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Attention: Comments

Re: Notice of Interim Final Rulemaking Regarding Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 C.F.R. Part 380; Notice of Proposed Rulemaking, Orderly Liquidation Authority, 12 CFR Part 380, RIN-3064-AD73

We are writing to provide comments in response to the Federal Deposit Insurance Corporation's ("FDIC") Notice of Interim Final Rulemaking Regarding Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and Notice of Proposed Rulemaking Regarding Orderly Liquidation Authority. Our comment is principally directed at Section 380.7 of title 12 of the Code of Federal Regulations (the "Claw-Back provisions"). This section implements the remuneration return provisions of Section 210(s) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1]

Summary of Comment

We applaud the rationale behind the Claw-Back provisions. However, we are concerned that the provisions as presently proposed would not serve their intended purpose. The provisions should impose responsibility on senior executives and directors when their firms fail, without further inquiry as to the executives' and directors' conduct. Instead, as currently proposed, they will lead to costly arguments about whether a director or executive "performed his or her duties with the requisite degree of skill and care required by that position," and, most likely, to the application of a standard under which virtually all directors and executives will not bear responsibility. Excessive risk-taking by employees, executives and directors of financial institutions has been too well rewarded, contributing to the financial crisis. True downside risk is needed, not an extended and costly inquiry unlikely to result in a claw-back. We thus think that the Claw-Back provisions should be revised to simply provide that senior executives and directors' compensation may be clawed back if their firms fail. This change would better reflect Congress's stated intention in passing Dodd-Frank. It also would be far more likely to positively influence director and officer behavior, minimizing excessive risk-taking.

If the FDIC decides to use its present approach or some variation thereof, seeking recompense of compensation only from executives not using "the requisite degree of skill and care" in performing their duties, we think it is critical that the law expressly disclaim reliance upon or incorporation of state law standards governing the duties of directors and officers. These state law standards, which include

[1] Public Law 111-203, July 23, 2010.

fiduciary duty standards, are set by state courts as a matter of corporate governance to establish the proper allocation of authority between directors, officers and stockholders. They are not designed to regulate the standards for return of compensation paid to directors and executives of failed covered financial companies. Were these standards incorporated into the Claw-Back provisions, those provisions would be rendered ineffectual.

Background: The Proposed Rules

Section 210(s)(1) of the Dodd-Frank Act provides:

> The Corporation, as receiver of a covered financial company, may recover from any current or former senior executive or director substantially responsible for the failed condition of the covered financial company any compensation received during the 2-year period preceding the date on which the Corporation was appointed as the receiver of the covered financial company, except that, in the case of fraud, no time limit shall apply.

Pursuant to Section 210(s)(3) the FDIC has rule-making authority to implement Section 210(s)(3). Under this authority the FDIC has proposed the Claw-Back provisions. The heart of these provisions is set forth in proposed Section 380.7(a), which states that:

> The Corporation, as receiver of a covered financial company, may recover from any current or former senior executive or director substantially responsible for the failed condition of the covered financial company any compensation received during the 2-year period preceding the date on which the Corporation was appointed as the receiver of the covered financial company . . . .

Proposed Section 380.7(a) further states that a senior executive officer or director shall be "deemed substantially responsible" if:

> (1) He or she failed to conduct his or her responsibilities with the requisite degree of skill and care required by that position, and
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> (2) As a result, individually or collectively, caused a loss to the covered financial company that materially contributed to the failure of the covered financial company under the facts and circumstances . . . .

Proposed Section 380.7(b)(1)(i) states that it is presumed that a party is "substantially responsible" if:

> The senior executive or director served as the chairman of the board of directors, chief executive officer, president, chief financial officer, or in any other similar role regardless of his or her title if in this role he or she had responsibility for the strategic, policymaking, or company-wide operational decisions of the covered financial company prior to the date that it was placed into receivership under the orderly liquidation authority of the Dodd-Frank Act . . . .

Proposed Section 380.7(b)(2) states that:

[T]he presumption under paragraph (b)(1)(i) of this section may be rebutted by evidence that the senior executive or director performed his or her duties with the requisite degrees of skill and care required by that position.

The currently proposed definition of "substantially responsible" should be revised to advance the underlying purposes of the Dodd-Frank Act.

The Dodd-Frank Act seeks to minimize the risk and severity of future financial crises. It seeks as well to "restore responsibility and accountability in our financial system to give Americans confidence that there is a system in place that works for and protects them."[2] Claw-back provisions can and should advance both of these purposes, but the provisions as presently proposed fall short.

The financial crisis revealed that financial executives had significant incentives to engage in excessively risky activities on behalf of their firms. The Dodd-Frank Act has sought to address these incentives and the difficulties they cause in a variety of ways, including by imposing limits on compensation that encourages excessive risk-taking.[3] The Claw-Back provisions also seek to address these incentives by exposing executives and directors to more of the downside of excessive risk, in the form of loss of previously-earned compensation.

It is generally agreed that compensation arrangements should not incentivize officers and directors to take excessive risks. Indeed, the Goldman Sachs & Co., Inc. compensation policy specifically states that compensation should be designed to "discourage excessive or concentrated risk taking".[4] But establishing the right incentives has been difficult in practice. Critically, officers and directors are often not sufficiently exposed to appropriate downside risks.[5] The Claw-Back provisions are intended to provide such exposure. An executive who is faced with the possibility of returning compensation will take greater care in decision-making and oversight, and will be disinclined to take, or to allow others to take, excessive risks.

The incentives fueling excessive risk-taking in the years leading up to the financial crisis were part of a broader shift away from responsibility. A shift in the opposite direction is needed, and dictated by the Dodd-Frank Act. Senior executives and directors of a firm are charged with, and compensated for, managing and overseeing the operation of the firm. When the firm fails, the managers and directors

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[2] Senate Committee on Banking, Housing, and Urban Affairs, Summary: Restoring American Financial Stability (undated), available at http://banking.senate.gov/public/_files/FinancialReformSummary231510FINAL.pdf

[3] *See, e.g.*, Sec. 956(b) of the Dodd Frank Act ("Federal regulators shall jointly prescribe regulations or guidelines that prohibit any types of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks by covered financial institution . . . .").

[4] Goldman Sachs & Co., Inc. Compensation Principles, dated May 8, 2009, available at http://www2.goldmansachs.com/ideas/public-policy/1-compensation/comp-princ.html. *See also* Lucian Bebchuk, *How to Fix Bankers' Pay*, Daedalus, Vol. 139, No. 4, Fall 2010 (discussing the optimal design of compensation to discourage excessive risk-taking), available at http://ssrn.com/abstract=1673250. Goldman's compensation policy also favors clawbacks. *See, e.g.*, Goldman Sachs & Co., Inc. Compensation Policy, dated May 9, 2009 (compensation should "allow for forfeiture or 'claw-back' effect in the event that conduct or judgment results in a restatement of the firm's financial statements or other significant harm to the firm's business" without setting forth a standard of care).

[5] *See* Lucian Ayre Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEORGETOWN L.J. 247-287(Jan. 2010) (outlining reasons why boards may not be relied on to choose arrangements necessary to prevent excessive risk-taking).

should be responsible and should be called to account.[6] Responsibility in this sense is not dependent upon what someone has done or not done.[7] Responsibility is a status that accompanies authority and power.

Responsibility thus conceived contrasts with the Claw-Back provisions as proposed. The provisions do not promote true responsibility: an executive or senior officer may be able to avoid downside risk if she can show that she used "the requisite degree of skill and care required by [her] position." The process of defining "requisite degree of skill and care" may not yield a high standard. The determination of requisite skill and care is likely to be significantly informed by industry norms; industry may develop norms for demonstrating use of requisite skill and care that better serve the evidentiary function than the intended one, of assuring that skill and care were used. Adherence to these norms could enable executives and directors to escape claw-back even if the failure of their institutions was due in significant part to their own poor decisions and risk oversight.[8] More importantly, state corporate law standards may be used to define "requisite degree of skill and care;" such standards accord significant deference to executive decision-making processes.

Moreover, even apart from the risk that the standard will be set too low, the determination itself is likely to be quite costly and time-consuming. This provides another important reason to have claw-back provisions that are based on title and duties rather than conduct. Understanding how particular conduct relates to a complex event such as the failure of a covered financial company is exceedingly difficult. When such a company fails, proof issues with respect to the Claw-Back provisions as currently proposed will take a significant amount of time and expertise. In the Lehman Brothers bankruptcy, for example, the examiner billed $38.4 million for its 2,209 page investigatory report, interviewing over 100 witnesses and producing 10 million pages.[9] Regulators might be deterred from bringing these types of cases on resource grounds alone. Indeed, this difficulty has been cited as one reason why more prosecutions have not been brought in the wake of the financial crisis.[10]

One comment letter argues that directors and officers of financial companies will be deterred from serving in those positions if state law standards of care cannot be used in rebutting the presumption of substantial responsibility.[11] This type of objection is always made whenever executives potentially face more liability or responsibility, but considerable evidence suggests otherwise. After the personal liability faced by Enron and WorldCom directors, we have not seen a significant decrease in the caliber of management, nor have there been intimations that the pool of candidates is markedly smaller or of poorer quality than it previously was. And even if it were, this consideration should not be determinative when weighed against Dodd-Frank's statutory mandate to reduce excessively risky practices.

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[6] *See* Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability,* 33 SEATTLE U. L. REV. 1173 (2010)

[7] Indeed, one important definition of the term "responsible" is "[a]nswerable, accountable . . . liable to be called to account . . . . having authority and control". Shorter Oxford English Dictionary (5th Ed. 2002 Oxford University Press).

[8] *See* Steven M. Davidoff, *In F.D.I.C.'s Proposal, Incentive for Excessive Risk Remains*, THE N.Y. TIMES, Apr. 12, 2011.

[9] *See* Amir Efrati, *Probe Yields Windfall for Legal Examiner*, THE WALL ST. J., Mar. 12, 2010.

[10] *See* Gretchen Morgenson and Louise Story, *In Financial Crisis, No Prosecutions of Top Figures*, THE N.Y. TIMES, Apr. 14, 2011.

[11] *See* Comment Letter of the Heritage Foundation, dated April 4, 2011.

Our proposal

The FDIC should repropose its definition of "substantially responsible" so that it is no longer a presumption subject to rebuttal. A person is "substantially responsible" if he or she has 1) oversight or decisional capacity over the covered financial company, 2) oversight or decisional capacity over the subsidiary, division or unit of a covered financial company, if the failure of the covered financial company is materially attributable to actions or inactions at the subsidiary, division or unit, or 3) material oversight or decision-making authority over individual actions or failures to act at the covered financial company if the failure of the covered financial company is materially attributable to such actions or inactions.

The three proposed categories are designed to cover all those who are "substantially responsible" for the failure of the covered financial company. In particular, the first category should encompass all of the directors and officers (i.e., CEO, CFO, and COO) of the covered financial company. These directors and officers have inherent in their responsibilities "authority and control" over the covered financial company as a matter of basic corporate governance. Their substantial responsibility exists by reason of their titles and jobs in the company; it is appropriate that they should be "substantially responsible" for purposes of the Claw-Back provisions without regard to how they did their jobs.[12]

The above definition accords better with the underlying purposes of the Dodd-Frank Act in general and Section 210(s) of the Dodd-Frank Act In particular. It provides better incentives for executives and directors. Moreover, it accords with Dodd-Frank's purpose of restoring responsibility and accountability. The most appropriate reading of Section 210(s) is to provide the FDIC with the ability to claw-back remuneration from directors and executives who had "authority and control" over the covered financial company without a standard of care or other disqualifier as our proposed definition provides. The alternative will not yield true responsibility and accountability; rather, it will yield costly efforts to establish a definition of "requisite skill and care" and to establish that particular behavior meets the standard. The result may be a safe harbor that makes the prospect of claw-back remote and perpetuates excessively risky conduct by directors and executives.

Alternatively, if the FDIC does decide to use an approach that potentially exempts directors and officers from having their compensation clawed back if they have met a particular standard of conduct, the approach should not use state corporate law standards .

If the FDIC chooses the approach of its present proposal, to allow directors and officers to rebut the presumption that they were "substantially responsible" for the failed condition of a covered financial company, the FDIC should specifically state that the Claw-Back provisions, and in particular the definition of "substantially responsible", are not intended to incorporate or adopt any state fiduciary duty standard. To understand why, a brief summary of state law fiduciary duties is necessary.

State law standards of corporate conduct – generally encompassed in director and officer fiduciary duties -- have been set through case-law over the last decades in order to allocate the proper division of responsibility among officers, directors and shareholders. They primarily regulate officer and director liability to shareholders, and hence have deliberately been set at a high level. Directors are protected by

[12] We agree with the present FDIC proposal that there should be a limited exception in the Claw-Back provisions for certain executives of deteriorating firms.

the business judgment rule. Directors and officers are presumed to have acted "without self dealing or personal interest and exercised reasonable diligence and acted with good faith".[13] To rebut this presumption a shareholder generally bears the burden of showing a breach of the duty of care or a breach of the duty of loyalty (including that the officer or director acted in bad faith).[14]

In particular, Delaware law is intended to make it difficult to establish a breach of fiduciary duties other than those implicating loyalty as traditionally conceived. In the Caremark case, Chancellor Allen of the Delaware Chancery Court stated that:

> What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests. To employ a different rule-one that permitted an "objective" evaluation of the decision-would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all good faith board decisions.[15]

A recent Delaware decision highlighted the difficulty of pursuing claims with respect to financial institutions.[16] In 2009, a Delaware Chancery Court found that the Citigroup board of directors had not breached its fiduciary duties for allowing the company to purchase $2.7 billion in subprime loans in 2007. The court stated that to allege a breach of fiduciary duty for a failure to properly supervise the corporation:

> [A] plaintiff must show that the directors knew they were not discharging their fiduciary obligations or that the directors demonstrated a conscious disregard for their responsibilities such as by failing to act in the face of a known duty to act. The test is rooted in concepts of bad faith; indeed, a showing of bad faith is a necessary condition to director oversight liability.[17]

This standard is designed to restrict the potential liability of directors and officers for breach of fiduciary duty claims in the corporate governance context where self-dealing and the like are not at issue. Not surprisingly, the Citigroup board was held not to have violated its fiduciary duties in failing to monitor and permit this investment, made just before the collapse of the subprime mortgage market.

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[13] Gries Sports Enters., Inc. v. Cleveland Browns Football Co., Inc., 496 N.E.2d 959, 963-964 (Ohio 1986).

[14] *Id.*

[15] In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967-68 (Del.Ch.1996).

[16] A majority of covered financial institutions are incorporated in Delaware law, and Delaware law is the primary standard-setter in the area of corporate law, so reference of their decisions on this matter is appropriate.

[17] In re Citigroup inc. Shareholder Derivative Litigation, 964 A.2d 106, 123 (Del.Ch. 2009) (footnotes omitted).

Numerous other decisions have established that violations of the fiduciary duty of care will be difficult to establish. Negligence is not sufficient. [18] Current law typically prevents a director or officer from being held to have breached his duty of care if the director or officer can show that he or she acted in good faith and with all material information before him or her. "Bad" decisions are not, by themselves, cause for liability.

Proving that a director or officer did not act in good faith – an alternative standard in the state law context -- is similarly difficult. Delaware courts have defined not acting in good faith as acting in bad faith. A director or officer is deemed to be acting in bad faith when he or she "knowingly violates a fiduciary duty or fails to act in violation of a known duty to act, demonstrating a conscious disregard for [his or] her duties".[19]

Incorporation of these state law standards would thus mean that cases against directors or executives under the Claw-Back provisions would depend on state law standards established for a different purpose—standards that set a high bar for claims against directors and officers. These standards would render the Claw-Back provisions ineffectual. Indeed, it is notable and appropriate that Section 210(s) makes no reference to state law standards: incorporating those standards into the definition of "substantially responsible" would prevent the law from properly serving its purpose.

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[18] *See, e.g.*, Gagliardi v. TriFoods Intern., Inc., 683 A.2d 1049, 1053 (Del.Ch. 1996) ("that plaintiff regards the decision as unwise, foolish, or even stupid in the circumstances is not legally significant; indeed that others may look back on it and agree that it was stupid is legally unimportant. . . .").

[19] Citigroup, 964 A.2d at 125.

Conclusion

For the reasons set forth above, we respectfully request that the FDIC repropose Section 380.7. Preferably, the FDIC should propose the definition of "substantially responsible" argued for in this comment (or a similar standard addressing the concerns outlined in this comment). Alternatively, should the FDIC retain an approach that allows the presumption of substantial responsibility to be rebutted, the provisions as enacted should specifically state that state law standards are not incorporated into, or to be used to interpret, the Claw-Back provisions.

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