Key Points

→ Most of the regulatory measures to control excessive risk taking by systemically important firms are designed to reduce moral hazard and to align the interests of managers and investors. These measures may be flawed because they are based on questionable assumptions.

→ Excessive corporate risk taking is, at its core, a corporate governance problem. Shareholder primacy requires managers to view the consequences of their firm’s risk taking only from the standpoint of the firm and its shareholders, ignoring harm to the public. In governing, managers of systemically important firms should also consider public harm.

→ This proposal engages the long-standing debate whether corporate governance law should require some duty to the public. The accepted wisdom is that corporate profit maximization provides jobs and other benefits that exceed public harm. The debate requires rethinking for systemic economic harm.

→ This policy brief rethinks that debate, demonstrating that a corporate governance duty can be designed to control systemic risk without unduly weakening wealth production.

Excessive corporate risk taking by systemically important financial firms is widely seen as one of the primary causes of the 2007-2008 global financial crisis. In response, governments have issued or are considering an array of regulatory measures to attempt to curb that risk taking and prevent another crisis. This policy brief argues that these measures are inadequate, and that controlling excessive risk taking also requires regulation of corporate governance.

Excessive Risk Taking and Systemic Harm

Existing Regulatory Measures to Control Excessive Risk Taking Are Flawed

The regulatory measures to control excessive risk taking by systemically important firms tend to fall into two broad categories. Some are designed to end the problem of “too big to fail,” assuming that firms engage in excessive risk taking because they would profit by a success and be
bailed out by the government in case of a failure.\(^2\) Other measures are designed to control excessive risk taking by aligning managerial and investor interests, assuming that the investors themselves would oppose excessively risky business ventures.\(^3\)

These measures may be flawed, however, because they are based on questionable assumptions. The assumption that systemically important firms engage in morally hazardous risk taking because they expect a bailout has no real empirical support. Some empirical studies conflate correlation and causation, assuming that if many systemically important firms engage in risky behaviour, that behaviour was predicated on bailout expectations.\(^4\) Other empirical studies merely show that systemically important firms can borrow at lower cost, which does not say anything about whether those firms in fact engage in morally hazardous risk taking because there are many other reasons why systemically important firms, which generally are large, can borrow at lower cost than smaller firms.\(^5\)

That assumption may also be contrary to management incentives. Managers who cause their firms to engage in excessive risk taking in the expectation of a government bailout are taking serious personal risks. If, as in the case of Lehman Brothers, the government fails to bail out the firm, those managers are almost certain to lose their jobs. Even if a bailout occurs, it may well be conditioned on those managers resigning or otherwise giving recompense.\(^6\) In either case, the ensuing reputational damage may permanently end a manager’s financial career.\(^7\)

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\(^2\) This is primarily a problem of moral hazard, that persons protected from the negative consequences of their risky actions will be tempted to take more risks.

\(^3\) These include, for example, requiring a systemically important firm to tie management compensation to the firm’s long-term performance, or requiring a systemically important firm to maintain so-called contingent capital, in which debt securities convert into equity upon specified conditions.


\(^7\) Ibid.
The assumption that a systemically important firm’s investors would oppose excessively risky business ventures is also questionable. What constitutes “excessive” risk taking depends on the observer: risk taking is excessive from a given observer’s standpoint if it has a negative expected value to that observer — i.e., the expected costs to that observer exceed the expected benefits. It is reasonable to assume that investors would oppose risky business ventures with a negative expected value to them. But because much of the systemic harm from their failure would be externalized onto the public (including ordinary citizens impacted by an economic collapse), systemically important firms can engage in risk-taking ventures that have a positive expected value to their investors but a negative expected value to the public.8

Regulators and policy makers are beginning to recognize that the existing regulatory measures are inadequate. Reporting on a widely attended meeting at the Federal Reserve Bank of Boston late last year, The New York Times observed that “policy makers have made little progress in figuring out how they might actually prevent another financial crisis.”9 Donald Kohn, former vice chair of the Federal Reserve Board, said that the Fed “doesn’t really have the tools” to prevent another crisis. Luc Laeven, the European Central Bank’s director general for research, summarized the consensus of the conference: “Both monetary policy and macroprudential [regulatory] policy are not really very effective.” He then asked, “Do we have other policies?”10

Excessive Risk Taking is a Corporate Governance Problem

We may well have other policies. Excessive corporate risk taking results from managerial decisions. At its core, therefore, it is a corporate governance problem. The shareholder-primacy framework for governance, followed throughout the world, requires corporate managers to view the consequences of their firm’s actions only from the standpoint of the firm and its shareholders. That perspective ignores externalities, including harm to the public caused by the firm’s risk taking.11 The most direct way of controlling that risk taking would be to regulate corporate governance, to require managers to also consider the public consequences of their firm’s actions.

Proposing such a requirement engages the longstanding debate whether corporate governance law should require some duty to the public. The accepted wisdom is not to require such a duty — that corporate profit maximization provides jobs and other public benefits that exceed any harm. This is especially true, the argument goes, because imposing specific regulatory requirements and making certain actions illegal or tortious — what this policy brief will call “regulating substance,” in contrast to “regulating governance” — can mitigate the harm without unduly impairing corporate wealth production. Opponents of a public duty also argue that managers could not feasibly govern if they had to take into account the myriad small externalities that result from corporate risk taking.

Whether or not these arguments are sensible in the traditional corporate context, they lose their force in the face of systemic economic harm. Systemic externalities are significant, including the devastating harm caused by an economic collapse. Regulating substance has so far proved inadequate to control those externalities.

Regulating governance also has an intrinsic advantage over regulating substance in controlling systemic externalities. Regulating substance often depends on regulators precisely understanding the financial “architecture” — the particular design and structure of financial firms, markets and other related institutions — at the time the regulation is promulgated.12 Because the financial architecture is constantly changing, that type of grounded regulation has value as long as it is updated as needed to adapt to those changes. But ongoing financial monitoring and regulatory updating can be costly and is subject to political interference at each updating stage. As a result, financial regulation of substance usually lags behind financial innovation, causing unanticipated consequences and allowing innovations to escape

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8 Schwarcz, “Misalignment”, supra note 1.
10 Ibid.
regulatory scrutiny. Regulating governance, in contrast, can overcome that regulatory time lag. To fulfill their governance duties, the managers of a firm that is proposing to engage in a financially innovative but risky project must try to obtain the most current information about the innovation and its consequences.

Regulating governance therefore could add value to regulating substance in controlling systemic externalities. Next, this policy brief considers how corporate governance regulation could be redesigned to accomplish that without impairing profit maximization.

**Redesigning Corporate Governance Regulation**

In making corporate risk-taking decisions, the duty that managers currently have toward systemically important firms and their investors should be expanded to the public, to reduce systemic externalities. So long as it does not unduly weaken wealth-producing capacity (corporate wealth production being in the public interest), such a public governance duty would help to align private and public interests.

The analysis next considers first the theory, and then the practicality, of implementing a public governance duty.

**Reconciling a Public Governance Duty with Corporate Governance Theory**

There are three theoretical models of corporate governance: a stakeholder model, a contractarian model and a shareholder-primacy model. As explained below, a public governance duty would not be inconsistent with these models except to the extent it intentionally limits shareholder primacy.

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13 See ibid (observing that this occurred in 2008, for example, when the pre-crisis financial regulatory framework, which assumed the dominance of bank-intermediated funding, failed to adequately address a collapsing financial system in which the majority of funding had become non-bank intermediated).

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**Stakeholder Model**

A public governance duty would most clearly be consistent with the stakeholder model of governance, which considers the interests of everyone affected by a firm’s actions to avoid anyone being unfairly exploited. The public, of course, is affected by a firm’s risk taking. This model, however, adds little explanatory value because there is fundamental disagreement on the extent to which non-investor stakeholder interests should be taken into account, valued and balanced with shareholder interests.

**Contractarian Model**

A public governance duty would, at first glance, appear to be inconsistent with the contractarian model of governance — that a firm is a “nexus of contracts” among private parties. After all, members of the public are not contracting parties. Contract law, however, does not limit its application to contracting parties. Government should be able to limit freedom of contracting when the contracting causes externalities. The critical question is which externalities should count in limiting that freedom.

Even under contract law, there is no absolute answer to that question. But we need to answer only a much more limited question: Should systemic externalities count in limiting freedom of contract? That question has already effectively been answered: systemic externalities not only harm the public, who cannot contract to protect themselves, but also cause much more harm than non-systemic externalities, including widespread poverty and unemployment. These are exactly the types of externalities that should count in limiting freedom of contract.

**Shareholder-primacy Model**

A public governance duty would technically be inconsistent with the shareholder-primacy model. Proponents of shareholder primacy argue that managers of for-profit corporations should govern the firm solely for the best interests of its shareholders. They accept that firms can cause externalities, but they believe the efficient response is for government to regulate substance, without interfering with corporate governance. However, where regulating substance is insufficient, as in the case of
controlling the excessive corporate risk taking that causes systemic externalities, the alternative should be to regulate corporate governance.

Next consider a public governance duty’s practicalities: how to regulate governance without unduly weakening corporate wealth-producing capacity.

Practicalities of a Public Governance Duty

Under a public governance duty, the managers of a systemically important firm would not only have a private corporate governance duty to the firm and its investors but also a duty not to engage in excessive risk taking that could systemically harm the public. That public duty raises several practical issues.

Legally Imposing the Duty

How should a public governance duty be legally imposed? Courts, for example, could create such a duty through judicial decisions. Or legislatures could amend their corporation laws to require such a duty. The latter may be preferred because imposing such a duty broadly impacts public policy.

In the United States, for example, this would mean that a public governance duty should be imposed either by state legislatures (especially the Delaware legislature, because most domestic firms are incorporated under Delaware law) or by the US Congress. Because corporation law in the United States is traditionally state, not federal, states ideally should take the lead in imposing such a duty.

It is questionable, however, whether state legislatures are well positioned to impose a public governance duty. Any given legislature would be unlikely to want to pioneer such a duty because it could discourage firms from incorporating in its state. Furthermore, systemic risk is a national and international problem, not usually a local state problem. The “internalization principle” recognizes that regulatory responsibilities should generally be assigned to the unit of government that best internalizes the full costs of the underlying regulated activity. For these reasons, Congress may be best situated to impose a public governance duty.

Assessing and Balancing Costs and Benefits

How should managers of a systemically important firm, or members of such a firm’s risk committee, assess and balance the public costs and private benefits of a risk-taking activity? Consider two approaches, one subjective and the other more objective and ministerial. On a case-by-case basis, managers could choose which approach to follow. Either approach should be needed only when deciding on a risky project whose failure might, either itself or in combination with other factors of which such managers are or should be aware, cause the firm to fail.

Managers following a subjective approach would simply consider those costs and balance them against benefits — the same way they would consider and balance any other relevant costs and benefits when making a corporate risk-taking decision. Their assessment and balancing might, but would not necessarily, be documented or explained. Managers may favour this approach because it would not change their current behaviour. This subjective approach would have at least three drawbacks, however. First, because the consequences of a systemic collapse can be devastating to the public, the decision-making process to mitigate that harm should be more transparent. Second, managers following a subjective approach may be subject to peer pressure to favour investor profitability over avoiding public harm — especially when, as later

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14 Cf John Carney, “Big Bank Board Game Puts Shareholders in Second Place”, The Wall Street Journal (5 April 2015) (noting a speech by US Federal Reserve Governor Daniel Tarullo suggesting that “corporate governance would need to change to broaden the scope of boards’ fiduciary duties to reflect macroprudential [i.e., systemic] regulatory objectives”). The nation of Iceland has actually enacted legislation that appears to require, at least in principle, the managers of certain systemically important firms to “operate[] [their firms] in the interests of . . . shareholders . . . and the entire national economy.” Ministry of Industries and Innovation, Act No 161/2002 on Financial Undertakings.

15 Surprisingly, even risk committees required by the Dodd-Frank Act in the United States are not obligated, and indeed may have no legal authority, to consider risks to the public.

16 Cf John Armour & Jeffrey N Gordon, “Systemic Harms and Shareholder Value” (2014) 6 J Leg Analysis 35 (observing that “it is surely the board’s responsibility to identify those risks which are of a magnitude and kind as to threaten the firm’s stability” at 69).

17 Cf supra note 8 and accompanying text (observing that systemic externalities can result from risk taking that causes the failure of a systemically important firm).
observed, managers often have conflicts of interest that favour the firm's shareholders over the public. Third, although courts generally try to avoid second-guessing management decisions, even managers should want to follow an approach that provides an explicit safe harbour against litigation — at least if the approach is relatively ministerial.

Consider how to craft a possible ministerial safe-harbour objective approach, using the generic example of a systemically important firm engaging in a risky project that could be profitable. The expected private benefits would be the expected value of the project to the firm's investors (usually the shareholders). The expected public costs would be the expected value of the project's systemic costs.18

In large part, the firm's managers should have sufficient information, or at least much more information than third parties, about these values. For example, managers should have much more information than third parties about valuing the chance of the project being successful, the value to investors from that success, the loss from the project's failure, and the chance of the firm failing as a result of the project's failure.

The exception, however, is valuing the systemic costs if the firm fails. That valuation should be a public policy choice. It might be based, for example, on the estimated cost of a government bailout to avoid a systemic failure. Such an estimate could be made by the government as part of the process of designating a firm as "systemically important," and thereafter periodically updated by the government.

From a strict (Kaldor-Hicks) economic efficiency standpoint, the project would be efficient if its expected value to investors exceeds the expected value of its systemic costs. As a public policy matter, however, simple economic efficiency may be insufficient because the magnitude and harmful consequences of a systemic collapse, if it occurs, could be devastating.

When balancing the costs and benefits of activities that might pose great harm, policy makers normally apply a precautionary principle directing regulators to err on the side of safety. Applying that to this policy brief's balancing, it may be appropriate (as Cass Sunstein has proposed in another context19) to require "a margin of safety" — for example, requiring that the expected value to investors considerably exceeds the expected value of systemic costs — to demonstrate that a given risk-taking activity is justified.

### Enforcing a Public Governance Duty

Who should enforce a public governance duty? Under existing corporate governance law, shareholder derivative suits are the primary enforcement mechanism. Shareholders would have no interest, however, in suing managers of their firm for externalizing systemic harm. Therefore, the government, by default, at least should have the right to enforce the public duty.

The government itself may be unable to effectively monitor a firm’s internal compliance with the public governance duty until the firm fails, when systemic consequences may be irremediable. To facilitate better monitoring, regulation implementing a public governance duty should include whistleblower incentives, including anti-retaliation protection for managers or others involved in the risk assessment who inform government officials of their firm’s non-compliance and possibly also monetary rewards. Regulation implementing a public governance duty might even impose an obligation on managers involved in the risk assessment to inform government officials of their firm’s non-compliance.

Another way to facilitate better monitoring, and more specifically enforcement, of the public governance duty would be to incentivize members of the public themselves. In the United States, for example, there is precedent for so-called qui tam suits, under which private citizens can sue alleged defrauders in the name of the government. If the suit is successful or settled, the citizen-plaintiff is entitled to a percentage of the award or settlement.20

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18 The “Misalignment” article on which this policy brief is partly based examines in detail how these costs and benefits could be calculated. See Schwartz, “Misalignment,” supra note 1.

19 See Cass R Sunstein, “Beyond the Precautionary Principle” (2003) 151 U Pa L Rev 1003 (discussing a form of the precautionary principle under which “regulation should include a margin of safety” at 1014).

Business Judgment Rule as a Defence

A critical issue concerns the business judgment rule as a defence to manager liability. In the traditional corporate governance context, managerial risk-taking decisions are protected to some extent by this rule, which presumes that managers should not be personally liable for harm caused by negligent decisions made in good faith and without conflicts of interest — and in some articulations of the business judgment rule, also without gross negligence. The rule attempts to balance the goal of protecting investors from losses against the goals of encouraging the best managers to serve and avoiding the exercise of inappropriate judicial discretion (as would occur if courts tried to second-guess business judgments).

The business judgment rule arguably should apply differently in a public-governance-duty context because one of the rule’s basic assumptions — that there be no conflict of interest — may be breached. The interest of a manager who holds significant shares or interests in shares, or whose compensation or retention is dependent on share price, is aligned with the firm’s shareholders, not with that of the public. To that extent, the manager would have a conflict of interest.

But how should the business judgment rule be modified without requiring courts to exercise inappropriate discretion or discouraging the best people from serving as managers? One approach would be to prevent conflicted managers who are grossly negligent — that is, who fail to use even slight care in assessing systemic harm to the public — from using the rule as a defence.

Technically, this modification merely applies the gross negligence standard that is often articulated as part of the business judgment rule, although rarely utilized with any rigour. Because courts routinely review whether other types of actions are grossly negligent, they should not find it inappropriate or impractical to review corporate risk-taking actions under a gross negligence standard. As a practical matter, managers who follow a reasonable procedure to balance public costs and private benefits should be protected. That would effectively conform the business judgment rule’s public-governance-duty application to a duty of process care, a standard commonly used.21

To What Extent Should Managers Be Protected under Directors and Officers Liability Insurance?

Another issue is the extent to which managers who become subject to liability for breaching the public governance duty should be protected under directors and officers (D&O) liability insurance, which indemnifies managers against personal liability. Although D&O liability insurance is needed to incentivize good managers and also to help ensure that sufficient funds are available to properly incentivize private-action lawsuits, it might compromise the deterrent effect of imposing personal liability. Furthermore, because the magnitude of systemic harm is open ended, insurers may be reluctant to offer D&O insurance covering breaches of the public governance duty. At least one possible solution to these concerns would be to specify a limit on the amount of the claim that could be imposed for breaching the public governance duty and, like a deductible, to require managers to be personally liable for some portion of that amount.

Conclusions

Since the financial crisis, regulators have been trying to prevent systemically important firms from engaging in excessive risk taking, which is widely seen as one of the primary causes of the crisis. Regulatory measures to date

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21 The requirement that managers use at least slight care in assessing systemic harm to the public would also be consistent with the business judgment rule’s actual application in at least some jurisdictions that do not formally articulate a gross negligence standard as part of the rule. Delaware, for example, disallows business-judgment-rule protection for managers who act in “bad faith.” See In re Walt Disney Co Derivative Litigation, 907 A 2d 693 (Del Ch 2005) (explaining that “[t]he presumption of the business judgment rule creates a presumption that a director acted in good faith” and that “[t]he good faith required of a corporate fiduciary includes . . . duties of care and loyalty” at 755). Bad faith is broadly defined as including conduct that “is known to constitute a violation of applicable positive law.” Gagliardi v TriFoods Int’l, Inc, 683 A 2d 1049 at 1051 n 2 (Del Ch 1996) [emphasis in original]. Such conduct is interpreted to include a manager failing to take “steps in a good faith effort to prevent or remedy” such a violation. In re Caremark Int’l Inc Derivative Litigation, 698 A 2d 959 at 971 (Del Ch 1996). A manager’s failure to use even slight care when assessing systemic harm to the public under a legally mandated public governance duty would appear to be bad faith under those interpretations.
are mostly designed to reduce moral hazard from such firms being too big to fail (and thus profiting from successful risk taking, but being bailed out by public money in case of a failure) or to align managerial and investor interests (assuming investors would oppose managers engaging their firm in excessive risk taking).

These regulatory measures are based on questionable assumptions. The assumption that systemically important firms engage in morally hazardous risk taking because they expect a bailout has no real empirical support and may be contrary to management incentives. The assumption that aligning managerial and investor interests would deter excessive risk taking is also questionable because what constitutes excessive risk taking depends on the observer. Although investors would oppose risk taking that has a negative expected value to them, systemically important firms can take business risks that have a positive expected value to their investors but a negative expected value to the public because much of the systemic harm from their failure would be externalized onto the public.

It therefore should not be surprising that regulators concede that existing regulatory measures are still inadequate to prevent another financial crisis. This policy brief argues that regulating corporate governance could help to prevent systemically important firms from engaging in excessive risk taking. Managers of those firms should have a duty not only to the firm and its investors but also to society (a public governance duty). The policy brief explains how to design such a duty that does not unduly weaken wealth-producing capacity, thereby better aligning private and public interests.

Because this policy brief errs on the side of protecting corporate wealth production, the proposed public governance duty may not completely prevent the excessive risk taking that causes systemic externalities. Even if imperfect, however, that duty should constitute an important first step toward shaping corporate governance norms to begin to take the public into account.

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22 See Appelbaum, supra note 8 and accompanying text.

23 The “Misalignment” article on which this policy brief is partly based proposes possible language for a Public Governance Duty Act incorporating such a duty. See Schwarcz, “Misalignment”, supra note 1.

24 Other more incremental, although less effective, first steps are also possible. One would be to expand on the idea of certain “constituency” statutes that permit, but do not require, managers to take into account potential systemic harm — effectively, a public governance right. Another first step might be to harness bondholders, who are more risk averse than shareholders, in the governance of systemically important firms. See Steven L Schwarcz, “Rethinking Corporate Governance for a Bondholder Financed, Systemically Risky World” (2017) 58 Wm & Mary L Rev 1345, online: <http://ssrn.com/abstract=2741794>.

25 This policy brief does not engage the broader question of whether corporate governance law should take into account other significant externalities, such as climate change and environmental harm or non-systemic economic harm, when traditional forms of regulation are insufficient. Future policy briefs may engage that question.
Since the first international investment agreement was negotiated nearly six decades ago, developed countries have sought to protect their investors against the possible failure of host countries (usually a developing country) to respect treaty standards. The North American Free Trade Agreement and the European Energy Charter, both dating from 1994, marked the first instances of developed countries signing an agreement containing provisions for investor-state arbitration (ISA) between themselves. Since then, ISA has become a standard feature of international investment agreements, even as the chorus of protest against ISA from civil society groups (and some nations) has grown louder.

Second Thoughts gathers the reflections of 16 international investment experts, examining experiences of ISA in Canada and various parts of the world, and asking whether ISA is appropriate between developed democracies.

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