# Initial Reflections on an Evolving Standard: Constraints on Risk Taking by Directors and Officers in Germany and the United States

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## I. INTRODUCTION

### *A. The Financial Crisis in the United States and Germany*

The collapse in the market for exotic financial instruments, the liquidity crisis in major financial institutions, and the government bailouts in 2008 and 2009 illustrate the massive social cost of financial risk taking. In 2007, the market experienced record downgrades in mortgage-backed securities, including Collateralized Debt Obligations (CDOs). Other complex debt securities fueled unprecedented bank write-downs. "Some AAA rated debt lost all its value."[1] January 2008 was the worst month for CDOs in more than 10 years with issuance of CDOs "grinding to a near halt worldwide."[2] Experts had previously estimated the value of the CDO market at more than $2 trillion.[3] As the value of CDOs fell, the market for them disappeared.

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[1] Jody Shenn, *CDO Market Is Almost Frozen, JP Morgan, Merrill Say (Update2)*, BLOOMBERG (Feb. 5, 2008 3:09 PM), http://www.bloomberg.com/apps/news?pid=20601087&sid=aCk0Qr1f2Eew&refer=home ("The slowdown of the more than $2 trillion CDO market follows record downgrades in mortgage-linked securities last year.").

[2] Paul J. Davies, *Trading in CDOs Slows to a Trickle*, FIN. TIMES (Feb. 11, 2008), http://www.ft.com/cms/s/0/39f3e128-d808-11dc-98f7-0000779fd2ac.html?nclick_check=1.

[3] *See* Yongheng Deng, Stuart A. Gabriel & Anthony B. Sanders, *CDO Market Implosion And The Pricing Of Subprime Mortgage-Backed Securities* 3 (Inst. of Real Estate

These are only a few examples of what went wrong in the United States in 2008.

Financial instability easily spreads from one institution to another and then across national boundaries.[4] The financial crisis of 2008 quickly spread to Germany, inflicting significant damage there even before German banks suffered a second blow from the sovereign debt crisis of 2010. IKB Deutsche Industriebank AG (IKB), Westdeutsche Landesbank (WestLB), Bayerische Landesbank (BayernLB), and Landesbank Sachsen AG (SachsenLB) cost the German taxpayer the most,[5] but many other German banks had also invested in CDOs and other American financial instruments. The banks made these investments through special purpose entities and other conduits in foreign jurisdictions that held CDOs and other long-term mortgage loans that had been financed with the proceeds of short-term financed Asset Backed Commercial Paper (ABCP) and Asset Backed Securities (ABSs).[6] The German banks provided guarantees in the form of credit enhancement and liquidity to the conduits,[7] which enabled the conduits to finance the long-term financial instruments through the issuance of the short-term financial instruments.[8] The conduits that actually held these investments were located mostly outside of the jurisdiction of German banking supervision.[9] The German banks' own exposure to these investments through the guaran-

Studies, Working Paper No. 2009-012, 2009), *available at* http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID1356630_code17741.pdf?abstractid=1356630&mirid=5.

[4] Kenneth W. Dam, *The Subprime Crisis and Financial Regulation: International and Comparative Perspectives*, 10 CHI. J. INT'L L. 581, 608 (2009).

[5] Marcus Lutter, *Bankenkrise und Organhaftung*, 5 ZEITSCHRIFT FÜR WIRTSCHAFTRECHT [ZIP] [JOURNAL OF BUSINESS LAW] 197, 199 (2009).

[6] Asset Backed Commercial Papers (ABCP) are short-term investment vehicles with a short maturity that is typically between 90 and 180 days. A financial institution typically issues the underlying security of the ABCP. The ABCP notes are backed by physical assets such as trade receivables and are generally used for short-term financing needs. *See generally* Swasi Bate, Stephany Bushweller & Everett Rutan, *The Fundamentals of Asset-Backed Commercial Paper*, MOODY'S INVESTOR SERVICE (Feb. 3, 2003), http://pages.stern.nyu.edu/~igiddy/ABS/moodysabcp.pdf.

[7] *See* Lutter, *supra* note 5.

[8] Asset Backed Securities (ABS) are financial securities that are backed by a loan, lease, or receivables against assets other than real estate and mortgage-backed securities. *See* Timothy J. Riddiough, *Optimal Design and Governance of Asset-Backed Securities*, 6 J. FIN. INTERMEDIATION 2, 121–22 (1997), *available at* http://research3.bus.wisc.edu/file.php/136/Papers/1995-10-12_Optimal_Design_and_Governance_of_Asset-Backed_Securities_Journal_of_Financial_Intermediation_.pdf.

[9] *Id.*; *see also* Christian Kirchner, *Combined Deficits of Corporate Governance and of Financial Reporting in the International Financial Markets Crisis*, at 5 (unpublished article) (on file with author).

tees was often hidden and not included in their accounting. The inherent risk of the guarantees to the banks, however, became apparent when the market for CDOs collapsed.[10]

One of many examples of such investments was IKB's involvement in so called Asset Backed Commercial Paper Programs (ABCP-Programs).[11] In these programs American Banks sold long-term mortgage and subprime loans to special purpose vehicles (SPVs).[12] In the case of IKB, its SPV, Rhineland Funding, transformed these subprime loans into short-term ABSs that were then sold to institutional investors.[13] IKB and other German banks ventured into ABCP-Programs hoping to profit from refinancing American mortgage loans. For example, a German bank, or more often its SPV, could buy a 6% long-term mortgage loan from an American Bank and transfer it into 4% ABCP while keeping the spread of 2%. A significant downside of this business model, however, was liquidity and resale risk—profiting through the spread only worked while the conduit (i.e. Rhineland Funding) found buyers for the ABCP it issued to pay for the American mortgage loans it bought.[14] The ABCP, unlike the mortgage loans, was short term, posing significant liquidity risk if new ABCP buyers could not be found to pay off ABCP holders that wanted to cash out.[15] To minimize liquidity and resale risk, and thus attract buyers for the ABCP, IKB provided credit enhancements to Rhineland Funding.[16] In 2007, institutional buyers started to realize

[10] Alexandra Krieger, *Wie kam es zur Subprime-Krise, und wie gerieten Banken in die Schieflage? Ursachen und Schlussfolgerungen für die Praxis am Beispiel der IKB Deutsche Industriebank AG*, HANS BÖCKLER STIFTUNG, 11–12 (Sept. 2008), http://www.boeckler.de/pdf/mbf_finanzinvestoren_ikd.pdf.

[11] *See generally* Kirchner, *supra* note 9; Krieger, *supra* note 10, at 12–13.

[12] JASON COX, JUDITH FAUCETTE & CONSUELO VALEZUELA LICKSTEIN, WHY DID THE CREDIT CRISIS SPREAD TO GLOBAL MARKETS? pt.B.1.a (Univ. of Iowa Ctr. For Int'l Fin. & Dev., March 2010), *available at* http://www.uiowa.edu/ifdebook/ebook2/contents/part5-II.shtml (explaining how SPVs were used to issue asset backed securities into the markets).

[13] Krieger, *supra* note 10, at 13.

[14] *Id.* at 18.

[15] *A Boom Amid the Bust*, ECONOMIST, June 14, 2008, at 1 ("[Money funds] bought much of the short-term debt propped up in structured finance. It was their sudden withdrawal that caused the market in asset-backed commercial paper (ABCP) to seize up. And banks' liquidity problems are largely the result of money funds' recent reluctance to hold their debt.").

[16] Carrick Mollenkamp, Edward Taylor & Ian McDonald, *Global Scale: Impact of Mortgage Crisis Spreads—How Subprime Mess Ensnared German Bank: IKB Gets a Bailout*, WALL ST. J., Aug. 10, 2007, at A1.

> The affiliate IKB set up for bond investing five years ago is Rhineland Funding Capital Corp. The purchases included bonds backed by subprime mortgages, those issued to home buyers with weak credit. It was

the high-risk market environment in which they were operating and began to pull out of the ABCP market.[17] Without buyers for ABCP Products, Rhineland Funding was forced to turn to IKB for the agreed upon credit enhancement and liquidity.[18] This eventually precipitated the demise of IKB and its bailout by the German Government.[19] However, IKB was not the only German bank engaged in America's housing market. At the end of 2006 three German banks—Deutsche Bank, IKB, and SachsenLB—were the leading bank sponsors with outstanding ABCP.[20] After accumulating $114 billion of toxic assets in the mortgage market that are now of questionable value, WestLB had to be bailed out four times.[21]

Part of the problem was that U.S. financial institutions sometimes were less than candid in their selling efforts directed at German banks. The U.S. Securities Exchange Commission (SEC) accused Goldman Sachs of conduct that amounted to fraud in selling CDOs to IKB.[22] In 2007, the Düsseldorf-based bank began talks with Goldman to invest in an instrument that would allow IKB to bet that housing prices would rise.[23] The SEC complaint alleged that Goldman systematically defrauded IKB; [24] in the SEC's view, it did not matter that IKB was a sophisticated investor because Goldman did not provide

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> a global circuit: Rhineland partly funded its bond purchases through short-term debt issued to U.S. investors, such as a suburban Minneapolis school district and the city of Oakland, Calif. But Rhineland's short-term borrowings had to be renewed frequently. And when investors realized that their collateral for the borrowings included U.S. subprime mortgages, they shut off the spigot.

*Id.*

[17] *Id.*

[18] Ragnhild Kjetland & Ulrike Dauer, *Credit Crunch: Markets' Ride: Sachsen's CEO, Rest of Board To Depart in Subprime Fallout*, WALL ST. J., Aug. 31, 2007, at C2 ("In late July [2007], IKB, whose main business is lending to small- and midsize German companies, announced it wouldn't be able to cover liquidity needs and risks at the investment vehicle Rhineland Funding.").

[19] Krieger, *supra* note 10, at 35–36.

[20] *Id.* at 12.

[21] *IKB, Credit-Crunch Chump, The Bigger Fools*, THE ECONOMIST, April 24, 2010, at 72.

[22] *See* Complaint at 20–21, Sec. & Exch. Comm'n v. Goldman Sachs & Co., *filed*, No. 10-CV-3229 (S.D.N.Y. Apr. 16, 2010), *available at* http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf; Settlement, Sec. & Exch. Comm'n v. Goldman Sachs & Co., No. 10-CV-3229 (S.D.N.Y July 14, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/judgment-pr2010-123.pdf.

[23] *See* Complaint *supra* note 22, at 15–16.

[24] *See id.* at 20–21.

the objective investment advice IKB expected to get.[25] More specifically, the SEC complaint alleged that:

> The fact that the portfolio had been selected by an independent third-party with experience and economic interests aligned with CDO investors was important to IKB. IKB would not have invested in the transaction had it known that Paulson [a hedge fund manager who took the other side of the bet] played a significant role in the collateral selection process while intending to take a short position . . . .[26]

The German government, which has not yet launched proceedings against Goldman Sachs, has indicated that it is examining its relationship with Goldman Sachs although it is not yet prepared to limit its dealings with the bank.[27]

Many observers around the world have concluded that debt markets failed to function properly in 2008 because of CDOs and other problems.[28] At least before the sovereign debt crisis of 2010, much of the alleged market failure was blamed on risky banking practices that originated in the United States.[29] The experience of German banks with CDOs, however, revealed that some of the non-U.S. victims were willing participants in the risk, even if they did not always fully understand the risks. In fact, the SEC's position in the Goldman complaint is that at least with respect to the transaction at issue, IKB did not understand important aspects of the risk.[30] Banks in England, Germany, and elsewhere also at times were facilitators and enablers of risky practices in the United States.[31] A U.K. Bank, for example, assisted Lehman Brothers with its efforts to conceal debt

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[25] *See id.* at 15–18.

[26] *See id.* at 17.

[27] *See* Zachary A. Goldfarb, *SEC Confident on IKB Part of Goldman Suit*, WASH. POST, Apr. 24, 2010, at A7, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2010/04/23/AR2010042305223.html.

[28] *See* Kara Scanell, *SEC Steps up Probe of Crisis Deals by Fund*, WALL ST. J., June 19, 2010, at A1 (noting that critics have said the crisis worsened when banks experienced great losses due to CDOs they had incurred but could not sell).

[29] *See* John Cassidy, *Banks Must Pay for Market Failure*, TELEGRAPH, Nov. 30, 2009, *available at* http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/6689145/Banks-must-pay-for-market-failure.

[30] *See* Complaint at 17, Sec. & Exch. Comm'n v. Goldman Sachs & Co., *filed*, No. 10-CV-3229 (S.D.N.Y. April 16, 2010), *available at* http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf.

[31] *See* Bill Buzenberg, *Commentary; The Mega-Banks Behind the Meltdown—How Wall Street's Greed Fueled the Subprime Disaster*, CTR. FOR PUB. INTEGRITY, May 6, 2009 *available at* http://www.publicintegrity.org/investigations/economic_meltdown/articles/entry/1343 (discussing how the largest American and European banks were not victims of the financial collapse, but enablers).

on its balance sheet through a transaction known as "Repo 105."[32] Market failure and excessively risky banking practices have been widely recognized as a global problem and not just an American problem.

*B. The Issues Confronting the United States and Germany*

This Article makes some preliminary observations on how two countries—the United States and Germany—are likely to deal with this problem in the aftermath of the 2008 financial crisis. As of the publication date for this Article, regulatory and other measures are being considered in both countries, and many of these measures have yet to be approved or implemented. Detailed commentary will have to wait.

We should also note at the outset that the concepts of "market failure" and "excessive risk" are both controversial. Whether markets fail and why they fail is one issue, and whether there is any such thing as excessive risk, and if so, how excessive risk is to be defined, is another issue. Viewpoints on these questions will have a substantial impact on how a policy maker—or a group of policy makers in a particular country—approaches regulation of risk in the banking sector. The intent of this Article is not to advance a particular perspective on these questions but to illustrate how attitudes toward markets and risk in the United States and in Germany will likely affect the response to the crisis of 2008.

Economists have long debated the theory of market failure.[33] Paul A. Samuelson defined the phenomenon of market failure and

[32] A Repo 105 is an accounting practice that allows a bank to take massive liabilities off its balance sheet, thus making the bank look significantly healthier than it actually is. *See* Report of Anton R. Valukas at 737, *In re* Lehman Bros. Holdings Inc., No. 08-13555, (Bankr. S.D.N.Y. Mar. 11, 2010). To call a repo a true sale based on legal technicalities, however, a law firm needs to write a legal opinion. *Id.* at 783 n.3017. In Lehman's case the bank was unable to find a U.S. law firm that would provide such an opinion letter permitting the true sale accounting treatment. *Id.* at 783. In order to get the Repo 105 treatment, Lehman had to transfer the securities involved to London where the transaction would take place and get a U.K. law firm to provide the legal opinion. *Id.* at 784. Here, Linklaters, a magic circle law firm in London, wrote the legal opinion for LBIE, Lehman's European broker-dealer in London, under English law. *Id.* at 784–86.

[33] For a thorough discussion of the theory of market failure and most of the arguments pro and contra, see generally DOUGLASS C. NORTH & ROBERT PAUL THOMAS, THE RISE OF THE WESTERN WORLD: A NEW ECONOMIC HISTORY (1973); PAUL A. SAMUELSON, ECONOMICS: AN INTRODUCTORY ANALYSIS (6th ed. 1964); DAVID L. WEIMER & AIDAN R. VINING, POLICY ANALYSIS: CONCEPTS AND PRACTICE (2d ed. 1992); Louis De Alessi, *Error and Bias in Benefit-Cost Analysis: HUD's Case for the Wind Rule*, 16 CATO J. 129 (1996), *available at* https://www.cato.org/pubs/journal/cj16n1/cj16n1-8.pdf; Steven N. S. Cheung, *The Fable of the Bees: An Economic Investigation*, 16 J. L. & ECON. 11 (1973); Ronald H. Coase, *The Lighthouse in Economics*, 17 J. L. & ECON. 357 (1974);

formalized it.[34] Other economists later opined that Samuelson's arguments were, in many respects, fallacious.[35] In some cases markets could be inefficient because agreements within the market were not enforced.[36] Some economists in Germany and elsewhere in Europe have been more skeptical about efficient markets than many of their counterparts in the United States.[37] Some economists in the United States, however, have always been suspicious of market efficiency,[38]

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Joseph Farrell, *Information and the Coase Theorem*, 1 J. ECON. PERSP. 113 (1987); James E. Meade, *External Economies and Diseconomies in a Competitive Situation*, 62 ECON. J. 54 (1952); Richard R. Nelson, *Roles of Government in a Mixed Economy*, 6 J. POL'Y ANALYSIS AND MGMT. 541 (1987); Charles Wolf, *A Theory of Nonmarket Failure: Framework for Implementation Analysis*, 22 J. L. & ECON. 107 (1979).

[34] *See* SAMUELSON, *supra* note 33 (outlining basic economic concepts and market theory).

[35] *See, e.g.*, THE THEORY OF MARKET FAILURE: A CRITICAL EXAMINATION (Tyler Cowen ed., 1988) (compiling a collection of primary critiques of market-failure theory with suggestions on further research, including contributions from James M. Buchanan, Robert J. Smith, Robert Axelrod, Earl R. Brubaker, Steven N. S. Cheung, Harold Demsetz, Jerome Ellig, Kenneth D. Goldin, and Jack High).

[36] *See* NORTH & THOMAS, *supra* note 33, at 8 ("Governments take over the protection and enforcement of property rights because they can do so at lower cost than private volunteer groups.").

[37] *See* Alberto Alesina & George-Marios Angeletos, *Fairness and Redistribution*, 95 AM. ECON. REV. 960, 974 (2005) (noting that Europeans favor forms of government intervention, whereas in the U.S., Americans favor limited regulation, which results in more efficient market outcomes); Torben G. Anderson & Tim Bollerslev, *Deutsche Mark-Dollar Volatility: Intraday Activity Patterns, Macroeconomic Announcements, and Longer Run Dependencies*, 53 J. FIN. 219, 219–21 (1998) (discussing that while the efficient market hypothesis asserts that price changes reflect the availability of new, relevant information, in Germany, the availability of such information does not explain overall volatility and what drives the German markets); Michael Melvin & Bettina Peiers Melvin, *The Global Transmission of Volatility in the Foreign Exchange Market*, 85 REV. ECON. & STAT. 670, 679 (2003) (noting the possibility of arguing that the persistent volatility in foreign exchange markets does not support the efficient market theory); Kurt Richebacher, *The Problems and Prospects of Integrating European Capital Markets*, 1 J. MONEY, CREDIT & BANKING 336, 338 (1969) (proposing that because the U.S. has a centralized market in New York, the market is highly efficient, but because Europe's market is decentralized, an efficient market solution for Europe "belongs in a utopian world"); Leland B. Yeager, *Austrian Economics, Neoclassicism, and the Market Test*, 11 J. ECON. PERSP. 153, 154 (1997) (asserting that Austrians consider the market system a complex arrangement that cannot be explained by an economic model but rather by analyzing the organization of the economy from individuals to agencies); Amir Amel-Zadeh, *The Return of the Size Anomaly: Evidence from the German Stock Market* 36 (Univ. of Cambridge, Judge Bus. Sch., Working Paper No. 23/2006, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952472 ("Our findings that firm-specific characteristics are able to explain some variation of stock returns adds to the growing literature at odds with the efficient markets hypothesis and leads us to seek salvation in behavioural [sic] explanation.").

[38] *See generally* ROBERT A. HAUGEN, THE NEW FINANCE: THE CASE AGAINST EFFICIENT MARKETS (1995) (arguing that the efficient market theory is unrealistic and presenting evidence supporting inefficient markets); ROBERT J. SHILLER, IRRATIONAL

and others are now pointing to the events of 2008 as an illustration of how markets can and do fail. Regardless of which perspective is correct, perspectives on market failure can affect both bankers' business practices and the policies of bank regulators. Bankers who believe that markets fail may be more cautious when investing in markets, and regulators who believe that markets fail may be more aggressive when regulating markets. Different perspectives on markets and their efficiency—or inefficiency—could be an important explanation for different responses in the United States and Germany to the events of 2008.

The credit crisis of 2008–2009 also convinced many observers that the level of risk in the financial sector was excessive.[39] In general, it is difficult to escape the conclusion that there was an enormous amount of risk taking in financial markets in the years leading up to 2008. Some investors—usually agents investing other people's money—traded in volatile financial instruments they only partially understood.[40] Observers blamed risky investments for the downfall of major financial institutions, destruction of markets for financial instruments, and widespread economic chaos. The more hotly debated question, however, is whether bankers assumed too much risk in particular transactions and if so, how to define how much risk is too much. Which particular decisions by bankers were excessively risky, which were not, and how can one distinguish between the two?

Risk is not inherently bad, and indeed, the economy thrives on some types of risk. Risk aversion can lead to suboptimal allocation of resources[41] and detriments to shareholders who demand high returns on capital.[42] Achieving an appropriate balance between risks that are

EXUBERANCE (2d ed. 2005) (discussing the obsession with stock markets and its effect on the market).

[39] James E. Kelly, *Transparency and Bank Supervision*, 73 ALB. L. REV. 421, 421 (recognizing that in light of the recent crisis, critics' concerns have focused on the role of systemic risk in financial institutions and markets).

[40] *See generally* Wulf A. Kaal, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability*, 28 ANN. REV. BANKING & FIN. L. 581 (2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1428387 (arguing that the lack of understanding of certain financial instruments and the hierarchies in financial institutions exacerbated the principal agent problem and contributed to the demise of markets in financial instruments).

[41] Markus Ruffner, *Sorgfalts- und Treuepflichten und die Versicherbarkeit von Haftungsrisiken in Publikumsgesellschaften – eine ökonomische Analyse*, 119 ZEITSCHRIFT FÜR SCHWEIZERISCHES RECHT [ZSR] [JOURNAL OF SWISS LAW] 195, 213 (2000) (Ger.).

[42] *See, e.g.*, Gagliardi v. TriFoods Int'l, 683 A.2d 1049, 1052 (Del. Ch. 1996) ("Shareholders do not want (or should not rationally want) directors to be risk averse. Shareholders' investment interest, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly

informed and reasonable on the one hand and risks that are unreasonable or uninformed on the other is a challenge in managing a business enterprise, particularly a financial institution. To the extent regulators and courts are charged with monitoring financial risk in private enterprise, achieving a balanced legal approach to risk is also a challenge.

Corporate directors are charged with numerous tasks, and the emphasis in the United States, and increasingly in other countries is on maximizing shareholder wealth.[43] In order to do their jobs, managers often must take reasonable risks while avoiding excessive risk.[44] Distinguishing the two is a subject of much debate, a debate which will intensify in light of recent events. Part of this debate is over how much of a role the law—as opposed to shareholders, markets, or other mechanisms—should have in defining the difference between risk that it reasonable and that which is not. If the law does intervene, a second debate is over how the law should intervene—government regulation of risk taking, mandatory disclosure rules that make shareholders and other investors aware of risks, shareholder suits, or other approaches.

Perspectives on the question of how much risk is too much risk and the related question of how to regulate it are likely to shape the attitudes of both bankers and policy makers. As discussed further in this Article, perspectives on risk are different in the United States and in Germany. The objective of this Article is not to discuss which perspective on risk is the correct one but instead to point out that perspectives on risk differ and that these differences are likely to affect both banking practices and regulation in the United States and Germany.

assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital.").

[43] *See* Dodge v. Ford Motors Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The power of the directors are to be employed for that end."); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001) ("There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value."); Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001) ("[S]hareholder wealth maximization is usually accepted as the appropriate goal in American business circles.").

[44] For a discussion on corporate responsibility and shareholder wealth maximization, see STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 419–29 (2002). *See also* FRANK E. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 104 (1991).

In both the United States and Germany the response to risk has included, and will likely include yet more, legal constraints on risk. Neither country relies exclusively on cultural and business risk avoidance norms. As explained more fully below, reliance on risk avoidance norms of private actors may be more prevalent in Germany than in the United States, but recent events have led both countries to be suspicious of unregulated financial risk. Generally, the legal constraint comes in two parts: rules that restrict risk taking itself and disclosure rules.

Rules that restrict risk taking often focus on particular types of risk—such rules include, for example, regulation of the investments made by banks and capital requirements for banks. Proposals to require banks to separate certain trading operations, such as derivatives from their regular banking operations, are an example of rules designed to limit risk taking in specific areas. Because of recent events, more such rules will likely emerge in both the United States and Germany in the near future.

Outside the scope of these rules that constrain specific types of risk, the law can also incorporate a more general principle barring managers from incurring risk that exceeds a certain standard. The law does not do so in most instances because defining such a standard is difficult. Corporate law instead protects the risk decisions of bank managers from challenge through a concept known as the "business judgment rule." The business judgment rule in both the United States and Germany precludes judicial review of most decisions by corporate directors and protects directors from potential liability for "good faith" decisions, even if those decisions ultimately end in failure.[45] The rule creates a rebuttable presumption that directors, while independent and disinterested, acted on an informed basis, with a proper business purpose, and in the best interest of the corporation.[46] Courts and legal commentators in the United States and Germany have long emphasized the importance of the rule in promoting the kind of risk taking by corporations that results in new ideas, new technologies, and new markets. As explained more fully below, the business judgment rule is articulated differently in the United States and in Germany, and there may be more latitude to challenge some risky decisions in Germany, but in both countries the rule is highly protective of corporate managers. Arguably, the busi-

[45] *See, e.g.*, Smith v. Van Gorkum, 488 A.2d 858, 872–73 (Del. 1985); Aktiengesetz [AktG] [German Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, § 93(1)–(2) (Ger.).

[46] *See id.*

ness judgment rule finds a middle ground between excessive risk and excessive risk aversion while taking into account the interests of shareholders, corporate directors, and sometimes other constituencies. Alternatively, one could view the business judgment rule as being too deferential to management, and an indication that corporate law is abandoning the field of risk regulation to more specific rules aimed at specific types of risk in specific types of institutions.

The United States and German governments, as most other industrialized countries, enacted mandatory disclosure laws to facilitate the flow of information about risks to investors. Registration statements in the United States, for example, have a separate section titled "risk factors."[47] These laws do not seek to regulate risk taking, or even to impose due care or other obligations on the risk takers, other than the duty of disclosure. Policy makers and commentators in the United States and Germany debate how much disclosure should be required and what the consequences—government sanctions, civil litigation, or both—should be for failure to disclose. Historically, disclosure obligations have been more robust in the United States than in Germany, but Germany along with the rest of the E.U. is moving toward more disclosure. Furthermore, disclosure rules in the United States, however robust, are sometimes ignored.

Finally, commentators on German and American approaches to risk inevitably confront one of the most often debated issues in comparative law: whether there is convergence or divergence in legal rules. In a global economy dominated by corporations as well as unincorporated entities,[48] to what extent is the relevant law converging or diverging in the world's largest economies?[49] Changes in the interpretation of the business judgment rule as well as legislative proposals pertaining to risk taking by managers in Germany and the United States may illustrate a trend towards divergence in legal ap-

[47] 17 C.F.R. § 230.421(b) (2009).

[48] *See, e.g.*, LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 2 (2010). *See generally* Larry E. Ribstein, *Uncorporating the Large Firm* (Ill. Law and Econ. Research Paper Series, Research Paper No. LE08-016, 2008), *available at* http://ssrn.com/sol3/papers.cfm?absact_id=1003790 (discussing the increase in the use of uncorporations, such as LLCs and limited partnerships, where large corporate firms previously dominated the corporate landscape).

[49] *See, e.g.*, John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications* (Colum. Law Sch. Ctr. for Law and Econ. Studies, Working Paper No. 144, 1999), *available at* http://ssrn.com/abstract=142833.

proaches.[50] At the time of this writing, it is unclear how much divergence there will be between these two countries, and whether there will be a later shift toward convergence when countries try to coordinate their rules on risk.

A closely related issue is whether there is a convergence or divergence in business practices. Will bankers respond to the events of 2008 differently in Germany than in the United States even in the absence of regulation? Will one or both countries experience more voluntary risk aversion on the part of bankers who have supposedly learned their lesson?

German banks of course have also been affected by the sovereign debt crisis of 2010, which was triggered by rising government debt together with downgrading of government debt in Europe. The countries of most concern were Greece, Italy, Spain, and Portugal. European countries and the International Monetary Fund agreed to a €110 billion ($146 billion) loan to Greece conditioned on harsh austerity measures.[51] The ensuing crisis triggered a widening of bond yield spreads and higher rates for risk insurance on credit default swaps between the most adversely affected countries and other EU member states.[52] The apparent inability of German bank managers to anticipate the implications of such a crisis until it was too late remains a great concern.

While we recognize the importance of the sovereign debt crisis and its implications for Germany, this Article will not address the implications of that crisis but will instead focus on the credit crisis of 2008–2009 and its effects on approaches to risk taking in Germany and the United States. The overall German approach to risk taking, however, may be affected by the fact that German banks, like American banks, have been exposed to the 2008 credit crisis, and unlike their American rivals, German banks also face a second threat in their exposure to the 2010 sovereign debt crisis. This combination of factors could lead the German regulators and bankers themselves to impose stricter substantive rules for risk management in comparison

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[50] The authors do not intend to imply that there is a general trend toward divergence in corporate law. The Article merely analyzes trends in the approaches to risk taking.

[51] Kerin Hope, Nikki Tait & Quentin Peel, *Eurozone Agrees €110bn Greece Loans*, FIN. TIMES (May 2, 2010), http://www.ft.com/cms/s/0/a3307762-5616-11df-b835-00144feab49a.html.

[52] David Oakley & Kerin Hope, *Gilt Yields Climb on UK Debt Concerns*, FIN. TIMES (Feb. 18, 2010), at 21, *available at* http://www.ft.com/cms/s/0/7d25573c-1ccc-11df-8d8e-00144feab49a.html.

with countries, such as the United States, that have not faced this combination of threats.

This Article begins an inquiry that cannot be completed until the courts and legislatures in both countries finish the bulk of their work sorting out what happened in 2008 and what they are going to do about it. This Article explores whether there is a divergence between the approach in the two countries and, if so, the reasons for the divergence and its likely practical impact. This Article also lays out some parameters for how policy makers and commentators might evaluate potential costs and benefits of responses to the credit crisis of 2008–2009 in Germany and the United States.

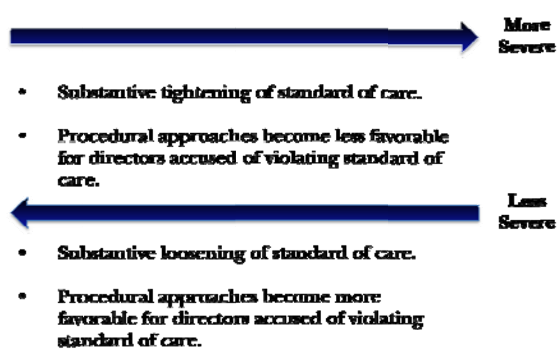
## II. COST VS. BENEFIT FROM THE DIRECTORS' DUTY TO MONITOR RISK[53]

One way of controlling risk in banks, as in other companies, is to impose a duty on corporate directors to monitor risk. There is a trade-off between the cost and the benefit of imposing such a duty to monitor risk on corporate directors. The graph above illustrates the cost structure in relation to changes in the severity of requirements to monitor risk that are imposed on directors by substantive and procedural rules. The more severe the monitoring requirement under substantive and procedural rules, the higher the costs (solid Lines 2a, 2b, or 2c) the company incurs in several ways, including administrative costs incurred in order to fulfill the duty to monitor risk, costs of

[53] It is important to note that any graphs in this Article have been added for illustration only and do not rely on actual data and are not intended to give a complete picture of all the issues involved.

legal disputes over whether directors failed in this duty, and costs of excessively cautious business decisions that forgo valuable opportunities because directors want to avoid disputes over whether they failed in their duty to monitor risk. As monitoring requirements become more severe substantively or are enforced through more rigorous procedural rules, however, there should be more monitoring by directors for risk and more efforts to limit risk. The cost to the company (dashed Line 1) of excessively risky business decisions that monitoring could have prevented will presumably decline.

Two principal ways exist to make the monitoring requirement more or less severe: changes to substantive law that impose on directors a more stringent duty to monitor for risk and changes to procedural rules (more vigorous agency enforcement, higher penalties, civil litigation, etc.) that make breaches of substantive legal standards more likely to be detected and punished:




When substantive standards of care are raised and/or procedural approaches become less favorable for directors accused of violating the standard of care, the severity of the monitoring requirement increases. The cost to the corporation of imposing this more stringent duty to monitor on board members will likely increase, but it is not clear how much and how fast this cost will increase. The three upward sloping solid lines illustrate some potential cost changes. Costs could increase very quickly and then level off at a later point, or costs could instead increase more slowly and gradually. At the same time, the cost of bad (e.g. excessively risky) business decisions that could have been avoided by monitoring decreases. We include alternative Lines 2a, 2b, and 2c because as discussed below, from a cost perspective *the way in which the monitoring requirement becomes more stringent matters.* The mix between agency enforcement and civil litigation matters; the mix between changes to substantive and procedural rules matters; and the particular changes to rules also matter. One particular combination of measures may create a sharply sloping line (Line 2b), whereas another may result in the more gently sloping line in which costs rise slowly (Line 2c). The cultural context also matters; a particular combination of substantive and procedural rules in one setting—for example, the U.S.—may result in a sharply rising solid line whereas the same combination in another setting—for example, Germany—may result in more gently rising costs, or vice versa. These differences are likely part of the explanation for why different countries have different approaches to directors' duty to monitor for risk as well as other ways of constraining risk; imposing a duty to monitor, or simply prohibiting certain types of derivative securities, for example, could be more costly for financial institutions in one country than in another.

The dashed downward sloping line (Line 1) shows the effect of a more stringent monitoring requirement on mitigating costs directly attributable to excessive risk taking. These costs should decline as the monitoring requirement becomes more severe. We only include one dashed line.[54] Conversely, the costs of bad business decisions rise when the severity of the monitoring requirement decreases because substantive standards of care are loosened and/or procedural rules become more favorable for directors accused of violating the standard. Less stringent procedural rules include less vigorous agency enforcement, higher burdens of proof to show a violation, and less private civil litigation. With a less stringent monitoring requirement, the cost of imposing a duty to monitor on directors also may decrease as shown by the left portion of Lines 2a, 2b, or 2c. The cost of bad

[54] This is an oversimplification because a given level of risk deterrence may still have a different impact on the company's costs from excessively risky decisions depending upon what specific types of risks are avoided; some risks are more costly to a company than others.

business decisions that could have been avoided by monitoring, however, increases as shown in Line 1.[55]

Presumably, the total costs involved would be a combination of upward sloping (solid) and downward sloping (dashed) lines. Given the multitude of unknown parameters, we dispense with showing a total cost line. Our objective is not to identify a formula for calculating the ideal level of severity for a monitoring requirement or an ideal level of deterrence of risk. Instead, our point is that different combinations of substantive rules and procedural rules and practices affect both types of costs (costs of monitoring and the cost of bad business decisions) differently. As discussed more fully below, an important factor is where—the United States, Germany, or somewhere else—a particular combination of substantive rules and procedures is implemented and how they are implemented. Different countries make different choices about whether and how to impose a duty to monitor risk and to what extent. They make these decisions within different institutional frameworks, and sometimes there are good reasons for these decisions.

## III. CULTURAL COMPONENTS OF RISK TAKING AND CONTROLLING RISK

Risk taking can be intentional or unintentional. Examples of intentional and sometimes ill-informed risk taking include investments in risky real estate deals in the 1980s and the purchase of some CDOs and other mortgage-backed securities by investment banks and institutional investors prior to the 2008 credit crisis. Examples of unintentional risk taking include miscalculations in valuation models or algorithmic trading. While unintentional risk taking can impose additional costs on the institutions that incur it because of the added element of surprise, both intentional and unintentional risk taking can be costly, and sometimes more costly than the benefits derived there from.

Countries where bankers do not typically embrace intentional risk taking are still vulnerable to collateral effects of intentional risk taking in other countries as well as unintentional risk taking in their own financial institutions. Regulation and business practices intended to control risk in such countries may be designed principally to address these problems, including, for example, rules that limit multinational banks' activities and rules that limit certain types of trading. Arguably, Germany is one such country; although, as illu-

[55] Although we show only one dashed Line 1, we recognize that the dashed line may slope upward to the left in varying ways depending on the types of risks that are incurred more often because of less stringent monitoring requirements.

strated by the active participation of German banks in CDOs, a lot of intentional risk taking has recently taken place in Germany, and the German response to the 2008 crisis will likely address this problem. Countries where bankers typically embrace intentional risk taking may focus management reform and regulation on curtailing incentives for risk taking, such as compensation arrangements that encourage bankers to take too much risk. The United States falls into this category.

Discerning excessive risk from other risk is highly subjective and an analysis likely to be undertaken differently in different cultural contexts. In most cultural settings, risk taking is not viewed as excessive simply because the risk did not pan out and somebody lost money. Hindsight bias[56] nonetheless can have a powerful influence on the definition of excessive risk. Hindsight bias and other conceptual approaches rooted in past experience—including valid lessons learned from past experience—may exert a more powerful influence in a country that is otherwise predisposed to be concerned with its past and not repeating the mistakes of its past. On the other hand, in a country that is not so concerned with the past and predisposed to view the future as being different from the past, experience may exert less influence over conceptions of risk. In such a country, the lessons of the past—whether the financial turmoil of the 1930s or more recent experiences—may be more easily forgotten or dismissed as irrelevant. Future observers are more likely to view the events of 2008 as unique rather than a modern rendition of what happened in financial bubbles from an earlier era. A different perspective on the past is

[56] *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 124 (Del. Ch. 2009) (stating that Delaware courts have developed doctrines such as the business judgment rule because of "the inadequacy of the [c]ourt, due in part to a concept known as hindsight bias, to properly evaluate whether corporate decision-makers made a 'right' or 'wrong' decision")

> When one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left appears to be plaintiff shareholders attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the company.

*Id.*; *see also* Stephen M. Bainbridge, Caremark *and Enterprise Risk Management*, 34 J. CORP. L. 967, 989 (2009); Paul E. McGreal, *Corporate Compliance Survey*, 65 BUS. LAW. 193, 210 (2009) (citing *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d at 124) (summarizing legal developments in corporate compliance in 2009 and noting that Delaware Courts have developed doctrines to "properly focus on the decision-making process rather than on a substantive evaluation of the merits of the decision . . . due in part to a concept known as hindsight bias"); Jeffrey J. Rachlinksi, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 621 (1998) ("The business judgment rule arises from the concern that even a good decision can produce an undesirable result and can be judged unfairly in hindsight.").

one of many respects in which the United States and Germany may be different.

The predominant unit of analysis for defining excessive risk—the individual risk bearer or society as a whole—can be different in different cultural contexts. One approach to defining excessive risk that is prevalent in United States jurisprudence is the "prudent person" standard, which focuses on the individual: risk is excessive if a reasonably prudent person would not incur that risk in the management of his or her own portfolio.[57] In keeping with this approach, one of the authors of this Article has suggested that excessive risk could be controlled by making sure that investment bankers are in fact managing their own portfolios.[58]

Another approach is to define excessive risk not by looking to the individual but by examining externalized social cost of risk.[59] Ronald H. Coase described social cost as "those actions of business firms which have harmful effects on others."[60] Here, social cost can be nar-

[57] *See* Stamp v. Touche Ross & Co., 636 N.E.2d 616, 620 (Ill. App. Ct. 1993) ("In addition to their fiduciary duty to the corporation, corporate directors must exercise . . . the degree of care which prudent men . . . would exercise in the management of their own affairs."). In establishing a prudent person standard,

> [S]ome courts take the view that it is a degree of care which prudent persons, prompted by self-interest, would exercise in the management of their own affairs. Other courts . . . stat[e] that the care which a director of a corporation is bound to exercise in the performance of the director's position is such care as a prudent person should exercise in like circumstances.

18B AM. JUR. 2D *Corporations* § 1467 (2010); *see also* MD. CODE ANN., CORPS. & ASS'NS § 2-405.1(a) (West 2010) (codifying the broader prudent person standard).

> A director shall perform his duties as a director, including his duties as a member of a committee of the board on which he serves:
>
> (1) In good faith;
>
> (2) In a manner he reasonably believes to be in the best interests of the corporation; and
>
> (3) With the care that an ordinarily prudent person in a like position would use under similar circumstances.

*Id.*

[58] *See* Claire A. Hill & Richard W. Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 U. SEATTLE L. REV. (2010), *available at* http://ssrn.com/abstract=1510443.

[59] *See* Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 COLUM. L. REV. 1203, 1239 (2002) ("Since we lack the 'control set' of an industrialized regime without limited liability, the extent of the overinvestment in this type of excessively risky activity remains an empirical question that is difficult to answer precisely."); *see also* EASTERBROOK & FISCHEL, *supra* note 44, at 50 ("Externalization of risk imposes social costs and thus is undesirable.").

[60] Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 1 (1960). "In devising and choosing between social arrangements we should have regard for the total effect." *Id.* at 44.

rowly defined by looking to identifiable individuals who are affected by excessive risk taking and asking if they are in a position to protect themselves. Excessive risk as externalized social cost would comprise any economic transaction involving a significant likelihood of a substantial economic loss being imposed on a party who is not directly involved in the transaction (we will leave aside for the moment what exactly is a "significant likelihood" or a "substantial economic loss" and how these two factors might relate to each other). A broader definition of social cost looks to the overall impact on a society of losses incurred by multiple parties because of risk, including the impact on society from fear of further losses, political destabilization, ethnic and national prejudices that might be engendered by financial losses and other adverse effects on the social fabric. If Germany is more concerned about these broader questions than the United States, Germany may prioritize the social unit of analysis over the individual unit of analysis and as a result define excessive risk differently.

Yet another factor influencing attitudes toward incurring risk as well as regulating risk is differing attitudes toward personal responsibility. To what extent should individual bankers be seen as personally accountable for the losses they inflict on others? A related question is personal liability. Should individual bankers be liable and if so, when? One explanation for excessive risk taking could be that bankers are incentivized to make excessively risky investment decisions if they are protected by limited liability. Limited liability arguably increases the probability that a corporation may not have sufficient assets to pay its creditors.[61] Accordingly, both managers and shareholders of a corporation enjoy most of the benefits of excessive risk taking but do not bear all of the costs.[62] Arguably, incentives should be realigned by assigning liability to corporate directors or the highest-ranking corporate officers[63] or the controlling shareholders.[64] Solutions that impose personal liability, however, run the risk of de-

[61] *See* EASTERBROOK & FISCHEL, *supra* note 44, at 49–50.

[62] *See id.* at 50–52.

[63] *See* Timothy P. Glynn, *Beyond "Unlimiting" Shareholder Liability: Vicarious Tort Liability for Corporate Officers*, 57 VAND. L. REV. 329, 433 (2004); Hill & Painter, *supra* note 58 (proposing that the most highly paid investment bankers have strict liability for some firm debts as they did in the days of general partnerships).

[64] Mendelson, *supra* note 59, at 1203 (noting that controlling shareholders would be first and foremost suitable for personal liability as they have "lower information costs, greater influence over managerial decisionmaking [sic], and greater ability to benefit from corporate activity").

terring reasonable and non-excessive risk taking.[65] The purpose of this Article is not to debate the merits of these different approaches but to point out that societies that emphasize personal responsibility may be more likely to hold individual bankers legally liable for their mistakes than those that do not. Societies that emphasize personal responsibility are also more likely to view corporate officers and directors as being an appropriate focus of regulation and, in appropriate circumstances, legal liability. Societies that deemphasize personal responsibility are more likely to focus principally on regulating the banks and other financial institutions than the individual bankers. As of this writing, there appears to be some acknowledgment of personal responsibility of bankers for excessive risk in both the United States and Germany with some concrete proposals directed at individual bankers at least in Germany. So far, however, both countries have focused primarily on the institutions rather than the individuals.

Appetite for risk also has a cultural dimension. Different cultures perceive risk taking differently. For instance, the business culture in the United States has traditionally been associated with a more entrepreneurial spirit, which is linked with an increased willingness to take risks in order to attain a higher return. New companies, including new financial services firms, also rise to the top relatively quickly in the United States, and some old names, such as Salomon Brothers, Lehman Brothers, and Bear Stearns, precipitously fall. Long-term relationships between banks and their corporate customers used to be important in the United States but these relationships have become less important in an increasingly competitive and more fluid market for banking services. The German culture, on the other hand, has been associated with an emphasis on control of financial institutions by larger financial institutions. Longstanding banking relationships also are still very important in Germany. For instance, German companies have traditionally had a very strong relationship with their banking institution, the so-called Hausbank—a relationship in which the bank furnishes capital required to run a business and watches the business closely to make sure the capital is used

[65] Kenneth J. Arrow, *The Economics of Agency*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37, 45 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (finding that personal liability may be a deterrent, assuming that "all individuals are averse to sufficiently large risks [and] the risks are large compared with the [individual's] wealth."). *See also* EIRIK G. FURUBOTN & RUDOLF RICHTER, INSTITUTIONS AND ECONOMIC THEORY: THE CONTRIBUTIONS OF THE NEW INSTITUTIONAL ECONOMICS 189–203 (1998).

well. Since the days of the hyperinflation in Germany in the 1920s,[66] German bankers also have had a dislike for risk and for the economic and political consequences that ensue from instability in financial markets. Bankers who incur excessive risk and inflict excessive risk on others probably are not as well liked in Germany as they are in the United States, although the younger generation of German bankers may be more similar to their American counterparts. Some of the American risk-taking culture memorialized in Michael Lewis's 1989 book about Salomon Brothers, *Liar's Poker*,[67] spread to Germany by the 1990s. Still, the risk-preferring culture was not as deeply embedded in Germany as it was in the United States or even the United Kingdom. After the disastrous developments of 2008 and 2010, Germany may return to its historical aversion to financial risk.

Incentive structures are yet another relevant factor that may encourage risk taking by banks' officers and directors. For instance, the United States has developed a corporate governance structure that emphasizes periodic disclosure of performance data and maximization of stock price.[68] Risk taking in this context may be encouraged by the perceived need to satisfy expectations of shareholders. Managers feel compelled to fulfill performance expectations whenever results are disclosed, be it quarterly, bi-annually, or annually. The German business culture has traditionally not emphasized disclosure and stock price as much as growth in the size and prestige of a banking corporation, its sustainability, and long-term client relationships. Risk taking still occurs in this context, but it may be driven not so much by meeting disclosure expectations and generating compensation related performance data and more by a desire to increase the size and power of the corporation and its position in the global market place, particularly Europe.[69] For German bankers, growth in size and prestige of their banks may bestow the most substantial boost to the managers' standing in business and social circles as well as perhaps their compensation.

Corporate law itself is also a factor in how risk is monitored and controlled. Corporate law in the United States focuses on regulation of conflicts of interest between shareholders and managers.

[66] In November 1923, the interest rate for call money on the Berlin Stock Exchange was 30% per day at times. SIDNEY HOMER, A HISTORY OF INTEREST RATES 465 (1960).

[67] MICHAEL LEWIS, LIAR'S POKER (1989).

[68] *See, e.g.*, Securities Exchange Act, 15 U.S.C. § 78a (2006).

[69] This might explain why German banks have suffered immense losses from their efforts to build relationships with EU sovereign debt issuers such as Greece.

German corporate law, for historical reasons,[70] emphasizes the regulation of conflicts between controlling and minority shareholders. Arguably, a legal system that focuses on the interaction of controlling and minority shareholders is not as well equipped to deal with managerial abuse of power, including excessive risk taking by managers. On the other hand, U.S. corporate law centers so much on conflicts of interest between shareholders and managers that managers are given enormous latitude to exercise unfettered business judgment when there is no demonstrable conflict of interest. Risk taking is one of those situations where U.S. corporate law assumes that managers' and shareholders' interests are aligned, or at least not sufficiently divergent that legal intervention is justified. Thus, perhaps for different reasons, corporate law in both countries may have little to say about the problem of excessive risk.

Governance mechanisms are also different. U.S. corporations are subjected to the supervision of a single board of directors. The German Aktiengesellschaft, or stock corporation, on the other hand, has a two-tier governance structure. The first tier of supervision is the Vorstand, or management board, comprised of persons who work full-time for the company and are usually its most senior officers. The second tier is the Aufsichtsrat, or supervisory board. In theory, the rights and duties of the Vorstand and the Aufsichtsrat are strictly separated. The German Aktiengesetz, or Corporation Act, allows the supervisory board to supervise the management board,[71] i.e. to oversee the management of the corporation and to co-approve all important transactions,[72] represent the Aktiengesellschaft in dealing with the management board,[73] request reports on recent business activity or planned initiatives,[74] and inspect the books and records annually. The Aufsichtsrat also appoints the members of the Vorstand, who are officers of the corporation, and can remove them from office.[75] The

[70] Historically, German corporations evolved in an environment of control—a controlling majority shareholder or a multitude of large shareholders—through individual families. The Piech family of BMW is still a good example. For more information on voting power concentration in Germany, see Marco Brecht & Ekkehart Böhmer, *Ownership and Power in Germany*, *in* CONTROL OF CORPORATE EUROPE 128 (Fabrizio Barca & Marco Becht eds., 2001).

[71] Aktiengesetz [AktG] [German Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, § 111(1) (Ger.).

[72] The articles of association for each Aufsichtsrat further specify these functions.

[73] AktG § 112.

[74] AktG § 90(1).

[75] Removing officers and board members before their term expires—the customary term being five years—requires cause, such as a material breach, incapacity, or a vote of no-confidence at the shareholder's meeting.

primary oversight function of the Aufsichtsrat is to limit self-dealing by managers and controlling shareholders. Secondly, through the appointment of Vorstand members, continuous evaluation of their performance, and the occasional removal of inefficient or underperforming members, the Aufsichtsrat monitors the performance of the Vorstand.

Under various codetermination acts,[76] the supervisory board is not entirely composed of the shareholders' representatives. Depending on the total number of employees of the corporation, the law may require the representation of members of the workforce on the supervisory board. In German corporations with more than two thousand employees, the shareholders appoint half of the Aufsichtsrat and the employees appoint the other half. In corporations with between 500 and 2,000 employees, the corporation's employees appoint one-third of the Aufsichtsrat. Although the chairman of the Aufsichtsrat has additional voting rights that can sway the Aufsichtsrat in favor of the representatives of the majority shareholders,[77] a codetermined Aufsichtsrat can make the decision-making process more cumbersome. Employee representatives may also feel that they represent the political objectives of unions as well as the interests of the company. It may be difficult for a co-determined Aufsichtsrat to respond quickly to rapidly changing developments, such as an escalation of financial risk in a securities portfolio or a liquidity crisis.

The impact of codetermination on corporate governance in Germany and on the market returns of German corporations is unclear.[78] The impact on risk is also unclear. It is possible that the Auf-

[76] *See, e.g.*, Gesetz über die Mitbestimmung der Arbeitnehmer in den Aufsichträten und Vorständen der Unternemen des Bergbaus und der Eisen und Stahl erzeugenden Industrie [MontanMitbestG], May 1951, BGBL I at 347 (Ger); Gesetz über die Mitbestimmung der Arbeitnehmer [Mitbestimmungsgesetz—MitbestG], May 4, 1976, BGBL II at 1153, § 9 (Ger.).

[77] The chairman can make the tie-breaking vote. *See* Theodor Baums & Bernd Frick, *The Market Value of the Codetermined Firm*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 206, 209 (Margaret M. Blair & Mark J. Roe eds., 1999).

[78] *See* Martin Henssler, *Arbeitnehmermitbestimmung im deutschen Gesellschaftsrecht*, *in* UNTERNEHMENS-MITBESTIMMUNG DER ARBEITNEHMER IM RECHT DER EU-MITGLIEDSTAATEN [EMPLOYEES' CO-DETERMINATION IN THE MEMBER STATES OF THE EUROPEAN UNION] 133, 147–48 (Theodor Baums & Peter Ulmer eds., 2004) (Ger.); Thomas Raiser, *Bewährung des Mitbestimmungsgesetzes nach zwanzig Jahren?*, *in* WIRTSCHAFTS- UND MEDIENRECHT IN DER OFFENEN DEMOKRATIE. FREUNDESGABE FÜR FRIEDRICH KÜBLER ZUM 65. GEBURTSTAG 477, 491–92 (Heinz-Dieter Assmann et al. eds., 1997) (Ger.); Rüdiger von Rosen, *Kapitalmarkt und Mitbestimmung*, *in* UNTERNEHMENSRECHT ZU BEGINN DES 21. JAHRHUNDERTS: FESTSCHRIFT FÜR EBERHARD SCHWARK 789, 793–94 (Stefan Grundmann et al. eds., 2009) (Ger.); Dieter Sadowski, Joachim Junkes & Sabine Lindenthal, *Gesetzliche Mitbestimmung in Deutschland: Idee, Erfahrungen und Perspektiven aus ökonomischer Sicht*, 30 ZEITSCHRIFT FÜR UNTERNEHMENS-

sichtsrat may have too many members for effective monitoring of risk, and the legally determined size of the Aufsichtsrat could curtail its supervision of management decisions.[79] The Gesetz zur Angemessenheit der Vorstandsvergütung (VorstAG), or German Law on the Appropriateness of Executive Compensation, improves the responsibilities of the Aufsichtsrat with regard to internal control and risk management.[80] Regardless of these recent improvements, codetermination may be a cumbersome vehicle for monitoring financial risk in German companies.

On the other hand, the legal duties of Aufsichtsrat members may weigh in favor of mitigating risk. The legal duties of the Aufsichtsrat derive from the duty of loyalty that each member of the Aufsichtsrat owes to the corporation. German courts have concluded that the purpose of these legal duties is not to protect the shareholders as the only constituents but to protect the interests of the firm.[81] Codetermination in Germany further supports this perspective. Non-

UND GESELLSCHAFTSRECHT [ZGR] [JOURNAL OF CORPORATE LAW] 110, 126–132 (2001) (Ger.). *See generally* Gregory Jackson, *Contested Boundaries: Ambiguity and Creativity in the Evolution of German Codetermination, in* BEYOND CONTINUITY: INSTITUTIONAL CHANGE IN ADVANCED POLITICAL ECONOMICS 229 (Wolfgang Streeck & Kathleen Thelen eds., 2005); Mark J. Roe, *German Co-Determination and German Securities Markets, in* COMPARATIVE CORPORATE GOVERNANCE, THE STATE OF THE ART AND EMERGING RESEARCH 361 (Klaus J. Hopt et al. eds., 1998); Gary Gorton & Frank A. Schmid, *Capital, Labor, and the Firm: A Study of German Codetermination*, 2 J. EUR. ECON. ASS'N 863 (2004); Larry Fauver & Michael E. Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards* (Maastricht Univ., Working Paper No. 1171, 2004), *available at* http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID552822_code98845.pdf?abstractid=534422&mirid=1; Gregory Jackson, *Employee Representation in the Board Compared: A Fuzzy Sets Analysis of Corporate Governance, Unionism and Political Institutions,* 12 INDUSTRIELLE BEZIEHUNGEN, no. 3, 2005, *available at* http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID800525_code287864.pdf?abstractid=800525&mirid=2; Wolfgang Schilling, *Wirtschaftliche Mitbestimmung im Meinungsstreit*, 128 ZEITSCHRIFT FÜR DAS GESAMTE HANDELSCRECHT UND WIRTSCHAFTSRECHT [ZHR] [JOURNAL OF COMMERCIAL AND BUSINESS LAW] 217, 219–227 (1966) (Ger.); Oliver Stettes, *Unternehmensmitbestimmung in Deutschland—Vorteil oder Ballast im Standortwettbewerb?*, 52 DIE AKTIENGESELLSCHAFT [AG] 611, 611–18 (2007) (Ger.); Herbert Wiedemann, *Codetermination by Workers in German Enterprises*, 28 AM. J. COMP. L. 79, 79 (1980); Christine Windbichler, *Arbeitnehmerinteressen im Unternehmen und gegenüber dem Unternehmen—Eine Zwischenbilanz*, 49 DIE AKTIENGESELLSCHAFT [AG] [Joint Stock Company] 190, 191 (2004) (Ger.).

[79] *See* Jan Lieder, *The German Supervisory Board on Its Way to Professionalism*, 11 GERMAN L.J. 115, 151–52 (1988). The size of an Aufsichtsrat is negatively correlated with the frequency of Aufsichtsrat meetings—i.e., smaller Aufsichtsrat meet more frequently. Less frequent coordination of the Aufsichtsrat in meetings and collective action problems may make supervision of risk taking of the Vorstand less effective.

[80] Gesetz zur Angemessenheit der Vorstandsvergütung [VorstAG], June 19, 2009, BGBL I, at 2509 (Ger.).

[81] *See, e.g.*, 64 BGHZ 325 (329) (1975) (Ger.).

shareholder constituencies, such as employees and creditors, are often more averse to risk than shareholders, particularly diversified shareholders who can afford to see some companies fail if others do spectacularly well. The Aufsichtsrat's legal duty of loyalty to the firm as distinct from its shareholders thus may dictate a more conservative attitude toward risk than that of a shareholder oriented board of directors in the United States.

The Aufsichtsrat is also different from the board of directors in the United States in that the Aufsichtsrat is primarily comprised of people who either work for the company, or work for banks, insurance companies, or other financial institutions with strong business ties to the company. The American concept of an "independent" director is relatively foreign to Germany—a difference between the two countries' governance regimes that came to the fore when German companies with securities listed in the United States struggled to comply with the heightened independence requirements for directors and audit committees in the Sarbanes-Oxley Act of 2002.[82] German Aufsichtsrat members may be more familiar with the business of the company than their American counterparts, but they rarely meet the American standard of independence, which emphasizes a director's lack of financial ties to the company.[83] Recent events suggest that the United States might not have much to show for the particular type of independence it has insisted upon, making it even less likely that Germany and other countries will conform to U.S. corporate governance norms in this respect. The recent failure of "independent" director oversight at Lehman Brothers and other large U.S. financial firms suggests that independent directors cannot effectively monitor for risk if they are kept in the dark by the firm's managers, accountants, lawyers, and other persons familiar with its business. Unless the United States changes its approach to independence, this

[82] *See* Minodora D. Vancea, *Exporting U.S. Corporate Governance Standards Through the Sarbanes-Oxley Act: Unilateralism or Cooperation?*, 53 DUKE L.J. 833, 842–43 (2003) (noting that since Germany's Stock Corporation Act serves to minimize the problems targeted by the Sarbanes-Oxley Act, it would be costly and inefficient for Germany to reconcile the regulations imposed by the Sarbanes-Oxley Act and Germany's Stock Corporation Law); Klaus J. Hopt, *Modern Company and Capital Market Problems: Improving European Corporate Governance after Enron* 461 (European Corporate Governance Inst., Working Paper No. 05/2002, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=356102 (recognizing that the independence requirements of the Sarbanes-Oxley Act may create considerable problems for Germany in light of its two-tiered board system and labor codetermination). *See generally* Georg Lanfermann & Silja Maul, *Auswirkungen des Sarbanes-Oxley Acts in Deutschland*, 55 DER BETRIEB (DB) 1725 (2002) (Ger.). The Sarbanes-Oxley Act is located at Pub. L. No. 107-204, 116 Stat. 745 (2002).

[83] *See* Hopt, *supra* note 82.

is an area where corporate governance norms in the United States and Germany may continue to diverge.

United States and German methods of raising equity capital and debt financing also differ. U.S. corporations rely heavily on capital markets, whether for selling their stock, long-term bonds, or short-term commercial paper. This makes U.S. companies particularly vulnerable to market conditions and thus to financial risks that correlate with markets.[84] This may also make managers of U.S. companies more aware of market conditions and in some circumstances more aware of market risks. Historically, U.S. companies have relied on markets for financing more than they have relied on each other, meaning U.S. managers are perhaps less aware than they should be of the risks that are being incurred by companies other than their own. With the growth of markets for swaps and other complex instruments, however, the fate of U.S. companies is directly vulnerable to conditions at other companies in addition to overall market conditions. For example, several companies, including Goldman Sachs, were owed billions of dollars by AIG—money they were paid only after the federal government bailed out AIG. U.S. managers, who were not used to assessing levels of risk in companies other than their own, may not have been prepared for this.

Because of their reliance on capital markets, U.S. companies also are vulnerable to short-term demands of shareholders. Managers struggle to meet shareholder expectations, and sometimes incur risks when they feel it is necessary to satisfy shareholders. The long-term health of the company may be secondary and the interests of creditors, who are not represented in the boardroom, also may be given less attention.

German companies, by contrast, rely on a combination of public markets and institutional financing for capital. Historically the emphasis has been on bank financing. Managers of one corporation have a direct interest in risks assumed by other corporations. German managers have developed a method for monitoring each other's risks through interlocking boards of directors, cross-ownership of large blocks of shares, and other mechanisms. How effective these mechanisms are in helping directors monitor for risk is debatable. But on its face, the German system of corporate governance appears

[84] In 2008 a severe liquidity crisis occurred, and investors for a time stopped buying commercial paper. Edmund L. Andrews & Michael M. Grynbaum, *Fed Announces Plan to Buy Short-Term Debt*, N.Y. TIMES, Oct. 8, 2008, http://www.nytimes.com/2008/10/08/business/08fed.html?ref=commercial_paper.

to facilitate the flow of information about different companies as well as the influence of different companies upon one another.

For all of the reasons discussed above, it is not surprising that Germany and the United States have very different ways of approaching risk in the banking sector. Germany and the United States are likely to follow different paths in defining "excessive risk" and in their legal, institutional, and social mechanisms used to control risk.

## IV. SOME SPECIFICS ON THE U.S. AND GERMAN APPROACHES TO EXCESSIVE RISK TAKING BY DIRECTORS

### *A. The Business Judgment Rule*

Decisions of directors about business risks, if challenged in court, are analyzed under the business judgment rule in both Germany and the United States. The business judgment rule is a concept in corporate law, whereby "directors of [a] corporation are clothed with [the] presumption . . . of being [motivated] in their conduct by a *bona fide* regard for the interests of the corporation whose affairs the stockholders have committed to their charge."[85] Unless the presumption has been rebutted, courts refuse to second-guess the actions of directors in managing the corporation, unless it is shown that the directors were grossly negligent in violating their duty of care to manage the corporation to the best of their abilities.[86]

Germany, among other nations,[87] modeled its business judgment rule after the American business judgment rule. Some of the countries that adopted the American business judgment rule, such as Australia, have introduced a statutory business judgment rule.[88] In Germany, the business judgment rule is code based in the Aktiengesetz (AktG).[89] The business judgment rule in the United States by

[85] Robinson v. Pittsburgh Oil Refining Corp., 126 A. 46, 48 (Del. Ch. 1924).

[86] Another approach is to articulate the presumption that the directors acted with due care, or "on an informed basis," as part of the presumption of the business judgment rule itself, a presumption which can then be rebutted by a plaintiff challenging the directors' actions. *See In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 124 (2009).

[87] Australia, for example, decided to implement the business judgment rule into their Corporate Codes. *See* Corporations Act 2001 s 180 (Austl.); Joan Gabel et al., *Evolving Regulation of Corporate Governance and the Implications for D&O Liability: The United States and Australia,* 11 SAN DIEGO INT'L L.J. 365, 398 (2010) (discussing how Australia's code utilizes the business judgment rule).

[88] *Id.*

[89] Aktiengesetz [AktG] [German Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, § 93(1)–(2) (Ger.).

contrast is articulated principally through case law in the state of incorporation.[90]

In the United States, attempts to implement a statutory business judgment rule have been unsuccessful.[91] In 1994, the American Law Institute attempted to provide black letter law for the business judgment rule in its Principles of Corporate Governance.[92] The drafters of the Revised Model Business Corporation Act in 1998, however, decided that it would not be desirable to "freeze the concept in a statute."[93] The business judgment rule in the United States thus remains embedded in case law.[94] The business judgment rule in most states embodies a rebuttable presumption that management has acted: (i) in good faith, (ii) in the best interest of the corporation and absent a conflict of interest, (iii) on an informed basis, and (iv) for a proper business purpose, which precludes extreme examples of waste of corporate assets.[95]

The German business judgment rule has five requirements: (i) a business decision by management, (ii) for the benefit of the corporation, (iii) no conflict of interest, (iv) based on sufficient in-

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[90] *See, e.g.*, *In re* Citigroup, 964 A.2d at 124. The state of incorporation is not necessarily the state where the company has its headquarters. Many large U.S. corporations are incorporated in Delaware.

[91] Thomas J. Dougherty, *Securities Litigation: Planning and Strategies*, SM086 A.L.I.–A.B.A., 327, 339 (June 7–8, 2007) (discussing Delaware, which has not adopted a business judgment rule statute, whereas forty-one states have passed statutes affecting how judges can apply the business judgment rule). Similarly, in 2000, the British Commission for the Reform of Company Law decided against the implementation of a statutory business judgment rule. *See* COMPANY LAW REVIEW, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: DEVELOPING THE FRAMEWORK § 3.69, at 42 (2000) *available at* ht tp://www.berr.gov.uk/files/file23248.pdf. The British government in December 2003, again, attempted unsuccessfully the introduction of the U.S. business judgment rule. DEP'T TRADE & INDUS., DIRECTOR AND AUDITOR LIABILITY–A CONSULTATIVE DOCUMENT § 5.4–5.13, at 17–21 (2003), *available at* http://www.treasurers.org/system/files/auditors_directors.pdf.

[92] A.L.I PRIN. CORP. GOV. § 4.01 (1994).

[93] MODEL BUS. CORP. ACT §8.31 cmt. 1 (2002). Interestingly, the business judgment rule is discussed in the *Corporate Director's Guide Book*. *See* AM. BAR ASS'N, CORPORATE DIRECTOR'S GUIDEBOOK 25–27 (5th ed. 2007).

[94] *See, e.g.*, Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919); Gagliardi v. TriFoods Int'l Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996); Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971); Gimbel v. Signal Cos., 316 A.2d 599, 608 (Del. Ch. 1974); Robinson v. Pittsburgh Oil Refinery Corp., 126 A. 46, 48–49 (Del. Ch. 1926).

[95] *See* Cottle v. Storer Commc'n, Inc., 849 F.2d 570, 575 (11th Cir. 1988); Grobow v. Perot, 539 A.2d at 187; Brock Built, LLC v. Blake, 686 S.E.2d 425, 822 (Ga. Ct. App. 2009).

formation, and—perhaps most important for the present analysis—(v) a no "hazard" decision or no excessive risk taking.[96] As pointed out below, it is in this last element where the business judgment rules in the United States and in Germany diverge the most. German law presumes no hazard and excessive risk, but this presumption can be rebutted. Law in the United States principally focuses on corporate "waste" and presumes the absence of corporate "waste."[97] The principal factual inquiry asks whether that presumption can be rebutted. Because most risk taking does not meet the definition of corporate waste, a showing of hazard or excessive risk is insufficient to rebut the business judgment rule in the United States.[98]

### *B. The German Approach to the Business Judgment Rule*

Although many of the elements of the business judgment rule are similar in the United States and Germany, we briefly summarize the German approach which is unfamiliar to most American readers.

#### 1. Business Decision of Management

A primary predicate of the business judgment rule is that management made a business decision.[99] A business decision under the business judgment rule requires that management could act one way or another in a given situation or not act at all.[100] The business decision must be a discretionary one for the business judgment rule to apply. There is no discretion if the decision was required by a duty of the officer or director under laws, bylaws, or contracts.[101] If the of-

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[96] Aktiengesetz [AktG] [German Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, § 93(1)–(2); Marcus Lutter, *Die Business Judgment Rule und ihre praktische Anwendung*, 18 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [ZIP] [JOURNAL OF BUSINESS LAW] 841, 843–45 (2007) (Ger.).

[97] *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del. 2006).

> To recover on a claim of corporate waste, the plaintiffs must shoulder the burden of proving that the exchange was so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration. A claim of waste will arise only in the rare, unconscionable case where directors irrationally squander or give away corporate assets. This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be attributed to any rational business purpose.

*Id.* (citations omitted).

[98] *See, e.g.*, *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 131 (Del. Ch. 2009).

[99] *See* Lutter, *supra* note 96, at 843.

[100] *See id.*

[101] HOLGER FLEICHER, HANDBUCH DES VORSTANDRECHTS 258 (2006) (Ger.).

ficer or director breached a specific duty or acted illegally, he or she has not acted with discretion and the business judgment rule does not apply. For instance, there is no discretion for management to usurp a business opportunity of the corporation, emit chemical substances into public waters despite a legal ban, or neglect the disclosure of material information as required by law.[102] If the officer or director did not act with discretion, the actions of management are not covered by the business judgment rule.

The U.S. business judgment rule does not require a business "decision" of management per se as a necessary element of the rule. It is implied, however, that management acted or the rule would not be at issue. Other elements of "discretion" in the U.S. business judgment rule fall under specific components of the rule (i.e. the directors acting for a "proper business purpose"). A doctrinal definition of "acting" does not seem to be necessary—or at least is not emphasized—in the United States.

2. For the Benefit of the Corporation

In Germany, the second element of the business judgment rule requires managers to reasonably believe they acted exclusively for the benefit of the corporation.[103] For instance, management does not act for the benefit of the corporation if its actions threaten the existence and economic survival of the corporation because, in those circumstances, management cannot reasonably expect to act for the benefit of the corporation.[104] Or, if a parent company forces a subsidiary in a group structure to make permanent changes that lead to cost inefficiencies and economic decline of the subsidiary, such actions would not be for the benefit of the subsidiary although they technically may be permitted under German group structure law.

Similarly, the U.S. business judgment rule presumes that management intended to act in the best interest of the corporation.[105] In the United States, however, this component of the rule is construed principally to mean an absence of conflict of interest—that the managers were acting in the best interests of the corporation and not

[102] Lutter, *supra* note 96, at 843.

[103] ARAG/GARMENBECK, Entscheidungen des Bundesgerichtshoffs in Zivilsachen [BGHZ] [Federal court of Justice], Apr. 21, 1997, 135, 244, 253 (Ger.). Before the Court articulated the German business judgment rule, the highest German Civil Court in 1930 already had required that the director's decision must be for the benefit of the corporation. *See id.*

[104] Lutter, *supra* note 96, at 844.

[105] *See In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 124 (Del. Ch. 2009).

another person or entity other than the corporation.[106] Provided the directors have no demonstrable personal conflict of interest or a conflict of interest from another corporation or some third party whose interests are being furthered at the expense of the corporation, they are presumed to be acting for the corporation's best interests.[107] U.S. courts generally do not inquire into whether managers acted in a manner that threatened the economic survival of the corporation, although managers may not engage in a complete waste of corporate assets (disposition of assets without receiving anything of value in return) and may not make some managerial decisions—such as stock buybacks—in circumstances where the corporation is in fact already insolvent.[108]

### 3. No Conflicts of Interest

A third requirement of the German business judgment rule is that directors and officers cannot act in circumstances that would amount to a conflict of interest. A classic example of a conflict of interest in this context is a CEO of a corporation who desires to hire his wife for a radio advertisement of a company product.[109] Unless the wife obtains a contract with provisions that would be in line with custom and industry standards or other precedent, the decision to hire the wife may be a conflict of interest transaction. Interestingly, this requirement has no foundation in either the *ARAG* decision by the Bundesgerichtshof[110] or in the code-based version of the German business judgment rule.[111] German academic literature, however, concludes that management decisions that were made while a conflict of interest existed cannot fulfill the requirement that management acted exclusively for the benefit of the corporation.[112] This view is in accordance with the legislative intent behind the AktG.[113]

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[106] *See, e.g.*, Gagliardi v. Trifoods Int'l, 683 A.2d 1049, 1052 (Del. Ch. 1996).

[107] *Id.*

[108] *See generally In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006); Gagliardi v. Trifoods Int'l, 683 A.2d 1049.

[109] This case arose in U.S. courts. *See* Bayer v. Beran, 49 N.Y.S.2d 2 (1944).

[110] *See* BGHZ 135, 244 (Ger.).

[111] Aktiengesetz [AktG] [German Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, § 93(1)–(2).

[112] *See supra* Part IV.B.2 (second requirement of the German Business Rule). Holger Fleischer, *Die "Business Judgment Rule": Vom Richterrecht zur Kodifizierung*, 9 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [ZIP] [JOURNAL OF BUSINESS LAW] 685, 691 (2004) (Ger.).

[113] Entwurf eines Gesetzes zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts [UMAG] [BR] 3/05, at 20 (Ger.).

The business judgment rule in the United States also requires that directors not act out of a conflict of interest.[114] Indeed, showing a conflict of interest is probably the most common way of rebutting the business judgment rule presumption in the United States.

4. Based on Sufficient Information

The requirement that directors and officers have sufficient information before they act is a crucial element of the German business judgment rule.[115] The sufficiency of information depends on the significance of the pending business decision. For instance, if management decides to purchase a new computer for the office, it may be sufficient that management obtain competing offers from different vendors. More extensive information including market research reports, due diligence, and fairness opinions, among other documentation, are required if management of a German corporation decides to acquire a foreign company.[116] This requirement is based on the understanding that if the corporation is not protected by the personal liability of the individual board members who act on its behalf, then the decisions of board members must be planned well and based on sufficient information in order to protect the corporation from the implicit risks.[117]

The German legislature has extended the protection of the business judgment rule to corporate managers' selection and weighing of information, an approach which avoids "hindsight bias" of judges.[118] The legislature reasoned that time pressure in decision-making ought to be taken into account and may justify collecting less information before making a business decision.[119] Other criteria are profitability of a business decision, risk parameters, amount of in-

[114] *See* Bayer v. Beran, N.Y.S.2d 2, 6-7 (N.Y. Sup. Ct. 1944) ("The 'business judgment rule', however, yields to the rule of undivided loyalty . . . . Such personal transactions of directors with their corporations, such transactions as may tend to produce a conflict between self-interest and fiduciary obligation, are, when challenged, examined with the most scrupulous care, and if there is any evidence of improvidence or oppression, any indication of unfairness or undue advantage, the transactions will be voided.").

[115] BGHZ 135, 244, 253 (Ger.).

[116] Oberlandesgericht [OLG] [Higher Regional Court], June 22, 2006, BETRIEBS BERATER [BB] 66, 2007 (Ger).

[117] Lutter, *supra* note 96, at 844.

[118] Fleischer, *supra* note 101, at 686.

[119] Lutter, *supra* note 96, at 845.

vestment, and financing requirements, as they may impact business decisions immediately.[120]

In the United States, this component of the business judgment rule is often articulated as a requirement that the director acted on an "informed basis."[121] A business decision must be based on sufficient information.[122] This requirement, however, is watered down in the United States by many states that allow corporations to adopt charter provisions that exculpate the directors from liability to the corporation for breach of a duty of care, including the duty to act on an informed basis.[123]

5. No Excessive Risk Taking—No Hazard Decision

Finally, excessively risky decisions by directors that may lead to the demise of the corporation are not protected by the German business judgment rule.[124] The Bundesgerichtshof, or BGH (the highest German court in civil matters), confirmed that a "hazard decision" by management is not protected by the business judgment rule if "the ability to take conscious business risks by management has been irresponsibly overstretched."[125] The application of this component of the business judgment rule in an environment of increased systemic risk, such as the recent credit crisis, is unclear.[126] The BGH in its *ARAG* decision[127] determined that the German business judgment rule[128] will not cover informed business decisions by management if "conscious business risk has been inappropriately excessive"[129]—i.e., no manager, regardless of whether the manager is a bank officer or board member, acts reasonably if he or she takes on risks on behalf of the corporation that, if realized, will result in the demise of the corporation.[130]

There is no equivalent to this component in the U.S. business judgment rule. One could argue that if directors act on an informed

[120] *Id.*
[121] *See In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 124 (2009).
[122] *See* Smith v. Van Gorkum, 488 A.2d 858, 872–73 (1985).
[123] *See* Del. Gen. Corp. Law § 102(b)(7) (2010); 805 Ill. Comp. Stat. Ann. 5/2.10(b)(3) (West 2010); N.J. Stat. Ann. 14A:2-7(3) (West 2010).
[124] Lutter, *supra* note 96, at 845.
[125] BGHZ 135, 244, 253 (Ger.).
[126] *See generally* Lutter, *supra* note 96.
[127] BGHZ 135, 244 (Ger.); ZIP 883 (Ger.).
[128] Now embodied in Aktiengesetz [AktG] [German Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, § 93(1)–(2) (Ger.).
[129] BGHZ 135, 244, 253(Ger.); ZIP 883, 886 (Ger.).
[130] Lutter, *supra* note 5, at 199.

basis, as required by the U.S. business judgment rule, they should at least know about the risks the company takes and monitor those risks. However, in an opinion that provided the first detailed analysis of potential liability of directors for losses incurred as a result of substantial exposure to subprime debt, the Delaware Court of Chancery held otherwise.[131]

In *In re Citigroup Inc. Shareholder Derivative Litigation*, the Delaware Chancery Court upheld the business judgment rule and its protection of directors' business decisions in the face of worldwide economic losses, finding that directors' duties to monitor for illegal conduct in some situations under the *Caremark*[132] line of cases would not be extended to impose oversight liability for business risk.[133] Shareholder plaintiffs alleged (1) breach of fiduciary duties for failing to properly monitor and manage the risk that Citigroup faced concerning problems in the subprime lending market, and (2) failure to properly disclose the company's exposure regarding subprime assets.[134] According to the complaint, starting in May 2005, "red flags" should have immediately alerted the defendants to problems in the real estate and credit markets.[135] Therefore, by ignoring these warning signs, the defendants allegedly overemphasized short-term profits and sacrificed the long-term viability of Citigroup.[136] According to the Delaware Chancery court, however, oversight liability can only be established if the plaintiff can show that "the directors *knew* that they were not discharging their fiduciary [duties] or that the directors demonstrated a *conscious* disregard for their responsibilities . . . ."[137] Inability to predict the future and an incorrect evaluation of business risk were not violations of a director's oversight responsibilities. Risk is inherent in maximizing shareholder value, and losses in and of themselves do not suffice to hold directors personally liable for taking risks that lead to losses.

In contrast with *In re Citigroup*, the German Bundesgerichtshof, more than ten years earlier in 1997, elaborated in its *ARAG* decision that business decisions by directors are not protected by the

[131] *See In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 139–40 (Del. Ch. 2009).

[132] *In re* Caremark Int'l Inc. Derivative Litig., 698 A 2d 959 (Del. Ch. 1996) (expanding the directors' duty of care to include a duty to monitor for illegal conduct).

[133] See Stone v. Ritter, 911 A2d 362 (2006) (reaffirming the *Caremark* duties).

[134] *In re Citigroup Inc.,* at 111.

[135] *Id.* at 114.

[136] *Id.* at 111.

[137] *Id.* at 123.

German business judgment rule if "business risk was inappropriately excessive."[138] In the context of the 2008 credit and banking crisis, German commentators—relied upon by courts more extensively than their counterparts are in the United States—have concluded that no manager acts reasonably in terms of the business judgment rule if he or she takes risks on behalf of the corporation that, if realized, result in the demise of the corporation.[139] As of this writing it is unclear how courts will apply this concept to the events of the 2008 financial crisis. In particular, it remains to be seen how much influence hindsight bias will have on judicial decisions regarding which risks are covered by the German business judgment rule. For example, will the fact that a particular risk led to the demise of a corporation be sufficient to abrogate the business judgment rule protection of managers' decision to take that risk, or will German courts instead examine the decision ex-ante and assess whether the managers could reasonably have foreseen the risk as likely to cause the corporation's demise?

### C. *Securities Disclosure*

One way of addressing excessive risk taking is to require that it be disclosed to a financial institution's stockholders, bondholders, and other investors so they can decide for themselves how much risk is too much. Investors who are told about risk and think it is unwise can sell their investments. They can vote out directors who allow managers to assume too much risk, or they can pressure managers to change their approach to risk. For investors to have an opportunity to take these steps, they must know about the risk. In a mandatory disclosure regime, the law requires that a minimum amount of information be publicly disclosed. Securities fraud laws also forbid material misrepresentations about risk and other facts that an investor would consider important in making a decision.[140]

Both the United States and Germany require public companies to disclose information about their financial condition to shareholders. Here, however, the United States probably has the stricter requirements as well as the more vigorous enforcement regime. Part of the difficulty for German securities disclosure is that Germany has, to some extent, waited for the European Union (EU) to develop a

138 BGHZ 135, 244 (Ger.).

139 *See* Lutter, *supra* note 5, at 199.

140 *See* TSC Industries v. Northway, 426 U.S. 438, 441–43 (1976); *see also* Basic Inc v. Levinson, 485 U.S. 224, 231–232 (1988) (setting forth this definition of "materiality").

comprehensive approach to disclosure, and the EU is still working toward coordination in corporate disclosure requirements. The EU has no central agency for securities regulation,[141] and there is no centralized system like the EDGAR Database of Online Corporate Financial Information[142] for continuous disclosure of pertinent information to investors. Only recently have European countries introduced mandatory and continuous issuer disclosure.[143] Such disclosure in Europe is often self-regulated rather than enforced by a government regulator.[144] The European Parliament and the European Commission have attempted to address disparate regulation and lack of enforcement in individual European member states by adopting the Market Abuse Directive,[145] the Transparency Directive,[146] the Markets in Financial Instruments Directive,[147] and the Prospectus Directive.[148] Despite many improvements,[149] the directives do not mandate coherent and comprehensive disclosure, and issuers continue to make disclosures in disparate ways.[150] Some scholars have argued that there is a need for a European SEC.[151] European investors continue to struggle to find material information about European companies,

[141] The Committee of European Securities Regulators (CESR) is an independent committee of European Union member states' securities regulators, but it has no enforcement powers. *See* CESR, http://www.cesr-eu.org/index.php?page=cesrinshort&mac=0&id=) (last visited Aug. 16, 2010).

[142] *EDGAR Database of Online Corporate Financial Information*, U.S. SECURITIES AND EXCHANGE COMMISSION, http://www.sec.gov/edgar.shtml (last visited Aug. 30, 2010).

[143] *See* Iris H-Y Chiu, *Delegated Regulatory Administration in Mandatory Disclosure—Some Observations from EU Securities Regulation*, 40 INT'L LAW. 737, 737 (2006).

[144] *See id.* at 746.

[145] Council Directive 2003/6, art. 6, 2003 O.J. (L 96) 16 (EC).

[146] Council Directive 2004/109, 2004 O.J. (L 390) 38 (EC).

[147] Council Directive 2004/39, 2004 O.J. (L 145) 1 (EC).

[148] Council Directive 2003/71, 2003 O.J. (L 345) 64 (EC).

[149] Generally, the improvement has occurred in the Markets in Financial Instruments Directive. *See* François P. Haas, *The Markets in Financial Instruments Directive: Banking on Market and Supervisory Efficiency* 4 (Int'l Monetary Fund, Working Paper No. 07/250, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1087165.

[150] *See* Chiu, *supra* note 143, at 767–68.

[151] *See generally* Yannis Avgerinos, *The Need and the Rationale for a European Securities Regulator*, *in* FINANCIAL MARKETS IN EUROPE: TOWARDS A SINGLE REGULATOR 83 (Mads Andenas & Yannis Avgerinos eds., 2003); Gilles Thieffry, *The Case for a European Securities Commission*, *in* REGULATING FINANCIAL SERVICES AND MARKETS IN THE 21ST CENTURY 211 (Ellís Ferran & Charles A.E. Goodhart eds., 2001); Roberta S. Karmel, *The Case for a European Securities Commission*, 38 COLUM. J. TRANS. L. 9 (1999); Eric Pan, *Harmonization of U.S.-EU Securities Regulation: The Case for a European Securities Regulator*, 34 LAW & POL'Y INT'L BUS. 499 (2003).

and even if they find appropriate sources, the information may be incomplete.[152]

Given the state of securities regulation in Europe, European investors arguably are more exposed to securities fraud than U.S. investors. On the other hand, the financial crisis of 2008 revealed a substantial amount of risk in U.S. issuers that was not disclosed to investors. The Lehman Brothers bankruptcy alone revealed two serious disclosure lapses for a U.S. company. The first was the "Repo 105" transaction whereby Lehman "sold" poorly performing assets to a London bank for cash at the end of each quarter; the assets were valued at 105% of the cash payment, which apparently qualified the transaction as a sale under English law.[153] The cash was used to pay down Lehman's debt and improve its balance sheet.[154] Coupled with the sale was a "repurchase" commitment from Lehman whereby a few days after the end of the quarter the transaction was reversed and the same assets were bought back from the bank for cash which Lehman again borrowed, increasing its debt.[155] The same transaction was repeated at the end of the next quarter, allowing each quarter's financial statements to show less debt than Lehman actually had.[156] The total amount of money involved may have been as much as $50 billion.[157] The second disclosure lapse involved a "captive company" called Hudson Castle, which was set up by former Lehman Brothers

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[152] *See* Chiu, *supra* note 143, at 767–68.

> Although Europe has seen increased securities regulation recently with the adoption of the Prospectus Directive, the Market Abuse Directive, the Markets in Financial Instruments Directive, and the Transparency Directive, the problem with these new rules is that issuers are still permitted to make disclosures in disparate ways. This means that investors may not be able to find material information on companies in which they invest, and even if they do, the information they find may be incomplete.

Shelley Thompson, *The Globalization of Securities Markets: Effects on Investor Protection*, 41 INT'L. LAW. 1121, 1128 (2007) (citing Iris H-Y Chiu, *supra* note 143, at 767). However, Europe-wide uniform securities prospectus rules are expected to improve disclosure requirements in Europe. *See* Harold S. Bloomenthal & Samuel Wolff, *Internationalization of World Capital Markets–Multinational Enterprises*, 10 INT.'L CAP. MARKETS & SEC. REG. § 2:3 n.66 (2010) ("[T]he EEC Commission's proposed European-wide uniform securities prospectus rules will greatly facilitate the disclosure and dissemination of information necessary for investor protection and informed investment decisions, and should ease regulatory restrictions currently precluding foreign access to domestic capital markets.").

[153] Report of Anton R. Valukas *supra* note 32, at 6–7.

[154] *Id.*

[155] *Id.* at 6.

[156] *Id.* at 6–7.

[157] *Id.* at 6.

employees specifically for the purpose of buying poorly performing assets from Lehman; Hudson Castle's close association with Lehman was not disclosed.[158] Hudson nonetheless showed up at the Lehman bankruptcy claiming billions of dollars of obligations owed to it by Lehman.[159]

These and other examples, including the Enron and WorldCom failures in 2001 and 2002, illustrate potential weakness in the supposedly rigorous U.S. disclosure regime. Public companies that engage in highly complex transactions as a matter of course can easily conceal risky transactions from investors. Indeed, management can also conceal these transactions from the company's own directors.[160] Although financial institutions in Germany also engage in highly complex transactions, to the extent financial innovation in the United States is ahead of that in Germany, the U.S. disclosure regime may be more vulnerable to misrepresentation and fraud.

The one aspect of U.S. securities laws that is substantially harsher than its German counterpart is the private litigation regime in which investors sue in class actions for securities fraud. In securities class actions, U.S. law allows plaintiffs to proceed on the basis of the "fraud on the market theory" rather than requiring plaintiffs to prove actual reliance on misleading statements.[161] This approach has been rejected in most other countries.[162] The application of Section 10(b) of the 1934 Securities Exchange Act[163] and Rule 10b-5[164] in conjunction with the fraud on the market theory makes it relatively easy to certify a plaintiff class for litigation and thus substantially increases the potential liability of issuers.[165] Lawyers who file unsuccessful lawsuits in the United States are not liable for the defendants' attorneys' fees, yet fee awards for successful plaintiffs' lawyers are very generous,

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[158] *See* Louise Story & Eric Dash, *Lehman Channeled Risks Through 'Alter Ego' Firm*, N.Y. TIMES, Apr. 12, 2010, at A1. Lehman did not have a sufficient equity interest in Hudson Castle to require consolidation of the two companies' balance sheets under GAAP.

[159] *Id.*

[160] The bankruptcy examiner for Lehman Brothers found that the company's outside directors had not breached their fiduciary duty to the company because they apparently had never been told about the above transactions and other problems with Lehman's exposure to risk. Report of Anton R. Valukas, *supra* note 32, at 54–58.

[161] *See* Basic, Inc. v. Levinson, 485 U.S. 224, 241–42 (1988).

[162] *See* Hannah L. Buxbaum, *Multinational Class Actions Under Federal Securities Law: Managing Jurisdictional Conflict*, 46 COLUM. J. TRANSNAT'L L. 14, 61–62 (2007).

[163] Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78lll (2006).

[164] 17 C.F.R. § 240.10b-5 (2009).

[165] *See* Cristof Aha & Jens Föderer, *Die RocheEntscheidung des U.S. Court of Appeals*, 49 RECHT DER INTERNATIONALEN WIRTSCHAFT [RIW] 450, 455 (2003) (Ger.).

sometimes running into the billions of dollars.[166] Although Congress significantly tightened up pleading requirements, limited damages, and took other pro-defendant steps in the 1995 Private Securities Litigation Reform Act,[167] the United States remains the most attractive regime in the world for class action securities litigation.[168] Indeed, foreign plaintiffs have sought to use U.S. courts to sue foreign defendants over securities purchased outside the United States (so-called f-cubed litigation) until the U.S. Supreme Court decided in June 2010 that U.S. securities laws do not cover securities bought or sold outside the United States.[169] In the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress almost immediately thereafter gave the SEC the authority to pursue conduct in the United States that defrauds investors outside the United States.[170] It is unclear how the SEC will use this authority and how much cooperation there will be between the SEC and securities regulators in Germany and elsewhere in combating securities fraud.

In Germany, class actions for securities fraud are virtually nonexistent. Unlike many of its European neighbors, Germany has elected to provide for group litigation only in a few substantive law areas, such as environmental law, and in most group litigation cases, German law only provides for injunctive relief.[171] Section 148(1) of the German Corporation Act (Aktiengesetz, or AktG), however, was amended by the German legislature in 2005 as part of the Integrity of Corporations and Modernization Act (Gesetz zur Unternehmensin-

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[166] *See* Jay N. Varon, *Promoting Settlements and Limiting Litigation Costs by Means of the Offer of Judgment: Some Suggestions for Using and Revising Rule 68*, 33 AM. U. L. REV. 813, 818–19 (1984) (noting that the dichotomy between winning plaintiff who is eligible for attorneys' fees and the defendant who not is eligible favors plaintiff's decisions not to settle).

[167] Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

[168] Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth Through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation*, 33 HARV. J.L. & PUB. POL'Y 607, 609 (2010) (discussing hindrances to capital formation as a result of the fact that the United States is one of few developed nations to allow class action securities litigation).

[169] *See* Morrison v. National Australia Bank, 130 S. Ct. 2869 (2010). For commentary on the dangers facing European companies in the context of *Morrison* and pending changes in the U.S. Congress, see Wulf A. Kaal & Richard W. Painter, *Extraterritorial Application of US Securities Law—Will the US Become the Default Jurisdiction for European Securities Litigation?*, 7 EUR. CO. L. 90 (2010).

[170] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 929P(c)(2) (2010) [hereinafter Dodd-Frank Act].

[171] Harald Koch, *Non-Class Group Litigation Under EU and German Law*, 11 DUKE J. COMP. & INT'L L. 355, 358 (2001).

tegrität und Modernisierung des Anfechtungsrechts 2005, or UMAG).[172] Section § 148(1) of the AktG, as amended by the UMAG, introduces the derivative suit in Germany and gives minority shareholders the right to sue management in certain circumstances.[173] This may be perceived as a tightening of the standard of care in Germany as it introduced the possibility for shareholders to sue on behalf of the corporation for wrongdoing of management. Unlike the derivative suit in the United States, however, section 148(1) of the AktG requires a threshold ownership of shares totaling €100,000 (about $127,090) for shareholders to have standing to sue on behalf of the corporation in German courts.[174] This ownership requirement for derivative suits is arguably counter-balanced by the introduction of other methods of recovering against directors, such as the 2009 Gesetz zur Angemessenheit der Vorstandsvergütung (VorstAG) provisions for liability and compensation reduction that are discussed below.[175]

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[172] Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts [UMAG] [Law on Company Integrity and Modernization of the Right to Appeal], Sept. 22, 2005, BGBL. I at 2802 (Ger.).

[173] Aktiengesetz [AktG] [German Stock Corporation Act], Sept. 6, 1965, BGBL. I at 1089, § 148(1). (Ger.).

> Proceedings for Admission of Legal Action:
> Shareholders whose shares amount to a total of one hundredth of the share capital or a pro rata amount of 100,000 euros on the date of filing an application, may apply for a claim for damages accruing to the company to be admitted in their own name as specified under § 147(1), first sentence. The court will admit such claim if:
>
> 1. the shareholders furnish evidence that their shares were acquired prior to the date on which they, or in the event of universal succession their predecessor, should have become aware of the alleged violation of obligations or the alleged damages following public disclosure of the same,
> 2. the shareholders furnish evidence that they have, to no avail, set a reasonable deadline for the company to file a claim in its own name
> 3. there are facts which justify the suspicion that the company has incurred damages as a result of dishonesty or gross breach of the law or of the company's articles of association, and
> 4. there are no prevailing interests on the part of the company providing grounds to prevent enforcement of the claim.

*Id.*, *translated in* Dieter Hahn, *Aktiengesetz*, RELATIV-KOMFORTABEL, http://www.relativ-komfortabel.de/148aktg.php, http://www.relativ-komfortabel.de/sec-148aktg.php.

[174] *Id.*

[175] *See* Gesetz zur Angemessenheit der Vorstandsvergütung [VorstAG] [Act on the Appropriateness of Executive Board Compensation], Aug. 31, 2009, BGBL. I, at 2509 (Ger.), *available at* http://www.bmj.bund.de/files/-/3516/Formulierungshilfe%20Gesetz%20zur%20Angemessenheit%20der%20Vorstandsverguetung.pdf.

In sum, what the United States lacks in its lenient approach to risk taking in the application of the business judgment rule the United States may make up for with its relatively strict disclosure regime and robust securities class action litigation regime. Managers are permitted to incur many of the risks that they want to incur, and courts applying the business judgment rule in the United States give little or no consideration to the overall health of the company or even whether the risk is jeopardizing the company's very existence. If the risk is not sufficiently disclosed to investors, however, the directors are likely to be sued under the securities laws. Directors thus may monitor for risk because they know they are responsible for disclosing it. Turning back to the graph earlier in this Article, substantive corporate law standards in the United States push the risk monitoring requirement toward leniency (toward the left on the graph), but the relatively robust securities disclosure rules, SEC enforcement procedures, and civil litigation regime shift the risk monitoring requirement back toward stringency (to the right on the graph).[176]

But the U.S. disclosure regime does not always work well, as illustrated by what happened at Lehman Brothers and other companies. This could be for a number of reasons: the risks incurred were too complex and investors did not understand what was being disclosed, investors ignored disclosures and instead relied on rating agencies when valuing debt securities, directors did not understand the risks enough to know whether they were being properly disclosed, disclosure rules were easy to circumvent as in the case of Lehman's Repo 105, the SEC failed in its oversight responsibility, and/or because the SEC had no oversight responsibility over security-based swaps and similar financial instruments that Congress had earlier explicitly prohibited the SEC from regulating.[177] The much-touted U.S. securities disclosure regime failed to prevent the 2008 financial crisis, yet the expansive U.S. version of the business judgment rule in corporate law that allowed the risk taking to begin with has remained intact.

Against this backdrop, Germany and other countries that have used corporate law to control excessive risk taking may be skeptical of

[176] *See supra* Part II.

[177] Earlier prohibitions on SEC enforcement are codified in the Securities Act of 1933, 15 U.S.C. § 77b-1(b)(2) (2006), and the Securities Act of 1934, 15 U.S.C. § 78c-1(b)(2) (2006), which state that security-based swap agreements are not securities for purposes of the securities laws and explicitly prohibiting the SEC from requiring registration of security-based swaps or even from taking proactive measures to prevent fraud in security-based swaps.

the traditional U.S. approach that allows almost any risk to be taken as long as it is disclosed.

*D. Other Recent developments*

The German approach to business risk continues to evolve. The *ARAG* case,[178] in which the German High Court (Bundesgerichtshof) decided that the German business judgment rule[179] will not cover informed business decisions by management if "conscious business risk has been inappropriately excessive,"[180] had a significant impact on the debate in Germany. Until recently, the debate was rather theoretical and dogmatic and the general public was not involved.[181] Now that scandals with risk taking by management have had an impact on the economy,[182] the general public is more aware of

[178] BGHZ 135, 244(Ger.); ZIP, 883 (Ger).

[179] The German business judgment rule is now embodied in Aktiengesetz [AktGg] [German Stock Corporations Act], Sept. 6, 1965, BGBL. I at 1089, at § 93(I)(2) (Ger.).

[180] BGHZ 135, 244, 253(Ger.); ZIP 883, 886 (Ger.).

[181] *See generally* Christian Kirchner & Richard W. Painter, *European Takeover Law—Towards a European Modified Business Judgment Rule for Takeover Law*, 1 EUR. BUS. ORG. L. REV. 353, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=247214 (discussing a suggested alteration of the German business judgment rule).

[182] For a general discussion of the problems of German banks in the context of the credit crisis, see Peter Gumbel, *Subprime on the Rhine*, FORTUNE, Sept. 3, 2007, at 71; Carrick Mollenkamp, Edward Taylor & Ian McDonald, *Global Scale: Impact of Mortgage Crisis Spreads—How Subprime Mess Ensnared German Bank—IKB Gets a Bailout*, WALL ST. J., Aug. 10, 2007, at A1. In the case of IKB Deutsche Industriebank, a banker in this mid-sized bank invested one-third of available funds in foreign and mostly unknown shares. Lutter, *supra* note 5, at 199. IKB Deutsche Industriebank announced a total loss of $954 million from its exposure to the subprime crisis on July 27, 2007 and the ECB joined the German Central Bank (Bundesbank) to form a consortium of major German banks to raise $4.789 billion for a bailout of IKB. Kara M. Westercamp, *A Crack in the Façade and the Whole Building Came Tumbling Down: A Critical Examination of the Central Banks' Response to the Subprime Mortgage Loan Crisis and Global Financial Market Turmoil*, 18 TRANSNAT'L L. & CONTEMP. PROBS. 197, 219 (2009). In the case of Sachsen LB, a Banker invested three times the value of the State budget of the state of Saxony in foreign and mostly unknown shares. Lutter, *supra note* 5, at 199. Less than three weeks after IKB's bailout, SachsenLB reported similar problems and forced a consortium of banks to provide a credit line of $17.3 billion to stabilize Sachsen's exposures. *Id.* For a summary of German cases in banking crisis, see Lutter, *supra* note 5, at 199; Dam, *supra* note 4, at 609–11 (elaborating on the effects of the subprime crisis on German banks including IKB).

> This German example illustrates the more general phenomenon that at least some European banks seized the opportunity to sell subprime securities backed by US mortgage loans and that European financial institutions used SIVs and conduits in much the same manner as American financial institutions. Thus, it would be wrong to assume that regulatory reform is primarily about changes required in US law or that these changes would affect operations of only US banks.

the dangers of financial risk.[183]

To address public concerns about management risk taking, the German legislature adopted the Act on the Appropriateness of Management Board Compensation (Gesetz zur Angemessenheit der Vorstandsvergütung, or VorstAG) on August 5, 2009.[184] Recognizing that "managers who emphasize short-term parameters in management lose sight of the long-term benefit of the corporation and are incentivized to take irresponsible risks,"[185] the VorstAG requires a reduction of management board compensation if the corporation is in a crisis.[186] The Act also introduces personal liability of management by way of a deductible for D&O insurance[187] as well as personal liability of members of the Supervisory Board for failure to appropriately determine management compensation.[188]

The VorstAG's attempt to limit risk taking by introducing personal liability for managers caused heightened media interest in these regulatory measures.[189] To encourage long-term decision making by management, the VorstAG requires that the performance-based part of management compensation, such as options, are payable four years after the respective manager was granted such options.[190] It also introduces a two-year hiatus between transitioning from management to supervisory board positions at the same company.[191] Moreover, a tentative proposal to reform the German insolvency law, the Restructuring of Systemically Important Credit Institutions Act (Gesetz zur Einführung einer Restrukturierungsverwaltung,

Dam, *supra* note 4, at 610.

[183] *Koalition verschärft Haftung von Managern*, DIE WELT, Apr. 24, 2009, *available at* http://www.welt.de/die-welt/article3613357/Koalition-verschaerft-Haftung-von-Managern.html (Ger.).

[184] VorstAG, *supra* note 175, at A–B.

[185] *Id.* at A (Problem und Ziel).

[186] *Id.* at Art. 1(b).

[187] The VorstAG changed section 93(2)(3) of the German Corporation Act (AktG). Pursuant to the new version of that section, a corporation that provides insurance coverage to the members of the Vorstand for risks resulting from their occupational activities, a mandatory deductible that is personally born by the member of the Vostand must be included. The value of the deductible ranges from a minimum of 10% of the damage up to the minimum amount of 1.5 times the annual base salary of the respective member of the Vorstand. *Id.* at Art 1(2).

[188] *Id.* at Art. 1(3).

[189] *See generally Koalition verschärft Haftung von Managern*, *supra* note 183.

[190] *Id.*

[191] *Id.* The hiatus does not apply to members of management who were elected to the Aufsichtsrat by a vote of more than 25% of shareholders of the corporation.

or Restrukturierungsverwaltungsgesetz—RestrVG),[192] would allow a newly created German authority to dismiss management of a financial institution if the institution is insolvent[193] and if it is systemically important to restructure the institution.[194] At the time of publication of this Article, it was unlikely that the German government would enact the RestrVG.

The combination of the 2010 sovereign debt crisis and the 2008 credit crisis has undermined confidence in the functioning of financial markets. Regulations in Germany and in the EU will likely focus not only on financial institutions and their managers but also on financial markets. One measure intended to ensure the integrity of financial markets in Germany and the EU was the prohibition of naked short sales by the German Finance Ministry in coordination with the German Securities and Markets Authority (Bundesanstalt für Finanzdienstleistungsaufsicht—BaFin).[195] The prohibition is, however, limited to trading in naked shorts of shares of a select group of banks, insurance companies, and financial market intermediaries.[196] The German Finance Ministry recently proposed a new Act to extend the time limit for the prohibition of naked short sales, thus making it permanent.[197] The Ministry also proposed to extend the scope of the prohibition.[198]

[192] Gesetz zur Einführung einer Restrukturierungsverwaltung [Restrukturierungsverwaltungsgesetz—RestrVG] [Restructuring of Systemically Important Credit Institutions Act], *available at* http://www.jura.uni-duesseldorf.de/dozenten/noack/Restrukturierung.pdf (Ger).

[193] *Id.* § 2(1)(a)–(c). This is a similar approach to Chapter 11 of the U.S. Insolvency law.

[194] *Id.* § 2(1)–(2). The German approach is different from the U.S. approach in Chapter 11 of the U.S. Insolvency law in that it requires a systemic element or systemic relevance (in German, Systemrelevanz).

[195] *See Verbot für Leerverkäufe verlängert*, BUNDESMINISTERIUM DER FINANZEN (Mar. 31, 2009), *available at* http://www.bundesfinanzministerium.de/DE/Wirtschaft__und__Verwaltung/Geld__und__Kredit/002__Bafin__Leerverkauf.html (Ger.). Short selling is the practice of selling securities or assets that have previously been borrowed from a third party with the intention of buying identical assets or securities at a later date to return to the lender. A naked short, on the other hand, describes the practice of short-selling a security without first borrowing such security or ensuring that the security can be borrowed.

[196] *Id.* The entities included: "Aareal Bank AG, Allianz SE, AMB Generali Holding AG, Commerzbank AG, Deutsche Bank AG, Deutsche Börse AG, Deutsche Postbank AG, Hannover Rückversicherung AG, Hypo Real Estate Holding SG, MLP AG, Münchener Rückversicherungs-Gesellschaft AG." *Id.*

[197] *See Regierungsentwurf für ein Gesetz zur Vorbeugung gegen missbräuchliche Wertpapier- und Derivategeschäfte*, BUNDESMINISTERIUM DER FINANZEN (Feb.6, 2010), *available at* http://www.bundesfinanzministerium.de/nn_54/DE/Wirtschaft__und__Verwaltung

In addressing these problems, however, Germany must contend with the EU. These German initiatives were instituted without consulting its European neighbors.[199] In response to this action, the EU Commission proposed legislation that would curtail the ability of individual EU member states to unilaterally prohibit certain instruments.[200] Under this proposed legislation, before regulators in individual EU member states can unilaterally put such measures in place, regulators must consult the European Securities and Markets Authority (ESMA) and other EU member states.[201] The proposed EU legislation would also give powers to EU member state authorities to restrict or ban credit-default swaps subject to coordination by ESMA.[202]

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/Finanz__und__Wirtschaftspolitik/Finanzpolitik/20100528-Leerverkaeufe.html?__nnn=true (Ger.).

[198] *See id.*

[199] Reinhard Hönighaus, *Kein Zockverbot mehr im Alleingang–BaFin soll Maßnahmen gegen Leerverkäufe besser abstimmen–EU Gesetz im Herbst*, FIN. TIMES DEUTSCHLAND, June 15, 2010, 16 (Ger.).

[200] *Id.*

[201] *Id.*

[202] Press Release, Public Consultation on Short Selling and Credit Default Swaps, U.N. Press Release 10/255 (June 14, 2010), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/255&format=PDF&aged=0&language=EN&guiLanguage=en. The intent of the new rules is described as:

> The intention is that the measures envisaged on short selling should:
> - ensure Member States have the power to act to reduce systemic risks and risks to financial stability and market integrity arising from short selling and Credit Default Swaps,
> - *facilitate co-ordination* between Member States and the European Securities Markets Authority (ESMA) in emergency situations;
> - *increase transparency* on the short positions held by investors; and
> - *reduce settlement risks* linked with uncovered or naked short selling. . . .
>
> The options envisaged can be grouped into three types:
> - Powers for competent authorities to temporarily restrict or ban short selling and Credit Default Swaps in emergency situations (subject to coordination by ESMA);
> - Measures to increase transparency to regulators and the market about short selling positions, including those obtained through the use of derivatives; and
> - Measures to reduce settlement risks of uncovered or naked short selling.
>
> The options under consideration also foresee powers for competent authorities to enforce the rules and the possibility of some limited exemptions (for market makers and shares whose principal market is outside the EU).

*Id.*

In a move likely to affect both financial institutions and financial markets, the German government also proposed publishing stress tests for banks in a unified and consolidated approach with other EU member states.[203] Stress tests for banks are intended to assess how well banks are prepared to deal with extreme market scenarios.[204] A stress test study was published last year in the United States, but banking institutions may have influenced it.[205] While critics allege the publication of stress tests could lead to panic in EU capital markets, the Spanish Federal Reserve has already announced its intent to publish stress tests for banks.[206] The former grand coalition government of Social Democrats and Christian Democrats in Germany had opposed the publication of such stress tests.[207] European banking regulators now perform stress tests on a regular basis.[208] The German banking industry opposed the publication of stress tests but most EU member states seem to favor such publication on the premise that "stress tests will show that Europe has an efficient mechanism to solve problems in the financial sector."[209] French President Nicolas Sarkozy and German Chancellor Angela Merkel agreed to disclose how banks perform on stress tests in order to ascertain that the financial system can withstand shocks.[210]

Recently, in an effort to reduce risk taking, the EU Parliament approved new rules to curtail bankers' bonuses and reinforce banks' capital requirements.[211] Under these new rules, bonuses would be

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[203] Christine Mai, *Sorge um Geldhäuser - Berlin koordiniert europaweite Bloßstellung der Banken*, FIN. TIMES DEUTSCHLAND, June 16, 2010, *available at* http://www.ftd.de/unternehmen/finanzdienstleister/:sorge-um-geldhaeuser-berlin-koordiniert-europaweite-blossstellung-der-banken/50128924.html (Ger.).

[204] *Id.*

[205] David Enrich, *New Doubts on EU Bank Stress Tests: Skeptics Wonder Why There's so Much Optimism in Official Circles; Friday Is Day of Reckoning,* WALL ST. J., July 20, 2010, at C2, available at http://online.wsj.com/article/SB10001424052748704720004575377202517842246.html (discussing effectiveness of stress tests of European banks).

[206] *Id.*

[207] *Id.*

[208] *Id.*

[209] Ina Lockhart, Meike Schreiber & Christine Mai, *Bund kommt Banken bei Stresstests entgegen*, FIN. TIMES DEUTSCHLAND, June 17, 2010, http://www.ftd.de/unternehmen/finanzdienstleister/:ftd-bankentag-bund-kommt-banken-bei-stresstests-entgegen/50129578.html (Ger.).

[210] *See* Tony Czuczka & Gregory Viscusi, *EU Leaders Agree to Publish Results of Banks' Performance on Stress Tests*, BLOOMBERG (June 17, 2010, 1:32 PM), http://www.bloomberg.com/apps/news?pid=20601087&sid=akJ9nzKi3ZMo&pos=4.

[211] Press Release, European Parliament, European Parliament ushers in new era for bankers' bonuses (July 7, 2010), *available at* http://www.europarl.europa.eu/

linked to salaries and the cash portion of bonuses would be capped at 30% of the total amount or 20% for particularly high bonuses.[212] Bankers also risk losing the remainder of the bonus if the bank's performance erodes over three years following the bonus payment.[213] Under the new rules, banks that do not curtail the salaries of staff "whose professional activities have a material impact on the risk profile of the bank or investment firm" will have to set aside more capital to make up for the risk.[214] Notably, there has not been a similar development in the United States.

In an attempt to prevent a recurrence of the recent financial crisis, the Basel Committee on Banking Supervision introduced new worldwide liquidity and leverage standards in its new Basel III Capital Accord.[215] All of the twenty-seven member countries have already signed on to the new principles.[216] The new principles will require banks to limit tier-one capital[217] to 3% of un-weighted assets.[218] The Committee also proposed that banks hold capital above the regulato-

news/expert/infopress_page/042-77908-186-07-28-907-20100706IPR77907-05-07-2010-2010-false/default_en.htm.

[212] *Id.*

[213] *Id.*

[214] Proposal for a Directive of the European Parliament and of the Council, amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, at 8 (2009), *available at* http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/Leg_Proposal_Adopted_1307.pdf.

[215] BANK FOR INTERNATIONAL SETTLEMENTS, BASEL COMMITTEE ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR (2010), http://www.bis.org/publ/bcbs164.pdf [hereinafter BIS REPORT: STRENGTHENING THE BANKING SECTOR].

[216] Brooke Masters, *Basel Breakthrough in Drive to Tighten Rules on Global Banking*, FIN. TIMES, July 27, 2010, at 1.

[217] BIS REPORT: STRENGTHENING THE BANKING SECTOR, *supra* note 215, at 12 ("The Committee therefore is announcing for consultation a series of measures to raise the quality, consistency, and transparency of the regulatory capital base. In particular, it is strengthening that component of the Tier 1 capital base which is fully available to absorb losses on a going concern basis, thus contributing to a reduction of systemic risk emanating from the banking sector.").

[218] BANK FOR INTERNATIONAL SETTLEMENTS, BASEL COMMITTEE ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: PROPOSED ENHANCEMENTS TO THE BASEL II FRAMEWORK (2009), http://www.bis.org/publ/bcbs150.pdf [hereinafter BIS REPORT: ENHANCEMENTS TO BASEL II]. *See also* Peter Miu, Bogie Ozdemire, & Michael Geisinger, *Can Basel III Work? Examining the New Capital Stability Rules by the Basel Committee: A Theoretical and Empirical Study of Capital Buffers,* (Feb. 20, 2010), http://ssrn.com/abstract=1556446 (". . . . the Basel Committee has proposed that a buffer range should be established above the minimum capital requirements such that, if Tier 1 capital should fall into the buffer range, [Financial Institutions] would be constrained in the total amount of discretionary earnings distributions.").

ry minimum by introducing capital buffers[219] that will rise and fall in a countercyclical manner.[220] The minimum capital requirement is less onerous than feared by the banking industry. Banks will not have to publish their capital ratios until 2015[221] and will not have to comply with the 3% minimum until the end of 2017.[222] To avoid a repeat of the Lehman Brothers collapse, however, regulators do want banks to retain enough liquid assets to survive a 30-day crisis.[223]

In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) addresses risk taking by banks and other large financial institutions by dramatically increasing the degree of government supervision.[224] The law evolved from earlier proposals, including Senator Charles Schumer's (D-NY) proposed Shareholder Bill of Rights Act of 2009, which set out corporate governance standards,[225] required shareholder input in board elections,[226] and, most importantly, required a shareholder vote on executive compensation disclosures.[227] Schumer's proposal also required that each public company board of directors establish a risk committee.[228] Such a risk committee would be comprised of independent directors and would be "responsible for the establishment and evaluation of risk-management practices."[229] Other legislative proposals included the "TARP Reform and Accountability Act of 2009."[230] Bar-

[219] Adrian Blundell-Wignall & Paul Atkinson, *Thinking Beyond Basel III: Necessary Solutions for Capital and Liquidity*, 2010 OECD J.: FIN. MARKET TRENDS ISSUE 1, 10 (2010) http://www.oecd.org/dataoecd/42/58/45314422.pdf.

[220] *Id.*

[221] Press Release, Bank for International Settlements, Basel Committee on Banking Supervision, Group of Governors and Heads of Supervision Announces Higher Global Minimum Capital Standards 7 (Sept. 12, 2010), http://www.bis.org/press/p100912.pdf.

[222] *Id.* at 2 ("In July [2010], Governors and Heads of Supervision agreed to test a minimum Tier 1 leverage ratio of 3% during the parallel run period. Based on the results of the parallel run period, any final adjustments would be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration.").

[223] Nout Wellink, Chairman, Basel Committee on Banking Supervision, Remarks at the Institute of International Finance 2010 Spring Meeting, *The Basel Committee and Regulatory Reform* 6 (Jun. 11, 2010), http://www.bis.org/speeches/sp100611.pdf ("Banks must hold a stock of high-quality liquid assets that is sufficient to allow them to survive a 30-day period of acute stress.").

[224] Dodd-Frank Act, Pub. L. No. 111-203, § 111 (2010).

[225] Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. § 5 (2009).

[226] § 4.

[227] § 3.

[228] § 5(e).

[229] § 5(e)(5)(A).

[230] TARP Reform and Accountability Act of 2009, H.R. 384, 111th Cong. (2009).

ney Frank (D-MA), the Chairman of the House Financial Services Committee, introduced the act to harmonize and broaden executive compensation standards applicable to companies accepting government financial assistance.[231] Representative Gary Peters (D-MI) introduced a more expansive version of the proposed law, the Shareholder Empowerment Act of 2009, on June 12, 2009.[232]

The Dodd-Frank Act that was eventually passed by Congress and signed by the President includes many of these provisions in thousands of pages of text.[233] The Act is enormous and far-reaching, and we point out here only a few of its most notable provisions. The Act creates a new "super regulator," the Financial Stability Oversight Council, to oversee the financial industry and address future financial crises.[234] The Council has the power to identify firms that threaten stability[235] and subject them to stricter oversight by the Federal Reserve.[236] The Federal Reserve and the Council can break up firms that have not responded to stricter oversight measures and continue to pose a threat.[237]

The Act also creates a new "resolution," or orderly liquidation, authority in which the Federal Deposit Insurance Corporation (FDIC) is given broad discretion to intervene between a financial institution and its creditors.[238] Critics of the Act say that this institutionalizes the bailout process.[239] Whereas European countries, including Germany, have been accustomed to a high degree of government intervention in the banking sector, including government ownership of some banks, the Dodd-Frank Act represents an acknowledgment in the United States that some financial institutions are too big to fail and government oversight and wind-up authority cannot be limited

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231 Deborah S. Prutzman, *The Changing Roles of Directors as a Result of the Financial Crisis*, 1766 P.L.I. Corp. 85, 97 (2009).

232 H.R. 2861, 111th Cong. (2009).

233 The rules promulgated under the Act will surely be thousands of more pages.

234 Dodd-Frank Act § 111 (2010).

235 § 112(a)(1).

236 § 113(a)(1).

237 § 165(d)(5)(B).

238 *See* § 172.

239 *See* John B. Taylor, *The Dodd-Frank Financial Fiasco*, WALL ST. J., July 1, 2010, at A19, *available at* http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748703426004575338732174405398.html (suggesting that the Act should have included reform of "Fannie Mae and Freddie Mac, the government sponsored enterprises that encouraged the origination of risky mortgages" and "reform of the bankruptcy code to allow large complex financial firms to go through a predictable, rules-based Chapter 11 process without financial disruption and without bailouts").

to commercial banks and other deposit-taking institutions. The U.S. has rescued many large investment banks, insurance companies, investment funds, and other firms, and the Act seeks to make that process more predictable and orderly.

The Act also creates a new federal entity, the Consumer Financial Protection Bureau.[240] The Bureau regulates consumer lending, which was the origination point for much of the financial risk taking that precipitated the 2008 crisis in the United States.[241] Consumer lending has been substantially less aggressive in Germany, making this aspect of financial reform less urgent there.[242] As pointed out above, reckless borrowing by poorer EU member states was the origination point in Europe for bad loans, and reform measures there are likely to focus on that aspect of the problem rather than on consumers.

The Dodd-Frank Act bestows on federal agencies broad regulatory authority over the trading of derivative securities and other financial instruments that were also blamed for the financial crisis.[243] Regulation of the over-the-counter derivatives market means that investors will trade many of these instruments, including credit-default swaps, through an organized clearing system that is intended to provide more transparency and liquidity. The Act requires bank-holding companies to spin off riskier derivatives trading into separate affiliates.[244] Earlier drafts of the legislation had even more sharply curtailed the ability of financial institutions to trade in derivative securities for their own account, but these provisions were scaled back after intensive lobbying by the banking industry.[245]

Risky investment funds are another area of concern. The Act restricts a banking entity from having an ownership interest in or be-

[240] Dodd-Frank Act § 1011 (2010).

[241] § 1011(a). The Act, however, exempts loans originated by auto dealer from the Bureau's oversight. §1029

[242] *German Growth, Confidence Create Virtuous Circle*, GULF TIMES, Aug. 27, 2010, http://www.gulf-times.com/site/topics/article.asp?cu_no=2&item_no=382337 &version=1&template_id=48&parent_id=28 (explaining private consumption driving domestic demand has traditionally lagged in Germany); Christel Kucharz, *German Leaders Blame U.S. for Financial Crisis*, WORLD VIEW (Sept. 25, 2008 7:58 AM), http://blogs.abcnews.com/worldview/2008/09/german-leaders.html (alluding to German banks losing money on loans originating in United States).

[243] *See, e.g.*, Dodd-Frank Act § 171(b)(7)(B)(i), § 610 (2010).

[244] § 608.

[245] *Banks Lobby Against Ban on Derivatives Trading*, DEALBOOK (May 10, 2010), http://dealbook.blogs.nytimes.com/2010/05/10/banks-lobby-against-derivatives-trading-ban (discussing banking industry lobbyists convincing lawmakers to scale back bill aspects negative to the industry).

ing a sponsor of a private equity or hedge fund if such investments amount to more than 3% of the bank's Tier 1 capital or the bank's interest is more than 3% of the total ownership of the fund.[246] Private equity and hedge funds with assets under management of $150 million or more will have to register with the SEC,[247] although venture capital funds will be exempt from full registration.[248]

The Act also continues the federal government's deep incursion into corporate governance that began in earnest with the Sarbanes-Oxley Act of 2002.[249] Whereas Sarbanes-Oxley regulated the composition and responsibilities of audit committees,[250] the Dodd-Frank Act requires a broad range of financial services firms also to have a risk committee.[251] The Act requires all publicly traded nonbank financial companies supervised by the Board of Governors of the Federal Reserve System to have a risk committee.[252] Also, all publicly traded bank-holding companies with assets of more than $10 billion must have a risk committee.[253] The risk committee is responsible for overseeing the firm's risk management practices, and the committee must have at least one risk-management expert having experience with similar firms.[254] The Board of Governors of the Federal Reserve is empowered to decide how many independent directors must serve on the committee.[255] The introduction of the risk committee will be a significant change because most boards now delegate risk oversight to

[246] Dodd-Frank Act § 619(d)(4)(B)(ii) (2010).

[247] § 408(m)(2).

[248] § 407.

[249] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

[250] *See, e.g.*, § 301.

[251] *See* Dodd-Frank Act § 165(h) (2010).

[252] *Id.*

[253] § 165(h)(2)(A).

[254] § 165(h)(3).

[255] § 165(h)(3)(B). As pointed out earlier in this Article, the emphasis in U.S. corporate law, the Sarbanes-Oxley Act, and now the Dodd-Frank Act on independent directors is not shared in many other countries, including Germany. Skeptics worry that perhaps because of their lack of ties to the company, independent directors do not have access to the information that they need to stop risks such as those that led to the 2008 financial crisis. *Bank Boards in the Aftermath of the Financial Crisis*, MOODY'S INVESTORS SERVICE 6 (March 2010), *available at* http://www.directorship.com/media/2010/03/Moodys-Bank-Boards-Mar-2010.pdf (discussing the importance of factors other than board independence in attaining board effectiveness, namely size of board); *see generally* David Yermack, *Remuneration, Retention, and Reputation Incentives for Outside Directors*, 59 J. FIN. 2281 (2004) (discussing how incentives structure relate to effectiveness of independent directors).

the audit committee.[256] This new committee could increase the size of the board and perhaps result in hiring of new staff for the risk-management committee. This requirement also could result in more litigation if the composition of the risk committee or its alleged failure to do its job appropriately becomes a basis for additional shareholder suits.

The Dodd-Frank Act is notable not only for its sheer length and the enormous power it bestows on the federal government but also for what it does not do. It does not break up the largest banks in the United States, which would have been one approach to the "too big to fail" problem. It does little to help smaller and regional banks compete with the big banks. Because complying with regulation is burdensome and expensive, the Act may have raised the barrier for entry into the financial services industry. The Act does not restore the separation of commercial banking from investment banking that characterized the United States financial market before the repeal of the Glass-Steagal Act in 1999, which many observers, including former Federal Reserve Chairman Paul Volcker, recommended be restored.[257] In some ways, Dodd-Frank may make the United States more similar to Germany and some other European countries that are dominated by a few gigantic banks which are allowed to do both commercial and investment banking but must also follow government dictates about what they can and cannot do.

## V. CONCLUSION

In Germany, the introduction of the business judgment rule in § 93(1)–(2) of the AktG could be indicative of a trend towards loosening the substantive standard of care. The imposition of an ownership requirement of €100,000 (about $127,090) for shareholders to have standing to sue on behalf of the corporation in a derivative suit in § 148(1) of the AktG makes at least this aspect of procedural rules more favorable for defendant directors. These developments are counterbalanced by the removal of some excessively risky decisions from the business judgment rule protection in the ARAG decision

[256] *Hot Topics: What Might Companies Do about the Risk Elephant in the Room?*, DELOITTE 1 (October 2009), *available at* http://internalaudits.duke.edu/documents/HotTopics_RiskElephant6_4_10.pdf (observing how less than 6% of one sample of companies has board-level standing risk committees).

[257] *See Dodd-Frank Alert: Regulators Take Center Stage*, DLA PIPER (2010), http://www.dlapiper.com/files/upload/dodd-frank-act-intro.pdf; Matthew Benjamin & Christine Harper, *Volcker Urges Dividing Investment, Commercial Banks* (Update1), BLOOMBERG (Mar. 6, 2009 11:48 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=atSsZ5Fp8xuY&dbk.

and some post-2008 developments, including the introduction of the VorstAG, which requires personal liability of the Vorstand for taking unusual risks and of the Aufsichtsrat for failure to appropriately determine management compensation. The German legislature also seems inclined to prohibit market practices that it believes result in excessive risk taking and potentially destabilized markets. The pending prohibition of naked shorts and credit-default swaps in Germany and the EU illustrates this trend.

In the United States, Delaware courts have not explicitly imposed a duty to monitor risk. Because failure to disclose risk is a violation of federal securities laws, however, this may be a moot point. Unmonitored risk is likely to be undisclosed risk. The Dodd-Frank Act now introduces a mandatory risk committee. The Act also continues the trend in the Sarbanes-Oxley Act toward a federally mandated approach to corporate governance. The federal government is prepared to tell financial services firms what they can and cannot do. The government also has new powers to sort out the mess the next time firms do not do what they are supposed to do or do it poorly.

In both Germany and the United States, there are likely to be new substantive rules in response to what policy makers and the public believe to be excessive risk taking that led to the financial crisis. In the United States in particular, tightening of the substantive rules could also lead to more litigation. More government interference in corporate governance is likely in both countries. It is unclear if the resulting increase in monitoring costs will be offset by a decrease in the costs of bad business decisions that are avoided because of the new rules. Depending on the cost of additional litigation and government interference, the trade-off between the cost and the benefit of imposing a duty to monitor risk on board members may or may not be "worthwhile" from the company's perspective, or even that of society as a whole. Indeed, the company's perspective may not matter so much given the current political climate and concern about social externalities of business failure. The severity of the substantive monitoring requirement and the procedures used to enforce it may increase regardless of net costs to the company.