# Corporate Risk-Taking and the Decline of Personal Blame

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Federal agencies and prosecutors are being criticized for seeking so few indictments against individuals in the wake of the 2008 financial crisis and its resulting banking failures. This article analyzes why—contrary to a longstanding historical trend—personal liability may be on the decline, and whether agencies and prosecutors should be doing more. The analysis confronts fundamental policy questions concerning changing corporate and social norms. The public and the media perceive the crisis's harm as a "wrong" caused by excessive risk-taking. But that view can be too simplistic, ignoring the reality that firms must take greater risks to try to innovate and create value in the increasingly competitive and complex global economy. This article examines how law should control that risk-taking and internalize its costs without impeding broader economic progress, focusing on two key elements of that inquiry: the extent to which corporate risk-taking should be regarded as excessive, and the extent to which personal liability should be used to control that excessive risk-taking.

There is confusion and ambiguity over what corporate risk-taking is excessive. Corporate governance law already covers, and subjects managers to personal liability for engaging in, certain types of excessive risk-taking. But it does not cover the type of increasingly common risk-taking that led to the financial crisis—risk-taking that could have systemic consequences to the financial system. Until that crisis, a firm's managers were viewed as agents for—and thus corporate risk-taking was assessed by its potential impact on—the firm's investors, focusing on the balance between risk-seeking shareholders and more risk-averse creditors. Excessive risk-taking was therefore implicitly viewed as risk-taking that violated that balance; in practice, that was relatively easy to assess because, absent actual or contingent insolvency, managers owed their duty solely to the shareholders.

Systemic risk, however, is complicating that assessment. A systemically important firm's failure can harm not only its investors but also, by triggering a systemic collapse, the public at large. As a result, firms engage in transactions that are expected to be profitable even though their failure could increase systemic risk, since much of the harm from a resulting systemic collapse would be externalized. The article argues that corporate governance law should require managers to take that externalized harm into account, in order to protect the public. That could be done by viewing a firm's managers as agents for—thereby assessing corporate risk-taking by its potential impact on—all of the affected parties, the public as well as the firm's investors. Given that reformulation of corporate governance law, the article examines how managers could assess the impact of risk-taking on the public and also how they could attempt to balance that impact with the impact on investors.

Just as corporate governance law already subjects managers to personal liability for engaging in certain types of excessive risk-taking, the article argues that managers should be subject to liability for engaging in excessive systemic risk-taking. In traditional corporate governance, shareholder derivative suits are the primary means to impose liability on managers. Shareholders would have no interest, however, in imposing liability on managers of their firm for externalizing systemic harm. Therefore, the government, by default, should have the right to impose that liability. The article also examines whether managers being exposed to that liability should be protected by the business judgment rule (and concludes they should).

Finally, the article analyzes less direct ways to impose personal liability to deter excessive systemic risk-taking. For example, by protecting a firm's shareholders from the firm's liabilities (except to the extent of invested capital), corporate limited liability fosters moral hazard, leading to excessive corporate risk-taking. In the past, corporate limited liability was justified because (by addressing shareholder risk aversion) it encourages equity-capital investment, and its potential for harm was thought to be limited to the firm's investors. The externalized systemic harm associated with the rise of shadow banking shifts that balance radically, however. Because shadow-banking firms are often managed directly by their primary shareholders, who are entitled to a significant share of their firm's profits but are protected under limited liability from losing more than their invested capital if the risk turns out poorly, those shareholder-managers have strong incentives to take high risks that could generate outsized profits. Moreover, the failure of a shadow-banking firm is likely to have systemic consequences: shadow banks not only engage in financial intermediation on which the real economy is dependent but also are highly interconnected with traditional banks. To help reduce these systemically risk-taking incentives, the article proposes narrowing the limited liability protection of shareholder-managers who have the power to control their shadow-banking firms.

The full article is available for download **here**.