Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability

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Berle’s Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability

Claire Hill and Richard Painter†

Abstract

This essay, published in a symposium on the work of Adolf Berle, approaches the Berle-Dodd debate from the perspective that corporate managers have responsibilities beyond pursuing the interests of shareholders. Stock based executive compensation, designed to align managers’ interests with those of shareholders, has, in the investment banking industry in particular, failed to avert, and may have caused, managers (in this case, bankers) to take excessive risks that in the present financial crisis inflicted great damage on creditors and on society as a whole. We describe here the broad outlines of a proposal that we will discuss in future publications in more detail to impose some measure of personal liability for a bank’s debts on the most highly paid bankers. The proposal would revive two mechanisms that imposed such personal liability in an earlier era: general partnership, which was common for investment banks prior to the 1980s, and assessable stock, which was relatively common in corporations (including some commercial banks) through the 1930s. One proposal is that bankers earning over $3 million per year be required to enter into a partnership/joint venture agreement with the employing bank that would make them personally liable for some of the bank’s debts. The other proposal is that compensation in excess of $1 million per year be paid to bankers only in stock that is assessable in the event

† University of Minnesota Law School. Thanks to the participants at the symposium In Berle’s Footsteps at the Adolf A. Berle, Jr. Center on Corporations, Law & Society at Seattle University School of Law, November 2009, and at faculty workshops at IDC Herzliya, Hebrew University, and the University of Minnesota Law School.
of the bank's insolvency in an amount equal to the book value of
the stock on the date of issue. In either case, the bankers' liability
would not be unlimited: they would be allowed to shield $1 million
from creditors. Imposing genuine downside risk through these or
other vehicles for personal liability may be the best way to make
bankers approach risk in a manner that reflects the potential for
externalities of the sort the crisis has so dramatically demonstrated.

I. INTRODUCTION

For close to eighty years, the debate between Adolf Berle and Merrick Dodd has been a linchpin for discussion of the principal duties of
corporate officers and directors. As pointed out in other papers pub-
lished in this symposium issue, Berle did not repudiate Dodd's argument
that officers and directors have obligations to creditors, employees, and
society as a whole. While he did argue for legal rules that would rein-
force officers' and directors' duties to shareholders, his arguments were
based on practical necessity. Making officers and directors responsible
principally to shareholders was better than allowing them to continue to
be responsible to nobody at all.

Berle's arguments were perhaps easy to mischaracterize as some-
thing they were not: broad philosophical statements about corporate pur-
pose. As the 1930s and the Depression wore on, Berle and Dodd both
recognized the broad social implications of managerial misconduct that
had occurred in the 1920s.1 With banks failing and unemployment lines
growing longer, the public also recognized that these social implications
extended well beyond the losses suffered by shareholders. It was clear
then, as it is clear in today's financial crisis, that shareholder (and even
creditor) losses are only a small part of the damage done.

Much has been written about the causes of the present crisis, how
future crises might be prevented, and how the damage from any crisis
might be limited. There has been some focus on compensation packages
of the bankers (a term we use generically in this essay to refer to highly-
compensated employees in banks) whose decisions effectively caused the

1. Berle's best-known book, written together with Gardiner Means is The Modern Corporation
and Private Property (1932). For a thoughtful analysis of Berle's work, see William W. Bratton &
Michael L. Wachter, Shareholder Primacy's Corporatist Origins: Adolf Berle and the 'Modern
Corporation,' 34 J. CORP. L. 99 (2008). Dodd's perspective on the social responsibility of corporate
managers is set forth in E. Merrick Dodd, Jr., For Whom are Corporate Managers Trustees?, 45
HARV. L. REV. 1145 (1932). For Dodd's perspective on these problems toward the end of the Great
Depression, see E. Merrick Dodd, Jr., The Modern Corporation: Private Property, and Recent Fed-
eral Legislation, 54 HARV. L. REV. 917 (1941).
But what has been criticized is the bankers' upside—the amount of money executives received if their firms did well. For reasons discussed below, we think that restricting upside is not enough. Bankers should be exposed to some downside risk as well, preferably in the form of some personal liability if their firms fail.

In this essay, we argue that bankers should be subject to some form of personal liability. We propose two possible approaches: a mandatory partnership/joint venture agreement and assessable stock. We sketch out these proposals in general terms, leaving a full exposition to future publications. Part II provides some background on the historical aspects of investment and commercial banks. Parts III through V address the theoretical underpinnings for our proposals. We describe our proposals in Part VI. We then consider and respond to some objections to our proposals in Part VII. Part VIII concludes.

II. (SOME) HISTORY AND BACKGROUND

Investment and commercial banks historically used arrangements that at least tried to tie financial interests of bankers at senior levels to the fate of creditors, including customers and depositors. One notable arrangement, used particularly before the 1930s, was assessable stock—stock that, as we explain in more detail below, may require the holder to pay amounts in addition to any amount he initially paid for the stock. Some commercial banks, as well as some other corporations, issued assessable stock to their directors and officers. When banks failed after the 1929 crash, state bank regulators and other receivers sought funds by making assessments on the assessable stock. Stockholders challenged the assessments, raising constitutional and statutory interpretation issues, but courts often upheld the assessments. For example, in *Broderick v. Rosner*, an opinion written by Justice Brandeis, the Supreme Court held


that under the Full Faith and Credit Clause of the United States Constitution, the New York Superintendent of Banks could bring suit for assessments against New Jersey residents holding stock in a New York bank. The Court held that the defendants could not avail themselves of a New Jersey statute prohibiting the initiation in New Jersey of suits brought under the laws of another state to enforce stockholders’ personal liability. The Court, Justice Brandeis observed, would not allow the New Jersey defendants to escape their voluntarily assumed statutory obligation:

In respect to the determination of liability for an assessment, the New Jersey stockholders submitted themselves to the jurisdiction of New York. For ‘the act of becoming a member (of a corporation) is something more than a contract, it is entering into a complex and abiding relation, and as marriage looks to domicile, membership looks to and must be governed by the law of the State granting the incorporation.’ . . . Obviously recognition could not be accorded to a local policy of New Jersey, if there really were one, of enabling all residents of the State to escape from the performance of a voluntarily assumed statutory obligation, consistent with morality, to contribute to the payment of the depositors of a bank of another State of which they were stockholders.  

6. Justice Louis Brandeis was ideally suited to write this opinion on assessable stock in a banking corporation. His book OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT (1914) was widely read, particularly by New Dealers in the Roosevelt Administration.

7. Rosner, 294 U.S. 629. Justice Brandeis’s opinion opened with a description of the relevant statute:

Pursuant to article 8, s 7, of the Constitution of New York, its Banking Law (Consol. Laws, c. 2) provides, section 120: ‘The stockholders of every bank will be individually responsible, equally and ratably and not one for another, for all contracts, debts and engagements of the bank, to the extent of the amount of their stock therein, at the par value thereof, in addition to the amount invested in such shares.’ Id. at 637.

Justice Brandeis then described the procedure used in this instance against the New Jersey defendants and upheld by the Supreme Court:

[On December 11, 1930, Broderick pursuant to section 57 of the New York Banking Law, took possession of the Bank’s business and property; that since May 6, 1931, he has been engaged in liquidating the same; that prior to July 1, 1932, he determined, pursuant to sections 80 and 120, that the reasonable value of the assets of the Bank was not sufficient to pay the creditors in full and that there was due them $30,000,000 in excess of such reasonable value; that the deficiency then fixed and determined has continued ever since; that upon the Superintendent of Banks is imposed the duty of making assessment upon the stockholders and enforcing the liability of stockholders for the benefit of the creditors and that actions to enforce the liability are to be brought in the name of the Superintendent; that prior to July 1, 1932, he determined that an assessment of $25 against each stockholder for each share of stock held by him was required for the payment of the Bank’s indebtedness; that he duly made upon each stockholder a demand for the payment thereof on August 8, 1932; and that among the stockholders upon whom such demand was made and who failed to pay are the several defendants. Id. at 641 (footnote omitted).  

8. Id. at 643–44 (citation omitted).
Stock ownership was thus a lot more than a simple contract; it was a relationship that involved legal and moral obligations to the corporation's creditors. As the New York statute demonstrates, these obligations were particularly strong when the corporation was a bank. In this era, before extensive federal regulation of banks, the state where a bank was chartered had the primary responsibility for defining the terms of that relationship.

However, without adequate federal government oversight of banks, state-mandated shareholder assessments proved inadequate to control banks' excessive risk taking. After the 1930s, the federal government forced the commercial banks out of the stock market and other aspects of investment banking in the Glass-Steagall Act, guaranteed commercial bank deposits, and regulated commercial banks for safety and soundness. In this post-Depression world, assessable stock was presumably no longer necessary because the government would tell the commercial banks how to manage their affairs and bail out depositors when banks failed.

Investment banks, on the other hand, were not regulated for safety and soundness. Indeed, these banks were subject to relatively little government oversight other than the customer protection regime imposed on broker-dealers by the 1934 Securities Exchange Act. But there may have been little need for such oversight. Until the 1980s, most investment banks were general partnerships run by partners who were personally liable for the debts of their firms. A partner of Lehman Brothers did not want or need the government to tell him how to run his business; if the business failed, the partner paid. Firms that did not exercise restraint failed in the next market downturn and they took their improvident partners with them.

All of this began to change in the 1970s. In 1970, the New York Stock Exchange changed its rules to allow brokerage firms to have a public float, a change arguably motivated by the need for outside capital. Most brokerage firms ceased being partnerships in which owners are unlimitedly liable; they became corporations, offering owners limited liability up to the amount of an investor's investment. The people who had been partners at these firms, and had had unlimited liability, became managing directors of the successor corporations, with no liability for their firms' obligations—a fact little discussed at the time. During the 1970s and 1980s, most of the major Wall Street firms switched from

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11. Id. at 278–79 (discussing the impact of the NYSE rule change).
partnership form to corporate form; the last holdout, Goldman Sachs, did much of its business through limited liability entities until it also abandoned partnership form in 1999. On the commercial banking side, government oversight gradually loosened, particularly when the Gramm-Leach-Bliley Act repealed much of the Glass-Steagall Act in 1999. Commercial bank holding companies, if not the banks themselves, could now carry a considerable amount of risk on their balance sheets. Commercial banking and investment banking also became more difficult to distinguish. This was true not only as to the businesses they conducted. It was also true as to how they compensated their managers -- mostly in stock and stock options. The now-familiar rationale was that the more stock the managers owned, the more faithful they presumably would be to their companies’ shareholders. The emphasis on stock-based compensation reflected that in many influential quarters, shareholder primacy had become the norm. To overstate the case (but not by much), many believed that making managers shareholders would solve everything. Thus, one of the problems that Berle identified—that managers too often do not do what stockholders want them to do—was supposedly solved, with enormous, some would say grotesque, stock compensation plans. The broader problem that Berle, Dodd and Brandeis had discussed—that corporations and particularly banks were sometimes run in a socially irresponsible manner—was largely ignored.

III. THE FINANCIAL CRISIS

Until 2008. We will not discuss in detail what led up to the present financial crisis; we will only state the obvious. Banks took excessive risks—risks that were not commensurate with the associated potential rewards. The government bailed out some of the banks at enormous cost to taxpayers. The creditors who were not bailed out suffered huge losses. Bank employees lost their jobs. The world went into the deepest economic downturn since the 1930s. People lost their homes.

12. See id. (discussing the changeover from partnerships to corporations by most Wall Street firms).
15. If managers hold significant shareholdings, their interests will therefore be at least somewhat aligned with those of shareholders. There are many articulations of this classic and common sense view. One such articulation, in a court case, is In re Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998), in which the court noted that directors with significant shareholdings in Disney would not be motivated to vote for a too-high compensation package.
16. See Bebchuk & Spamann, supra note 2 (citing publications of Berle and Dodd); see also Morrison & Wilhelm, supra note 10 (citing LOUIS BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT (1914)).
The bankers whose risk-taking precipitated this crisis saw the value of their stocks and options in their companies fall dramatically. But they kept the money they had earned in previous investment banking jobs where they probably took similar risks. They kept the amounts they had earned on their present job that had been paid in cash; they also kept the amounts paid in stock that they had managed to turn into cash before the crash. 17 If they were particularly lucky, they had already left their banks for a government job regulating banks, and had been forced by government ethics lawyers to sell their bank stock at the high prices that prevailed before 2008—with an Office of Government Ethics certificate of divestiture thrown in so capital gains tax would be deferred. 18 They kept whatever family money they had. They kept their homes, their cars, their jets and everything else not tied to bank stock or stock options. Some of these bankers lost an extraordinary amount of money, others less. They almost all, however, had a lot left over.

IV. FROM PARTNERSHIP TO LIAR’S POKER AND WORSE

How did this happen? As we mentioned earlier, investment banks used to be partnerships; the “managers” were partners, unlimitedly liable for obligations of their banks. If the banks failed they would not have much of anything left over. In what follows, we trace in a bit more detail the trajectory by which investment banks became corporations and bankers became “managers” with limited liability shields.

In earlier years, investment banking partnerships were managed by partners. Partners face a real downside if their business fails. They are personally liable for the debts of their partnership; they can lose their savings, their houses, and just about everything else. In investment banking partnerships, it often took many years for someone to become a partner because the other partners had to be willing to risk everything on the new partner. Because they bore the collective responsibility of paying creditors, they were collectively involved in risk taking over certain dollar amounts, sometimes huddling together on their trading floor to discuss a big trade. In contrast, commercial banks were organized as limited liability entities. Their managers thus did not have the same constraints investment bankers had on risk-taking; what did constrain their risk-taking was government regulation.


Salomon Brothers provides a good example of risk-taking informed and constrained by the potential for unlimited liability. Salomon Brothers took calculated risks. It specialized in bonds, and developed its business with the expansion in government and corporate bond offerings in the years after the Great Depression. The firm conducted high-quality bond market research, although most of this research focused on predicting interest rates and analyzing the yield curve (the relationship between the interest earned on a bond and its maturity). Like the rest of Wall Street, Salomon relied on the major rating agencies, Moody’s and Standard and Poor’s, to analyze borrower creditworthiness. In an era before credit default swaps and other recent innovations in debt markets, Salomon’s bond business was considered to be one of the most boring parts of an investment banking business that was itself relatively boring. The firm’s partners appreciated the lack of excitement: as young men, during the Depression, they had seen too much “excitement” in their financial affairs. In the 1960s, when Salomon became one of Wall Street’s biggest firms, it was run by William Salomon and other senior partners. This generation of bankers knew what it was like to have a banking partnership fail and be stuck personally paying firm creditors.


20. Id. A Salomon researcher could likely provide information regarding the yield on a debt instrument in ancient Mesopotamia. See SIDNEY HOMER, A HISTORY OF INTEREST RATES (Rutgers University Press 1963) (tracing interest rates back to the year 2000 B.C.). Martin Leibowitz brought the mathematical modeling of the yield curve to Solomon. See SIDNEY HOMER & MARTIN L. LEIBOWITZ, INSIDE THE YIELD BOOK: NEW TOOLS FOR BOND MARKET STRATEGY (Prentice Hall & the New York Institute of Finance 1972). Henry Kaufman became Salomon’s chief economist and earned his reputation as “Dr. Doom” when he consistently, and usually correctly, predicted that interest rates were headed up. Salomon researchers even continued to work together after they had left the firm. See SIDNEY HOMER & MARTIN L. LEIBOWITZ, INSIDE THE YIELD BOOK: THE CLASSIC THAT CREATED THE SCIENCE OF BOND ANALYSIS (Bloomberg Press 2004) (this more recent edition includes a foreword by Henry Kaufman and two new sections by Martin Leibowitz).

21. Analysis of borrower creditworthiness was for the most part outsourced to the rating agencies; (issuer-specific research for equity securities, by contrast, has traditionally been done by in-house analysts at most major Wall Street firms. This reliance on rating agencies apparently worked for several decades. However, by the 1980s, Salomon was a corporation, and would become a key player in the development of exotic debt instruments that made borrower creditworthiness increasingly difficult to analyze. Would the earlier generation of bond market researchers have recognized that reliance on the credit rating agencies was increasingly problematic? Maybe less-than-ideally-careful investment bankers could not recognize less-than-ideally-careful (and, some argue, conflicted) rating agencies. For discussion of the problems rating agencies had in rating the securities involved in the crisis, see CLAIRE A. HILL, Why Did the Rating Agencies Do Such a Bad Job With Subprime Securities?, 71 U. PIT. L. REV. 585 (2010).

22. See supra note 19.

23. We should disclose that Sidney Homer, a partner of Salomon Brothers and head of its bond market research department until 1972, was Mr. Painter’s grandfather. Earlier, Mr. Homer had
Salomon's capital belonged to the partners; there were no shareholders. The money partners invested was their own, and they had to leave as much of it as possible in the firm so the firm could grow. Large cash distributions to the firm's partners were not an option; raising capital from outside investors or borrowing funds simply was not feasible. Partnership tax rules made the cash flow situation even more challenging: partners paid taxes on the firm's profits whether or not the profits were distributed to them. Between the tax demands of the government and the capital requirements of the firm, investment banking partners had to lead relatively modest lives. When they retired, partners usually had a significant amount of money in the firm, but it was paid out slowly over several years because the firm still needed the capital.

Beginning in the 1970s and 1980s, many of these investment banks switched from partnership form to corporate form; with corporate form, the banks could access huge amounts of capital from stockholders and other investors. For the investment bankers who ran these firms, the switch also brought important new developments: liquidity for the money they had locked up in their firms; a compensation system based on bonuses, stock, and stock options instead of slow but steady accrual of partnership capital within the firm; and, most significant to our analysis here, no personal liability for the debts of the firm. Each firm had its own trajectory, but the impact on investment bankers' behavior seemed uniform. Wall Street changed in the 1980s, from a fairly staid place to

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24. Top federal income tax brackets have fluctuated but have been as high as 94% during World War II and 70% throughout the 1970's. These rates were lowered significantly in 1981. For historical information on tax rates from 1913 to 2002, see http://www.irs.gov/pub/irs-soi/02inpetr.pdf.

25. The partners' and retired partners' capital was often the only capital the firm had. Investment bankers in those days could live in nice homes and put food on the table; they even rode in limousines to work and probably spent too much of their money on cigars. They did not, however, live the lavish lifestyles that many investment bankers live today. With the cigars mostly gone, Wall Street investment bankers' bodies are probably healthier—but, as the crisis has made clear, their firms are not.

26. See supra note 10 and accompanying text. The New York Stock Exchange rules once prohibited brokerage firms from being publicly held, but this rule was changed in 1970. Id.

27. Michael Bloomberg was one of the Salomon Brothers partners who withdrew money from the firm in 1981, the year he also left the firm. He used the money to start his electronic financial information service that eventually made him billions. See http://ecommerce.hostip.info/pages/111/Bloomberg-L-P-EARLY-HISTORY.html
one where frenetic risk-taking became the norm. Limited liability, and the moral hazard that comes with it, is an important reason for the change.

Again, Salomon Brothers provides an example. It switched from partnership form to corporate form in 1981 when it merged with Phibro Commodities. After the switch, traders now traded with other people’s money, not with their own or their partners’ money. Their personal assets outside of the firm were not at risk. The age of Liar’s Poker had begun. Michael Lewis’s description in this book, published in 1989, of the term used for a star trader—a “Big Swinging Dick”—reflected not only the rise of obscenity on trading floors, but also an ethos in which investment bankers engaged in risky conduct and were no longer personally responsible for their actions. Senior management steered the firm into junk bonds, and several top executives, including economist Henry Kaufman, quit in protest. A scandal involving a rogue trader in the 1990s was disastrously handled by senior management until shareholder Warren Buffett (one of the few shareholders in America who does not have to worry about the Berle-Means problem) intervened and fired top management. By the late 1990s, the firm’s name had lost its luster and what remained of Salomon’s investment banking business was, along with Phibro, merged into Sandy Weill’s financial empire at Citicorp. Citicorp could run the business as it pleased, with relatively little federal oversight: the commercial bank Citibank was kept separate. One more

28. See infra notes 30–32 and accompanying text.
29. See supra note 19.
30. MICHAEL LEWIS, LIAR’S POKER: RISING THROUGH THE WRECKAGE ON WALL STREET (Penguin Books 1990). Lewis’s account begins when he was hired by Salomon in 1984 and the training class he participated in shortly thereafter. By the time Lewis joined the firm, Salomon had only been a corporation for three years; however, from his account, it appears the culture had already changed.
32. For discussion of Warren Buffett’s role at Salomon, see ROGER LOWENSTEIN, BUFFETT: THE MAKING OF AN AMERICAN CAPITALIST (Main Street Books 1996). For a discussion of the role of the General Counsel in the treasury bid scandal at Salomon, see Painter & Duggan, supra note 31. Nobody, including Salomon’s General Counsel Don Fauerstein, reported the rogue trader’s misconduct to the Board of Directors, even though senior management would not do anything about it. Warren Buffett, as a member of the Board and a major investor, was understandably upset. The firm’s reputation, built up over many years by its partners and employees, was ruined in a few months. The Salomon incident and other similar incidents led to proposals (eventually enacted in Section 307 of the Sarbanes-Oxley Act of 2002) to require corporate lawyers to address this aspect of the separation of ownership from control by reporting known illegal acts to client boards of directors.
detail contributed to the impending disaster: the Glass-Steagall Act was repealed. The Act had prohibited commercial banks from getting into investment banking; it was repealed thanks to pressure from banks—pressure that was legitimized by the then-enormous faith in markets and market actors.

This history suggests that when investment banks became corporations, they changed dramatically from what they had been as partnerships. It is as corporations, with their new-found corporate ethos, that they engaged in the behavior that arguably caused the financial crisis. Corporations, of course, must act through individuals. Our next section discusses why a corporate manager might take excessive risks even if he has a significant financial stake in the corporation—risks that he probably would not have taken had he been a partner in a partnership.

V. THE PSYCHOLOGY OF LIMITED LIABILITY

Imagine a casino that you can enter with no money and no chips. You are given chips when you enter the casino, and the more time you spend in the casino, the more chips you are given. You are supposed to gamble with your own chips and the chips of other people outside the casino called “investors” or “customers.” If you bet and win, you get to keep all of your own winnings and some of the winnings from the people you gamble for. If you win big, the casino gives you more chips as a bonus. You know, however, that you can be kicked out of the casino if you talk too much about excessive risk-taking by other gamblers in the casino or suggest that it might be provident for the government to regulate the casino. At any time, you can leave the casino, cash in your chips, bank the money, and move on to another casino that will let you play by the same rules with new chips. If you lose, the most you can lose is all of your chips and money of the people you were gambling for. Whatever property you had before you entered the casino is still yours. If you are lucky, you will cash in your chips before things get really bad.

34. See supra note 13.

35. Some subsequent history is of interest. Phibro’s business turned out to be extremely risky and its compensation arrangements with its top executive, Andrew Hall, turned out to be extremely generous: a year after Citibank had gotten billions of federal bailout dollars, it was supposed to pay Hall over $100 million. This led Citicorp to rethink limited liability, albeit under pressure from the federal government. Citicorp was apparently considering spinning off Phibro as a general partnership with Mr. Hall as a managing partner. Eric Dash, Citigroup Considers Changes at Phibro, N.Y. TIMES, Aug. 7, 2009, at B1 ("Citigroup executives are considering what to do next. One option would be to transform Phibro into a partnership headed by Mr. Hall."). Citicorp ended up solving the problem in a different way: by selling Phibro, along with Mr. Hall’s bonus problem, to Occidental Petroleum. See David Enrich, Ben Casselman & Deborah Solomon, How Occidental Scored Citi Unit Cheaply: Bailout, Andrew Hall Factor Hurt Bank’s Bargaining Position; ‘Why Should I Pay a Premium?’, WALL ST. J., Oct. 12, 2009, at A28.
Even if things get really bad, you might have enough influence in Washington to get the government to bail you out by giving you more chips.

Before the 2008 crisis, banking in the post-partnership era was much the same. Many people have argued that the structure of manager compensation contributed significantly to the crisis: managers got huge bonuses based on short term results. These commentators have argued that giving managers more of their compensation in the form of long-term stock options, or stock to be held long term, might be an important solution. This suggestion accords with common sense: one might think huge equity stakes would suffice to make bankers proceed very cautiously before incurring huge risks, especially risks that the bankers (at least many of them) are now plausibly claiming they did not understand. How could any banker not think long and hard—longer and harder, apparently, than bankers did think—about the real possibility of losing a great deal of their own money, perhaps amounting to hundreds of millions of dollars? The casino analogy above suggests an answer; in what follows, we elaborate and offer various complementary explanations.

Various terms and frameworks in psychology are available to describe the effects at issue: these include “prospect theory,” and more specifically, the “house money effect.” The “house money effect” is a term coined by Richard Thaler. The intuition is straightforward, and he and others have found evidence to support it. A prior gain may be experienced as “house money”—people may be far more willing to make a risky bet with house money than they would with what they might regard as their own money. We share this intuition, and find this dynamic and others like it helpful in explaining why managers took the risks they took. A contrast with a more traditional economic view about risk is instructive. Such a view is hard pressed to understand excessive risk taking of the sort that occurred in the crisis. Paradigmatically, it looks at

37. Daniel Kahneman and Amos Tversky originally developed prospect theory in 1979. See Daniel Kahneman & Amos Tversky, Prospect Theory: An Analysis of Decision under Risk, 47 ECONOMETRICA 263 (1979). Prospect theory’s key elements are: “(1) a value function that is concave for gains, convex for losses, and steeper for losses than for gains, and (2) a nonlinear transformation of the probability scale, which overweight small probabilities and underweights moderate and high probabilities.” Amos Tversky & Daniel Kahneman, Advances in Prospect Theory: Cumulative Representations of Uncertainty, in CHOICE, VALUES, AND FRAMES 44, 44 (Kahneman & Tversky eds., Cambridge University Press 2000).
absolutes: a computation of the expected gains and losses of a particular gamble. The more nuanced view we advance takes into account many other things, including a reference point above or below which a particular outcome would be experienced as a gain (or loss).

More orthodox dynamics may also be at issue, such as the declining marginal utility of money. Beyond a certain point, money for the sake of its purchasing power may not matter much. Thus, bankers may not have minded the prospect of huge losses: despite those losses, many of them are left over with more money than they can reasonably spend on themselves and their families. Moreover, a person may also get enormous utility out of “being in the game”—his identity as a “player” or his acceptance into an elite circle of high rollers may yield significant payoffs. He may also get payoffs in the form of professional and social advancement. He may be motivated, too, by fear of acquiring a reputation for being a “retrograde” banker stuck in “luddite” modes of investing, not savvy enough to recognize and appreciate new investment strategies. In a business world obsessed with stock price, institutional shareholders and stock analysts may shun bankers who acquire a reputation for conservatism in favor of those who are willing to take big risks in highly leveraged firms; indeed, shareholders generally should benefit from risks taken with creditors’ money.

This same risk-prone banker, however, might have a different attitude if faced with the prospect of having very few personal assets left over because he took a bad risk. For a banker assured of always having a certain amount of money, the loss of some money, even a considerable amount, may not matter much. In contrast, for a banker faced with the prospect of having less than a certain amount of money, the loss of more money may matter a lot. The curve is not linear. In other words, what may matter more to a banker than the absolute amount of money he has “in the game” (that is, the amount he can lose) is his position in a worst-case scenario. The possibility of a loss of $950 million of a $1 billion portfolio, having $50 million left over, may matter less than the possibility of a loss of all but $1 million of just about any large portfolio.

We do not need to hypothesize an elaborate reason, whether “rational” or “irrational,” for the bankers to have taken the risks they did. Perhaps they simply were not up to the task of assessing risks properly,

40. Another possibility is that the banker may be a hyperbolic discounter, preferring to ride high in the short term, notwithstanding that he may later have to pay the piper. For a discussion of hyperbolic discounting, see generally David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 Q. J. ECON. 443 (1997).

41. For further discussion about identity payoffs of this sort, see Claire A. Hill, *The Law and Economics of Identity*, 32 QUEENS L. J. 389 (2007).
or were just over-optimistic. Regardless of the explanation, it seems evident from the latest crisis that bankers are willing to take big risks, even when they stand to lose significant amounts themselves, if they are likely to have a significant amount of assets left over. Risk-preferring behavior can be more effectively reduced by focusing on what a banker would have left over after his firm’s risky gamble failed, rather than the amount he personally lost in the gamble.

We should make an additional point: for whatever reason, the process by which “natural selection” chooses the people who rise to the top in banking has, in recent years, favored bankers who are willing to take big risks with the banks they work for, whether or not they have enormous exposure of their own stock holdings to downside risk. Asking how hypothetical “rational” wealth-maximizing bankers who have significant equity interests in their banks would approach risk may be the wrong question. The right question may be: What types of people are likely to be senior managers (and large equity holders) of banks, responsible for making decisions about risks the banks will incur? We may also want to ask what, other than the ineffective approach of throwing yet more stock at these bankers, can be done to recalibrate attitudes toward risk and bring them closer in line with the more conservative expectations of society after the 2008 debacle? We now turn to this question.

VI. IMPOSING (SOME) PERSONAL LIABILITY ON BANKERS

Much discussion about the present financial crisis has addressed the role of bankers’ compensation in precipitating the crisis. However, the principal focus has been on bankers’ short time horizons. Bankers receive bonuses at year-end, based supposedly on results they or their banks have achieved during the year; these bonuses are much larger than a banker’s yearly salary. Moreover, as part of their compensation, bankers typically get stock options; these options are also believed to shorten bankers’ time horizons. Shorter time horizons motivate risk-taking, encouraging bankers to seek year-end results that may not be lasting or may simply be a mirage. Thus, long-term stock holdings are touted as an alternative to bonuses and stock options. More careful monitoring of compensation also has been proposed, as have restrictions on compensation for excessive risk-taking and “say on pay,” shareholder advisory votes on

42. For a discussion of psychological traits of people who become CEOs, see generally Donald C. Langevoort, Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls, 93 GEO. L.J. 285 (2004).

43. See supra note 2 and accompanying text.
executive compensation. Scholars and other commentators have been active participants in the debate, as has the Obama administration.\textsuperscript{44} The agency problem, in which bankers prefer their own interests rather than the interests of those they are supposed to be working for, presumably would be minimized through compensation schemes that would better align bankers' interests with those of the shareholders.

In our view, although it is appropriate to focus on lengthening bankers' time horizons and aligning their interests with those of their shareholders, these measures are far from sufficient to curtail excessive risk taking. Many bankers had enormous equity stakes in their companies and nevertheless took big risks. Indeed, their shareholders may have wanted them to do so (although probably not ex post). Shareholders can lose their investment in a company, but cannot lose more; they get significant upside benefit from risk and bear only part of the downside cost. The rest of the cost has been borne by other actors, including, prominently, taxpayers. And the cost has been enormous.

We argued above that when banks became corporations, they began behaving in a far riskier manner than they had when they were partnerships, and that this increment of extra risk was a significant cause of the crisis. What if we could turn back the clock? Clearly, we cannot do so altogether: general partnership, with the illiquidity and liability it imposes on general partners and the constraints it imposes on a bank's ability to raise capital, probably will not be considered a viable option.\textsuperscript{45} But perhaps we can go part of the way, imposing a form of personal liability for bankers. How would we achieve this? Our objective is to design a way to impose some of the risks of personal liability on the most highly compensated bankers at investment banks and other financial services and trading firms. We seek to do so without requiring the firm itself to switch to general partnership form or to make any other change in its organizational structure. We discuss below two approaches, which could be adopted individually, alternatively, or in tandem with one another. Both would impose on bank-

\textsuperscript{44} See Tung, supra note 2, and Romano, supra note 36. For a discussion of attempts to restrict executive compensation more broadly, see Claire Hill & Brett McDonnell, Executive Compensation and the Optimal Penumbra of Delaware Corporation Law, 4 VA. L. & BUS. REV. 333, 368-71 (2009).

\textsuperscript{45} It should be noted that some investment banks, including Goldman Sachs and Morgan Stanley, have put themselves under commercial bank holding company structures for the time being in order to get access to credit from the Federal Reserve. When the Federal Reserve money is no longer needed, however, these banks will probably want to liberate themselves from federal commercial bank regulations by switching back to the investment banking model they used before. Many other investment banks have remained investment banks. It is uncertain what federal regulation will be imposed on the safety and soundness of investment banks in response to the present crisis.
ers the obligation to potentially pay some amounts from their own assets to pay their firms’ debts. Our discussion is not intended to be comprehensive; our aim here is to sketch out the approaches, leaving the details to future publications.

The first approach is a mandatory partnership/joint venture agreement between certain companies (as defined further below, “Covered Companies”) and certain highly compensated bankers (as defined further below, “Covered Employees”) earning over $3 million per year in compensation. Covered Employees would have exposure to personal liability, just as investment bankers who were partners not so long ago had such exposure. The second approach requires that Covered Companies pay any employee whose compensation exceeds $1 million in any year the excess over $1 million in assessable stock. In the event of firm insolvency, the stock would be assessable in an amount equal to its fair market value at the time of issuance. The assessment would be a personal debt of the record holder of the stock just as it was in the 1930s for the unfortunate holder of assessable stock in a commercial bank that failed.

Other commentators have suggested measures that could change the behavior of bankers by making them think harder about the position of creditors or of their own personal liability for mismanagement. Some of these proposals would affect compensation, while others involve enhanced personal liability for demonstrated wrongdoing. For example, Lucian Bebchuk and Holger Spamann have proposed that bankers’ compensation be tied to the performance of the bank’s debt securities, not just its stock.46 Even before the 2008 crisis, Don Langevoort proposed making it easier to impose personal liability on corporate executives for securities fraud.47 Lyman Johnson has proposed not allowing corporate officers to avail themselves of the protection of the business judgment rule; the rule, he argues, is appropriate only for outside directors.48

These proposals are headed in the right direction, but we are concerned that they may not go far enough. The Bebchuk-Spamann compensation proposal is better than prevailing practices linking compensation principally to reported earnings and stock performance, but it still involves no risk of loss for bankers—only forgone gains—if creditors do poorly. The Langevoort and Johnson proposals make it easier to show management wrongdoing and to impose personal liability, but still turn

46. See Bebchuk & Spamann, supra note 2.
upon a showing of wrongdoing. The uncertainties and transaction costs of any fault-based legal system will limit its influence on executives’ behavior. Realistically, the best we can hope for is modest change for the better. What we will certainly get, whether or not executive behavior changes for the better, is more litigation and more excuses made by executives in the course of defending themselves in litigation.

More importantly, none of these proposals go as far as our proposals do in approaching banking as the type of socially useful yet potentially “ultra-hazardous” activity that should involve (as it has involved at times in the past) some measure of strict personal liability. Although it is debatable how much strict personal liability there should be, and for whom, we strongly believe that at least some liability is necessary and appropriate to curtail the excessive risk-taking that led to the crisis. The people who need the most protection are not shareholders, or even creditors, but rather “the public”—a very expansive list including taxpayers who have funded the bailouts, many other people who have suffered from the financial crisis, and firms that were careful in controlling risk but still lost money in transactions with firms that were not. Bankers who profit enormously from their occupations in good times should be prepared to share in the costs borne by the public when the risks they take do not pan out. We should note, though, that the principal mechanism our proposal relies on is not an additional pot of funds from now liable bankers available for payment to those damaged by a firm’s risk-taking. Rather, we envision that the specter of liability would make them more circumspect about risk, so that the damage would not arise in the first instance, or would be far smaller.

A. Mandatory Joint Venture/Partnership Agreement

The first approach is a Joint Venture/Partnership Agreement (JVPA) between a Covered Company, as defined below, and a Covered Employee as defined below. The joint venture/partnership agreement between the Covered Employee and the Covered Company would exist regardless of the organizational form chosen by the company and the liability rules that normally attach. Indeed, we anticipate that many, if not most, Covered Companies would do business as limited liability entities; the proposed agreement would make some of their employees personally liable for some debts of those companies.

What companies would be Covered Companies? Covered Companies would include categories of companies for which it would be desirable, from a societal perspective, for highly paid executives to be personally responsible for company liabilities. The limited liability rule would continue to shield executives of other companies whose organizational
form provides limited liability. We initially propose for discussion purposes that the list of Covered Companies include most firms that are federally insured banks or bank holding companies; firms that originate, buy, or sell mortgages; firms registered as broker-dealers or investment advisors under the Securities Exchange Act; and at least the larger hedge funds.

What employees would be Covered Employees? We propose that an appropriate threshold amount would be $3 million (to be adjusted for inflation) in annual compensation, where compensation is broadly defined to include, among other things, stock options and phantom stock. Anti-abuse rules would be designed to deal with "creative" ways of structuring compensation so as to avoid Covered Employee status. We recognize that both employees in management positions whose job includes oversight of firm operations and employees (such as traders) who are principally responsible only for their own work and do not have oversight responsibilities could be Covered Employees. The case for imposing liability on the first group is stronger, yet traders and other employees without oversight responsibilities can still have a substantial impact on a firm's risk-taking. Making the second group personally liable for the firm's debts (as trader partners were in the old investment banking partnerships) is likely to make the firm's approach decidedly more conservative. For discussion purposes at least, we propose that the personal liability rule extend to all employees earning over the threshold amount, whether or not those employees are technically corporate officers or managers.

What type of event would trigger personal liability of a Covered Employee under the JVPA (the "Triggering Event")? We mean to include only situations where the company cannot pay the amounts at issue; in this regard, a basic premise of the JVPA is that the Covered Company itself should be primarily liable for its debts and the Covered Employee should only stand in the position of a guarantor similar to that of a general partner in a partnership. Thus, the Triggering Events would include bankruptcy, receivership, and similar events, but not much else.

How long would a JVPA last? Our proposal would specify the beginning and ending dates of JVPAs. The beginning date is easy to specify: the time the employee became a Covered Employee. The ending date is harder, as we want to include some period after the person ceased to be a Covered Employee and indeed, even after the person ceased to be an employee of the company at all. The premise is that a Covered Employee would likely have some responsibility for risks that lead to a bank's insolvency shortly after his departure and thus should have some financial responsibility for the consequences. A starting proposal might
be to extend the joint venture agreement for one year, although the amount of personal liability could perhaps be phased down during that year.

Which of a Covered Company's liabilities would be covered by the JVPA? The main liabilities we mean to cover are those a company would incur because it has taken on financial risk. For example, many contract liabilities to creditors would be covered, as would tort liabilities under the securities laws, including underwriter liability and liabilities for any type of fraud. Most ordinary tort liabilities would not be covered; we see no policy reason why torts unrelated to the financial services business should render a Covered Employee liable. Nor would ordinary contract liabilities be covered if they are of the sort also incurred by companies that are not Covered Companies, such as pension or health care obligations to employees and retirees. In these contexts there is little policy rationale for differentiation between Covered Companies and other companies.

Critically, we are not proposing unlimited liability. But what should the limit be? How far should a Covered Employee's liability extend? Which, and how much, of her assets should be available to her firm's creditors? We propose an exemption that would allow a Covered Employee to designate $1 million in personal assets that would not be subject to attachment by creditors of the Covered Company. We would also exempt assets acquired in the future from reach by the Covered Company's creditors, saving Covered Employees from the humiliation and expense of filing bankruptcy in order to protect future income.

We recognize, of course, that our proposal here is scarcely invulnerable to gaming. In particular, asset protection strategies would probably be developed by which Covered Employees would place their assets out of reach. A more detailed exposition of our proposal will address

49. One objection should be anticipated: people may be liable for matters they had nothing to do with. Our response is as follows: the vast bulk of people subject to our proposal will be high-level managers. While such people may be specialized within the firm, they are senior enough in the hierarchy that they are chargeable with the consequences of whatever happens to the firm. Their bonuses may relate to overall firm results. In partnerships, a partner could not get out of liability by pointing out that he had nothing to do with the activity which had generated liability. There may be highly paid people who are not senior managers. While we recognize the objections to having them be liable for something that happened somewhere else in the firm, it is important to avoid the inquiry into "whodunit." Divisions with more clout may be able to attribute the mistake to other divisions with less clout. If managers' personal liability exposure motivates firms to shrink, we would consider this an additional benefit.

50. Our proposal would also include a higher amount of protected assets for older Covered Employees because such employees would not have sufficient opportunity to rebuild their assets after a firm failure. Otherwise, our proposal might be counterproductive if it encouraged older, more experienced investment bankers to leave the field.
such strategies.\textsuperscript{51} We should note, too, another mechanism by which our proposal might be circumvented: senior management of a Covered Company could arrange a government bailout as an alternative to firm failure.\textsuperscript{52} Without proper safeguards, our proposal could even result in political pressure for bailouts that otherwise would not occur. Thus, for our proposal to be effective and not just become a catalyst for yet more government bailouts, bailouts would have to be conditioned upon contribution by Covered Employees of the same capital amount they would have been required to contribute had the firm failed.

\textbf{B. Assessable Stock}

Our second proposal also imposes liability on bankers if their firms become insolvent. Bankers would receive part of their compensation in the form of assessable stock;\textsuperscript{53} assessments would be made if their firms became insolvent and additional funds were needed to pay the firms’ creditors. Assessable stock can thus be a significant exception to the limited liability rules that normally comes with the corporate form.

Assessable stock is not common today. Indeed, today the norm is stock that is "fully-paid and non-assessable."\textsuperscript{54} Such stock is deemed to be fully paid for (even if the payment is services and the shares are part of a compensation package with a generous salary and bonus) and cannot be assessed. Lawyers starting practice in the last generation might be excused for recounting the phrase “fully paid and non-assessable” by rote whenever describing any stock to be issued, sold or pledged. In an earli-

\textsuperscript{51} In a more detailed exposition of our proposal, we will discuss fraudulent conveyance law and other mechanisms by which such strategies would be derailed. We will also discuss whether Covered Employees should be permitted to buy personal liability insurance or whether insurance proceeds would instead have to be forfeited to the Covered Company’s estate. Many of these asset protection strategies existed (and were sometimes used) in the days when investment banks operated as general partnerships. To the extent that asset protection strategies were widespread, they may have somewhat undermined the ethos of personal responsibility that comes with personal liability. Still, however, the norm in partnerships is that every partner is expected to take responsibility for the firm’s actions because every partner is personally liable. Responsibility and liability fall on a spectrum, and we seek to remove investment bankers from an extreme end of that spectrum where both characteristics have been lacking. Asset protection strategies that cannot be derailed will affect the efficacy of our proposal but will not recreate the world we have today in which there is little or no personal liability for the consequences of risks that investment bankers take behind the corporate shield.

\textsuperscript{52} For a discussion of the arbitrariness of government bailouts and the role of political influence of firm managers in obtaining bailouts, see Richard W. Painter, Bailouts: An Essay on Conflicts of Interest and Ethics When Government Pays the Tab, (Minnesota Legal Studies, Research Paper No. 09-37, 2009).

\textsuperscript{53} We are grateful for John Ellicott’s suggestion at this conference that we consider using assessable stock and for his mention of experiences that his own family had in the 1930s holding assessable stock in a failed bank.

\textsuperscript{54} See generally BAYLESS MANNING, LEGAL CAPITAL (4th ed. 2002).
er era, however, assessable stock was commonly used, particularly by banks and other corporations that had large numbers of creditors and sometimes urgently needed additional equity capital to survive. Generally, the assessment reflected that the stock had been sold at a discount—it was intended to assure that shareholders finished paying for their stock and did not simply walk away if the company's fortunes declined. If the company needed additional capital, consideration not paid for the stock, usually up to its par value, could be assessed by a vote of the board of directors.

We propose that assessable stock would be the only permissible medium that could be used to compensate any employee of a Covered Company in excess of a certain amount; our starting proposal is to require compensation in excess of a certain amount, generally $1 million annually, to be paid in the form of assessable stock. Compensation up to this amount, but no more, could be paid in cash, non-assessable stock, or other consideration; compensation over this amount could only be paid in assessable stock. The amount would be adjusted for inflation; in addition, we would provide that as employees became more senior, they could receive steadily decreasing percentages of their compensation in assessable stock. This would limit their incentive to change jobs frequently to avoid the accumulation of too much assessable stock (and too much exposure to their firms' downside risks).

Employees would be required to hold onto their assessable stock for some period (our initial suggestion would be one year) after they left their firms.

How much could the assessment be? Our initial proposal is that it be for the difference between the amount paid for the stock and the stock's fair market value (determined in some way we would specify) on the date the stock was issued. The amount paid will typically be zero since the stock will typically have been awarded as part of the banker's compensation package. If the company becomes insolvent, it seems appropriate that the banker's services should be deemed to be inadequate consideration for the stock, and the banker should be required to make up the shortfall.

55. See supra notes 3-10 and accompanying text.
56. Id.
57. Under our proposal the assessable stock itself would have to be used; compensation in options to buy assessable stock would not be allowed.
58. For instance, after working at a company for five years, an employee might be able to get the higher of 25% of her annual compensation, or the amount in excess of $1 million in cash; after 10 years, the percentage might increase to 35%, and so on.
59. There is no need to define a "Covered Employee" for the assessable stock version of our proposal because any employee receiving over $1 million (as adjusted as described in the text) in compensation would be paid that excess amount in assessable stock. We do not propose making any exceptions.
For reasons similar to those discussed in the context of a JVPA, we propose to exempt up to $1 million in personal assets from the assessment. Although assessable stock used in earlier years contained no such exemption for stockholders of limited means, such an exemption avoids the undue hardship which some families still remember from assessable shares held by relatives during the Great Depression. For the reasons explained above, making assets in excess of $1 million subject to the assessment probably imposes sufficient downside risk to encourage prudent management decisions by bankers who hold the stock. Recall in this regard that our aim is not to create a pot of assets available to the bank's creditors, including for this purpose the public, but rather to put the brakes on excessive risk-taking. Moreover, unlike with the JVPA proposal, where we expect that the firm liabilities for which a banker could be liable would almost certainly exceed his assets, with this proposal, the banker's liability would be capped at the maximum amount of the assessment, thus potentially letting him keep more than $1 million.

The incentives created by this version of our proposal are somewhat different from those created by the proposed mandatory JVPA. The mandatory JVPA is an on-off switch that turns on when a Covered Employee earns over $3 million per year. The assessable shares gradually phase in personal liability depending on the amount of accumulated annual compensation over $1 million per year. The longer an employee has been with the company accumulating stock, the more personal liability exposure that employee has. The most senior employees are likely to pay the most, although some less senior employees who have been with the company accumulating stock for a long time would pay a lot as well.

Assessable stock is a less severe measure than the JVPA, which potentially imposes (almost) unlimited liability. Assessable stock would impose some degree of personal liability on a senior employee in circumstances where the harsher measure of imposing a JVPA relationship would not be justified. However, it could be extended to more employees: employees earning less than $3 million could be required to accept some of their compensation in assessable stock. This proposal might be more palatable to policy makers than the JVPA. They might be more willing to require that compensation over a certain amount only be in assessable stock than to support an erosion of limited liability; historically, the reaction to erosions of limited liability have been strongly negative among important constituencies.60

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60. For example, corporate directors and officers and their insurers were swift to react even to a gross negligence standard being imposed on them. See Charles O'Kelley & Robert
Since assessable stock would in most cases expose fewer of a manager's assets to potential seizure, it would not be as effective a risk deterrent as the JVPA. But it may prove more feasible than the JVPA. In any event, it is a step in the right direction. That being said, we should mention a potential downside of our proposal. To limit their liability, employees might leave their jobs and sell their assessable stock. We think, however, that the effect on turnover need not be too significant an issue, for several reasons. First, we would restrict employees' ability to sell their assessable stock upon departure from their firms. Furthermore, under our proposal, as an employee continued her employment at the same firm, steadily decreasing portions of her compensation would be paid in assessable stock. The rate at which employees would accumulate assessable stock would decrease, as would the growth of their commensurate liability. Finally, that employees have significant human capital invested in their firms should limit their inclinations to terminate their employment.

VII. POSSIBLE OBJECTIONS TO THE PROPOSALS AND OUR RESPONSES

We can anticipate several objections to our proposals. We set forth these objections below and our responses. First, if the U.S. were to adopt our proposals or something like them, U.S. investment banks and other Covered Companies might find it difficult to attract employees. They might lose some employees to foreign competitors; they might even move their legal domiciles outside of the U.S. to avoid application of the law.

We think that this objection is somewhat overblown. Wall Street's competitive position is raised as an objection to virtually every regulatory proposal in the financial arena, including the Sarbanes-Oxley Act in 2002, as well as proposals now being considered in response to the latest failure of unregulated financial markets. The objection is that Wall Street will not be able to get the best employees if it is constrained in how much it can pay them, or if it has to offer worse terms than the employees might get elsewhere. But many people are willing to pay significant amounts to live or work in particular places. For instance, New York has much higher taxes than Connecticut, yet many people (indeed, many people who would be subject to our proposal) who could commute to New York from Connecticut live in New York. The sorts of people who would be subject to our proposal may be willing to assume the risks

of some personal liability in order to enjoy the financial and other benefits from being able to ply their trade in their country of choice.

Still, we recognize that part of our proposal would have to include considerable buy-in by many desirable jurisdictions. The employees we are concerned with cannot too easily be able to move to an otherwise comparable jurisdiction that has limited liability. The buy-in could consist of jurisdictions' adoption of some version of personal liability, or perhaps an outright restriction on high compensation. And the jurisdictions at issue would have to impose their rules based on the presence of sufficient personnel, transactions or assets—not "formal legal domicile," lest firms all evade the rules by becoming domiciled in the Cayman Islands.

Second, employees at Covered Companies might seek higher pay to compensate for the added risk they would be facing, fueling an upward spiral in compensation. This is a serious objection as well; we can only hope that the forces now set in motion to limit compensation, including outrage and the desire to pre-empt regulation, will serve as a limiting force. If it does not, we might have to look to increased regulation of pay, as undesirable an option as that may be.

Third, personal liability could drive many experienced people, especially those who have acquired significant assets, out of the investment banking business. Banking might suffer as a result. The old investment banking partnerships did not seem to have this problem; still, we do not want to assume it away. We have two responses: first, as the new set of rules becomes the norm, the specter of personal liability should loom less prominently in motivating departures from the investment banking business. Moreover, we are not proposing to leave bankers penniless: we do allow them to keep enough for a comfortable retirement.61

Fourth, investment bankers might try to evade personal liability through insurance or other contractual arrangements. They could ask for a "firm failure" rider to director and officers' insurance. Although they cannot themselves legally short their company's stock to hedge against firm failure, they can encourage family members to do so.62 Some of these strategies could be regulated—for example, by providing that proceeds from firm-failure liability insurance contracts would be assets subject to attachment by firm creditors—but some would probably avoid

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61. Partnerships of old did not offer this type of asset protection; however, limited asset protection is not inconsistent with our intent to impose enough downside on highly paid investment bankers to discourage excessive risk. The threat of genuine poverty might have popular appeal but is not required. Relative poverty should suffice.
62. This of course assumes they do not have inside information; if they do, encouraging family members to exploit such information would be illegal.
regulation. The old investment banking partnerships also saw their share of contractual arrangements that shielded partners from firm debts: family trust funds sometimes served this purpose, and Goldman Sachs, which did not become a corporation until 1999, did some of its business through limited liability entities controlled by the partnership. Indeed, the old investment banking partnerships themselves had insurance; insofar as the partners were liable for the partnerships' debts, the insurance covered the partners as well, paying out before the partners would have to give creditors access to their own assets. But insurance cannot realistically cover the kind of catastrophic losses potentially at issue. Thus, if some form of our proposals were adopted, even partners of firms with high insurance coverage would be mindful of potential personal liability. In some situations the insurer itself might be insolvent, as was the case with AIG. Our proposal addresses this situation by including within the definition of Covered Company insurance companies that transact with large financial institutions; such companies' most highly paid executives would be Covered Employees.

We do not seek to eliminate every avenue by which an employee's personal assets could be protected if his firm fails. As we have noted, our proposal is mainly intended to work by influencing those making decisions about risk within their firms. It is only secondarily intended to make a pot of assets available for recovery by a firm's creditors, especially since the assets available to be seized are likely to be a small portion of the firm's debt. Our proposal would require a sufficient number of the top decision-makers at a sufficient number of firms to have enough of their financial well-being on the line to make a difference in the risks they take with other people's money. The direction in which the herd of investment bankers is headed should change with exposure to personal liability; excessive risk takers will stand out from the herd instead of leading everyone else over the precipice.

We should note another related objection: that with clever structuring, an employee or company could manage to avoid applicability of a law adopting our proposal. A Covered Company could function with very few employees, and contractual arrangements by which it obtained the other services it needed from companies that were not Covered Companies. We think such structuring is clearly possible, but we also think it would be limited, such that most intended targets of the regime would be covered.

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63. Insurers may have arguments against having to pay, but that is beyond the scope of our article.
Finally, personal liability may discourage some financial innovation. This is a genuine concern. But—to overstate our position for a moment—in the financial services area, perhaps we have had enough innovation for the time being. We do not need more new products that investors do not understand, particularly when so many investors are institutions run by bankers who respond not by shunning unfamiliar products but instead by succumbing to a herd mentality of doing whatever other investors do. Innovations scarcely warrant the favorable connotation that term carries in an atmosphere where investors—many playing with money that is not their own—refuse, at least ex ante, to admit that they do not understand them.

We are in good company with our less-than-ringing endorsement of financial innovation. Paul Volcker was quoted in an interview in the Wall Street Journal as follows:

We hear about these wonderful innovations in the financial markets, and they sure as hell need a lot of innovation. I can tell you of two—credit-default swaps and collateralized debt obligations—which took us right to the brink of disaster. Were they wonderful innovations that we want to create more of?

You want boards of directors to be informed about all of these innovative new products and to understand them, but I do not know what boards of directors you are talking about. I have been on boards of directors, and the chance that they are going to understand these products that you are dishing out, or that you are going to want to explain it to them, quite frankly, is nil.

I mean: Wake up, gentlemen. I can only say that your response is inadequate. I wish that somebody would give me some shred of neutral evidence about the relationship between financial innovation recently and the growth of the economy, just one shred of information [sic].

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64. See Claire A. Hill, Why Didn't Subprime Investors Demand A (Much Larger) Lemons Premium, LAW & CONTEMP. PROBS (forthcoming) (discussing the role herding played in investor behavior in the present financial crisis).

65. It should be noted that ex post, they have been quick to make this admission.

66. Paul Volcker: Think More Boldly, WALL ST. J., Dec. 14, 2009, available at http://online.wsj.com/article/SB1000142405274870482504574586330960597134.html. For a measured defense of innovation, see Robert Litan, In Defense of Much, But Not All, Financial Innovation, THE BROOKINGS INST., Feb. 17, 2010, available at http://www.brookings.edu/papers/2010/0217_financial_innovation_litan.aspx. Litan concludes that "there has been more socially useful financial innovation over the past several decades..." Id. at 47. He talks about how such innovations could be encouraged. But his is not a blanket endorsement of innovation. He concludes that "we should stand ready to correct abuses when they appear and not let destructive financial innovations wreak the kind of economic havoc we have unfortunately just witnessed." Id.
To state our position more moderately, we think financial innovation is overrated and can be quite perilous. In other fields, such as the development of pharmaceuticals, we are quite willing to tolerate rules and policies that may interfere with innovation. To the claim that in the pharmaceuticals field the stakes are higher, the current crisis is evidence enough that financial snake oil also has an enormous social cost. Our response here is also our response to a related objection: that our proposal would make financial executives too risk-averse.67 There is such a thing as too little risk-taking; there is also such a thing as too much risk-taking, and we are very much suffering the result of the latter. Just as the benefits of financial innovation have been a reflexive mantra for some time, so have the costs of too little risk taking in general. There is no principled way to determine the ideal level of risk-taking; our proposal simply reflects our view that we have apparently swung in the direction of encouraging too much of it.

VIII. CONCLUSION

Our proposals are intended to spur debate on a significant problem: what to do when market actors have the incentive and ability to take excessive risks that can impose significant costs on the entire society. We appreciate the logistical and political hurdles that would confront an effort to re-impose personal liability on investment bankers. The regulation would deal with a notoriously porous part of the market, in which structuring to circumvent rules is a much-practiced (and lauded) craft. Moreover, we are suggesting a strict liability regime for executives who may have done nothing wrong. Strict liability can at times be unfair, just as the unlimited liability of general partnership law can be unfair. Imposing liability for failed investment banks exclusively on creditors or on society as a whole, however, is even less fair. The present regime is deeply flawed: we think the present financial crisis shows how necessary it is to at least start a vigorous debate on the subject and consider a radical proposal, a return to the past. We can only hope that what Adolf Berle said in 1932 is true today: “[T]he public is in a mood to impose on [the corporate system] a steadily growing degree of responsibility for our economic welfare.”68

67. This is, of course, a familiar objection—one made to justify very deferential review of business decisions.
68. BERLE & MEANS, supra note 1, at viii.