminal courts should take notice and respect the case law of the civil law judges who deal with more cases and are more specialized in corporate and banking law than the criminal law courts. As it stands now there is no procedural nor even informal coordination between both courts.[102]

The UK offence, by contrast, is more carefully and narrowly drafted, though its introduction was controversial. It is certainly right in requiring behaviour that "falls far below" the reasonably expected standard. Still, whether it will actually be applied remains to be seen.[103] While in most cases the senior manager will be aware of the risk of failure, it will be difficult to find that the implementation of the decision actually has "caused" the failure. If causation is interpreted as any contribution to the failure, whether substantial or not, as for example in civil law, this causation element would be more or less meaningless. On the other side, if it is taken seriously, it might be very hard to find causation in the concrete case. Still the preventive effect of the threat may be substantial.

3. *More severe civil liability of bank directors and key function holders:* Other reform proposals for dealing with bank governance focus on the civil law liability of directors as distinguished from regulatory duties. They appear in three different forms: first. it is postulated that there should be another, much stricter level of negligence for them; second, it is recommended to do away with the business judgment rule for bank directors; and third, it is suggested to change the burden of proof, which should be placed on them and not on the bank or the creditors. Yet in the end, all three proposals are unconvincing.

(a) Reform proposals that suggest having *stronger negligence rules for bank directors than for non-bank directors*[104] appear in different forms. If this means that there should be a

[102] Experience shows that even informal coordination among different civil law senates at the Bundesgerichtshof, say between the corporate law senate and the banking law senate or the insolvency law senate, is difficult.
[103] A. Kokkinis, loc. cit., p. 135 et seq., 169 fears that enforcement will be too difficult and criticizes the need of causation and of gross negligence.
[104] J. R. Macey, M. O'Hara, "The Corporate Governance of Banks", (2003) 9 *Economic Policy Review (FRBNY)* 91 at p. 102 et seq., 107 et seq.

different level of negligence than under general civil or corporate law, then this is unconvincing, since this would go well beyond what would be relevant for the systemic risk and would subject bank directors to a specific liability system for all banking risks. As a further consequence, it might become necessary to create specific liability systems also for many other risky professions, such as medical doctors. In the same vein, it has been proposed to hold bank directors to a strict duty of loyalty without the possibility of release by the shareholders, as for example under Delaware law. A further proposal is to require bank directors to take into consideration specifically the systemic risk of the banks;[105] this is a dramatic reform in countries that follow the shareholder value rule in corporate law, while for countries with an enlightened shareholder value rule – and in particular those with some kind of stakeholder principle that includes the promotion of the public good, as for example in Germany – this can and should already be the case, though practice has varied. Still another proposal is to change the burden of proof and impose it on the bank director.

Instead of all this, it seems more convincing to stick to the general rules of director liability, which means that they are liable if they are negligent. Negligence is a standard which differs of course depending on the facts of the case, ie more care is needed if there is more risk, professionals are subject to a higher standard than non-professionals and those who have or ought to have specific knowledge or abilities must make use of them if need be. Accordingly, under present law it is well established and even self-evident that *bank directors have specific duties of behaviour and organization* as necessary for banks in the concrete case.[106] There are also detailed duties for board members, including bank directors, on how to act if fellow-directors or even the whole board acts negligently or otherwise in breach of the law, ie duties to speak up, to dissent, to inform the chairman of the board or even the bank supervisors and, as an ultimate step, to resign.[107]

In Germany at least, the number of civil liability lawsuits against former directors has increased quite considerably,[108] this following the financial crisis and a landmark judgment of the Bundesgerichtshof, *ARAG v. Garmenbeck*, according to which the supervisory board members may become personally liable if they do not hold management board members liable.[109] The most recent case is the Hypo-Vereinsbank case that just commenced at the court of first instance in Munich in January 2018. Three former management board

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[105] S. L. Schwartz et al., loc. cit., ch. 4 C with further references. Above s. I note 14 Royal Bank of Scotland case.

[106] In detail J.-H. Binder, “ Organisationspflichten und das Finanzdiensleistungs-Unternehmensrecht: Bestandsaufnahme, Probleme, Konsequenzen”, *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* 2015, 667. For the USA Litwin v. Allen, 25 N.Y.2d 667 at 668 (Sup.Ct. 1940).

[107] Cf. for German law K. J. Hopt, M. Roth, loc. cit., 2015, § 93 comments 370 et seq.; for UK law cf. A. Kokkinis, loc. cit., p. 177.

[108] K. J. Hopt, “Responsibility of Banks and Their Directors, Including Liability and Enforcement”, in: Gorton/Kleineman/Wibom, eds., Functional or dysfunctional – the law as a cure? Risk and liability in the financial markets, Stockholm 2014, p. 159; idem, “Die Verantwortlichkeit von Vorstand und Aufsichtsrat”, *Zeitschrift für Wirtschaftsrecht (ZIP)* 2013, 1793 at 1793/1794 with recent case law. Cf. H. C. Grigoleit, “Directors’ Liability and Enforcement Mechanisms from the German Perspective – General Structure and Key Issues”, in: H. Fleischer/H. Kanda/K. S. Kim/P. Mülbert, eds., *German and Asian Perspectives on Company Law*, 2016, p. 105, available at SSRN: https://ssrn.com/abstract=2728726, under IV: overly rigorous set of liability rules.

[109] German Bundesgerichtshof, decision of 21 April 1997, Arag v. Garmenbeck, *Decisions of the Bundesgerichtshof* vol. 135, p. 244.

members are being sued by their bank for not having stepped in against doubtful tax transactions (the "cum-ex" tax trick that amounted to receiving tax repayment from the state twice).[110]

Furthermore, the well-established risk-related duties of bank directors *include systemic risk* already under present law. It is rather the case that this risk has not been seen, if seen, not taken seriously. It is also questionable whether an additional specific duty to take into consideration the systemic risk of banks would be meaningful in light of the enormous damages that are well beyond what the directors could reimburse. It would be a too open-ended standard.[111]Insofar it seems well justified that the British government rejected the proposal of the Department of Business, Innovations and Skills to introduce "a new primary duty on bank directors to promote the financial stability of their companies over the interests of shareholders."[112] To be sure, it is not argued here that shareholder primacy should be the standard, since a longstanding experience in Germany shows that not only an enlightened shareholder primacy can work, but that even a pluralistic aim of the corporation and the duty of the management board to act in the interest of the shareholders, the creditors and the public is satisfactory, both in theory and in practice.[113] Under bank corporate governance aspects one might even postulate that the interests of the creditors come before the interests of the shareholders.[114] Yet singling out the systemic risk and therefore digging a civil liability ditch between the few banks carrying systemic risks and all the others is unsatisfactory; while it may work for regulatory purposes, it is not suitable for directors and possible claimants in civil liability.

What is certainly helpful is to require specific abilities and experiences for bank directors[115] and to have regulators enforce these requirements when, as suggested earlier, bank directors are approved by the regulator.[116] One might label this as a specific *"banking literacy"*,[117] which would be part of the "fit and proper" requirements imposed by regulators. Yet as for other skills and experience that are necessary in the board, this requirement should be only

[110] Frankfurter Allgemeine Zeitung, 12.1.2018, No. 10 p. 17; Handelsblatt, 11.1.2018, No. 8 p. 30.
[111] A. Hamdani, " Bank Directors: Duties Towards the Public?", lecture, Society of European Contract Law (SECOLA), 16-17.6.2017 Bocconi University.
[112] Contra A. Kokkinis, loc. cit., p. 170 et seq.
[113] See supra s. IV note 66. For the more recent version of the enlightened shareholder interest approach see A. Keay, *The Enlightened Shareholder Value Principle and Corporate Governance,* 2013.
[114] Cf. Basel Committee on Banking Supervision, *Guidelines, Corporate governance principles for banks,* July 2015, p. 3 , Introduction No. 2: "The primary objective of corporate governance should be safeguarding stakeholders' interest in conformity with public interest on a sustainable basis. Among stakeholders, particularly with respect to retail banks, shareholders' interest would be secondary to depositors' interest." See K. J. Hopt, "Corporate Governance von Finanzinstituten, Empirische Befunde, Theorie und Fragen in den Rechts- und Wirtschaftswissenschaften", *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* 2017, 438 at 446 et seq. Same proposal by A. Kokkinis, loc. cit., p. 183.
[115] This knowledge and experience is key, also in comparison to independence, J. de Haan, R. Vlahu, "Corporate Governance of Banks: A Survey", *Journal of Economic Surveys* 30 (2016) 228 at 250 et seq.; J.-H. Binder, loc. cit., *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* 2018, 88 at 101 et seq.
[116] Above s. II.
[117] J. R. Macey, M. O'Hara, loc. cit., 102 et seq.

for the board as a whole, not for each director.[118] Otherwise the necessary diversity might not be reached or maintained.

(b) In corporate law there are several rationales for the *business judgment rule:* first, to avoid that directors are overly deterred from taking decisions for the company that may be commercially promising but risky, and second, to reduce the danger that judges later on succumb to the hindsight bias which is very difficult to avoid.[119] It has been proposed not to apply the business judgment rule to bank directors[120] in order to incentivize them better to take into consideration bank specific risks, in particular systemic risk. For this it has been correctly observed that for managers with equity-based pay, the fear of liability would not lead to undesirable risk-aversion on the part of managers and for diversified shareholders because of the systemic harm that has effects will beyond the bank.[121] Yet this relates only to the systemic risk. For other risks, whether bank specific or the general enterprise risk, both rationales for the business judgment rule remain untouched. This is the reason why the business judgment rule should remain available also to bank directors.[122]

(c) There is also no case for changing the *burden of proof*, as the reform in the UK has rightly refused to do.[123] In Germany the burden of proof falls on the (bank and non-bank) director, and this is mandatory.[124] But the German reform discussion criticizes this rule as having lost touch with modern reality.[125] Usually liability cases against directors are started when the old directors have been ousted and the new directors either are legally bound to or want to show that they enforce the liability of their predecessors. At that point it is difficult or even impossible for the former director to meet this burden of proof, since he or she no longer has access to the email system of the corporation. Giving him or her right of information against the corporation, as the traditional doctrine maintains, no longer works. All this is even more difficult if the lawsuit is brought only years afterwards or takes very long. The same analysis applies for bank directors.

(d) An interesting proposal for an *insolvency related responsibility* of bank directors has been made recently in the United Kingdom.[126] The liability standard proposed is said to be

[118] Cf. German Corporate Governance Code as of 7 February 2017, s. 5.4.1: "The Supervisory Board has to be composed in such a way that its members *as a group* possess the knowledge, ability and expert experience required to properly complete its tasks." (emphasis added).
[119] For details see K. J. Hopt, M. Roth, loc. cit., article 93 comments 66-131.
[120] J. Armour/J. Gordon, "Systemic Harms and Shareholder Value", *Journal of Legal Analysis* 2014, 6 (35) at 39 et seq., and same, ECGI Law Working Paper No. 222/2014, August 2014.
[121] J. Armour et al., loc. cit., at p. 379.
[122] G. Ferrarini, "Understanding the Role of Corporate Governance in Financial Institutions: A Research Agenda", ECGI Law Working Paper No. 347/2017, March 2017, p. 7 at p. 21 et seq. referring also to case of the Delaware Court of Chancery; A. Hamdani, loc. cit., and T. Tröger, "Managers' Duties Towards Shareholders and Debtholders", lecture, Society of European Contract Law (SECOLA), 16-17.6.2017 Bocconi University.
[123] Above s. II note 25. Contra A. Kokkinis, loc. cit., p. 176. See the detailed discussion on this issue in Australia, M. Legg, D. Jordan, "The Australian Business Judgment Rule After *ASIC v Rich*: Balancing Director Authority and Accountability", 34 (2014) *Adelaide Law Review* 403.
[124] Article 93 of the German Stock Corporation Act.
[125] See K. J. Hopt, "Die Reform der Organhaftung nach § 93 AktG", in: T. Ackermann, J. Köndgen, eds., *Privat- und Wirtschaftsrecht in Europa, Festschrift für Wulf-Henning Roth,* 2015, p. 225 at p. 232 et seq.
[126] A. Kokkinis, loc. cit., p. 169 et seq.

a capped strict liability, with a defence of reasonable management consistent with financial sustainability, but actually it is a sort of mandatory contribution of bank directors to the assets of an insolvent bank that is linked to the total level of the remuneration paid in the last five years. While this liability is supposed to be strict and not dependent on bad faith or negligence nor on causation, the director can defend himself by showing reasonable management, which thus seems to yield a standard of negligent behavior. As to the link to insolvency, the proposed provision would be similar to the traditional wrongful trading liability.[127] It also resembles to a certain degree the French action en responsabilité pour insuffisance d'actif.[128] This action, however, presupposes a fault on the part of the directors, a link of causation and the insolvency of the bank. The amount to be paid by the director lies in the discretion of the court.

(e) *Responsibility of key function holders*.[129] This is a concept that traditionally is not used in corporate law, but one that has rightly been introduced in bank regulation mainly after the financial crisis (though primarily as far as concerns improper remuneration incentives). Normally employees of the company, even those directly under the CEO, are liable to the company under the specific employment rules of labour law, which shield employees from general liability. As to key function holders, one might think of treating them as organs of the company, just like the members of the board.[130] This may be particularly relevant for the risk officer of the parent company. But the better solution is to subject key function holders solely to regulatory duties, possibly including a sort of banking literacy[131] corresponding to their functions and tasks, and not to extend these duties so as to have them become also civil and corporate law duties given that both regimes have different goals and the specific labour law liability regime for employees should remain open for all employees.[132]

On the other side, holding the board and its directors personally strictly liable for the misbehaviour of key function holders would also go too far. Instead, strict duties of the board to organize the bank processes and to supervise these processes,[133] not only for the

[127] Idem at p. 172, but also for an amendment of the wrongful trading and disqualification provisions at p. 183 et seq.. As to wrongful trading see P. L. Davies, S. Worthington, *Gower Principles of Modern Company Law,* 10th ed., 2016, s. 9-6 et seq. For a comparison with German law see F. Steffek, *Gläubigerschutz in der Kapitalgesellschaft,* 2011.

[128] Article L. 651-2 of the French Code de commerce (formerly: action en comblement du passif). Cf. M. Cozian, A. Viandier, F. Deboissy, *Droit des sociétés,* 30e éd., 2017, nos 422 et s., 2057 et s.

[129] See above II for the UK.

[130] Basel Committee on Banking Supervision, Guidelines, Corporate governance principles for banks, July 2015, Principle 4: senior management.

[131] Above s. V 3 (a).

[132] I. H.-Y Chiu, "Comparing Directors' Duties in the Financial Services Sector with Regulatory Duties under the Senior Persons Regime – Some Critical Observations", *European Business Law Review* 27 (2016) 261 at p. 278 et seq. Contra A. Kokkinis, loc. cit., p. 173 et seq., who proposes to extend section 36 of the UK Financial Services (Bank Reform) Act 2013 (see above s. V 2) to a civil law responsibility for both directors and senior managers. Yet in this context one should beware that the dividing line between directors and senior managers differs: in the UK, apart from the CEO, the board consists nearly exclusively of non-executive directors, while in Germany all of the managing board directors are executive members. As to separate rules for directors and senior managers also in the UK see P. L. Davies, S. Worthington, loc. cit., s. 16-11.

[133] As to the growing role of directors' organizational duties see for credit institutions J.-H. Binder, loc. cit., *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* 2018, 88; for general nonbank

single bank but group-wide, is more appropriate and fits into the traditional concept of negligence as mentioned before.

(f) In the end there are proposals to do away with limited liability entirely. For tort law this is a classic proposal[134] which is not to be pursued further in this context. But similar proposals have been made specifically for the banking sector. Historically bank shareholders were subject to liability for corporate obligations in an amount equal to the par value of their shares.[135] After the financial crisis, when it turned out to be difficult or impossible to hold bankers and bank directors liable, one recalled that originally Wall Street firms were run as partnerships with unlimited liability, which amounted of course to a completely different incentive structure as to engaging in unduly high risks. Accordingly it was proposed to impose some personal liability on investment bankers.[136] A theoretically interesting and more recent proposal concerns only investor-managers of shadow banks.[137] Investor-managers under this proposal are equity investors who also have significant power to control the firm's actions and among them only those with a significant share of their firm's profit. These investor-managers should be subject to a liability that is a multiple of their original investment, say the double, provided that their firm has not made due contributions to a systemic risk fund to be set up by the systemically risky shadow banks.

4. *Stricter enforcement by the board, by the creditors and/or by regulators:* As we have seen, subjecting bank directors to a specific and stricter rule than ordinary board members is anything but obvious. But this reform agenda becomes even more complicated if one looks at enforcement. It is common wisdom that liability without adequate enforcement is meaningless, and better enforcement may even lead to better deterrence than stricter duties and liabilities.

(a) Traditionally it is up to *the whole board* to bring liability suits against the members of management and the board itself. Since it is natural that the board will be reluctant to take action against management colleagues or fellow-members in the board, the power to do so is better vested in the independent directors in a one-tier system or the supervisory board in a two-tier system. In addition, a *minority of shareholders* may have standing to initiate such a lawsuit, though this happens rarely. As mentioned before, in some jurisdictions, such as in Germany under the ARAG-Garmenbeck decision of the Bundesgerichtshof, there is even a mandatory legal duty that falls on the (supervisory) board to bring an action but for

directors K. J. Hopt, M. Roth, loc. cit., article 93 comments 182 et seq. For the UK I. H.-Y. Chiu, loc. cit., *Journal of Business Law* 2016, 465; A. Kokkinis, loc. cit., p. 176 et seq.

[134] H. Hansmann, R. Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts", 100 *Yale Law Journal* 1879 (1991); N. A. Mendelson, "A Control-Based Approach to Shareholder Liability for Corporate Torts", 102 *Columbia Law Review* 1203 (2002). See also R. Kraakman et al., *The Anatomy of Corporate Law*, 3d ed., 2017, 1.1.2 Limited Liability, 5.1.2.3 Externalities, non-adjusting creditors.

[135] Still in the National Banking Act o 1863 and partially elsewhere until 1935, J. R. Macey, G. P. Miller, "Double Liability of Bank Shareholders: History and Implications", 27 Wake Forest Law Review 31 (1992) at 36.

[136] C. Hill, R. Painter, "Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability", 33 Seattle University Law Review 1173 (2010).

[137] S. L. Schwarcz, "The Governance Structure of Shadow Banking: Rethinking Assumptions About Limited Liability", Notre Dame Law Review 90 (2014) 1.

very exceptional circumstances.[138] While the number of such lawsuits brought by boards is relative small, such a duty requires the board to think twice as to whether or not to enforce a claim of the corporation against a director, since if it fails to do so its members will risk being liable themselves. This seems to work fairly well, though there is criticism that there should be more room for the business judgment also of the (supervisory) board as to whether, in view of the legal and non-legal consequences, it is really advantageous for the corporation to initiate judicial proceedings.

The proposal to extend standing to each *single shareholder* has not met with the approval of a clear majority.[139] It is true, however, that the duty of care of directors even apart from the business judgment rule is seldom enforced,[140] whereas violations of the duty of loyalty are more egregious, easier to prove and more often enforced. A far-reaching reform proposal in the UK would give standing to the *stakeholders* in conformity with a stakeholder conception in company law that would make directors responsible not to the shareholders but to the company as a whole.[141]

(b) For banks, one might wonder whether *engaging the creditors in enforcement* might lead to more liability suits against directors. This could be done by making directors, or even key function holders, directly liable to creditors, possibly even group-wide, and giving these creditors standing to sue. Under special circumstances, for example product liability, this can be done already today. Yet going further shows the incentive problems. Normal creditors will not have an incentive to bring such suits; rational apathy is experienced not only by ordinary shareholders but also by creditors. Larger creditors, in particular major banks as creditors, usually have no such an incentive because of the securities and pledges that they hold. This may be slightly different for long-term creditors, in particular bondholders, yet even for them litigation may ultimately be unattractive.

(c) The *enforcement of the regulatory duties* of the directors and key function holders is of course up to the regulators and supervisors who have not only the task but also the regulatory and supervisory powers for doing so. Indeed, as said before, these regulatory duties and the corresponding enforcement powers were reformed dramatically after the financial crisis under the CRD IV; at this point there is even the fear of too much intrusion into the organization, management and day-to-day business, in short a fear of overregulation.[142] As to the European Union, it must be remembered that the CRD IV is being transformed into national law with the consequence that the enforcement standards vary widely.[143] Harmonization not only of substantive law but also of the related procedural

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[138] Pursuant to the above-mentioned decision of the German Bundesgerichtshof, ARAG v. Garmenbeck.

[139] Cf. 69th German Lawyers' Association (Deutscher Juristentag), Munich 2012, Resolution No. 22 and the discussion at the meeting before, insofar the expert opinion of M. Habersack was not followed.

[140] J. Armour et al., loc. cit., p. 389.

[141] I. H.-Y. Chiu, "Operationalising a stakeholder conception in company law", *Law and Financial Markets Review* 10 (2016) 173.

[142] G. Ferrarini, loc. cit., p. 2: favouring cautious deregulation, 24 et seq.

[143] C. Zilioli, Director General of Legal Services of the European Central Bank, "Advances in Corporate Governance: Financial Corporations", lecture at the Hertie School of Governance, Berlin 20 February 2018. Curiously enough, in its supervisory capacity the ECB has to apply the national supervisory laws of 19 member states.

and enforcement law, including the concretization of the fit and proper rule and the liability of the supervisors,[144] is needed to ensure a level playing field in the governance of European banks.[145]

Regulatory duties as dealt with here are public duties under bank supervisory law. But it must not be overlooked that banks may be and are quite often liable under securities regulation in the USA and under – harmonized or now increasingly genuine – European capital markets law. In a recent case study the point has been made quite rightly that securities viz. capital market law litigation is becoming an increasingly effective substitute for duty of care actions in risk oversight failure scenarios.[146]

As to *criminal responsibility* it is long since established that supervisors inform the public prosecutor if it is found that directors have engaged in criminal behaviour and criminal transactions. This is not to be underestimated because there is a clear tendency for legislators to penalize administrative and supervisory law violations as penal infractions or even as outright crimes.

But what remains is the proposal to *give regulators a role in enforcing civil liability*. There are different ways to do this. Regulators could make it easier for private plaintiffs to prove their liability claims by making available their own findings on directors' violations of regulatory duties.[147] A more far-reaching reform would be to give bank regulators standing for enforcing the civil liability of directors. This has been done, for example, in Australia[148] and has occasionally been proposed also in Europe.[149] Yet the German Lawyers' Association has discussed this proposal and rejected it for a number of reasons.[150] The main reason being that that regulators have other more direct means of enforcing the obedience of the regulatory duties of bank directors and should devote their limited personnel and financial resources to direct enforcement, leaving civil liability to the corporation,

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[144] This is also a problem for the European Central Bank under its task of bank supervision under national supervisory law.
[145] This is the conclusion of C. Zilioli, loc. cit.
[146] M. T. Moore, "Redressing Risk Oversight Failure in UK and US Listed Companies: Lessons from the *RBS* and *Citigroup* Litigation", *European Business Organization Law Review* 18 (2017) 733.
[147] From a comparative law perspective this is similar in France, where civil claimants use the information extracted in the corresponding prior criminal lawsuit and more generally in those countries where corporate law provides for a special inquiry by experts which the court may grant at the application of shareholders. See also A. Kokkinis, loc. cit., p. 182, who argues for a mandatory in-depth inquiry by an independent committee in each case of financial institution failure.
[148] Australian Securities and Investments Commission (ASIC) Act 2001 (Cth), s. 50. For details I. Ramsay, "Increased Corporate Governance Powers of Shareholders and Regulators and the Role of the Corporate Regulator in Enforcing Duties Owed by Corporate Directors and Managers", *European Business Law Review* 26 (2015) 49 at 63 et seq.; J. J. du Plessis, N. Cordes, "Claiming Damages from Members of Management Boards in Germany: Time for a Radical Rethink and Possible Lessons from Down Under?", unpublished manuscript, 2017, p. 23 et seq.. 29 et seq.
[149] U. H. Schneider with a motion at the 69th German Lawyers' Association; I. H.-Y Chiu, loc. cit., *Law and Financial Markets Review* 10 (2016) 173 at 185 without mentioning the Australian experience.
[150] 69th German Lawyers' Association (Deutscher Juristentag), loc. cit., Resolution No. 17; cf. K. J. Hopt, Festschrift für Roth, loc. cit., at p. 237 et seq.

shareholders and, as the case may be, private creditors.[151] As to the incentive structure of the directors, it is doubtful whether the additional threat of financial liability enforced by regulators may add very much to the threat of being censured or even dismissed by a regulator. In the end, such a reform would be motivated more by the social policy argument of securing compensation for damaged persons than by the need to cope with the incentive structure as to bank specific systemic risk.

VI. Summary

Starting from the well-evidenced fact that banks with shareholder-focussed corporate governance fared worse in the financial crisis than those without, this paper considers various initiatives and proposals to re-orient board rules in relation to banks. The paper considers three type change. First, increased influenced over board composition and behaviour without granted new rights of board representation to any group of persons. In this section we look at influence for the general public interest in bank stability via an increased role for bank supervisors in the selection and monitoring of bank directors and significant bank executives, and at an increased role for long-term creditors, in particular bondholders. The former is partly already in place and for the latter we suggest ways in which changes could be made, mainly via contract.

Second, we look at influence via board representation, mainly for creditors but also for the public interest. We are sceptical about the scale of the benefits such representation is likely to afford and point out some of the costs of these proposals. Finally, we look at enhanced liability, whether regulatory, criminal or civil. There are many proposals for change in this area, some very far-reaching. We doubt the benefits of enhanced criminal liability, but think that more enforcement effort, especially in the regulatory field, but also as to civil liability, would yield positive results.

[151] There may be a role for regulators in securing private redress as part of the settlement of a regulatory action as in the Tesco case in the UK.

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