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COMMENT

Recoupment Under Dodd-Frank: Punishing Financial Executives and Perpetuating "Too Big To Fail"

In July 2011, the Federal Deposit Insurance Corporation (FDIC) promulgated new rules implementing Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act. These rules define a cause of action to recoup compensation paid to senior executives and directors of failed nonbank financial institutions placed into the FDIC's "orderly liquidation authority" receivership. An action for recoupment is based on a negligence theory of liability, but it does not require establishing that an executive's conduct caused the financial institution any harm. The rules presume liability merely for having held executive responsibility prior to the firm entering receivership. The executive may rebut the presumption of negligent conduct, but not causation. Put simply, a senior executive or director can lose two years of pay even if he or she could conclusively establish the total absence of any link between his or her conduct and the firm's failure.

This Comment argues that disconnecting recoupment from causation leads to overdeterrence and perpetuates the dangerous phenomenon of "too big to fail." In particular, executives may abstain from taking optimal risks that may be mischaracterized later as negligent should other factors cause the firm's failure. Such overdeterrence is likely to cause talented executives to gravitate toward financial institutions that have the lowest risk of failure. Recoupment thus imposes a cost concomitant with a firm's perceived risk of failure, giving large, interconnected institutions an advantage when competing for managerial talent. Indeed, the liquidation of firms perceived as "too big to fail" may be so improbable that they can credibly offer executive compensation with little to no risk of recoupment.

The remedy for this deficient rule is to make causation a rebuttable presumption. Because executives can cheaply show that other factors were responsible for the firm's failure, they would discount potential recoupment liability chiefly by the likelihood of causing actual harm. This probability would not vary between firms, promoting healthy competition among financial institutions and reversing the arbitrary advantages conferred by the current regime on "too big to fail" firms. Retaining a presumption of causation would still ease the evidentiary burden of holding financial executives accountable for reckless behavior.

I. TITLE II AND RECOUPING EXECUTIVE COMPENSATION

Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act grants the FDIC the authority to conduct an "orderly liquidation" of "failing financial companies that pose a significant risk to the financial stability of the United States."[1] Under Title II, the FDIC may "act as the receiver" for a "covered financial company."[2] A "covered financial company"[3] must meet a series of criteria, including (1) being "in default or in danger of default"[4] (as defined in the statute[5]); (2) posing such a risk that "failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States"[6]; and (3) leaving no choice but a public rescue because "no viable private sector alternative is available to prevent the default of the financial company."[7] As receiver, the FDIC succeeds to the financial company,[8] operates it with the goal

1. 12 U.S.C.A. § 5384(a) (West 2012).
2. *Id.* § 5384(b).
3. The term "financial company" is defined as a "bank holding company"; a "nonbank financial company supervised by the Board of Governors" of the Federal Reserve; "any company that is predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto"; and any subsidiary of the foregoing companies "that is predominantly engaged in activities that the board of governors has determined are financial in nature or incidental thereto." *Id.* § 5381(a)(11).
4. *Id.* § 5383(b)(1).
5. *Id.* § 5383(c)(4) ("[A] financial company shall be considered to be in default or in danger of default if . . . (A) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code; (B) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion; (C) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or (D) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.").
6. *Id.* § 5383(b)(2).
7. *Id.* § 5383(b)(3).
8. *Id.* § 5390(a)(1)(A).

of maximizing the value of its assets,[9] and ultimately must "liquidate, and wind-up [its] affairs."[10]

The statute does not, however, limit the FDIC's powers to operate the failed financial institution. Title II also 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 . . . .[11]

On July 15, 2011, the FDIC promulgated rules implementing this recoupment authority.[12] The rules empower the FDIC to "file an action" to recover any compensation paid in the preceding two years as provided in the statute.[13] The rules provide that a "senior executive or director" shall be "substantially responsible" for the financial company's failure if he or she:

> (1) Failed to conduct his or her responsibilities with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances, 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.[14]

These conditions reflect a negligence theory of liability, which requires establishing failure to act with reasonable care, causation, and injury.[15] But the

9. *Id.* § 5390(a)(1)(B)(iv).
10. *Id.* § 5390(a)(1)(D).
11. *Id.* § 5390(s)(1).
12. 12 C.F.R. § 380.7 (2012).
13. *Id.* § 380.7(a).
14. *Id.* While this language suggests two independent causation elements—causing loss to the company and such loss materially contributing to its failure—these can be treated conceptually as a single requirement for this analysis because both are conclusively presumed under the rules. *See also infra* note 18 (discussing conclusive presumption of causation).
15. *See* PROSSER AND KEETON ON THE LAW OF TORTS 164-65 (W. Page Keeton et al. eds., 5th ed. 1984) (defining negligence as consisting of four elements: (1) a "duty . . . requiring the person to conform to a certain standard of conduct, for the protection of others against unreasonable risks"; (2) a "failure on the person's part to conform to the standard required"; (3) a "reasonably close causal connection between the conduct and the resulting

rules establish a presumption that allows for recoupment without proving causation:

> It shall be presumed that a senior executive or director is substantially responsible . . . under any of the following circumstances:
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> (i) 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 . . . .[16]

In essence, these executives are presumed liable solely based on title and responsibility. Moreover, this presumption may only "be rebutted by evidence that the senior executive or director conducted his or her responsibilities with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances."[17] Such language indicates that an executive may disprove only the first element of recoupment—negligent conduct—but not causation.[18] Put simply, a senior executive or director can lose two years of pay even if market forces like tightening credit conditions or

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injury"; and (4) "[a]ctual loss or damage resulting to the interests of another" (footnotes omitted)).

16. 12 C.F.R. § 380.7(b)(1)(i). This presumption does not apply to senior executives "hired . . . during the two years prior . . . to assist in preventing further deterioration of the financial condition of the covered financial company" or directors "who joined the board of directors . . . under an agreement or resolution to assist in preventing further deterioration of the financial condition of the covered financial company." *Id.* § 380.7(b)(3). The rules also establish other presumptions of liability under certain scenarios, *id.* § 380.7(b)(1)(ii)-(iv), but these are rebuttable as to causation, *id.* § 380.7(b)(2); *see also infra* note 18 (discussing conclusive presumption of causation).

17. 12 C.F.R. § 380.7(b)(2).

18. This subsection reproduces word-for-word the first element of liability under 12 C.F.R. § 380.7(a), indicating that negligent conduct alone is rebuttable. Moreover, the rules expressly permit rebutting causation when such a presumption arises in other contexts. *See id.* § 380.7(b)(1)-(2) (listing other presumptions and stating expressly that they are rebuttable). This discrepancy implies that causation is nonrebuttable here. *See also FDIC's Second Notice of Proposed Rulemaking Under the Orderly Liquidation Authority*, DAVIS POLK & WARDWELL LLP 16 (Mar. 28, 2011), http://www.davispolk.com/files/Publication/7b49d031-5cf1-4e65-a066-00bda7e3546f/Presentation/PublicationAttachment/14cff5ec-bf6e-4c26-95be-2d1d15e81542/032411_OLA_prop_rule_sum.pdf (concluding that the proposed version of this subsection, unchanged in the final rules, imposes a conclusive presumption of causation).

employee misconduct like fraud or embezzlement caused the firm to fail.[19] Liability attaches even if the executive can conclusively establish the total absence of any causal link between his or her conduct and the firm's failure.

The FDIC has provided little explanation of the rationale behind the conclusive presumption of causation. It has merely stated that the rule is "aligned with the intent shown in the statutory language."[20] The history of the statutory provision for recoupment indicates that it was driven by a popular backlash against executives of failed firms receiving substantial compensation alongside government support.[21] When introducing the amendment providing for recoupment, Senator Robert Corker stated:

> No question, the bonuses and things we saw, after getting taxpayer money to make sure they survived, no doubt that created a backlash. As a matter of fact, the Senator from Virginia and I are working on an amendment that would say, if this ever happens again and we have to take one of these firms through resolution, which is part of the Dodd bill right now, the bonuses and other types of things in recent years would all be clawed back. You cannot make huge sums of money, take your company down the tubes, and do things to America in that way without paying a price.[22]

While liquidation under Title II is not a bailout,[23] Senator Corker's statement suggests that the rule was intended to further a similar populist policy of denying compensation to executives of failed institutions under government-supervised liquidation.

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19. *See FDIC's Second Notice of Proposed Rulemaking Under the Orderly Liquidation Authority*, *supra* note 18, at 16 (listing examples of failure without causation as "market forces, illegal behavior, fraud by some third party or governmental policies or actions").

20. Certain Orderly Liquidation Authority Provisions Under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 41,626, 41,631 (July 15, 2011).

21. *See, e.g.*, Ryan J. Donmoyer & Laura Litvan, *Geithner Vows To Recoup AIG Bonuses as Lawmakers Express Fury*, BLOOMBERG NEWS (Mar. 18, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a_TbsRunotbQ; *see also* Eric Dash, *Wall St. Pay Is a Focus of Many in Washington*, N.Y. TIMES, Jan. 12, 2010, http://www.nytimes.com/2010/01/13/business/13bank.html (describing efforts to recoup executive compensation in the financial sector in response to popular outrage over bank bonuses). The amendment containing the recoupment provision was introduced shortly after this uproar. 156 CONG. REC. S3195-3200 (daily ed. May 5, 2010).

22. 156 CONG. REC. S2993-94 (daily ed. Apr. 30, 2010) (statement of Sen. Robert Corker).

23. *See* 12 U.S.C.A. § 5394(a) (West 2012) ("All financial companies put into receivership under this subchapter shall be liquidated.").

II. INEFFICIENT OVERDETERRENCE OF INDIVIDUAL EXECUTIVES

Liability without causation is dangerous because causation promotes economic efficiency. In *A Theory of Negligence*, Judge Richard Posner explained why this is so:

> If the defendant was negligent but the accident would have occurred anyway, it would be incorrect to view the costs of the accident as the consequence of his negligence since they would not have been avoided by the exercise of due care. . . . Punishment for negligence would close an important safety valve in the negligence system. A standard of care is necessarily a crude approximation to optimality. Allowing enterprises a choice whether to comply or pay the social costs of violation may permit a closer approximation.[24]

Awarding monetary damages equal to actual injury permits the defendant to internalize the social cost of his or her conduct. This promotes efficiency when the legal standard of reasonable care differs from truly optimal behavior. By divorcing negligence from causation, the FDIC's new rules inefficiently overdeter individual financial executives.

The new rules exacerbate the crudeness of the "approximation to optimality" that Judge Posner identifies. The rules define a "business judgment" standard to determine whether an executive has acted negligently,[25] yet the FDIC has expressly rejected state law business judgment doctrines that insulate directors and officers from the unpredictable effects of ordinary negligence liability.[26] The FDIC also emphasized that gross negligence, the

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24. Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29, 40-41 (1972). For a detailed analysis of causation in tort law, see Guido Calabresi, *Concerning Cause and the Law of Torts: An Essay for Harry Kalven, Jr.*, 43 U. CHI. L. REV. 69 (1975). The importance of the causation requirement as correcting for potential hindsight bias is widely accepted in the economic analysis of law today. *E.g.*, STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 252 (2004) ("One advantage of the causation requirement is that to the extent that there are errors in the negligence determination, the negligence system takes on aspects of strict liability, so that the problem of overdeterrence . . . would be exacerbated were the scope of liability extended to losses not caused by negligence.").

25. Certain Orderly Liquidation Authority Provisions Under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. at 41,631 ("In the event that a covered financial company is liquidated under Title II, the FDIC as receiver will undertake an analysis of whether the individual has breached his or her duty of care, including an assessment of whether the individual exercised his or her business judgment.").

26. *Id.* ("State 'business judgment rules' and 'insulating statutes' will not shift the burden of proof to the FDIC or increase the standard of care under which the FDIC as receiver may default standard under state law, will not be required.[27] The ambiguity of this FDIC-specific "business judgment rule" could lead to significant uncertainty because courts cannot accurately determine the ex ante optimality of executives' complex risk-return calculations in hindsight. The potentially crippling chilling effect of judicial second-guessing of directors' decisions is precisely what motivated the development of the business judgment rule in Delaware corporate law.[28] It is no mystery why Delaware courts defer to directors' judgment unless the high bar of gross negligence is met: mischaracterizing efficient conduct as negligent would have grave consequences if causation did not serve as a "safety valve" for such error.[29]

As Posner points out, any divergence between efficiency and the applicable standard of care matters little when damages equal actual harm. The individual can internalize surplus utility by taking the risk and paying damages equal to the harm. Imposing a fixed penalty of two years of pay could, however, lead to over and underdeterrence. Overdeterrence would result if executives refrain from taking efficient risks that may be improperly characterized as negligent in hindsight.[30] Underdeterrence may also occur if executives take inefficient risks in an attempt to capture the surplus between the risky activity's utility and the two-year compensation amount. The potential for over and underdeterrence increases as the gap between the expected harm and the amount of the executive's two-year compensation grows.

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recoup compensation."). Under Delaware law, the business judgment rule establishes a high standard of liability for carelessness. *See* discussion *infra* note 28.

27. 76 Fed. Reg. at 41,631.

28. *See, e.g.*, Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) ("[D]irectors will tend to deviate from [a] rational acceptance of corporate risk *if* in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to *ex post facto* claims of derivative liability for any resulting corporate loss. . . . [A] very small probability of director liability based on 'negligence', 'inattention', 'waste', etc., could induce a board to avoid authorizing risky investment projects to any extent!"). Scholars have also justified the business judgment rule by pointing to the risk of hindsight bias. *E.g.*, Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 114-16 (2004); Andrew S. Gold, *A Decision Theory Approach to the Business Judgment Rule: Reflections on* Disney*, Good Faith, and Judicial Uncertainty*, 66 MD. L. REV 398, 443 (2007).

29. Posner, *supra* note 24, at 41.

30. While certain forms of executive compensation in the financial sector (e.g., stock options) might encourage inefficient risk taking, *see* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 251 (2010), ordinary negligence liability for any resulting harm would sufficiently counteract these incentives by imposing damages equal to resulting harm. Nonetheless, making causation rebuttable and the recoupment award adjustable to proven damages would ensure efficiency while granting the FDIC the evidentiary advantage of shifting the burden of proof to the executive. *See infra* Part IV.

Admittedly, the recent financial crisis has shown that there is a general problem of underdeterrence of risky conduct imposing social externalities. However, the proposed rule would lead to inefficient overdeterrence and distort the market for executive talent, rendering the proposed rule less effective than other approaches at reducing systemic risk.[31] Moreover, along with the reform outlined in this Comment, the proposed rule goes a long way toward reducing underdeterrence. If individual executives take reckless risks with an expected utility in excess of two years of pay, the potential for recoupment for actual harm would counteract the incentive to capture such surplus as personal compensation.[32] The FDIC can also pursue state law gross negligence actions in parallel, permitting the recovery of damages in excess of the two-year pay amount and negating residual underdeterrence.[33] The FDIC could rebut the business judgment rule by showing that an extraordinarily reckless decision was uninformed or made in bad faith.[34] Injury to the firm arising from decisions protected by the business judgment rule yet captured by the executive as personal compensation is compensable according to existing negligence law.[35]

31. For a comprehensive discussion of ways to reduce the social externality of systemic risk, see Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008).

32. While the executive would discount potential recoupment liability by the probability of the firm's failure, the expected payoff of the activity would likely correlate with this probability of failure because greater reward implies greater risk.

33. *See* 12 C.F.R. § 380.7(c) (2012).

34. *See, e.g.*, Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith." (citation omitted)); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("[T]he party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one."), *overruled on other grounds by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

35. The broader question of whether corporate law provides proper liability incentives apart from executive compensation for management to counter inappropriate risk taking is outside the scope of this Comment. Nonetheless, it is worth noting that lowering the general standard for managerial liability for failed firms—for example, by eliminating the business judgment rule—could have crippling consequences. *See, e.g.*, Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996); Bainbridge, *supra* note 28, at 114-15 ("[T]here is a substantial risk that suing shareholders and reviewing judges will be unable to distinguish between competent and negligent management because bad outcomes will be regarded, ex post, as having been foreseeable and, therefore, preventable ex ante. If liability results from bad outcomes, without regard to the ex ante quality of the decision or the decision-making process, however, managers will be discouraged from taking risks."); Gold, *supra* note 28, at 443-45 (discussing hindsight bias and instrumental justifications for the business judgment rule).

Finally, some might argue that the status quo without recoupment leads to systemic underdeterrence because an executive's negligent conduct causes indirect, externalized harms such as a loss of confidence in financial markets. The new recoupment rule, however, imposes liability in the absence of *any* causation. Even if negligent executives should pay for harms imposed on society, punishing harmless conduct would have significant negative consequences by distorting the market for managerial talent and thereby reducing competition in the financial sector.

III. THE CONSEQUENCES OF OVERDETERRENCE: REDUCING COMPETITION IN THE FINANCIAL SECTOR AND PERPETUATING "TOO BIG TO FAIL"

The overdeterrence resulting from imposing liability in the absence of causation is likely to cause talented executives to gravitate toward well-capitalized financial institutions that have the lowest risk of failure. At first glance, this might seem beneficial, but as smaller firms lose highly skilled managers who refuse to put two years of compensation at risk for engaging in harmless behavior, recoupment will lead to greater market concentration in the financial services industry. This market concentration will further perpetuate the dangerous phenomenon of "too big to fail."

Firms compete for managerial talent based on an executive's opportunity cost or "reservation value."[36] As scholars have noted, "An executive's reservation value is in part a function of her appetite for risk. A firm that requires a risk-averse executive to accept risky elements of compensation will have to provide more total compensation on an expected value basis to offset risk-bearing costs."[37] The uncertainty surrounding the standard of care under the new rules and the charged political atmosphere accompanying the failure of financial institutions would likely lead executives to assume a high probability of recoupment liability under FDIC receivership. Thus, for any individual subject to recoupment, his or her expected compensation is discounted by a factor approaching two times the probability of the firm's failure. For example, if the firm has a ten percent chance of failure in a given year, the expected value

36. Lucian Arye Bebchuck, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 762 (2002).

37. *Id.* at 762-63. This notion of "risk-adjusted pay" is widely accepted in the financial literature. *E.g.*, Martin J. Conyon et al., *Are U.S. CEOs Paid More than U.K. CEOs? Inferences from Risk-Adjusted Pay*, 24 REV. FIN. STUD. 402 (2011); Alex Edmans & Xavier Gabaix, *The Effect of Risk on the CEO Market*, 24 REV. FIN. STUD. 2822, 2822-24 (2011); Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 7 (2002).

of the executive's annual pay might be reduced by as much as twenty percent.[38] This discount can impose a substantial competitive burden on firms that are perceived as relatively more likely to fail.

Management theory holds that all else being equal, firms with more human capital that is rare and valuable will have a competitive advantage in the marketplace.[39] As empirical studies and intuition suggest, competent senior executives and directors of financial institutions are both rare and valuable.[40] The human capital advantage that would inure to the most capitalized firms perceived as having the lowest chances of failure would tilt the competitive landscape in their favor, trapping relatively less-capitalized firms in a vicious cycle of increasing likelihood of failure and departure of even more talent because of the resulting lower expected value of compensation. Moreover, while insurance might reduce the absolute cost imposed by the recoupment regime, riskier firms will still face a substantial disadvantage relative to competitors perceived as having a lower probability of failure.[41] Loss shifting

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38. The "in default or in danger of default" criterion for recoupment, *see* 12 U.S.C.A. § 5383(c)(4) (West 2012), implies that private sector alternatives have been exhausted. Executives might assign some probability to the outcome that the firm is not declared systemically important but rather enters ordinary bankruptcy proceedings instead of FDIC receivership. However, the uncertainty inherent in the systemic risk determination would likely render this probability very small. *See infra* notes 46-52 and accompanying text.

39. *See, e.g.*, Jay Barney, *Firm Resources and Sustained Competitive Advantage*, 17 J. MGMT. 99, 105-07 (1991).

40. *See, e.g.*, Charles P. Himmelberg & R. Glenn Hubbard, Incentive Pay and the Market for CEOs: An Analysis of Pay-for-Performance Sensitivity 20 (Mar. 6, 2000) (unpublished manuscript), http://ssrn.com/abstract=236089 ("[T]he supply of CEOs who are capable of running [large] firms is relatively less elastic.").

41. Interestingly, in April 2011 one insurer announced an "FDIC Receivership Endorsement" as an add-on to its directors and officers policy. Press Release, Marsh, Marsh Launches First-of-Its Kind Dodd-Frank/FDIC Receivership Endorsement (Apr. 21, 2011), http://www.businesswire.com/news/home/20110421005208/en/Marsh-Launches-First-of-its-Kind-Dodd-FrankFDIC-Receivership-Endorsement. However, as no recoupment claims have been filed yet, the economic viability of insuring against a risk of harmless negligence remains untested and uncertain. Moreover, the enforceability of such indemnification is unclear because it undermines the personal liability at the heart of the recoupment regime. *Cf.* Cohen v. Viray, 622 F.3d 188 (2d Cir. 2010) (invalidating corporate indemnification of CEO and CFO from clawback liability under section 304 of the Sarbanes-Oxley Act). While *Cohen* concerned indemnification, clawback insurance would have a similar effect of undermining personal liability. Indeed, in May 2012, Representative Barney Frank introduced H.R. 5860, which would expressly prohibit "insur[ing,] . . . hedg[ing] against, or otherwise transfer[ring] the risks" of recoupment liability. H.R. 5860, 112th Cong. (2012); *see also* Alexandra Alper & Ben Berkowitz, *Representative Frank Offers Bill To Bar Insurance on Claw-Backs*, REUTERS, May 30, 2012, http://www.reuters.com/article/2012/05/30/us-usa-congress-clawbacks-idUSBRE84T15720120530?irpc=932 (suggesting that Representative Frank introduced this bill in response to the "FDIC Receivership

may improve the efficiency of the recoupment regime, but each firm's premium would still reflect its idiosyncratic risk of recoupment. Insuring a riskier firm would naturally command a higher premium, imposing a greater cost on firms perceived as more likely to fail relative to their competitors.

The anticompetitive effects of recoupment will perpetuate the dangerous phenomenon of "too big to fail" financial firms. Title II was intended to end "too big to fail" by ensuring that failed nonbank financial institutions undergo orderly liquidations rather than chaotic bankruptcies (e.g., Lehman Brothers) or ad hoc bailouts (e.g., Bear Stearns).[42] Yet the higher cost imposed by recoupment on firms perceived as riskier will promote market concentration and encourage the emergence of a small number of large, stable institutions. Indeed, the high cost of compliance with Dodd-Frank is already serving as an impetus for mergers and acquisitions in the financial sector.[43] The heavy burden imposed by recoupment on firms perceived as more likely to fail will facilitate such market concentration even further. Moreover, as the Federal Reserve Bank of Dallas recently emphasized, the largest financial institutions "often follow parallel business strategies and hold similar assets," making it likely that they will fail simultaneously.[44] The failure of several large institutions at once—"too *many* to fail"—would likely be too catastrophic to permit liquidation under Title II.[45] Firms that reach the requisite size and correlated risk of failure could credibly offer executive compensation with little to no recoupment potential, further obtaining a competitive advantage in the market for managerial talent.

Some would argue that these anticompetitive effects are exaggerated because relatively few nonbank financial institutions are systemically

Endorsement" offered by Marsh). Furthermore, the insurance premium would be tied to the firm's likelihood of failure, imposing a cost analogous to compensating the executive directly for the increased recoupment risk. While an insurer might bear this risk more cheaply than a financial institution, riskier firms would still face a competitive disadvantage from these increased costs.

42. *See, e.g.*, 12 U.S.C.A. § 5384(a) ("It is the purpose of this subchapter to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard."); *id.* § 5394(a) ("All financial companies put into receivership under this subchapter shall be liquidated.").

43. *See* Richard Smith, *US Bank Regulation—From Millstone to M&A Deal Driver?*, FIN. NEWS (Apr. 11, 2012), http://www.efinancialnews.com/story/2012-04-11/richard-smith-allen-overy-mergers-acquisitions?mod=sectionheadlines-AM-IB.

44. *Choosing the Road to Prosperity: Why We Must End Too Big To Fail—Now—2011 Annual Report*, FED. RESERVE BANK OF DALL. 19 (2011), http://www.dallasfed.org/assets/documents/fed/annual/2011/ar11.pdf (footnote omitted).

45. *Id.*

important. Admittedly, the Financial Stability Oversight Council (FSOC) has adopted fairly stringent criteria for designating nonbank financial firms as posing systemic risk upon failure,[46] and only eight U.S. financial institutions have been publicly designated as systemically important by the international Financial Stability Board.[47] However, the FSOC's ex ante designation of a firm as systemically important under *Title I* of the Dodd-Frank Act is entirely independent of the FDIC's ex post determination under *Title II*, which triggers recoupment.[48] The recent financial crisis has shown that it is not always possible to anticipate in advance which firms will endanger the stability of the financial system.[49] For example, even the failure of a small hedge fund known for holding a popular asset class could precipitate a market-wide panic.[50] The inability to determine in advance which firms would be designated systemically important—as well as the inherent uncertainty in the decision to subject an institution to recoupment[51]—could lead executives of many nonbank firms in

46. *See* 12 C.F.R. § 1310 app. A (2012).

47. *Policy Measures To Address Systemically Important Financial Institutions*, FIN. STABILITY BD. 4 (Nov. 4, 2011), http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

48. 12 U.S.C.A. § 5383(b)(1) (West 2012) makes no mention of the ex ante designation of a nonbank financial institution as systemically important under 12 U.S.C.A. § 5330(a), implying that such a designation is independent of the decision to place an institution into FDIC receivership under Title II.

49. *Compare* Felix Salmon, *How Systemically Important Is Bear Stearns?*, SEEKING ALPHA (Mar. 16, 2008), http://seekingalpha.com/article/68640-how-systemically-important-is-bear-stearns (discussing the debate over whether Bear Stearns is systemically important and acknowledging two respected investors' views that it is not), *with What Did the Fed Do To Combat the Financial Crisis?*, FED. RESERVE BANK OF S.F., http://www.frbsf.org/econanswers/FR_Q1.pdf (last visited Aug. 15, 2012) (stating that Bear Stearns was a systemically important financial institution because its failure "risked a domino effect that would have severely disrupted financial markets").

50. Interestingly, the recent crisis was precipitated by the failure of relatively small firms holding subprime mortgage-backed securities. *See The Financial Crisis Inquiry Report*, FIN. CRISIS INQUIRY COMM'N 233 (2011), http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

51. The decision to subject an institution to recoupment is ultimately left in the hands of the Secretary of the Treasury. The Secretary must receive a written recommendation from the Federal Reserve Board of Governors and the FDIC addressing eight factors regarding the financial company and the effect of default. 12 U.S.C.A. § 5383(a)(1)-(2). Even after receiving a written recommendation, the Secretary retains discretion to make the final decision after weighing seven additional factors. *Id.* § 5383(b)(2). The subjectivity inherent in these multifactor determinations would likely engender significant uncertainty among financial executives.

the financial sector to plan for the worst-case scenario of FDIC receivership and adjust their expected compensation accordingly.[52]

IV. A REBUTTABLE PRESUMPTION OF CAUSATION

Preventing these inefficiencies and anticompetitive effects requires a simple solution: causation should be a rebuttable presumption and the two-year compensation amount merely a default award, adjustable to actual damage upon proof. Admittedly, it is unclear whether the statutory language referring to "any compensation received during the 2-year period"[53] can be construed as merely a presumption rebuttable by showing actual injury. Nonetheless, even if a statutory change is required, this is the right approach. Retaining a presumption of causation would facilitate holding executives of failed financial institutions accountable, as information asymmetries likely place the FDIC at an evidentiary disadvantage when proving causation. It would likely be more costly for the FDIC to obtain the requisite internal accounting information to establish causation than for the executive to show that other factors were responsible for the firm's failure. Yet permitting executives to disprove this presumption of causation and establish lower damages would also eliminate overdeterrence because damages would more accurately approximate actual harm, if any. For example, an executive could show that any allegedly reckless conduct—e.g., failure to adequately supervise trading—did not causally contribute to the firm's failure because market forces caused asset values to plummet. Such a decline in asset values would have forced the firm into insolvency even if the executive had not engaged in the allegedly negligent conduct.

As these informational advantages are known ex ante, executives will anticipate that regardless of the probability of failure, it would be relatively inexpensive to disprove the causal link necessary for recoupment liability.[54] This would eliminate the competitive advantage held by the largest firms because executives would discount potential recoupment liability solely by the likelihood of their conduct causing actual harm. As this probability depends on

52. The recent availability of an "FDIC Receivership Endorsement" for directors' and officers' insurance indicates that this risk is already imposing a cost on firms. *See supra* note 41.

53. 12 U.S.C.A. § 5390(s).

54. It is possible that rebutting causation may be too expensive (in absolute terms) for even a rebuttable presumption to counteract the ex ante overdeterrence described *supra* Part II. Yet this is still likely the best possible solution because removing the responsibility-based presumptions at the core of the recoupment regime would contradict the statutory language that recoupment impose liability beyond existing state law negligence theories based on conduct alone.

the nature of the executive's conduct, it would not vary across firms based on perceived risk of failure. This would level the playing field among financial institutions competing for executive talent, promoting healthy competition and reversing the arbitrary advantages conferred by the current regime on large, potentially "too big to fail" firms.

CONCLUSION

In promulgating these rules, the FDIC undoubtedly sought to discourage negligent management of institutions posing a substantial risk to the financial system. Such a goal is laudable. As defined in the new rules, recoupment is particularly appealing because its presumptions enable the FDIC to pursue executives without the burden of affirmatively proving every element of negligence. Yet by penalizing executives who caused the company little or no loss, the FDIC's new rules institute an inefficient liability regime. Such inefficiency would lead to overdeterrence and encourage executives to gravitate to the most stable financial institutions, because riskier firms face a competitive disadvantage with executive compensation as a result of the higher likelihood of recoupment. The anticompetitive effects of recoupment would promote concentration in the financial sector and facilitate the emergence of "too big to fail" institutions.

The solution is simple: causation should be a rebuttable presumption and the two-year compensation amount merely a default award, adjustable to actual damage upon proof. The informational advantages held by executives would permit cheaply disproving the presumption of causation, leading executives to discount potential recoupment liability solely by the likelihood of causing actual harm. This probability would not vary across firms on the basis of size, leveling the playing field among financial institutions competing for executive talent.

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