

THE MARKET REVOLUTION IN BANK AND INSURANCE FIRM GOVERNANCE: ITS LOGIC AND LIMITS

DAVID A. SKEEL, JR.*

INTRODUCTION

By any yardstick, these are times of great transition in the financial services industry. The divisions among commercial banking, investment banking, and insurance established by the Glass-Steagall Act¹ more than sixty-five years ago have steadily eroded, and many expect Congress to jettison them soon. Many banks issue insurance-like annuities, and investment banking subsidiaries of commercial banks have become increasingly common. At the same time, an unprecedented wave of bank mergers has transformed bank governance. Exemplifying both trends, Citibank and Travelers threw caution to the wind and completed a Glass-Steagall defying merger in the expectation that Congress would undo the law before it was too late.²

These are not your father's financial intermediaries, the trends seem to suggest. More than ever before, the governance of U.S. banks and insurance firms has come to resemble the governance of other U.S. firms, with takeovers and attention to stock prices playing an uncharacteristically central role. This market revolution in bank and insurance governance raises an obvious question: How far will the current trends go? Will financial firm governance and insolvency regulation eventually replicate the governance of nonfinancial firms?

This Article attempts to address these questions. The short answer the Article provides—that we cannot expect true convergence between financial and nonfinancial firm governance—will not come as an enormous surprise. But exploring the recent trends in banking and insurance from a corporate

* Professor of Law, University of Pennsylvania. I am grateful to Heidi Black and the *Washington University Law Quarterly* for inviting me to participate in this Symposium, and to Ronald Mann, Lisa Schiltz, and the conference participants for helpful comments.

1. Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

2. See generally Phil Kuntz, *Per Usual, Bank Bill Fails To Pass but Succeeds as Big Congressional Campaign Fund-Raiser*, WALL ST. J., Oct. 20, 1998, at A24 (noting Citigroup's need for legislation in order to retain insurance underwriting). For a valuable overview and analysis of the recent trends, see Allen N. Berger et al., *The Consolidation of the Financial Service Industry: Causes, Consequences, and Implications for the Future*, 23 J. BANKING & FIN. (forthcoming 1999).

governance perspective will both shed light on the significance of the new developments and suggest several changes lawmakers might make to improve the current insolvency framework. The Article will focus especially on commercial banks and to a lesser extent on insurance companies, but much of the analysis also applies to other bank-like financial intermediaries.

The central assumption of the Article is that we must consider both corporate governance and the background insolvency procedures to fully appreciate the overall governance framework.³ This is because the relationship between corporate governance and insolvency tends to be complementary. The governance of nonfinancial U.S. firms, for instance, relies on reactive correctives, such as takeovers, to address conflicts of interest between managers and widely scattered shareholders. If the firm fails, U.S. corporations can invoke a manager-driven reorganization option. In other nations, such as Germany and Japan, banks and other large investors actively participate in corporate governance, and bankruptcy is characterized by immediate displacement of managers and liquidation of the firm. I describe U.S. governance as an “ex post” approach and the German and Japanese alternative as an “ex ante” approach.⁴

Unlike that of nonfinancial U.S. firms, the governance of U.S. banks and insurance companies has long been ex ante in character. Takeovers and other ex post correctives have been rare, and insolvency means immediate removal of the managers and liquidation of the firm. Although the principal overseer of bank and insurance managers is a governmental regulator rather than a private investor, the overall governance framework functions very much like the approach used by nonfinancial firms in Germany and Japan.

The recent changes in bank and insurance firm governance have introduced a significantly greater market component, but the regulatory framework puts real limits on how far the transition can or will go. Despite the changes, bank and insurance governance has retained much of its traditional character.

As the discussion thus far suggests, much of the Article’s analysis is

3. I have presented and analyzed this assumption in several of my other works. *See, e.g.*, David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325 (1998) [hereinafter Skeel, *An Evolutionary Theory*]; David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994) [hereinafter Skeel, *Rethinking the Line*].

4. The characterization of governance as “ex ante” or “ex post” is introduced in Skeel, *An Evolutionary Theory*, *supra* note 3, at 1328, and corresponds loosely to the distinction other commentators have made between “bank-centered” and “stock market-centered” systems. *See, e.g.*, Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 328 (1996).

descriptive rather than normative in character. In discussing the treatment of insolvent banks and insurers, however, the Article offers several explicit prescriptions for improving the governance framework. First, in order to reduce managers' current incentives to avoid insolvency proceedings at all costs, and to harness managers' superior information about the firm, both bank and insurance insolvency law must be changed. Bank insolvency law should permit managers to propose a "prepackaged" purchase and assumption transaction (transferring the bank's assets and liabilities to another bank).⁵ In insurance insolvency, lawmakers should provide a traditional reorganization option. The Article also argues that lawmakers should add insurance insolvency (though not bank insolvency) to the Bankruptcy Code.

The Article proceeds as follows. Part I describes the relationship between corporate law and insolvency in the overall corporate governance framework. It also contrasts the *ex post* framework that characterizes most U.S. nonfinancial firms with the *ex ante* approach one sees in U.S. bank and insurance firm governance. Part II then explores the recent transition in bank and insurance governance. It first considers the increasing influence of market-oriented governance techniques in the financial services industry and whether this market revolution will dissolve the distinctions between financial and nonfinancial firm governance. The Part then focuses in even greater detail on the insolvency framework and the ways it might be improved.

I. THE SYSTEMS OF FINANCIAL AND NONFINANCIAL FIRM GOVERNANCE: THEORY AND HISTORY

Much of the recent literature on nonfinancial firms in the United States emphasizes the extent to which U.S. corporate governance reflects politics rather than simply economic necessity.⁶ A more complete explanation of U.S. corporate governance must also account for the role of corporate bankruptcy, as well as the economic and political forces that have shaped its evolution. In order to provide such an explanation, this Part sketches out a theory that highlights the complementary relationship between corporate governance and insolvency law.⁷ The Part first shows that U.S. corporate

5. For a discussion of purchase and assumption transactions, see *infra* note 42 and accompanying text.

6. The wellspring of much of this literature, and the seminal work, is MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS* (1994). For a more complete overview and description, see Skeel, *An Evolutionary Theory*, *supra* note 3, at 1332-39.

7. For an earlier version of the general theory, see Skeel, *An Evolutionary Theory*, *supra* note 3. Part

governance has moved in an ex post direction, relying on market correctives such as takeovers and a manager-driven insolvency regime. It then demonstrates how the governance and insolvency framework of financial intermediaries reflects precisely the opposite approach. The Part ends with a description of the existing regulatory framework of bank and insurance company governance.

A. Complements and Substitutes in U.S. Corporate Law

In contrast with nations such as Japan and Germany, U.S. corporate governance has long been characterized by relatively passive shareholdings and, as a result, a sharp separation between ownership and control. In recent years, institutional shareholders have acquired an eye-opening percentage of the stock of America's largest corporations, and a few public pension funds have begun to play an important role in corporate governance.⁸ Nevertheless, U.S. shareholders still are far more passive than their Japanese and German counterparts. Rather than active monitoring, U.S. investors look to ex post correctives, such as hostile takeovers, to address poor performance.⁹

In addition to passive shareholders and ex post correctives, other features of U.S. corporate governance include remarkably liquid securities markets and active managerial labor markets. In recent decades, most U.S. firms also have adopted stock options and other performance-based compensation devices in an effort to align managers' incentives more closely with shareholders' interests.¹⁰

Although these features are a useful starting point, one cannot fully understand U.S. corporate governance without taking bankruptcy into account. To see this point, it is helpful to focus in more detail on the

I further develops the framework and considers for the first time its implications for bank and insurance firm governance.

8. One highly visible participant has been California's public pension fund ("CalPERS"). The question whether institutional shareholders will transform U.S. corporate governance has generated a vigorous debate. For an optimistic view of institutional investors' likely role, see generally Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990). For more skeptical views, see Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991) (exploring conflicts of interest and other factors that discourage monitoring by institutional shareholders); Thomas A. Smith, *Institutions and Entrepreneurs in American Corporate Finance*, 85 CAL. L. REV. 1 (1997) (suggesting financial intermediary "customers" prefer passivity to minimize risk).

9. The contrast in monitoring techniques between shareholders of U.S. firms and their counterparts in Japan and Germany is an important theme in Roe's political account of U.S. corporate governance. See ROE, *supra* note 6; Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927 (1993).

10. For an empirical account of the increasing use of incentive-based compensation by U.S. firms, see generally Randall Krozner, *Were the Good Old Days that Good?* (1997) (unpublished manuscript, on file with author).

incentives of managers. Because they often lose their jobs after a takeover, and at best lose much of their authority, the managers of possible takeover targets have a strong interest in making takeovers difficult. As a result, U.S. managers have adopted a wide variety of antitakeover devices to protect themselves. Since the 1980s, these devices have ranged from staggered boards and poison pills to share-repurchase arrangements that increase the firm's debt and diminish the free cash that bidders might otherwise use to finance a takeover bid.¹¹

For the managers of firms with significant debt and little free cash, increasing the firm's debtload is a double-edged sword. The added debt may reduce the risk of a takeover, but it also increases the possibility of default. If managers faced immediate replacement after default, they would have an incentive either to protect themselves from takeovers in some other way—perhaps by encouraging one or more investors to acquire a large, stable stake in the firm—or to push the nation's bankruptcy regime in a more manager-friendly direction.¹² American corporate governance reflects the second approach. Although shareholdings are scattered and managers face the threat of hostile takeovers, American bankruptcy law permits managers to continue to run the firm (at least initially) after it files for bankruptcy.¹³

If American lawmakers had not prevented banks and other financial firms from holding large stakes in nonfinancial firms, and if financial intermediaries had assumed an active role in U.S. corporate governance,¹⁴ a different bankruptcy regime might have developed. An investor who holds a large stake in a firm has a much greater incentive than small investors to monitor that firm. The more leverage the investor has over managers, the more effective the monitoring will be. This is where bankruptcy comes in. A manager-driven bankruptcy regime would undermine the investor's leverage because the managers in such a regime could credibly threaten to file for

11. Managers also have persuaded nearly every state to adopt antitakeover legislation that imposes additional obstacles on takeover activity. For an account of the politics of antitakeover legislation, see Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

12. Investors also have good reason to favor these options. If a firm's stock and debtholders are widely scattered, investors face a coordination problem in the event the firm encounters financial distress. Manager-initiated bankruptcy could be seen as a mechanism for solving the coordination problem. If investors hold concentrated stakes, as in the ex ante framework described below, the investors themselves can step in and restructure the firm, making bankruptcy largely unnecessary.

13. The seeds of the current U.S. bankruptcy framework were sown in the 1950s and came to fruition with the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended in scattered titles of U.S.C.). For a detailed discussion of the emergence of manager-initiated reorganization during this period, see Skeel, *An Evolutionary Theory*, *supra* note 3, at 1372-79.

14. These obviously are big "ifs." Although J.P. Morgan and other Wall Street banks engaged in relational governance early in the century, it is quite possible that U.S. corporate governance would have moved in an ex post direction even without legislative interference.

bankruptcy rather than agree to changes demanded by the investor in the event of financial distress. By contrast, if managers face the prospect of immediate displacement, as they would in a manager-displacing bankruptcy regime, they would have a strong incentive to heed the investor's suggestions.¹⁵

Simply put, manager-displacing bankruptcy is crucial to relational governance in an ex ante system. We would therefore expect to see large, active investors in nations with a manager-displacing bankruptcy regime; and we would expect these concentrated investors to throw their political weight behind manager-displacing bankruptcy and to resist the U.S.-style, manager-driven approach.

As I have suggested, U.S. corporate governance has evolved in a very different direction. Although J.P. Morgan and other Wall Street banks engaged in relational governance early in the twentieth century, federal and state lawmakers actively intervened to usher banks and other financial intermediaries out of corporate governance.¹⁶ By tying the hands of financial intermediaries, lawmakers eliminated the most likely source of concentrated investment, and thus reinforced the fragmentation of U.S. stock ownership. Liquid markets, scattered shareholdings, and ex post correctives began to characterize U.S. corporate governance. On the bankruptcy side, a manager-driven insolvency regime emerged (or more precisely, reemerged) at roughly the same time to complete the ex post framework.¹⁷ The attributes of the two approaches are summarized in Table 1.

15. See Skeel, *An Evolutionary Theory*, *supra* note 3, at 1344-45. For a similar point about the role of banks in Canadian corporate governance, see F.H. Buckley, *The Canadian Keiretsu*, J. APPLIED CORP. FIN., Winter 1997, at 46, 52.

16. Much of the legislation as well as the popular pressure on financial intermediaries to diminish their role in corporate governance were inspired by a series of investigations that included the Armstrong investigation of large insurers in 1906 and the Pujo and Pecora investigations of Wall Street banks in the early 1910s and early 1930s. For a detailed description of the investigations, see ROE, *supra* note 6, at 31-35, 60-79, 110-11.

The most dramatic banking reforms came in the 1930s when Congress passed the Glass-Steagall Act, among other measures. Insurance companies faced stringent limitations on their ability to own stock for much of the century. See ROE, *supra* note 6, at 26. Mutual funds are permitted to hold large amounts of equity but are discouraged from taking concentrated stakes by the Investment Company Act of 1940 and the tax laws, both of which encourage diversification. See *id.* at 102-10. The Employee Retirement Income Security Act of 1974 ("ERISA") chills active monitoring by private public funds, and manager control over the choice of investment advisor creates even greater disincentives to activism. See *id.* at 125-26.

17. See Skeel, *An Evolutionary Theory*, *supra* note 3, at 1372-79; see also David A. Skeel, Jr., *The Rise and Fall of the SEC in Bankruptcy* (1998) (unpublished manuscript, on file with author).

Table 1: The Two Governance Approaches

<i>Type of Framework</i>	<i>Corporate Governance Characteristics</i>	<i>Bankruptcy/Insolvency Characteristics</i>
<i>Ex Ante</i>	Relational share/debtholders; thin managerial labor markets	Manager-displacing, liquidation-based
<i>Ex Post</i>	Passive shareholders; liquid securities markets; thick managerial labor markets and incentive-based compensation	Manager-driven, reorganization-based

It is important to emphasize the extent to which corporate governance in the United States, as elsewhere, reflects both politics and economics. Political factors figure prominently, but so, too, do the different parties' responses to them. For example, the fragmentation of U.S. stock ownership gave parties an incentive to adopt mechanisms other than relational governance for addressing managerial agency costs, such as incentive-based compensation and takeovers. Manager-driven bankruptcy is the natural complement to these mechanisms, and such a bankruptcy approach has in fact emerged in the United States.¹⁸ If lawmakers and courts had insisted on manager-displacing bankruptcy instead, the mix of ex post corporate governance and ex ante bankruptcy would have proven unstable. Because manager-displacing bankruptcy would increase the gains available to relational investing, investors might have begun to acquire concentrated stakes, thereby pushing corporate governance in an ex ante direction.¹⁹

Investors did not do this, however. By the 1950s, American corporate governance had turned in a decisively ex post direction. Although American corporate bankruptcy had a manager-displacing character in the 1950s, this began to change. The ex post pattern in American corporate governance soon became clear.

B. The Ex Ante Habit of Bank and Insurance Firm Governance

Financial intermediaries have already figured prominently in this story. Thus far, however, we have seen them only as investors in nonfinancial

18. Manager-driven bankruptcy offers a soft landing to managers of firms that have encountered financial distress despite remaining otherwise viable, and it also addresses the coordination problem that arises in the absence of concentrated investment. *See supra* notes 12-13 and accompanying text.

19. *See Skeel, An Evolutionary Theory*, *supra* note 3, at 1348 (noting that investors' gains could stem either from improved monitoring or from less benign sources such as "special treatment" from managers of firm).

corporations. An examination of the governance and insolvency of financial intermediaries themselves quickly reveals an interesting irony. Although U.S. nonfinancial firm governance has evolved in an ex post direction, the governance of financial intermediaries has not followed; to the contrary, it has developed characteristics that look strikingly different.

In the early decades of the nineteenth century, banks were treated largely like other corporations. Both were chartered by the states and were managed by a small group of shareholders who held most or all of the firm's stock.²⁰ The separation between ownership and control came later,²¹ and unless the state intervened to help out, a failing firm was invariably liquidated.

Not until the late nineteenth century did the railroads emerge as the nation's first large corporations. As the railroads and other firms grew to unprecedented size,²² the governance of these firms exemplified the separation of ownership and control that Berle and Means would document in the 1930s.²³ The late nineteenth century also witnessed a remarkable development in railroad insolvency law. When large numbers of railroads failed, often due to a combination of overexpansion and a downturn in the national economy, nearly everyone agreed that both the public good and the interests of shareholders and other stakeholders required preservation rather than liquidation.²⁴ Although neither Congress nor the states could easily intervene, the courts did. Over a period of several decades, state and federal courts managed to transform ordinary foreclosure law into a device for corporate reorganization that became known as equity receivership.²⁵

Although the stock of banks and insurance companies also became more widely held during the course of the nineteenth century, bank and insurance firm ownership remained more concentrated, and the insolvency approach retained its ex ante character. The National Bank Act, for instance, subjected shareholders to "double liability"—an obligation to contribute up to the amount they had paid for their stock if the bank failed.²⁶ Similarly, some

20. The earliest U.S. corporations tended to be banks and corporations formed to complete quasi-public projects such as building turnpikes and bridges. *See, e.g.*, 2 JOSEPH S. DAVIS, *ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS* 3, 21-33 (1917); LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 188-89 (2d ed. 1985).

21. Though not nearly so late as is often thought. *See* Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL. 671, 684 (1995) (separation present almost from beginning).

22. For a classic account of the emergence of modern business enterprises, see ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* (1977).

23. *See* ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

24. For a detailed account, see Skeel, *An Evolutionary Theory*, *supra* note 3, at 1353-58.

25. *See id.*

26. *See* Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders:*

states experimented with coinsurance arrangements that held other banks liable if one of the banks in the group failed.²⁷ Each of these approaches discouraged failure by penalizing either the shareholders (under double liability) or other banks (under coinsurance) if a bank failed.

Interestingly, the same package of New Deal reforms that reinforced the ex post tendencies in nonfinancial firm governance produced precisely the opposite effect for financial intermediaries. This was especially true for banks. At the same time that it introduced deposit insurance to protect depositors, the Banking Act of 1933²⁸ also introduced stringent new capital requirements to reduce banks' ability to take risks at the expense of the insurance scheme.²⁹ In addition, regulators were given sweeping authority to remove a bank's managers and initiate insolvency proceedings if the bank encountered financial distress.

The New Deal does not figure as prominently in the history of insurance company governance, both because state regulators rather than Congress have long regulated insurance law,³⁰ and because the Depression did not create as great a crisis for insurance companies as it did for banks. Nevertheless, the historical picture is similar. As with bank regulators, insurance regulators have a pervasive, ongoing role in governance. They also hold the reins to the insolvency framework, which immediately displaces managers when an insolvency proceeding is initiated.

Before we jump to the conclusion that bank and insurance firm governance reflects (and has always reflected) the ex ante strategy I have described, we must consider two important complications. The first is the nature of the relational monitor. Whereas private investors (who often are themselves banks, as we have seen) serve as the relational monitors of nonfinancial German and Japanese firms, the monitors of U.S. banks and insurers are governmental regulators. Not least of the differences is that governmental regulators do not have the same direct financial interests as a private investor. Regulators focus on "safety and soundness," whereas

History and Implications, 27 WAKE FOREST L. REV. 31 (1992).

27. See Charles W. Calomiris, *Deposit Insurance: Lessons from the Record*, ECON. PERSP., May/June 1989, at 10 (describing nineteenth century state-run bank insurance schemes).

28. Pub. L. No. 73-66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

29. See, e.g., Michael Klausner, *An Economic Analysis of Bank Regulatory Reform: The Financial Institutions Safety and Consumer Choice Act of 1991*, 69 WASH. U. L.Q. 695, 713-14 (1991) (describing capital requirements and moral hazards stemming from their imperfections).

30. State regulation of insurance law was assured by *Paul v. Virginia*, 75 U.S. (8 Wall.) 168, 183 (1868), which held that the Commerce Clause forbids federal regulation of insurance. *Paul* was eventually overruled by *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533, 543-49, 553 (1944), but Congress quickly passed the McCarran-Ferguson Act, Pub. L. No. 79-15, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011-1015 (1994)), to ensure continued state control.

private relational investors seek to maximize profitability. In practice, however, the similarities between private, relational investors in Germany and Japan, on the one hand, and U.S. bank and insurance regulators, on the other, prove far more striking than the ostensible differences. Both regulators and private investors have access to substantial soft information about firm performance, for instance. Although German and Japanese relational investors have a direct financial stake in the nonfinancial firms they monitor, they, like governmental regulators, have an incentive to discourage even beneficial risk taking because the monitors themselves are highly leveraged, often hold substantial debt stakes in the firms they monitor, and are closely regulated.³¹ In effect, the private relational monitors of German and Japanese corporations focus on the safety and soundness of the firms they invest in, just as U.S. bank and insurance regulators do.

The second complication involves going concern value. The governance theory developed in this Article is designed to identify different approaches to preserving and enhancing a firm's going concern value. Because banks and insurers hold unusually liquid assets, there is a real question how much going concern value they have—that is, how much the value of their franchise as a whole exceeds the value of the individual assets. In the absence of going concern value, the theory would have little application because there would be nothing to preserve or enhance. On inspection, financial firms do have at least some value beyond the value of their individual assets. For banks, for instance, customer service networks and depositor lists may have substantial value. But it is important to keep in mind that the going concern value of financial intermediaries is less obvious than that of nonfinancial firms.

C. Banks and Insurance: Regulation and Insolvency

Thus far, this Article has considered the governance of U.S. financial and nonfinancial firms from a general and historical perspective. This section concludes our initial discussion by providing a brief description of the existing regulatory framework.

Banks are regulated by one or more of four different regulators.³² The Comptroller of the Currency regulates national banks; both state regulators

31. For a discussion of these incentives, see Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 96 (1995).

32. In addition to the regulation of individual banks as described below, bank holding companies are regulated by the Federal Reserve. For a description and discussion of the tension between the Federal Reserve and the Comptroller over financial services reform, see Bevis Longstreth & Ivan E. Mattei, *Organizational Freedom for Banks: The Case in Support*, 97 COLUM. L. REV. 1895 (1997).

and the Federal Reserve oversee state banks that have joined the Federal Reserve system; and both state regulators and the FDIC have jurisdiction over state banks that do not join the Federal Reserve system.³³ Notwithstanding the multiple sources of regulation, much of the regulation is comparable for most banks. For example, the vast majority of banks participate in the deposit insurance system, which guarantees a maximum of \$100,000 per account,³⁴ and all banks are statutorily subject to similar capital requirements.³⁵

Regulators monitor banks in a number of ways. They conduct regular audits, they oversee the issuance of bank charters, and they have authority to approve or disapprove mergers and other consolidations among banks.³⁶ Prior to the FDIC Improvement Act of 1991 ("FDICIA"),³⁷ a bank's principal regulator also determined whether and when to initiate an insolvency proceeding if the bank encountered financial distress. Thus, the Comptroller made the insolvency decision for national banks; state regulators or the Federal Reserve did so for state banks belonging to the Federal Reserve system; and state regulators alone had this authority for nonmember banks.³⁸ In response to widespread dissatisfaction with state regulators' handling of the bank failures of the 1980s, however, Congress significantly expanded the FDIC's authority when it enacted FDICIA. As a result, the FDIC now can initiate an insolvency proceeding for any bank.³⁹

A common theme in every bank insolvency is that bank managers are immediately displaced, and insolvency results in liquidation rather than reorganization.⁴⁰ When bank regulators decide to intervene, they generally set up a receivership and liquidate the troubled bank's assets in one of three ways.⁴¹ First, in a purchase and assumption transaction ("P&A"), a favorite

33. See David A. Skeel, Jr., *The Law and Finance of Bank and Insurance Insolvency Regulation*, 76 TEX. L. REV. 723, 727-28 (1998).

34. See 12 U.S.C. § 1821(a) (1994 & Supp. III 1997).

35. See 12 U.S.C. § 3907(a) (1994) (requiring regulators to set minimum capital levels).

36. For a discussion of bank consolidation jurisdiction, see James A. Bernstein, *Mergers and Acquisitions: The Legal Hurdles Banks Face in Choosing to Consolidate*, 109 BANKING L.J. 205, 221-24 (1992).

37. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified as amended in scattered sections of 12 U.S.C.).

38. See Paul W. Grace, *Regulatory Seizure of Banks and Thrifts*, in BANKS AND THRIFTS: INTRODUCTION TO FDIC/RTC RECEIVERSHIP LAW 177, 180-95 (PLI Commercial Law & Practice Course Handbook Series No. 616, 1992) [hereinafter RECEIVERSHIP LAW] (explaining role of regulators in insolvency initiation both before and after FDICIA).

39. See *id.* at 180-83.

40. See, e.g., 12 U.S.C. § 1831o(f)(2)(F)(ii)-(iii) (1994) (authorizing regulators to dismiss directors and officers).

41. For a more detailed overview of the resolution techniques described below, see Skeel, *supra* note 33, at 728-30, 767-72; see also EDWARD L. SYMONS, JR. & JAMES J. WHITE, BANKING LAW 604-07 (3d

technique in the 1980s, regulators can transfer some or all of the troubled bank's assets and liabilities to a healthy bank.⁴² Alternatively, in an insured deposit transaction, regulators can transfer a bank's insured deposits, but not its assets, to a third party. As a final option, regulators can liquidate the bank's assets and pay off its insured depositors in a straight liquidation. In the 1980s bank regulators had almost unbridled discretion in deciding which option to pursue. When FDICIA was enacted, however, the same legislation that expanded the FDIC's role in initiation of insolvency proceedings also provided a detailed framework of prompt corrective action regulations prescribing both how and when regulators must act when a bank encounters financial distress.⁴³

As noted above, insurance companies are regulated entirely by state regulators.⁴⁴ Although the insurer's primary regulator is the insurance commissioner of its domicile state, the insurer also is subject to regulation by every state in which its policy holders live. Insurance regulation varies from state to state, but most states have adopted either the Insurers Rehabilitation and Liquidation Model Act ("NAIC Model Act"),⁴⁵ drafted and promoted by the National Association of Insurance Commissioners, or the older Uniform Insurers Liquidation Act.⁴⁶

Like bank regulators, insurance regulators conduct regular audits and focus on minimum capital standards as a means of enhancing insurance stability.⁴⁷ The insurer counterpart to deposit insurance is states' guaranty funds. In the last three decades, most states have established guaranty funds designed to protect policyholders who live in the state in the event their insurer fails.⁴⁸ These funds tend to set relatively low limits on their coverage, however, and thus far they have played only a limited role in insurance company governance.

Like their counterparts in banking, insurance regulators have exclusive

ed. 1991).

42. In the 1980s regulators often structured P&A's to protect not just insured bank depositors, but also uninsured ones. For a criticism of this policy, see Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1182-84 (1988).

43. For an overview of these regulations, see Skeel, *supra* note 33, at 740-42.

44. See *supra* note 30 and accompanying text.

45. See INSURERS REHABILITATION AND LIQUIDATION MODEL ACT (National Ass'n of Ins. Comm'rs 1995) [hereinafter NAIC MODEL ACT].

46. See UNIF. INSURERS LIQUIDATION ACT (1939). For a discussion and lists of the states that have enacted each of the statutes, see Kent M. Forney, *Insurer Insolvencies and Guaranty Associations*, 43 DRAKE L. REV. 813, 817-18 nn.42-44 (1995).

47. See, e.g., J. David Cummins et al., *Insolvency Experience, Risk-Based Capital, and Prompt Corrective Action in Property-Liability Insurance*, 19 J. BANKING & FIN. 511 (1995).

48. For a brief description, see Skeel, *supra* note 33, at 732.

control over the decision to initiate an insolvency proceeding.⁴⁹ Insolvency proceedings take one of two forms: liquidation or rehabilitation. In a liquidation, regulators simply sell off and distribute the insurer's assets; in a rehabilitation, regulators attempt to stabilize the insurer in order to rehabilitate it, failure of which will lead to a subsequent liquidation. The state insurance commissioner serves as rehabilitator or conservator.⁵⁰ The managers of the insurer are routinely replaced and rarely participate in the insolvency process.

II. THE TRANSFORMATION OF FINANCIAL FIRM GOVERNANCE AND INSOLVENCY

For much of the immediate post-World War II era, bank and insurance governance fit neatly and comfortably within the traditional paradigm: managers were monitored by regulators, who acted both as governmental overseer and relational investor. Several characteristic aspects of financial firm activity made this paradigm possible. For decades, the managers of many banks had the great luxury of enjoying what, in effect, amounted to a local monopoly. Banks alone were permitted to offer traditional deposit accounts, and regulators carefully limited access to bank franchises.⁵¹ And although insurance companies were less insulated from competition, the fire wall set up by the Glass-Steagall Act ensured that banks would stay out of the insurance business. In both banking and insurance, managers were notoriously cautious.⁵² They viewed regulators as their principal monitor, and they faced little or no threat from ex post correctives such as hostile takeovers.

In the last three decades, changes in the financial markets have put tremendous pressure on the traditional approach to bank and insurance governance. More than ever before, banks and insurance companies face the same kinds of competitive pressures that have long shaped other industries. These changes in their product markets have prompted changes in bank and insurance company governance. Mergers and other combinations are no longer rare, and outside investors have begun to play an increasingly

49. See, e.g., Forney, *supra* note 46, at 819.

50. See, e.g., NAIC MODEL ACT § 17 (commissioner as rehabilitator); *id.* § 19 (commissioner as liquidator).

51. See, e.g., Klausner, *supra* note 29, at 699-705.

52. For contemporaneous accounts of this tendency in banking, see A. Dale Tussing, *The Case for Bank Failure*, 10 J.L. & ECON. 129, 130-31 (1967) (citing CHRIS ARGYRIS, *ORGANIZATION OF A BANK: A STUDY OF THE NATURE OF ORGANIZATION AND THE FUSION PROCESS* (1954); Robert N. McMurry, *Recruitment, Dependency, and Morale in the Banking Industry*, 3 ADMIN. SCI. Q. 87 (1958)).

important role.

This Part describes the transformation of bank and insurance company governance and attempts to determine how far the changes will go. The Part begins, in the first section, by describing the most important recent developments. Although regulatory barriers will limit the scope of these changes, increased reliance on market-based monitoring devices will put enormous pressure on the traditional insolvency framework. The second and third sections consider how to adjust bank and insurance insolvency regulation to better fit current governance patterns. The Part concludes by considering the existing regulatory structure, focusing in particular on the question whether to include bank and insurance insolvency in the bankruptcy laws that regulate the insolvency of nonfinancial firms.

A. The Ex Post Turn in Bank and Insurance Governance

In banking, increased competition dates back to the emergence of market alternatives to traditional bank loans in the 1960s and 1970s. As large firms began to issue commercial paper rather than borrowing from banks, and with the increased use of the securities markets for raising capital, banks' traditional role as lender of choice became more precarious.⁵³ Ironically, the same laws that had insulated banks from competition made it difficult for banks to compete in the new marketplace. For instance, the McFadden Act⁵⁴ and related laws limited banks' ability to expand geographically, and the Glass-Steagall Act restricted the range of products banks could offer.⁵⁵

Changes in the financial markets have had a similar effect on the insurance industry. Insurance companies had always been less protected from competition than banks, and they too have faced challenges from the new financial landscape.

In order to compete, banks have not only acceded to, but have actively encouraged, the dismantling of many of the reforms set in place during the New Deal. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994⁵⁶ has eliminated most of the geographical restrictions created by the

53. For an extensive account, see David G. Litt et al., *Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan*, 139 U. PA. L. REV. 369 (1990).

54. Act of Feb. 25, 1927, Pub. L. No. 69-639, 44 Stat. 1224 (codified as amended at 12 U.S.C. § 36 (1994 & Supp. III 1997)).

55. See, e.g., Klausner, *supra* note 29, at 726-36.

56. Riegle-Neal Interstate Banking and Banking Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (codified in scattered sections of 12 U.S.C.).

McFadden Act.⁵⁷ And although rumors of the death of the Glass-Steagall Act continue to prove premature, the walls between commercial banking, investment banking, and insurance have eroded considerably, making the repeal of the Glass-Steagall Act seem inevitable.⁵⁸

Increased competition has led to remarkable changes in bank and insurance governance. The most visible change in bank governance has been the wave of bank takeovers in this decade.⁵⁹ Until recently, the market for bank control had been almost nonexistent. Now, scarcely a week goes by without news of a proposed bank merger. Much as with U.S. nonfinancial firms, takeovers have become the strategy of choice for addressing managerial agency costs and other performance concerns, and no underperforming bank is immune.⁶⁰

Managerial compensation, and the overall managerial labor market, has undergone a similar transformation. Banks traditionally have paid their managers less, and relied less on performance-based compensation, than nonfinancial firms, just as one would expect with a heavily-regulated industry.⁶¹ With increasing competition, and as the decline of geographical barriers has unleashed the takeover market, banks have substantially increased their use of incentive-based compensation. The shift has been most pronounced with firms that have high charter values and as geographical obstacles to expansion have been removed.⁶² As with their counterparts in other industries, banks that have significant growth opportunities now seek to inspire their managers with incentive-based compensation.

57. For a detailed description, see Mark D. Rollinger, *Interstate Banking and Branching Under the Riegle-Neal Act of 1994*, 33 HARV. J. ON LEGIS. 183 (1996).

58. See, e.g., Kuntz, *supra* note 2, at A24 (noting continued failure to repeal).

59. See Berger et al., *supra* note 2. Banking scholars are sharply divided on the desirability of the consolidation that has resulted. Compare Geoffrey P. Miller, *Legal Restrictions on Bank Consolidation: An Economic Analysis*, 77 IOWA L. REV. 1083 (1992) (defending consolidation), with Arthur E. Wilmarth, Jr., *Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks*, 77 IOWA L. REV. 957 (1992) (criticizing consolidation).

60. One difference, however, is that nearly all of the bank takeovers have been consensual mergers—at least in form.

61. In the corporate finance literature, proponents of the “contracting theory” of executive compensation predict that the managers of regulated firms will be paid less, and will receive less performance-based compensation, because effective managers have less room to distinguish themselves. See, e.g., Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990).

62. See Joel F. Houston & Christopher James, *CEO Compensation and Bank Risk: Is Compensation in Banking Structured to Promote Risk Taking?*, 36 J. MONETARY ECON. 405 (1995) (banks with high franchise value use more incentive compensation); R. Glenn Hubbard & Darius Palia, *Executive Pay and Performance: Evidence from the U.S. Banking Industry*, 39 J. FIN. ECON. 105 (1995) (deregulation by states has led to higher pay, greater use of performance-based compensation, and higher managerial turnover).

The trend in all of this should be clear. Bank and insurance governance is more market driven than ever before and has taken on many of the ex post characteristics we tend to associate with other types of widely held U.S. firms. Nevertheless, it would be a mistake to conclude that bank and insurance governance will soon look just like nonfinancial firm governance. The same forces that produced the New Deal reforms in financial regulation ensure that any changes in bank and insurance governance will stop well short of a true ex post framework.

The principal countervailing force is the perception that banks (and, to a somewhat lesser extent, insurance companies) play a unique role in the economy. Although the financial markets are far more stable than in the Depression, the belief that bank depositors and the payment system as a whole must be protected continues to resonate deeply.⁶³ So long as the deposit insurance framework remains in place to address these concerns, regulators will continue to play a crucial dual role: overseeing healthy banks and, when a bank fails, stepping into depositors' shoes as the largest single creditor of the bank. For bank governance as a whole, regulators will continue to function very much like the relational investors of nonfinancial firms in an ex ante governance framework.

Bank takeovers present perhaps the best evidence of the analogy between bank regulators and large private investors. Notwithstanding the recent wave of takeovers, regulators still stand squarely between any would-be bidder and a bank targeted for acquisition.⁶⁴ Even more than the relational investors of a German or Japanese firm, bank regulators can simply refuse to let a takeover bid go through.⁶⁵

The story with incentive-based compensation is quite similar. Although many more banks use incentive-based compensation than in the past, they still lag behind nonfinancial firms in employing this strategy.⁶⁶ An obvious reason is that, despite the market revolution, banks remain far more heavily regulated than other firms and face substantial limitations on their investment opportunities. The theory of this Article suggests that the prospect for immediate displacement in the event of failure, and the relatively thin managerial labor market, further undermine the attractiveness to managers of incentive-based compensation.

63. See, e.g., DEPARTMENT OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS 2-3 (1991) [hereinafter TREASURY REPORT].

64. See Bernstein, *supra* note 36, at 221-24.

65. See Berger et al., *supra* note 2 (manuscript at 8-9, on file with *Law Quarterly*) (speculating that restrictions allowing only banks to acquire other banks, together with regulatory approval process, may explain dearth of hostile takeovers).

66. See Houston & James, *supra* note 62.

Each of these factors also applies to insurance companies, though in a slightly muted form. Concern over protecting policyholders ensures that regulators will remain at the heart of insurance firm governance. Moreover, insurance company regulators are also in a position to dampen the scope and effectiveness of ex post correctives such as takeovers.

In the banking context especially, commentators have proposed a wide variety of reforms that would inject more market-based monitoring into financial firm governance.⁶⁷ Proposals include partial privatization of deposit insurance,⁶⁸ implementation of a system of cross-guarantees,⁶⁹ and a requirement that banks issue a minimum amount of subordinated debt with an imbedded put option.⁷⁰ Each of the proposals has much-noted limitations, and the effectiveness of all of the proposals remains untested.⁷¹ For present purposes, an interesting characteristic of the proposals is that, like the existing framework, each is ex ante in orientation. They are each designed to discourage failure, either by supplementing regulators with a private monitor (private insurance, cross-guarantees) or by penalizing firms that encounter financial distress (subdebt with put options).

The upshot of this analysis is that absent a dramatic change in the regulatory framework, regulators' dual role as monitor and, in effect, relational creditor seriously limits the extent to which the market revolution in banking and insurance can blur the distinctions between financial and nonfinancial firm governance. Although the increased influence of market forces is dramatic and probably permanent, financial intermediary governance will remain more ex ante than ex post in orientation.

Although these conclusions are primarily descriptive, the analysis has important normative implications as well. One implication concerns the rapid consolidation of the banking industry. Much of the consolidation reflects the removal of artificial barriers to expansion and will produce a more sensible allocation of banking assets. But the analysis of this Part suggest that critics' attacks on the consolidation trend are not entirely unfounded.⁷² Because the

67. For a useful overview and critique of the proposals, see TREASURY REPORT, *supra* note 63, at VII-1 to VII-37. See also Skeel, *supra* note 33, at 736-39.

68. See, e.g., Herbert Baer, *Private Prices, Public Insurance: The Pricing of Federal Deposit Insurance*, FED. RESERVE BANK OF CHICAGO ECON. PERSP., Sept./Oct. 1985, at 47.

69. See, e.g., Thomas E. Petry & Bert Ely, *Real Taxpayer Protection: Sound Deposit Insurance Through Cross-Guarantees*, POL'Y REV., Spring 1992, at 25.

70. See, e.g., Larry D. Wall, *A Plan for Reducing Future Deposit Insurance Losses: Puttable Subordinated Debt*, FED. RESERVE BANK OF ATLANTA ECON. REV., July/Aug. 1989, at 2-3.

71. A pervasive complaint is that, unlike regulators, market players would not have an adequate incentive to take systemic factors (such as the risk that one bank failure would precipitate other failures) into account. See Skeel, *supra* note 33, at 737-38.

72. Arthur Wilmarth has been the most vocal critic in the legal literature. See, e.g., Arthur E.

ex ante governance approach is more effective at preserving going concern value than at reallocating it (that is, ex ante governance relies less on creative destruction), consolidation may be less “reversible” than with ex post governance.⁷³ More than with nonfinancial firms, there may be substantial barriers to downsizing once a bank or insurer has expanded, a problem that is compounded by regulators’ unwillingness, under the “too big to fail” doctrine, to allow large banks to fail.⁷⁴

A second implication concerns the recent debate in the corporate law literature as to whether financial intermediaries should be given more flexibility to participate in the governance of nonfinancial U.S. firms.⁷⁵ Given the risk aversion encouraged by ex ante governance, we could expect bank or insurance firm monitors to discourage risk taking by the nonfinancial firms they monitored. In particular, and as noted earlier, banks themselves are heavily leveraged and tend to hold large debt stakes, which will influence their perspective as monitors. Moreover, regulators’ efforts to assure the banks’ safety and soundness also will affect the way banks monitor nonfinancial firms.⁷⁶

B. Opening Up Bank Insolvency Regulation

The rapid consolidation of the banking and insurance industries and the increasing competition have been dramatic and visible. The same developments that have altered bank and insurance governance will also put pressure on the existing insolvency framework.

Wilmarth, Jr., *Too Good to be True? The Unfulfilled Promises Behind Big Bank Mergers*, 2 STAN. J.L., BUS. & FIN. 1 (1995); Wilmarth, *supra* note 59.

73. For a fascinating discussion of the relationship between size and the reversibility of organizations generally, see Saul Levmore, *Irreversibility and the Law: The Size of Firms and Other Organizations*, 18 J. CORP. L. 333 (1993).

74. Notice that this suggests that careful antitrust scrutiny, which has been advocated by both critics and (in much weaker form) proponents of consolidation, may not address all of the potential problems posed by consolidation.

75. Bernard Black has been the most enthusiastic advocate of such steps. See Black, *supra* note 8.

76. For a discussion of the problems caused by regulatory intervention in troubled banks under the “implicit safety net” in Japan, see Curtis J. Milhaupt, *Japan’s Experience with Deposit Insurance and Failing Banks: Implications for Financial Regulatory Design*, 77 WASH. U. L.Q. 399 (1999).

Interestingly, at the same time as commentators have advocated greater involvement by financial intermediaries in the governance of nonfinancial firms, there has been an increase in the opposite phenomenon: nonfinancial firm ownership of banks and thrifts. Due to a loophole in the Bank Holding Company Act, 12 U.S.C. § 1841(c)(2)(F) (1994), many retailers now own “credit card banks”; and the Savings and Loan Holding Company Act, 12 U.S.C. § 1467a(c)(3), permits nonfinancial firms to own one thrift. The nonfinancial firm owners of these banks and thrifts can be expected to bring their ex post perspective to bear on their governance of the financial firms they run.

In the early 1990s, Congress passed FDICIA in an effort to address the widespread dissatisfaction with regulators' handling of the savings and loan and bank crises. Because regulators have an incentive to wait too long to initiate insolvency proceedings, FDICIA utilizes a command and control approach that requires regulators to take action at specified stages in a bank's financial decline.⁷⁷ Most dramatically, FDICIA instructs regulators to initiate an insolvency proceeding when a bank's assets exceed its liabilities by less than two percent.⁷⁸

Most commentators correctly view FDICIA as a significant improvement on the prior framework.⁷⁹ Sweeping as they are, however, the new reforms have an unfortunate limitation: they continue to assume that regulators alone should decide whether and when to initiate an insolvency proceeding and how to dispose of an insolvent bank's assets. Unlike those of other U.S. firms, the managers of a troubled bank are not given a role.

The traditional explanation for displacing managers at the outset of an insolvency proceeding was probabilistic. When banks failed, their failure almost always stemmed from gross mismanagement or fraud.⁸⁰ Thus, lawmakers simply assumed that displacing managers was the first step in addressing bank failure. In an era when banks enjoyed local monopolies, the assumption made a great deal of sense. But as the competitiveness of banking markets continues to rise, an increasing percentage of bank failures will stem from competition rather than mismanagement.⁸¹

Softening the presumptive displacement of managers and including managers in the insolvency process makes sense for two reasons. First, although the auditing process gives regulators a great deal of information about bank performance, bank managers have even more. Far more than

77. FDICIA establishes five zones of bank capital. Zones 1 and 2 reflect at least adequate capital, whereas increasingly serious undercapitalization is reflected in Zones 3, 4, and 5. FDICIA imposes specific sanctions for Zone 3 and Zone 4 banks and calls for the merger of, or initiation of insolvency proceedings for, Zone 5 banks. The Zones are defined at 12 U.S.C. § 1831o(b)(1) (1994). The requirements and sanctions are codified at section 1831o(d)-(h). For a more detailed description, see Klausner, *supra* note 29, at 760-64.

78. See 12 U.S.C. § 1831o(c)(3)(B) (1994). Lawmakers assumed that, due to accounting inaccuracies, a bank whose books reflect only two percent tangible capital is likely to be insolvent in reality. See, e.g., Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 DUKE L.J. 469, 489 n.93 (1992).

79. See, e.g., Wayne D. Angell, *Bank Capital: Lessons from the Past and Thoughts for the Future*, 27 WAKE FOREST L. REV. 603, 610 (1992) (describing FDICIA as notable improvement). On the other hand, many commentators also express reservations. The principal complaint is that regulators still have substantial discretion, even under the prompt corrective action requirements. See, e.g., David S. Jones & Kathleen Kuester King, *The Implementation of Prompt Corrective Action: An Assessment*, 19 J. BANKING & FIN. 491, 508-09 (1995).

80. See, e.g., Swire, *supra* note 78, at 507-08.

81. See, e.g., *id.* at 509-10 (increased competition); but see, e.g., *id.* at 510-18 (describing factors that make fraud in banks still more likely than in other firms).

regulators, bank managers will have information about issues such as market trends, possible consolidations, and products likely to appeal to the bank's particular customer base. This kind of information is both crucial and too impressionistic for regulators to develop. Harnessing this information could lead to better decisions on whether, when, and how to initiate and conduct insolvency proceedings.

Second, enlisting managers in the initiation decision would reinforce the shift toward more market driven governance. For instance, manager initiation would decrease managers' incentives to forestall insolvency proceedings and, as we shall see, could expand the market for bank control to include marginally insolvent firms as well as solvent ones.

In one respect, Congress already has incorporated managers into the insolvency process. In 1989 Congress enacted "cross-guarantee" obligations that require the banking subsidiaries of a bank holding company to infuse capital into a failing subsidiary as part of FIRREA.⁸² And in 1991 FDICIA added "controlling company" obligations that encourage a holding company to guarantee a troubled banking subsidiary's compliance with submitted and accepted restoration plans.⁸³ Because most banks are part of a holding company,⁸⁴ these obligations ensure that the managers of most banks have an obligation to support a failing subsidiary. But the holding company's obligations are limited in important respects. These obligations do not apply to firms that do not belong to a holding company,⁸⁵ for instance, and the obligations only have bite if the holding company has significant assets outside of the troubled banking subsidiary.⁸⁶ Moreover, if insolvency

82. See Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (codified as amended in scattered titles and sections of U.S.C.). The cross-guarantee provisions are set forth in 12 U.S.C. § 1815(e) (1994). For a discussion of liabilities and amounts of compensation, see Lissa Lamkin Broome, *Redistributing Bank Insolvency Risks: Challenges to Limited Liability in the Bank Holding Company Structure*, 26 U.C. DAVIS L. REV. 935, 960-62 (1993).

83. See 12 U.S.C. § 1831o(e)(2)(C)(ii) (1994). The controlling company provision limits the holding company's liability from that guarantee to the lesser of five percent of a troubled bank's liabilities, or enough to restore the troubled bank's standard, required capital. See *id.* § 1831o(e)(2)(E). For a general description, see Broome, *supra* note 82, at 963-67. See also Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507, 536-39 (1994).

84. See Allen N. Berger et al., *The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It's Been*, in 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 55, 65-68 (William C. Brainard & George L. Perry eds., 1995) (substantial majority of bank assets in holding companies).

85. In view of this, Howell Jackson proposed an expanded holding-company liability framework that would impose comparable requirements on nonholding company banks (or, in the alternative, compensate holding companies for their extra burden through adjustments such as more lenient capital requirements). See Jackson, *supra* note 83, at 615-19 app.

86. See Skeel, *supra* note 33, at 750; cf. Jackson, *supra* note 83, at 603 (obligations only effective to extent of holding company solvency to support subsidiary). In addition, the holding company obligations do not actually *require* the holding company to infuse capital into a troubled subsidiary. Absent an infusion,

proceedings become necessary, the holding company provisions continue to presume that managers will have no role to play.

By itself, leaving managers in place would not improve on the existing approach. Because regulators control every aspect of the process, and insolvency proceedings always lead to liquidation, initiation would still be much less attractive to managers than attempting to forestall the proceedings. In other work, I have argued that lawmakers could assure timely initiation either by structuring a bonus plan that rewarded managers for initiating in a timely fashion or by penalizing managers for failing to do so, as is done in nonfinancial firm governance and insolvency in some other nations.⁸⁷ Lawmakers could achieve the same effect in a more practical way by giving managers at least a modicum of control over the insolvency process. In bankruptcies involving U.S. nonfinancial firms, for instance, managers' ability to propose a reorganization plan (which often ensures shareholders at least a limited recovery) gives managers a much greater incentive to file for bankruptcy than they would otherwise have.⁸⁸

Adding a full-blown reorganization option is much less attractive for banks than for nonfinancial firms. The reorganization process takes time. Even with deposit insurance, prolonged negotiations might well lead to depositor runs. Moreover, the presence of a single, central creditor—the FDIC—diminishes the coordination problems that justify reorganization in other contexts.⁸⁹

Although full-blown reorganization would not make sense for banks, another reorganization technique—prepackaged bankruptcy—offers much more promise. In a prepackaged plan, managers negotiate a reorganization plan *before* they file for bankruptcy and submit it along with their bankruptcy petition.⁹⁰ Prepackaged plans dramatically reduce the duration of the

regulators would refuse to approve a capital restoration plan for the subsidiary; but, in theory, the holding company could simply allow the subsidiary to fail. *See id.* at 539.

87. *See, e.g.,* Skeel, *supra* note 33, at 745-64. The most promising approach would be to establish an initiation bonus for shareholders in the event the firm initiates insolvency proceedings, *see id.* at 754-62, or to give managers “phantom debt” that they can redeem after termination or insolvency. *Id.* at 753-54.

In addition to assuring more timely initiation of insolvency proceedings, another attraction of encouraging managerial initiation is that it would contribute to the further expansion of the managerial labor market. To the extent initiation reflects factors other than fraud or gross misperformance, managers of failed firms should have better future prospects in the managerial labor market than they currently do.

88. *See generally* Skeel, *supra* note 33.

89. This is another respect in which bank governance parallels the *ex ante* corporate governance approaches used in Germany and Japan. Much like the FDIC, concentrated investors such as banks eliminate for German and Japanese firms the coordination problems that make manager-driven reorganization necessary for nonfinancial corporations in the United States.

90. For a general description of this process, see Marc. S. Kirschner et al., *Prepackaged Bankruptcy*

bankruptcy case because they obviate the need for time-consuming postfiling negotiations.

One can easily imagine the attraction of this approach for banks. Under existing law, a troubled bank that is at or near insolvency is a poor candidate for a merger because of the low or negative value the bank would have to give any acquirer that agreed to purchase all of its assets and liabilities.⁹¹ Yet a merger will often be the best solution to the problems of a troubled bank, and the bank's managers can be expected to appreciate the alternatives better than anyone else. Managers of such banks currently have an incentive to disguise the firm's troubles for as long as possible because failure means immediate displacement. By contrast, if managers could propose a prepackaged purchase and assumption transaction that transferred some but not all of the firm's liabilities to an acquirer, they would have far more reason to contribute to the insolvency decision. As a result, a bank could transfer its assets while much of its franchise value remains intact, and it would do so with the managers' participation rather than their resistance.

In effect, a prepackaged P&A would enable the managers of a troubled bank to obtain an implicit side payment from the acquiring bank, such as a promise of continued employment, in return for their participation in the initiation decision. In some circumstances, the prepackaged P&A option might even counteract regulators' own political disincentives to initiate insolvency proceedings because a prepackaged P&A proposal would force the issue.

An important question is whether manager-initiated P&As could be effectively integrated into the current framework, which depends on secrecy and decisive regulator action. On inspection, formal managerial involvement should not pose a serious problem. Bank managers could make their proposal to regulators in secret. Once a bank's managers put a prepackaged P&A on the table, it seems unlikely that regulators would balk if the proposal made

Plans: The Deleveraging Tool of the '90s in the Wake of OID and Tax Concerns, 21 SETON HALL L. REV. 643 (1991).

91. Bank regulators have sometimes agreed to mergers that required an infusion of cash, but this has been the exception rather than the rule. See generally Berger et al., *supra* note 2 (manuscript at 9, on file with *Law Quarterly*) (noting that "[d]uring periods of financial crisis, the government may provide financial assistance or otherwise aid in the consolidation of troubled financial institutions").

The combination of regulators' "least costly" disposition requirement and the recently enacted depositor preference provision limits regulators' ability to provide assistance both under existing law and under the prepackaged P&A option I have proposed. "Least costly" disposition requires the FDIC to choose the disposition option that is least costly to the insurance fund. 12 U.S.C. § 1823(c)(4)(A)(ii) (1994). The depositor preference provision gives priority to depositor's claims. See *id.* § 1821(d)(11) (1994). Because depositors have priority, straight liquidation would often pay depositors in full, thus proving less costly than a P&A that required an infusion of cash from the FDIC. For additional discussion, see Skeel, *supra* note 33, at 770-71.

sense.⁹²

Much of the preceding analysis is framed in normative terms—as an argument about what lawmakers *should* do. But a similar point can be made from a descriptive perspective. As the traditional restrictions on banks erode and bank governance becomes more market-driven, these trends will also put pressure on the insolvency framework. An increasing number of bank failures will reflect factors other than managerial fraud, and managers may well take affirmative steps in an effort to evade immediate displacement on insolvency. One such step would be to propose a prepackaged purchase and assumption to regulators—one that preserves some continued role for the existing managers. Thus, we reach the same substantive result as we had under the normative perspective.

C. Reorganizing Failed Insurers?

As we have seen, the recent trends in insurance governance closely parallel the overall direction in banking. Although regulators remain a pervasive presence, market competition plays an increasingly prominent role. As in banking, the same developments that have altered insurer governance will also put pressure on the insurance company insolvency framework.

Once again, a key limitation of insurance insolvency regulation is the assumption that managers should always be replaced. Permitting managers to participate, at least in a limited way, could significantly improve the decision whether and when to initiate an insolvency proceeding. Interestingly, the appropriate role for managers might be appreciably larger in insurance insolvency than in banking insolvency. In contrast to banks, where the risk of depositor runs requires that the insolvency proceeding be kept short and relatively secret, timing is less crucial to insurance companies.⁹³ Even in the existing framework, large insurance insolvency cases parallel the reorganization of nonfinancial firms in many respects. These cases take substantially longer than bank insolvencies, and the regulators involved in them are much more likely to preserve the existing firm.

These differences suggest that a much stronger case is made for adopting a more extensive, manager-driven reorganization option in insurance insolvency cases than in bank insolvency cases. A limited reorganization period would give managers a powerful incentive to participate in the

92. Notice that this suggests that although regulators' decision on the proposal should be subject to judicial review, the review should be as deferential as it is on other banking issues.

93. See Skeel, *supra* note 33, at 776-77 (noting that many policyholders cannot easily switch insurance companies and regulators can freeze insurance policies).

insolvency decision and would ensure a more timely resolution of an insurer's insolvency.⁹⁴ The principal question with this reform is whether insurance firms have sufficient going concern value to make reorganization worthwhile. Insurance firms have liquid assets and a more limited franchise value even than banks. Although this reduces the usefulness of insurer reorganization, the prospect of timely initiation would justify at least a limited manager-driven reorganization option.

Even if lawmakers were to adopt a full-blown reorganization option, insurance governance would still fall well short of a true ex post regime. As with relational creditors in an ex ante regime, regulators' pervasive authority would impose substantial limits on managers' flexibility. The system would be more market-driven than in the past, but subject to a wide range of regulatory constraints that make the framework, at most, intermediate in character.

D. Regulatory Structure and the Bankruptcy Code

Just as focusing on the overall governance framework illuminates both the governance of solvent firms and the treatment of insolvent ones, it also casts a useful light on the existing regulatory structure. For instance, even as the boundaries blur between the different types of financial firms, the regulatory structure will continue to force financial entities that wish to combine to do so through separate corporations.⁹⁵ In addition to the traditional justifications for separation, separating bank and insurance company subsidiaries makes sense from a governance perspective, given the different insolvency approaches appropriate to each. On the other hand, the governance benefits of requiring separation between commercial and investment banks are less clear.

For the most part, I leave analysis of the regulators and their jurisdiction to other work. But one regulatory issue warrants a somewhat closer look—particularly given the emphasis this Article places on insolvency regulation. That issue is whether lawmakers should continue to exclude banks and insurance companies from the bankruptcy provisions that govern other insolvent U.S. firms.

The traditional explanation for excluding banks and insurance companies

94. *See id.* at 778.

95. This is currently the case. For a general discussion of so-called "Section 20" investment banking subsidiaries of commercial banks, see Rahul Bhargava & Donald R. Fraser, *On the Wealth and Risk Effects of Commercial Bank Expansion into Securities Underwriting: An Analysis of Section 20 Subsidiaries*, 22 J. BANKING & FIN. 447 (1998).

from the Bankruptcy Code is that each is extensively regulated outside of bankruptcy. As a result, bank and insurance regulators are better positioned to oversee the insolvency process than a bankruptcy judge would be.⁹⁶ For banks, the traditional explanation ultimately proves persuasive, though a bit simplistic. First, consider the limitations of the traditional explanation. Although bank regulators have unique expertise on banking issues, the FDIC's interest as a creditor creates a systematic (and potentially inefficient) bias in favor of public depositors as against other creditors.⁹⁷ In addition, the existence of an expert regulator has not precluded Congress from including other kinds of firms in the Bankruptcy Code. For example, broker-dealers are extensively regulated by the SEC outside of bankruptcy, yet they are still subject to bankruptcy jurisdiction.⁹⁸

Despite these quibbles, leaving bank insolvency to bank regulators is nevertheless defensible. Given the importance of speed and secrecy, little would be gained by adding another decision maker to the process.⁹⁹ Moreover, the FDIC's status as dominant creditor diminishes the coordination problems that make bankruptcy jurisdiction necessary in other contexts.

This question becomes much closer if we turn from banks to insurance companies. As we have seen, timing is less crucial for troubled insurers, and insurance insolvency would benefit from a traditional reorganization option.¹⁰⁰ These facts suggest that including insurance companies in the Bankruptcy Code might make sense. Reinforcing this are the jurisdictional limitations of the existing insurance insolvency process. Because insurance is regulated by the states, and because each state has only a limited jurisdictional reach, regulators must set up separate receiverships in each state in which an insolvent insurer does business.¹⁰¹ Unfortunately, even if state insurance commissioners retained broad oversight authority over the bankruptcy process, it is not at all clear that adding insurers to the

96. For a good (though critical) discussion of the traditional rationale for exclusion, see Michael I. Sovern, *Section 4 of the Bankruptcy Act: The Excluded Corporations*, 42 MINN. L. REV. 171 (1957).

97. See, e.g., Note, *Unsecured Creditors of Failed Banks: It's Not a Wonderful Life*, 104 HARV. L. REV. 1052 (1991) (criticizing differential treatment of bank creditors by FDIC). Now that depositors have explicit priority under depositor preference, see *supra* note 91, regulators' bias may not have as significant an effect.

98. See 11 U.S.C. §§ 741-752 (1994) (stockbroker liquidation); *id.* §§ 761-766 (commodity broker liquidation).

99. See, e.g., Robert Charles Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 99-100 (1976) (same conclusion).

100. See *supra* note 94 and accompanying text.

101. See, e.g., Sovern, *supra* note 96, at 209-11 (quoting from Prefatory Note to Uniform Insurers Liquidation Act to note difficulties in insurance regulation).

Bankruptcy Code will ever be politically feasible.¹⁰² If such a change were possible, this Article suggests that the reform would be a good one.¹⁰³

CONCLUSION

The recent past has been a time of extraordinary transition in the financial services industry. Along with increasingly competitive markets have come the crisis of the 1980s, subsequent recovery, and the continued erosion of many of the regulatory strictures that have long defined banking and insurance.

This Article argues that the best way to appreciate banking and insurance governance is to consider how governance strategies interact with the background insolvency rules. In contrast to the governance of other U.S. firms, which has long relied on markets and ex post correctives, bank and insurance governance traditionally has depended on ex ante monitoring by regulators as well as an insolvency framework that discourages failure at all costs.

Viewing bank and insurance governance through this lens reveals an intriguing tension in recent banking reforms. In order to help banks compete in the financial marketplace, lawmakers and regulators have loosened many of the geographical and product market restrictions that have limited banks' flexibility. At the same time, lawmakers have taken steps to reduce the flexibility of bank insolvency procedures.¹⁰⁴ For now, the overall effect is an increase in the role of takeovers and other market correctives, yet financial

102. The most obvious political opposition would come from state insurance commissioners. It is not clear whether the managers of insurers would actively support a proposal to include insurance insolvency (together with a reorganization option) in the Bankruptcy Code, although they would be the principal beneficiaries. *See generally* Skeel, *An Evolutionary Theory*, *supra* note 3, at 1365-66 (discussing fact that managers of nonfinancial firms have not participated actively in legislative reform of bankruptcy laws, probably because managers tend to assume that their firm will not become insolvent). Reformers could reduce insurance commissioners' likely opposition by ensuring them with a decisive say in the process, but state commissioners almost certainly would continue to oppose such a change.

In recent years, as an alternative to federalizing insurance insolvency, insurance reformers have discussed the possibility of an interstate compact to deal with the limitations of insolvency jurisdiction.

103. This conclusion reflects a change in my earlier views on the issue. *See* Skeel, *supra* note 33, at 726 n.5 (suggesting that neither bank nor insurance insolvency should be included in the Bankruptcy Code).

Ironically, the best strategy on insolvency might be for Congress to regulate insurance insolvency but to shift authority over the bankruptcies of other corporations back to the states. This is because charter competition gives states an incentive to enact generally efficient regulation for the nonfinancial firms incorporated in the state, as I have argued at length elsewhere. *See* Skeel, *Rethinking the Line*, *supra* note 3. State lawmakers do not have the same incentive with insurance because courts do not consistently apply the laws of the domiciliary state in insurance, as they do with other corporations.

104. The common theme, of course, is that lawmakers and regulators wish to give banks the ability to compete in current markets but want to discourage risk taking that would jeopardize depositors or the insurance fund.

firm governance remains squarely within the traditional ex ante regulatory framework.

In time, however, the increased play of market forces will inevitably contribute to a new round of bank and insurer failures. This Article suggests that these failures will put significant pressure on the existing insolvency options. In the banking context, the pressures could (and, as a normative matter, should) spur innovations such as manager-initiated purchase and assumption plans. In the insurance context, the pressures justify going even further, even as far as establishing a Chapter 11-style reorganization option and including insurance insolvency in the Bankruptcy Code.

None of these changes would seriously alter the ex ante, regulatory character of bank and insurance firm governance. Their effect would simply be to adjust its focus slightly, to shift a bit more authority from regulators to the regulated parties themselves, and, in doing so, to improve the efficiency of financial intermediary governance.