LAW AND ECONOMICS SEMINAR
Winter 2026

Professor A. Mitchell Polinsky

Thursday, January 15, 2026
4:15 - 5:45 p.m.
Stanford Law School
Room 272

Sanctioning Negligent Bankers

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<u>Note:</u> It is expected that you will have reviewed the speaker's paper before the seminar. Prof. Zhang was asked to provide a "reader's guide" to the paper for attendees not able to read the entire paper. Here is his response:

"If you'd like a streamlined account of the article's argument, focus on Part I and Part II. Those interested in the normative core of the proposal should then read Part III, which sets out the fault standard, causation framework, and sanction design. Part IV can be read selectively for implementation details. During the presentation, I will provide additional background and institutional context, so familiarity with banking law is not required."

ARTICLE

SANCTIONING NEGLIGENT BANKERS

KYLE D. LOGUE, W. ROBERT THOMAS & JEFFERY Y. ZHANG †

Abstract. Over just one week in 2023, depositor runs at a few U.S. banks threatened a worldwide banking crisis. Afterwards, the United States would suffer three of the biggest bank failures in the nation's history; in Europe, Credit Suisse became the largest financial institution to fail since the 2007-2008 Global Financial Crisis. Stunned by this lightning-fast panic, lawmakers, regulators, and academics have called for significant changes to the U.S. financial regulatory framework. Leading among these proposals are calls to improve supervisory oversight of banks, to tighten existing regulations on banks, and to increase deposit insurance limits. But these proposals alone are insufficient to stop the next wave of bank collapses, and they might even exacerbate a central problem contributing to bank runs: the bankers themselves.

Combining insights from banking regulation, corporate enforcement, and insurance law, we argue that proposed banking reforms should be paired with a credible sanctions regime imposed upon negligent bankers. Our approach would push oversight duties back into the C-suite through a civil penalty de-signed to disgorge compensation from a bank executive whose negligence substantially increases the risk of a bank collapse. We defend the theoretical basis for such an approach, including why a civil penalty, rather than criminal punishment, is the best solution to this problem; identify key features of our pro-posed liability regime, distinguishing it from previous proposals to hold bankers accountable; and then identify and evaluate preliminary implementation considerations for Congress and regulators to consider.

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Introduction

"It should be easier for the bank, or the regulator, to go after people who demonstrated great negligence in their duties."
- UBS Chief Executive Sergio Ermotti[1]

Silicon Valley Bank had quite the year in 2023. Demonstrating a "textbook case of mismanagement,"[2] the bank's senior executives frightened Silicon Valley depositors into a run on the bank, creating an international banking crisis from nothing. Virtually overnight, regional bank stocks plummeted by upwards of 80%.[3] Seeing portents of 1929, senior officials at the Federal Deposit Insurance Corporation (FDIC), Federal Reserve, and Treasury Department invoked emergency measures to assure depositors and prevent the spread of financial contagion before markets reopened the next week.[4] By the time the dust settled, the United States had suffered three of the four largest bank failures in the country's history.[5] Across the Atlantic, the Swiss government took unprecedented measures to force the takeover of Credit Suisse by its in-country rival, UBS, as a last-ditch solution for stabilizing the largest failure of a financial institution since the 2007-2008 Global Financial Crisis.[6]

The panic started by Silicon Valley Bank might have been new, but its cause was not. Excessive risk-taking and mismanagement by bank executives are the perennial manifestation of moral hazard—the proverbial "dark side" of FDIC deposit insurance.[7] A moral hazard arises because insurance premiums are not calibrated to cover the idiosyncratic risk of a bank's collapse, much less to insure against system-wide harms triggered when that bank collapses.[8] Academic

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[1] Owen Walker, *UBS Chief Sergio Ermotti Calls for Tougher Sanctions on Negligent Bankers*, FIN. TIMES (Nov. 22, 2023), https://www.ft.com/content/7caceb97-c7cf-40be-93ea-4b8ac9919bf7.

[2] BD. OF GOVERNORS OF THE FED. RSRV. SYS., REVIEW OF THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF SILICON VALLEY BANK, cover letter at 1 (Apr. 28, 2023), https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf [hereinafter SVB REVIEW]. As we discuss further below, the mismanagement involved failing to manage interest-rate risk and investing too heavily in the tech sector.

[3] Rob Copeland, Joe Rennison & Matthew Goldstein, *Smaller Banks Are Scrambling as Share Prices Plunge*, N.Y. TIMES, (May 4, 2023), https://www.nytimes.com/2023/05/04/business/regional-banks-stock-price-pacwest.html.

[4] Press Release, Joint Statement by the Treasury Dep't, Fed. Rsrv. Bd., and Fed. Deposit Ins. Corp. (Mar. 12, 2023); Noele Illien, *UBS Completes Credit Suisse Takeover to Become Wealth Management Behemoth*, REUTERS (June 12, 2023), https://www.reuters.com/markets/europe. For a timeline of events in Switzerland, see *Timeline*, FED. DEP'T OF FIN. (Apr. 10, 2024), https://www.efd.admin.ch/en/timeline-credit-suisse-ubs.

[5] *See* Albert H. Choi & Jeffery Y. Zhang, *Creditors, Shareholders, and Losers in Between: A Failed Regulatory Experiment*, 110 CORN. L. REV. 271, 273 (2025).

[6] *See id.*

[7] *See infra* Part I.C.

[8] *See infra* Part I.C. Silicon Valley Bank's collapse exemplifies both idiosyncratic and systemic harms: the former manifested itself as the wipeout of the bank's shareholders, the latter manifested itself in runs on regional banks across the country and the subsequent

economists and legal scholars have sought to ameliorate this market failure by addressing the mismatch between private rewards given to bank executives and the public costs of their poor decisions—often by regulating how bank executives are compensated in normal times.[9] The driving intuition is that bank executives should not reap all the benefits in good times while letting others hold the bag during bad times; adjusting their compensation to require more "skin in the game" thereby reduces risk-taking and mismanagement.

Tackling banking's moral hazard problem is especially important now, as Congress considers proposals to prevent the next round of bank runs, some of which—like the expansion of FDIC deposit insurance—could exacerbate executives' risk-taking incentives.[10] To be sure, there is much to recommend in proposals that better align executive compensation. But while we agree many outstanding proposals could improve the safety and soundness of banks, two empirical observations have limited or outright stymied their success.

First, previous attempts to solve the problem through *ex ante* agency regulation and enforcement have proven ineffective. Put simply, federal regulators have not exercised their enforcement powers to deter individual bank executives. Consider that, after the Global Financial Crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. As part of these reforms, Congress instructed financial regulators to place restrictions on executive compensation that encouraged excessive risk-taking.[11] Yet, fifteen

collapse of other banks.

[9] *E.g.*, Sanjai Bhagat & Roberta Romano, Essay, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REGUL. 359 (2009) (proposing long-term equity pay for bankers); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247 (2010) (paying bankers in preferred stock and bonds as well as common equity); Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation*, 105 NW. U. L. REV. 1205, 1207 (2011) (including publicly traded subordinated debt securities in executive compensation); Deniz Anginer, Jinjing Liu, Cindy A. Schipani & H. Nejat Seyhun, *Why Do Banks Fail Together? Evidence from Executive Compensation*, 29 FORDHAM J. CORP. & FIN. L. 503, 538-42 (2024) (summarizing various executive compensation proposals); *see also* Anat R. Admati, Peter Conti-Brown & Paul Pfleiderer, *Liability Holding Companies*, 59 UCLA L. REV. 852 (2012) (calling for the creation of a liability holding company); Christina Parajon Skinner, *Misconduct Risk*, 84 FORDHAM L. REV. 1559 (2016) (proposing "compliance stress testing" to reduce misconduct risk); Charles Goodhart & Rosa Lastra, *Equity Finance: Matching Liability to Power*, 6 J. FIN. REG. 1 (2020) (recommending separate equity classes for insiders and outsiders, respectively).

[10] *See* Lev Menand & Morgan Ricks, *Rebuilding Banking Law: Banks as Public Utilities*, 41 YALE J. ON REGUL. 591, 603 (2024) (proposing a full government guarantee for member banks' money liabilities). Critics of expanding deposit insurance argue that greater insurance coverage would lead to increased moral hazard, and unlimited deposit insurance would incentivize banks to take excessive risks. Patricia A. McCoy, The Moral Hazard Implications of Deposit Insurance: Theory and Evidence 9 (2007); *cf.* Jonathan R. Macey & Geoffrey P. Miller, *Deposit Insurance, the Implicit Regulatory Contract, and the Mismatch in the Term Structure of Banks' Assets and Liabilities*, 12 YALE J. ON REGUL. 1, 19 (1995) (arguing that depositors don't benefit from deposit insurance as much as it would appear because banks pay them lower interest rates).

[11] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124

years later, no such regulation has been implemented.[12] Congress took another stab with the RECOUP Act, which would have expanded the FDIC's authority to claw back compensation from senior bank executives.[13] But if history is any indication, such legislation is equally unlikely to be effective. Da Lin and Lev Menand, for example, show that even where the Federal Reserve has authority to hold bank directors and officers accountable for mismanagement, it rarely exercises this power.[14] Likewise, the FDIC has statutory authority to fine executives for "gross negligence," but has not used it in a manner that would deter future violators.[15] These examples speak to a broader observation, made by Peter Conti-Brown and Sean Vanatta, that many bank supervisors view their job as "fire wardens" instead of "cops on the beat," reducing their willingness to directly intervene on issues that involve individual bankers.[16]

Second, several recent proposals to reduce excessive risk-taking by bank executives focus on clawing back executive compensation. These proposals suffer similar regulatory challenges: the SEC, for example, only last year finalized clawback regulations mandated by Dodd-Frank.[17] But moreover, many proposals presuppose that banks are publicly traded—that is, executives can be paid with their bank's equity or debt, which can be sold in a liquid secondary

Stat. 1376 (2010) (codified at 12 U.S.C. §§ 5301-641). According to the 2016 proposed rule, Section 956 requires the relevant agencies to "(1) [p]rohibit[] incentive-based payment arrangements that the Agencies determine encourage inappropriate risks by certain financial institutions by providing excessive compensation or that could lead to material financial loss; and (2) requir[e] those financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate Federal regulator." Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37670 (proposed June 10, 2016).

[12] *See* Tara Payne, *Powell on Capitol Hill: Basel Will Likely Undergo 'Broad and Material' Changes*, BPINSIGHTS (Mar. 9, 2024), https://bpi.com/bpinsights-march-9-2024 (noting Representatives' concerns that Section 956 of the Dodd-Frank Act, "which sets the stage for a rule on executive compensation," has not been implemented).

[13] The legislation would establish "the authority to recover from a senior executive bonus compensation and profits from the sale of securities received during the 24-month period preceding the failure." Cong. Rsch. Serv., *Summary: S.2190 — 118th Congress (2023-2024)*, CONGRESS.GOV (June 22, 2023), https://www.congress.gov/bill/118th-congress/senate-bill/2190.

[14] Da Lin & Lev Menand, *The Banker Removal Power*, 108 VA. L. REV. 1, 3-4 (2022). If the Federal Reserve adopted the proposals by Lin and Menand, the agency would increase *ex ante* deterrence. Our proposed liability regime, detailed later, would be complementary as an *ex post* deterrence regime. *See infra* Part III.

[15] 12 U.S.C. § 1821(k). For more on FDIC's enforcement philosophy, see *infra* Part IV.A.

[16] PETER CONTI-BROWN & SEAN H. VANATTA, PRIVATE FINANCE, PUBLIC POWER: A HISTORY OF BANK SUPERVISION IN AMERICA 4 (2025) (describing the different views of bank supervision). The Department of Justice has not fared noticeably better in bringing enforcement actions against individual executives. *See infra* Part II.C.

[17] 17 C.F.R. § 240.10D-1; *see* Harold S. Bloomenthal & Samuel Wolff, *Recovery of Executive Compensation Under Dodd-Frank: Introduction*, 1 SEC. LAW HANDBOOK § 15:48 (2025).

market.[18] However, only about 14% of U.S. banks are publicly traded.[19] And while many publicly traded banks are categorized as "too big to fail,"[20] they are not the only institutions that matter for maintaining financial stability. Indeed, Jeremy Kress and Matthew Turk point out that "*every* banking crisis in the United States prior to 2008 consisted exclusively of the simultaneous failure of many small banks."[21] It is generally a hard problem to address moral hazard concerns for banking executives, and compensation reform is a valuable part of the solution. But we need a framework that scopes in *all* bank executives in the United States.

Responding to these empirical challenges, we argue in this Article for imposing (1) an *ex post* monetary penalty on (2) executives who negligently and materially increase (3) the likelihood of an actual or constructive bank collapse.[22] This sanction will apply to executives at every U.S. bank, regardless of the institution's size or whether it is publicly traded. Specific triggering events can automatically begin the sanction process, substantially limiting banking agencies' discretion over whether to bring an action. The magnitude of this sanction will be calibrated according to the executive's pay. As a starting point, the baseline penalty would be equivalent to five years' worth of total compensation—significantly higher than that of existing proposals—with treble penalties available for circumstances involving, for example, gross negligence or criminal misconduct. Finally, to prevent Directors and Officers (D&O) insurance[23] from blunting the deterrent effect of this new civil sanction, we propose prohibiting the coverage of this sanction through D&O (or equivalent) liability policies.

Our Article proceeds as follows. Part I dives into the economic phenomenon known as "moral hazard" to clarify why bank executives are reliably, and uniquely, prone to excessive risk-taking and mismanagement. (The short answer: government subsidies provided to banks in the form of government-subsidized

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[18] *See* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 249 (2010) (providing recommendations to correct distortions created by stock and option compensation, instruments that exist mainly in publicly traded firms). *But see* Anginer et al., *supra* note 9, at 552 (arguing, in discussing bankers' compensation structures, that relative performance evaluations provided a compensation metric that correlates with less systemic risk).

[19] There are 4,414 insured depository institutions. *BankFind Suite*, FDIC, https://banks.data.fdic.gov/bankfind-suite/bankfind (last visited July 28, 2024). Of these institutions, 622 are publicly traded. *Publicly Traded Commercial Banks Companies*, FINTEL, https://fintel.io/industry/list/commercial-banks (last visited July 28, 2024).

[20] Saule T. Omarova, *The "Too Big to Fail" Problem*, 103 MINN. L. REV. 2495, 2495-96 (2019) (defining the term and providing historical context).

[21] Jeremy C. Kress & Matthew C. Turk, *Too Many to Fail: Against Community Bank Deregulation*, 115 NW. U. L. REV. 647, 655 (2020).

[22] *See infra* Part III.

[23] D&O insurance is a "unique type of corporate-owned insurance" that reimburses a firm should a director or officer "have to settle or defend a lawsuit related to his or her service to the firm." John E. Core, *On the Corporate Demand for Directors' and Officers' Insurance*, 64 J. RISK & INS. 63, 63 (1997). For further discussion, see Part III.C below.

deposit insurance.) Part II lays the theoretical foundation for adopting an *ex post* civil fault system to address moral hazard in banking. In doing so, we argue that expanding the criminal legal system—*viz.*, by punishing conduct that falls short of extreme acts of personal lawlessness, which existing statutes already criminalize—would be less effective than civil sanctions for incentivizing better behavior from bank executives. This insight might strike many as counterintuitive because criminal punishment is often seen as the highest order of deterrence. Indeed, many have lamented the status quo of "too big to jail" for bankers.[24] But while we generally agree that the criminal law both can and should play a role in regulating corporate America, our analysis shows that a civil, fault-based framework provides a better deterrence framework for reaching much of the conduct that immediately concerns the risks attendant to a bank collapse.

Part III defends the core elements of our proposed sanctions regime: a fault standard, causation requirements, triggering conditions, and the magnitude of a sanction. Taken together, these elements justify the decision to sanction negligent bank executives with a civil monetary penalty calibrated to their total compensation. Part III closes by discussing the possibility of insurance reforms meant to ensure that the sanctions regime provides an effective deterrent for bank executives. Finally, and mindful of the regulatory challenges that adopting this proposal invites, Part IV identifies several methods for implementing our proposed *ex post* liability regime. We provide a menu of legislative and regulatory options to complement the theoretical analysis in Parts I-III. These options include revising Section 11(k) of the Federal Deposit Insurance Act; establishing a new enforcement mechanism for private actors, through either *qui tam* legislation or shareholder suits; and pairing existing executive compensation reforms with creatively designed corporate penalties.

I. Bank Runs, Deposit Insurance, and Moral Hazard

While the failure of Silicon Valley Bank was a "textbook case of mismanagement," mismanagement and excessive risk-taking by bank executives are nothing new. To see why, this Part provides a primer on what banking is, how government subsidies like deposit insurance work, why deposit insurance creates moral hazard, and why all this matters for economic stability.

A. Banks Are Inherently Fragile

Banks are susceptible to runs because their business models are fragile by design. They take in money from individuals and businesses, but they do not keep all that money on hand. Much of the money is lent out, which is why their business model is referred to as "fractional reserve banking"—only a fraction of the money is held in the bank.[25] If depositors believe that everything is going smoothly at the bank, there is no need to withdraw money except to meet the demands of daily life (for example, to pay rent or to buy groceries). But if

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[24] *E.g.*, Ending Too Big to Jail Act, S. 2544, 115th Cong. (2008).
[25] *See* Nicholas K. Tabor & Jeffery Y. Zhang, 2020 COLUM. BUS. L. REV. 575, 588 (2020).

depositors believe the bank is in trouble, they have a strong incentive to withdraw *all* their money as soon as possible—the makings of a classic bank run.[26]

Imagine, for example, a newspaper announcing that the (fictional) Bank of Hutchins suffered a massive cyberattack. Depositors of the Bank of Hutchins, concerned that the bank's financial integrity is compromised, may start withdrawing their money. These depositors are acting on the belief that (a) the Bank of Hutchins does not keep all their money in reserve and (b) their fellow depositors will also be spooked and seek to withdraw. The resulting equilibrium is one in which everyone runs on the bank, hoping not to be the loser at the end of the line when the bank's cash pile has been depleted. This incentive structure is powerful enough that runs have occurred merely because of rumors.[27]

Public officials care about bank runs not only because individual depositors lose their money but also because runs can threaten the entire economy. For one, banks provide loans to large companies, small businesses, and individuals. When banks fail, the overall provision of credit declines and economic activity falls as an immediate consequence. Firms are no longer able to make investments or meet payroll, and employees are laid off. Economics Nobel laureate Ben Bernanke empirically showed the occurrence of this bank-credit channel during the Great Depression of the 1930s;[28] academics have shown this linkage recurred in the 2007-2008 Global Financial Crisis.[29] For another, banks play an important role in maintaining the government's money supply function.[30] And that requires full confidence in the value of money.[31] Even a hint of trouble during times of stress can lead to bank runs.[32] In this respect, bank runs impose an acute systemic harm on the national economy significantly greater than the garden variety business failure.

In short, the harms from individual bank failures can be widespread and catastrophic. Consider again March 2023. A run on Silicon Valley Bank—a single bank—by its uninsured depositors sufficiently threatened the national economy that the Treasury Department, Federal Reserve, and FDIC collectively resorted to using emergency measures to rescue the entire banking system, which

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[26] *See* Heidi M. Schooner, *The Secrets of Bank Regulation: A Reply to Professor Cohen*, 6 GREEN BAG 2D 389, 389 (2003).

[27] *See* Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 404 (1983).

[28] Ben S. Bernanke, *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 73 AM. ECON. REV. 257, 267 (describing how an impacted bank credit channel may have lowered economic output) (1983).

[29] *E.g.*, Gabriel Chodorow-Reich, *The Employment Effects of Credit Market Disruptions: Firm-level Evidence from the 2008-9 Financial Crisis*, 129 Q. J. ECON. 1, 1 (finding that impacted bank lending can lower employment in the economy) (2014).

[30] Koshy Mathai, *Monetary Policy: Stabilizing Prices and Output*, FIN. & DEV. MAG., https://www.imf.org/en/Publications/fandd/issues/Series/Back-to-Basics/Monetary-Policy (last visited Jan. 1, 2025) (discussing transmission channels of monetary policy).

[31] *See* DAN AWREY, BEYOND BANKS: TECHNOLOGY, REGULATION, AND THE FUTURE OF MONEY 18-19 (2024) (describing how to make create monetary instruments that are more trusted).

[32] *See* Diamond & Dybvig, *supra* note 27, at 404 (noting in this Nobel Prize-winning model that runs are caused "by a shift in expectations, which could depend on almost anything").

included providing insurance to cover *uninsured* depositors.[33] Federal regulators came to the rescue because they remembered what occurred after the financial maelstroms of the 1930s and the late 2000s. The former turned into the Great Depression and the latter into the Great Recession—in both cases, millions lost their jobs.[34]

B. Deposit Insurance to the Rescue

Before March 2023, Americans would be forgiven for thinking of bank runs as a rarity, a thing of Hollywood past rather than real-world present.[35] As it turns out, deposit insurance has a lot to do with that perception. The motivating idea behind deposit insurance is straightforward. Destabilizing bank runs are caused by scared depositors who believe their money is in danger from other, equally scared depositors.[36] But if deposits are insured, then there is no need to fear that those who cannot get to the bank in time will lose their savings.[37] If depositors believe that government backstop is credible, then they will stay home during times of economic distress, thus preventing bank runs from starting in the first place.

Conventional economic wisdom is that the creation of FDIC insurance largely solved the problem of bank runs in the United States.[38] Despite deep reservations within the Roosevelt Administration and among prominent bankers, the federal government created FDIC insurance in 1933 in response to the Great Depression.[39] So successful was this policy intervention that some economists refer to the decades following 1933 as "the Quiet Period."[40] Thus, in the aftermath of the 2023 Banking Panic, lawmakers and scholars have called for

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[33] *America's Government Steps in to Protect Depositors at Silicon Valley Bank*, THE ECONOMIST (Mar. 13, 2023), https://www.economist.com/finance-and-economics/2023/03/13/americas-government-steps-in-to-protect-depositors-at-silicon-valley-bank.

[34] Nelson D. Schwartz, Ben Casselman & Ella Koeze, *How Bad is Unemployment? 'Literally Off the Charts,'* N.Y. TIMES (May 8, 2020), https://www.nytimes.com/interactive/2020/05/08/business/economy/april-jobs-report.html.

[35] *E.g.*, IT'S A WONDERFUL LIFE (Frank Capra dir., 1946).

[36] *See* Eric A. Posner, *Law and the Emotions*, 89 GEO. L.J. 1977, 2004 (2001).

[37] McCoy, *supra* note 10, at 8.

[38] MILTON FRIEDMAN & ANNA SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867-1960, at 440 (1963).

[39] FDIC, OPTIONS FOR DEPOSIT INSURANCE REFORM 1 (2023), https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf.

[40] *See* GARY B. GORTON, MISUNDERSTANDING FINANCIAL CRISES: WHY WE DON'T SEE THEM COMING 4 (2012). The Global Financial Crisis did not involve bank runs in the classic sense. Rather, it was caused by a run on "shadow banks"—that is, bank-like entities which operated outside of the regulatory perimeter. Shadow banks were not regulated or supervised as banks and so lacked deposit insurance. *See* Laura Kodres, *Shadow Banks: Out of the Eyes of Regulators*, FIN. & DEV. MAG., https://www.imf.org/en/Publications/fandd/issues/Series/Back-to-Basics/Shadow-Banks (last visited Jan. 1, 2025).

increasing deposit insurance by a substantial amount—perhaps even insuring all deposits.[41] Under such a system, every depositor would be fully insured by the government; no depositor would want to run. There would, in theory, be no more runs.

C. Moral Hazard and the Dark Side of Insurance

There is, unfortunately, a cost associated with increasing deposit insurance coverage. Deposit insurance creates a phenomenon of *moral hazard*, which is defined as a person or entity having an incentive to increase their risk exposure because they do not bear the full cost of that risk.[42] By design, insurance protects the insured party from bearing the full cost of injury. As a result, however, the insured entity tends to act marginally more carelessly precisely because it does not bear the full cost.[43]

The problem of moral hazard is a serious one, capable of swamping any benefit gained from the deposit insurance that brought it into existence. Indeed, initial fears about creating FDIC insurance in the 1930s were driven in part by recent "experiences with deposit insurance at the state level [that] had proved disastrous."[44] Since then, international experiences repeatedly show that the marginal increase in moral hazard is large enough to ultimately *increase*, rather than decrease, the incidence of bank failures.[45]

Deposit insurance invites moral hazard among three constituencies: executives, depositors, and shareholders. To exemplify these hazards, consider the following stylized bank balance sheet of our fictional Bank of Hutchins:

BALANCE SHEET: BANK OF HUTCHINS

Assets	$100
Reserves	$20
Securities	$30
Loans	$50

[41] *See*, *e.g.*, Lev Menand & Morgan Ricks, *Scrap the Bank Deposit Insurance Limit*, WASH. POST (Mar. 17, 2023), https://www.washingtonpost.com/opinions/2023/03/15/silicon-valley-bank-deposit-bailout/; Amy B. Wang, *Sen. Warren Calls for Lifting Deposit Insurance Cap, Blasts Fed,* WASH. POST (Mar. 19, 2023); https://www.washingtonpost.com/politics/2023/03/19/elizabeth-warren-federalreserve-fdic-banks/.

[42] Daniel R. Fischel, Andrew M. Rosenfield & Robert S. Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 314-15 (1987); *see* William A. Lovett, *Moral Hazard, Bank Supervision and Risk-Based Capital Requirements*, 49 OHIO ST. L.J. 1365, 1365 (1989); Krishna G. Mantripragada, *Depositors as a Source of Market Discipline*, 9 YALE J. ON REGUL. 543, 548 (1992). For a history of the use of the term "moral hazard" more generally, see Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996).

[43] *See* FED. DEPOSIT INS. CORP, *supra* note **Error! Bookmark not defined.**, at 2.

[44] *See* CLAUDIA GOLDIN & GARY D. LIBECAP, THE REGULATED ECONOMY: A HISTORICAL APPROACH TO POLITICAL ECONOMY 146 (1994).

[45] Ash Demirgüç-Kunt & Edward Kane, *Deposit Insurance Around the Globe: Where Does it Work?*, 16 J. ECON. PERSPS. 175, 186 (2002).

Liabilities	$70
Deposits	$50
Corporate Bonds	$20
Equity	$30
Liabilities + Equity	$100

Per the above, Bank of Hutchins has $100 in assets allocated between reserves, securities, and loans. Hutchins has borrowed $70 to fund its operations, split between deposits and corporate bonds as funding sources. Finally, the bank has financed its operations via $30 in equity (think of common stock sold through a public offering). According to the fundamental accounting identity, assets are equal to the sum of liabilities and equity.[46]

An increase in deposit insurance coverage can introduce moral hazard with respect to all three segments of the balance sheet corresponding to the three constituencies. Start with depositors. In the absence of deposit insurance, Hutchins's depositors "monitor" the bank and influence its risk tolerance threshold, at least indirectly, by adjusting how much money they deposit.[47] If depositors believe that the bank's risk management is inadequate, or that Hutchins is not adequately compensating this risk through higher interest rates, then depositors will limit or withdraw their deposits. And if deposits fall—say, from $50 to $40—then Hutchins will be forced to readjust its portfolio of assets.[48] Against this background, insured deposits operate as a form of government-subsidized funding for banks. But because their deposits are (partially) insured, depositors' monitoring incentives are correspondingly weakened.[49] In the extreme case where every penny is insured, depositors have zero incentive to monitor. Thus, when deposit insurance increases, market discipline via watchful depositors decreases.

Second, moral hazard applies to equity shareholders, especially when the bank nears insolvency.[50] Hutchins's shareholders who have something to lose will behave prudently by, for example, voting for careful management of the

[46] *See* Choi & Zhang, *supra* note **Error! Bookmark not defined.**, at 282.

[47] *See* Helen A. Garten, *Banking on the Market: Relying on Depositors to Control Bank Risks*, 4 YALE J. ON REGUL. 129, 130 (1986) ("It is assumed that depositors will demand high risk premiums from or avoid those banks that incur too much risk."); *Cf.* FED. DEPOSIT INS. CORP., *supra* note 43, at 3 (acknowledging that depositors "have little or no incentive to monitor the performance of insured institutions or discipline their risk behavior in a system of blanket guarantees").

[48] *See* McCoy, *supra* note 10, at 5-6.

[49] *See* FED. DEPOSIT INS. CORP. *supra* note **Error! Bookmark not defined.**, at 28.

[50] *See* Vincent S.J. Buccola, *Beyond Insolvency*, 62 U. KAN. L. REV. 1, 10 (2013) (discussing shareholders' increasing support for managerial risk-taking as firm approaches vicinity of insolvency) moral hazard as firms approach insolvency).

bank. However, as cautioned by the FDIC, shareholders who have little or no equity left to lose might be tempted to put the deposit insurer's or the government's funds at risk.[51] Thus, shareholders are less likely to sell their shares for any given level of the bank's performance because they understand that the government is there to insure against downside risk.[52]

Third, Hutchins's executives influence the bank's ability to take risks with their day-to-day decisions. For instance, under their directive, Hutchins could create a more aggressive asset portfolio by increasing its (relatively risky) loan portfolio from $50 to $60 and decreasing its (relatively safe) reserves from $20 to $10. If insurance coverage increases, then executives have greater incentive to take additional risks: the possibility of reward is higher, while the downside is more limited. Described another way, deposit insurance makes it more likely that executives at Bank of Hutchins will keep their jobs for any given level of risk-taking, and so they act more recklessly.

Moral hazard from deposit insurance could, in theory, be eliminated by charging banks an insurance premium that perfectly and continuously adjusts to reflect the effect of management's decisions on the bank's risk profile.[53] That is, if a bank executive adopts a policy substantially increasing the risk of default, this increased risk could be internalized onto the executive provided that the insurance premium charged to the bank increased proportionally with the increased risk.

In reality, such adjustments don't happen. While insurance premiums are occasionally adjusted to reflect changes in insured risks, those adjustments are, at best rough approximations of actual changes in risk. FDIC premiums are based on broad categories that only roughly capture the risk to stakeholders of an individual bank's failure.[54] They make no effort to subcategorize based on, for example, the sort of mismanagement that led to Silicon Valley Bank's collapse. Further, the methodology used to calculate FDIC premiums cannot perfectly

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[51] 1 FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE: AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S, at 183 (1997) (noting the incentives of insolvent S&Ls, "with nothing to lose").

[52] McCoy, *supra* note 10, at 9.

[53] The deterrence literature in tort has long understood that perfectly risk-adjusted insurance premiums can produce optimal deterrence. *See generally* GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS 48-49 (1970); STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 195 (1987) (making the observation that the presence of liability insurance, which charges premiums that do not adjust to reflect changes in liability risks, undermines the deterrence goal of tort law).

[54] The FDIC's first risk-based system, introduced in 1993, simply divided banks into nine categories based on capital levels and supervisory ratings. EDWARD GARNETT, LAVAUGHN HENRY, DANIEL HOOPLE & ASHLEY MIHALIK, A HISTORY OF RISK-BASED PREMIUMS AT THE FDIC 4 (2020). More recently, there have been reforms designed to improve the extent to which deposit insurance premiums reflect the risks of individual institutions. *Id.* at 8-9 However, there continue to be serious limitations on the extent to which the FDIC may vary premiums according to risk differentials. *FDIC Assessment Rates*, FDIC., https://www.fdic.gov/deposit-insurance-assessments/fdic-assessment-rates (archived) (showing caps placed on premium differentials).

capture the *systemic* risks stemming from an individual bank run.[55] This phenomenon—the presence of insurance with only imperfectly risk-adjusted premiums—is the source of moral hazard that undermines bank executives' incentives to take care in their choices regarding how to manage the investments of the banks over which they have responsibility.[56]

What can regulators do to mitigate this moral hazard? Countries in which deposit insurance has generally succeeded, like the United States, have succeeded by pairing the carrot with the stick—usually by combining deposit insurance with rigorous *ex ante* bank supervision.[57] Whereas the insurance provides a "carrot" to encourage depositors to trust the system, agency supervision provides the "stick" to discipline banks and mitigate moral hazard.

Bank supervisors aren't perfect either—an obvious point spectacularly demonstrated in 2023. Silicon Valley Bank failed to manage its interest rate risk and maintained a dangerously high level of concentration in the tech sector.[58] Prior to 2021, this formula served as the bank's rocket fuel, tripling its assets in only a few years.[59] But then the Federal Reserve started raising interest rates, and the tech sector experienced turbulence.[60] Rising interest rates proved challenging for many banks, but especially for one facing this double whammy. Arguably, supervisors of Silicon Valley Bank overlooked a business model that left a rocketing bank liable to explode.[61] But in fairness to supervisors, they cannot be expected to spot everything. *Ex ante* tools are naturally limited in this way. And,

[55] The FDIC's insurance premiums are determined mainly by capital levels, supervisory ratings, and a limited set of financial ratios. INTERNATIONAL ASSOCIATION OF DEPOSIT INSURERS, EVALUATION OF DIFFERENTIAL PREMIUM SYSTEMS FOR DEPOSIT INSURANCE (2020), https://www.iadi.org/uploads/DPS_Paper_final_16June2020_Final.pdf; Shavell, *supra* note 53. Those inputs do not reflect a bank's interest-rate risk management or depositor base concentration, which were the primary deficiencies identified in the Federal Reserve's review of Silicon Valley Bank. BD. OF GOVERNORS OF THE FED. RSRV. SYS., REVIEW OF THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF SILICON VALLEY BANK (2023), https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf.

[56] Guido Calabresi calls this the "externalization due to insufficient subcategorization." CALABRESI, *supra* note 53, at 145; *see also* Jon D. Hanson & Kyle D. Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 CORN. L. REV. 129, 131 (1990) (coining the term "insurance externality").

[57] *See* Demirgüç-Kunt & Kane, *supra* note 45, at 186.

[58] SVB REVIEW, *supra* note **Error! Bookmark not defined.**, at 1.

[59] *See Evolution of Silicon Valley Bank*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Apr. 2023), https://www.federalreserve.gov/publications/2023-April-SVB-Evolution-of-Silicon-Valley-Bank.htm.

[60] *See* Andrew Ross Sorkin, Ravi Mattu, Bernhard Warner, Sarah Kessler, Lauren Hirsch & Ephrat Livni, *Interest Rate Jitters Sink the Heavyweights of Tech*, N.Y. TIMES (Aug. 18, 2023), https://www.nytimes.com/2023/08/18/business/interest-rates-markets-tech-slump.html.

[61] *See* Press Release, U.S. Comm. on Oversight & Accountability, U.S. House of Representatives, Hearing Wrap Up: Silicon Valley Bank Collapse is a 'Case of Failed Supervision' (May 25, 2023), https://oversight.house.gov/release/hearing-wrap-up-silicon-valley-bank-collapse-is-a-case-of-failed-supervision/; *see also* SVB REVIEW, *supra* note **ERROR! BOOKMARK NOT DEFINED.** ("Federal Reserve supervisors failed to take forceful enough action.").

even if supervisors accurately flag concerns in real time, higher-ups might not heed their warnings.

These limits of supervision invite the question: what else can be done to offset the increase in moral hazard that leads to excessive risk-taking and mismanagement? This is why we offer an *ex post* "stick." Lawmakers and regulators can incentivize bank executives with credible *ex post* civil money penalties—ones that apply automatically upon the failure of their banks.

II. Modeling Optimal Enforcement to Deter Bank Runs

Viewed from a high enough level of abstraction, our ambition is to credibly threaten actors with a sanction large enough to offset the expected cost that we want them to internalize. Part II introduces a hybrid model of corporate enforcement (the "hybrid model") for inducing optimal deterrence of corporate harms through *ex post* sanctions. In this Article, the hybrid model refers to a dual-track approach to corporate deterrence in which both the corporation and the employees responsible for the misconduct face sanctions. Rather than relying solely on corporate fines or solely on individual liability, the model combines the two: the firm is penalized to reflect the overall harm it caused, while the executives or managers whose decisions led to that harm are held personally accountable. This dual structure is intended to better internalize the expected social costs of risky behavior.[62] Though this hybrid model was originally developed in response to corporate-caused environmental catastrophes and mass torts—what we refer to collectively as "industrial disasters"—we defend its extension to banking generally and, with caveats, to bank runs specifically.

On the other hand, some advocates of this hybrid model further claim that optimal deterrence requires criminal punishment—namely, jail time for individual executives. In general, we agree that, for all its challenges, the criminal law both can and should play a role in regulating corporate America; executives and employees who engage in criminal activity should pay for their crimes.[63] Nevertheless, Part II shows why individual prosecutions are a poor tool for reaching a large swath of managerial behavior that immediately concerns us here. In a nutshell, there is plenty of individual behavior that, despite not being obviously criminal, still needs to be deterred.

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[62] Jennifer Arlen & Lewis A. Kornhauser, *Battle for Our Souls: A Psychological Justification for Corporate and Individual Liability for Organizational Misconduct*, 2023 U. ILL. L. REV. 673, 681 (2023) (noting that classical deterrence theory or "CDT" calls for holding both individuals and corporations responsible for wrongdoing); *see* Jonathan R. Macey, *Agency Theory and the Criminal Liability of Organizations*, 71 B.U. L. REV. 315, 319 (1991) (applying classical deterrence theory to organizational misconduct); Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 835 (1994) (same); A. Mitchell Polinsky & Steven Shavell, *Should Employees Be Subject to Fines and Imprisonment Given the Existence of Corporate Liability?* 13 INT'L REV. L. & ECON. 239 (1993) (same).

[63] There already exists an array of criminal prohibitions that might apply to a bank collapse, depending on the specific situation. But, and to that point, if there is a species of misconduct not currently captured by the federal criminal law, we are open to reaching that conduct through new legislation.

A. The Hybrid Model: Fine the Firm, Sanction the Individual

Scholars have long argued that, at least under certain assumptions, a hybrid model optimally deters corporate actors: a sanction on the corporation itself and, separately, on responsible employees.[64] This hybrid model has the benefit of (1) motivating the firm to do what it can to incentivize its executives to minimize the risk of losses, and (2) further discouraging executive misconduct beyond what the firm can accomplish with its limited toolkit and resources. And although hybrid deterrence models have been developed primarily in response to industrial disasters and mass torts, we think the underlying framework applies, with caveats, to the problem of bank runs.

Most of the key scholarly articles setting out the case for hybrid enforcement date to the 1980s and early 1990s. This spate of scholarship followed, and may have been prompted by a period of high-profile, large-scale industrial disasters: Love Canal, Time Beach, the Bhopal Disaster, and Agent Orange, and Exxon Valdez, to name but a few then household scandals.[65] These disasters triggered huge environmental- and tort-liability related claims against various corporations.[66] One major lesson learned was that imposing liability only on the corporate entity, while leaving responsible corporate employees off the hook, did not create optimal deterrence, in part because the harms in those cases vastly outstripped the assets of the responsible corporations. Firms are legal entities with finite financial resources; impose a sanction that is too large and the business will go bankrupt.[67] As a result, organizational penalties deter the

[64] *See, e.g.*, Jennifer Arlen & Lewis A. Kornhauser, *supra* note 61, at 683-87 (summarizing literature on classical deterrence theory approaches to optimal liability for organizational misconduct).

[65] At least some of the scholars developing the hybrid model expressly referred to the industrial disasters. *See, e.g.*, Macey, *supra* note 62, at 331 (discussing the Exxon-Valdez oil spill); Polinsky & Shavell, *supra* note 62, at 256 (discussing "the Union Carbide chemical plant explosion in Bhopal, the Johns Manville Corporation's asbestos-containing products, the Dalkon-Shield IUD injuries, and the Exxon Valdez oil spill"). And all those scholars were writing in a period that followed a spate of large industrial accidents. Such accidents exposed the well-understood deterrence problem posed by corporate defendants whose assets were less than the harm their activities can cause. *See, e.g.,* Kornhauser, *supra* note 62, at 1362-63 (discussing the effects on incentives of judgment-proof corporate defendants); Polinsky & Shavell, *supra* note 62, at 256 ("Clearly, no employee of the relevant corporations, including the highest-level officers, had assets anywhere near the resulting harms.").

[66] *See generally* Zarook Shareefdeen & Janak Bhojwani, *Hazardous Waste Accidents: From the Past to the Present*, *in* HAZARDOUS WASTE MANAGEMENT 27 (Zarook Shareefdeen ed., 2022) (surveying the environmental catastrophes of the late twentieth century and the legislative and regulatory responses designed to hold polluters financially accountable); Alexandra D. Lahav, *Mass Tort Class Actions—Past, Present, and Future*, 92 N.Y.U. L. REV. 998 (2017) (doing the same for mass torts and the ensuing class-action tort liability claims).

[67] *See* Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345, 1366 (1982) ("Less than socially optimal levels of care will be taken because neither the agent nor the principal will bear the true costs of the accident.").

rational firm only up to the point of insolvency.[68] There exists a gap between the theoretical size of a sanction that a regulator would need to impose in order to deter—in other words, how large a sanction the economist would like to impose—and the practical limits on sanctions that will actually deter before sending the firm into bankruptcy.[69] Under circumstances where the potential for harm is large enough to bankrupt the firm, as is clearly the case with respect to bank runs, the firm becomes essentially judgment proof.[70]

It was in that milieu that legal scholars converged on holding both the firm and its managers responsible for corporate wrongdoing. Mitchell Polinsky and Steven Shavell's classic 1993 article neatly captures the conceptual framework underwriting this hybrid model.[71] Using examples like the Bhopal disaster and asbestos litigation as illustrations, they identify situations under which optimal incentives result from subjecting employees to criminal sanctions—either a fine, or jail time if the fine is not paid—and then pairing those individual sanctions with a monetary fine on the corporation.[72]

For immediate purposes, we put aside the specific penalty of imprisonment and just focus on the reasons why this hybrid model provides the most efficient course of action for responding to large-scale corporate harms.[73] Start with firm liability. Imposing liability directly on a firm incentivizes it to minimize the risk of triggering said sanction.[74] Generally, the function of imposing corporate liability *ex post* is to incentivize the firm to monitor and control its executives *ex ante*.[75] After all, the firm is the institution best situated both to monitor its agents

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[68] Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 869 n.31 (1984); *see also* John C. Coffee, Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 389-93 (1981).

[69] *See* Coffee, *supra* note 68, at 389-93.

[70] *Id.* at 389. It is well known that *ex post* monetary sanctions have limited deterrence effects when the party being sanctioned is judgment proof. Steven Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45, 45 (1986).

[71] Polinsky & Shavell, *supra* note 62.

[72] *See id.* at 253-56.

[73] While many scholars accept a hybrid approach to deterrence, some doubt whether imprisonment of white-collar criminals provides optimal deterrence. *See, e.g.*, Dan M. Kahan & Eric A. Posner, *Shaming White-Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines*, 42 J.L. & ECON. 365, 375 (1999) (arguing against imprisonment as a cost-effective deterrent for white-collar crimes); *accord* Richard A. Posner, *Optimal Sentences for White-Collar Criminals*, 17 AM. CRIM. L. REV. 409 (1980).

[74] Some commentators use the term "enterprise liability" to capture what we are calling "firm liability." *E.g.*, Kornhauser, *supra* note 67, at 1345; Kraakman, *supra* note 68, at 858; Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1, 1 (1980). We avoid the use of the term "enterprise liability" here to avoid confusion with another use of that term in the deterrence literature.

[75] The basic contours of a simplified rational-actor calculus are familiar enough: A firm will refrain from engaging in misconduct when the benefits to be gained are outweighed by the penalty imposed, discounted by the probability of enforcement. Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 207-208 (1968); *accord* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW ch. 7 (9th ed. 2014).

and to influence their behavior through compensation, oversight, and a variety of governance mechanisms.[76] Faced with the prospect of a firm-level sanction, the entity will have reason to avoid that outcome by dedicating resources to control its executives.[77]

But while a firm is best situated to monitor and control its own employees, control over them is still limited.[78] Often, the most a firm can do is terminate employment.[79] The magnitude of an ideal sanction, even if nowhere near the full social harm caused by the corporation's failure, will almost certainly far exceed the executive's net loss of wages from termination. And a firm cannot impose even this degree of leverage over former executives because consequences for the sort of excessive risk-taking at issue here might take a while to manifest.[80] Executives have incentives to engage in shirking or delay tactics if it means pushing the risk of a collapse until after their tenure. But sanctioning executives can ameliorate behavior designed to outrun the firm's monitoring function.[81] Hence the need for a hybrid sanction against both the firm and responsible employees at the firm.

This argument for use of the hybrid model, which made sense in the context of industrial disasters and mass torts, also makes sense in the context of bank failures—and for mostly the same reasons. Like an industrial accident or mass tort, a bank collapse causes external harm that we should want to internalize.[82] First, there is the externality associated with the presence of FDIC insurance that protects the bank, and its executives, from the risk of losing deposits in the event of a collapse—a problem that, as discussed above, is not solved by perfectly-fine-tuned FDIC insurance premiums. Additionally, the FDIC fund is restored primarily through special payments imposed on the rest of the banking sector. Thus, a bank collapse weakens other banks as well, even after the dust has settled.[83]

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[76] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 13-14 (1991).

[77] *See* Kornhauser, *supra* note 67, at 1350.

[78] There are also limits to the firm's monitoring function—or, at least, to the extent that the prospect of an external sanction can incentivize optimal monitoring. *See* Kornhauser, *supra* note 67, at 1351; Coffee, *supra* note 68, at 394.

[79] Of course, in extreme cases, the firm can report the employee's misconduct to regulators or prosecutors. *See infra* Part II.C. (discussing incentives).

[80] *See* MIRIAM H. BAER, MYTHS AND MISUNDERSTANDINGS IN WHITE-COLLAR CRIME 110-111 (2023).

[81] Here too we have a judgment-proof problem. If the idea is to incentivize the employees to take reasonable steps to avoid corporate-caused harms, sometimes the threat of, say, monetary sanctions will not be enough; the potential for harm resulting from the employee's conduct may far exceed the assets of that employee. Polinsky & Shavell, *supra* note 71, at 240 n.4. For implications, see Part III below.

[82] *See* Valerio Paolo Vacca et al., *Measuring the Impact of a Bank Failure on the Real Economy: An EU-Wide Analytical Framework* 7, 21 (Eur. Cent. Bank, Working Paper No. 122, 2021) (showcasing the effect of bank failures on real GDP in the European Union by size of the bank).

[83] *See* Itai Agur & Maria Demertzis, *Excessive Bank Risk Taking and Monetary Policy* 3 (Eur.

To give a sense of the magnitude of those externalities: The FDIC estimates that First Republic Bank's failure cost the agency over $15 billion, while the failure of Silicon Valley Bank cost it over $19 billion.[84] So that portion of the harm is also an external cost that needs to be internalized. Moreover, these estimated losses are limited to the FDIC's insurance fund. They do not factor in losses borne by society in the form of lost jobs, lost economic productivity, etc. The 2023 Banking Panic is an object lesson for the insight at the heart of this project: FDIC insurance, though valuable for many reasons, creates moral hazard that externalizes harms outside the bank.[85]

To be sure, the analogy from industrial disasters to bank runs is imperfect. Importantly, the banking sector provides a public function that other private industries simply do not: money creation.[86] It is a vital matter of public policy that people can transact using a stable currency. Bank runs are so dangerous to the national economy precisely because they threaten to upend trust in the stability of the money supply.[87] In this respect, bank runs impose an acute systemic harm on the national economy significantly greater than do industrial disasters or mass torts.

There is one other disanalogy worth flagging. The analysis above indicates that banking is not *sui generis*. But bank collapses might press the limits of the hybrid model to the extent that they virtually guarantee insolvency, which means that the threat of an organizational sanction does not provide any further incentive to monitor.[88] A bank is already incentivized to monitor its employees to avoid the risk of insolvency; a post-insolvency fine on the bank isn't likely to add any additional incentive. So, while the hybrid model can carry over to the context of banking generally, the corporate sanction dimension of the hybrid model is less important here. This observation points to the importance of getting right the individual sanction component of the hybrid model.

All these reasons amount to two takeaways. First, the hybrid model is generally apt for theorizing about bank failures. Second, the sum of these external harms will, doubtless, far exceed any assets of the bank executive, which introduces the judgment-proof problem—and further complicates the choice of the optimal level of sanction. Ultimately, we don't expect to uniquely solve the problem. Our *ex post* sanctions would not be the only regulatory response available. We are proposing adding sanctions to the enforcement toolkit, rather than substituting them for *ex ante* regulation and oversight.[89]

Cent. Bank, Working Paper No. 1457, 2012) ("The bank regulator can counteract banks' risk-taking incentives by using a risk-based capital requirement.").

[84] *BankFind Suite: Bank Failures & Assistance Data*, FDIC, https://banks.data.fdic.gov/bankfind-suite/failures.

[85] *See supra* Section I.C.

[86] *See* Mathai, *supra* note 30.

[87] *See supra* notes 30-32 and accompanying text.

[88] *See supra* notes 67-70 and accompanying text.

[89] *See* Steven Shavell, *Liability for Harm Versus Regulation of Safety*, 13 J. LEGAL STUD. 357, 360-361 (1984) (providing the theory behind the intuition that, in cases in which a regulated entity is likely to be judgment proof, *ex ante* agency-based regulation is essential).

B. The Limits of Criminal Punishment to Address Negligent Bankers

Now we return to the element of the hybrid model that we introduced earlier but temporarily set aside: the possibility of using criminal law to address moral hazard in banking. After all, nothing motivates like the threat of jail time. If we want to deter bankers, why not just (threaten to) throw them in prison?

There is, unsurprisingly, a literature on the propriety of criminal sanctions for regulating corporate behavior.[90] The core insights from the hybrid model are firmly embedded into criminal enforcement. Since at least the introduction of the Organizational Offenders chapter of the U.S. Sentencing Guidelines in the early 1990s, the classic enforcement arrangement has purported to pair corporate sanctions with individual prosecutions and especially the threat of incarceration.[91] But whatever one thinks about this approach for industrial disasters, we would not recommend adopting this approach as a cure-all to prevent future bank failures.[92]

1. The Challenges of Corporate and White-Collar Enforcement

The threat of criminal punishment—here, incarceration—can deter only to the extent that it is credible. But, in reality, there is little credibility behind the threat of imprisoning high-level executives absent extreme, brazen instances of personal lawlessness.[93] Consider the federal government's response to the Global

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[90] *See, e.g.*, Cindy R. Alexander & Mark A. Cohen, *The Causes of Corporate Crime: An Economic Perspective*, *in* PROSECUTORS IN THE BOARDROOM 11 (Anthony S. Barkow & Rachel E. Barkow eds., 2011); Jennifer Arlen, *Corporate Criminal Liability: Theory and Evidence*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CRIMINAL LAW 144 (Alon Harel & Keith N. Hylton eds., 2012); Arlen & Kornhauser, *supra* note 64; Assaf Hamdani & Alon Klement, *Corporate Crime and Deterrence*, 61 STAN. L. REV. 271, 274 (2008); Vikramaditya S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 HARV. L. REV. 1477, 1477-78 (1996).

[91] *See* Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 952-953 (2009) (describing modern compliance's roots in criminal enforcement). *See generally* W. Robert Thomas, *Incapacitating Criminal Corporations*, 72 VAND. L. REV. 905, 941-946 (2019) (surveying distinct approaches toward corporate and individual punishment).

[92] On the limitations and challenges of criminal liability as an effective deterrent in corporate contexts due in part to under-enforcement, see, for example, Jennifer Arlen, *Evolution of Director Oversight Duties and Liability Under Caremark: Using Enhanced Information-Acquisition Duties in the Public Interest*, *in* RESEARCH HANDBOOK ON CORPORATE LIABILITY 194, 195-96 (Martin Petrin & Christian A. Witting eds., 2023).

[93] *See* Mihailis E. Diamantis & William S. Laufer, *Prosecution and Punishment of Corporate Criminality*, 15 ANN. REV. L. & SOC. SCI. 453, 466 (2019) (discussing the low rate at which individuals are prosecuted in connection to corporate wrongdoing); Samuel W. Buell, *The Limits of Individual Prosecutions in Deterring Corporate Fraud*, 59 WAKE FOREST L. REV. 557, 570 (2024) (demonstrating that even executives facing prosecution still have comparatively good odds to avoid conviction and punishment). *But see* BAER, *supra* note 80, at 14-24 (collecting citations to, but challenging, narratives around underenforcement of white-collar misconduct)

Financial Crisis. Populists on both sides of the political spectrum decried a federal response that bailed out Wall Street while leaving Main Street to suffer.[94] In reality, the truth is always more complicated: The federal government took a variety of actions against the financial institutions in the aftermath of the Global Financial Crisis. Many of the largest financial institutions entered massive settlement agreements with the federal government.[95] For the rest of the industry, Congress legislated a wide array of forward-looking reforms, most prominently through the Dodd-Frank Act.[96]

But the populist critique got at least one thing right: Bankers themselves didn't go to jail or otherwise pay the bill for causing a global collapse.[97] And it wasn't just the political fringe complaining about the lack of individual prosecutions. Jed Rakoff—a sitting federal judge and prominent public voice on issues of white-collar crime—excoriated both the Bush and Obama administrations for failing to secure a single conviction against any high-level executives in connection with the crisis.[98] Todd Haugh was able to find only *one* banker ever prosecuted.[99]

What is happening here? As it turns out, it is just very difficult to enforce white-collar crime laws, especially against senior executives. Some of the difficulty traces to the sorts of crimes carried out in a business context—notably, various types of fraud or financial deceit—which by design can go on for long periods without being detected; victims of these crimes usually do not even realize they are being victimized.[100] This delay between crime and discovery provides offenders substantial opportunity and resources to avoid detection, even

[94] *See, e.g.*, Angie Drobnic Holan, *Bankers Largely Escape Prosecution*, TAMPA BAY TIMES (Oct. 10, 2011), https://www.tampabay.com/archive/2011/10/10/bankers-largely-escape-prosecution/.

[95] *See* Brandon L. Garrett, *The Rise of Bank Prosecutions*, 126 YALE L.J. F. 33, 42 n.33 (2016); Jerry W. Markham, *Regulating the "Too Big to Jail" Financial Institutions*, 83 BROOK. L. REV. 517, 517 (2018). Whether these sanctions were effective is a different matter. Both Garrett and Markham find that these settlements resulted in few consequences for bank executives and did little to prevent future abuses.

[96] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. §§ 5301-641).

[97] *See, e.g.*, Gretchen Morgenson & Louise Story, *In Financial Crisis, No Prosecutions of Top Figures*, N.Y. TIMES (Apr. 14, 2011), https://www.nytimes.com/2011/04/14/business/14prosecute.html.

[98] Jed S. Rakoff, *Why Have No High-Level Executives Been Prosecuted?*, 3 REG. REV. IN DEPTH 1, 5, 7-8 (2014).

[99] Todd Haugh, *The Most Senior Wall Street Official: Evaluating the State of Financial Crisis Prosecutions*, 9 VA. L. & BUS. REV. 153, 155 (2015). If anything, this exception proves the rule: despite the government's framing, this individual was ultimately convicted of a minor offense that was tangentially related to the Crisis. *See id.* at 156-57.

[100] Alicia R. Williams et al., *2022 Fraud Victim Recontact Study,* AARP RESEARCH (2023) (finding, in a survey of 890 fraud victims that 81% did not realize they had given money to fraudulent schemes). *Cf.* BRANDON L. GARRETT, TOO BIG TO JAIL: HOW PROSECUTORS COMPROMISE WITH CORPORATIONS 127-28 136-37 (2014) (discussing legal shortcomings in victim notification processes for corporate crimes).

by their own firms.[101] Correspondingly, investigation and prosecution of business crimes require "a substantial investment due to their complexity, the organizations' greater ability to conceal information, attorney-client privilege issues, access to very highly paid defense counsel, and the factual complexity of such cases."[102] As a result, only the main Justice Department and a handful of U.S. Attorney's offices even have the resources necessary to reliably prosecute corporate and white-collar criminality.[103]

Existing enforcement challenges speak to, but also complicate, the federal government's reliance on firms to uncover and report their own criminal wrongdoing in exchange for lenient treatment.[104] Whatever the merits of this policy, reliance on firm cooperation has a tendency to bias enforcement away from high-level executives, who are the individuals best-positioned to shape and direct the firm's internal investigation.[105] Presidential administrations have placed different emphasis on using corporate enforcement to produce individual prosecutions; prioritizing individual prosecutions reached its rhetorical zenith in the Obama Administration.[106] And yet, researchers saw no change in individual enforcement statistics across administrations.[107]

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[101] *See generally* Miriam H. Baer, *When the Corporation Investigates Itself*, *in* RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING 308, 326-27 (Jennifer Arlen ed., 2018) (detailing methods of "detection avoidance" available to employees and middle managers).

[102] Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 881 (2007).

[103] *See* Rachel E. Barkow, *The Prosecutor as Regulatory Agency*, *in* PROSECUTORS IN THE BOARDROOM 192 (Anthony S. Barkow & Rachel E. Barkow eds., 2011).

[104] Jennifer Arlen, *Prosecuting Beyond the Rule of Law: Corporate Mandates Imposed Through Deferred Prosecution Agreements*, 8 J. LEGAL ANALYSIS 191, 198-99 (2016); Garrett, *supra* note 102, at 888-89. The Biden Administration made voluntary self-disclosure a centerpiece of its enforcement strategy. Memorandum from Lisa O. Monaco, Deputy Att'y Gen., U.S. Dep't of Just., on Corporate Crime Advisory Group and Initial Revisions to Corporate Criminal Enforcement Policies (Oct. 28, 2021), https://www.justice.gov/dag/page/file/1445106/download.

[105] *See* Garrett, *supra* note 100 at 13-14; William S. Laufer, *Illusions of Compliance and Governance*, 6 CORP. GOVERNANCE 239, 243-44 (2006); W. Robert Thomas, *Corporate Criminal Law Is Too Broad—Worse, It's Too Narrow*, 53 ARIZ. ST. L. REV. 199, 255-57 (2021).

[106] Memorandum from Sally Quillian Yates, Deputy Att'y Gen., U.S. Dep't of Just., on Individual Accountability for Corporate Wrongdoing (Sept. 9, 2015), https://www.justice.gov/archives/dag/file/769036/download; Andrew Spalding, *Restoring Pre-Existing Compliance through the FCPA Pilot Program*, 48 U. TOL. L. REV. 519, 530 (2017); *see* Sara Sun Beale, *The Development and Evolution of the U.S. Law of Corporate Criminal Liability and the Yates Memo*, 46 STETSON L. REV. 41, 63-66 (2016) (situating the memo's emphasis on individual prosecution as response to public frustration over the absence of individual accountability for the 2008 Financial Crisis).

[107] *See* Kevin P. Turner, A Promise Yet Unfulfilled: The Yates Memo's Impact on Individual Accountability for Corporate Wrongdoing Eight Years On 20 (2025) (unpublished manuscript) (on file with Seton Hall University).

2. Beyond Enforcement: Problems with the Responsibility Gap

Particularly with respect to enforcement against senior executives, the limitations of criminal law go much deeper than the admittedly considerable epistemic and enforcement challenges sketched in the prior Subpart. The problem is a substantive one—what some have coined the "responsibility gap"[108]—that goes to the heart of criminal theory, and specifically the ways in which the ideals underlying liberal theory and criminal justice crash into the realities of complex organizational management.

This Article is not meant to explore the foundations of political liberalism, so we'll just assert the following truism and beg indulgence: people should be punished only for the crimes that they commit. Narrow (and still controversial!) exceptions aside,[109] the basic contours of American criminal law purport to reflect this basic commitment. In order to justly exercise its monopoly on violence, the State bears the burden of proving beyond a reasonable doubt that a defendant committed some proscribed act (*actus reus*) concurrent with a proscribed attitude (*mens rea*).[110] And this vision of criminal law is arguably most alive with respect to white-collar and especially well-off, high-status defendants.[111] And yet it is also in this setting that criminal law is least suited to respond to individual misbehavior.[112]

As a vast oversimplification, high-level executives don't tend to commit crimes at work. This claim is an organizational observation more than it is a psychological or classist one. Leaders of large organizations are rarely in a position to satisfy both the *actus reus* and *mens rea* corresponding to an instance of organizational misconduct.[113] Or, to reverse the explanatory relationship, large

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[108] *See* Samuel W. Buell, *The Responsibility Gap in Corporate Crime*, 12 CRIM. L. & PHIL. 471, 473 (2018); *see also* Stephanie Collins, *Collective Responsibility Gaps*, 154 J. BUS. ETHICS 943, 946 (2019).

[109] *See, e.g.*, Jennifer Bragg, John Bentivoglio & Andrew Collins, *Onus of Responsibility: The Changing Responsible Corporate Officer Doctrine*, 65 FOOD & DRUG L.J. 525 (2010) (describing the scope and narrow limits on managerial vicarious criminal liability). Granted, to say that an individual should be responsible only for the crimes she commits risks begging the question of what it is the criminal law prohibits; the criminal legal system has long been comfortable, after all, punishing those who abet, encourage, solicit, or conspire. But at least in this instance, the same systemic constraints that stymie enforcement against high-level executives—particularly with respect to establishing *mens rea*—likewise tend to short-circuit attempts to hold them liable as accessories to the crimes of other, lower-level employees. *See infra* notes 115-125 and accompanying text. Our thanks to our colleague, Gabe Mendlow, for pressing this point.

[110] WAYNE R. LAFAVE, 1 SUBST. CRIM. L. § 1.2 (2d ed. 2003).

[111] *See generally* Samuel W. Buell, *Is the White-Collar Offender Privileged*, 63 DUKE L.J. 823 (2014) (critically appraising claims surrounding differences between white-collar and street-level criminal law, procedure, and enforcement).

[112] This is not a new problem; corporate criminal liability arose in part an attempt to address this responsibility gap. W. Robert Thomas, *How and Why Corporations Became (and Remain) Persons Under the Criminal Law*, 45 FLA. ST. U. L. REV. 479, 534–36 (2017).

[113] Sam Buell, *Criminally Bad Management*, *in* RESEARCH HANDBOOK ON CORPORATE CRIME

organizations are designed in a manner that makes it difficult for senior executives to commit or carry out all elements of a crime that correspond to an instance of individual criminal responsibility. Corporations are, on one description, delegation machines. The value of the firm is to leverage non-separable team production beyond what individual effort could achieve on its own or via contractual relationships.[114] Indeed, merging individual contributions into a cohesive, unified output is a primary reason that well-structured entities are valuable in the first place.[115] Thus, if a CEO is coming up with a plan and carrying out its specifics, then something has probably gone wrong at the level of basic organizational design.

It's no surprise, then, that we see most individual prosecutions happening at the low- to mid-tier level of executive leadership. This band is the Goldilocks range for criminal behavior, where individuals are junior enough to still be carrying out misconduct, but senior enough to satisfy the specific intent requirements common to white-collar offenses.[116] By contrast, the elements of criminal law rarely cohere within individual top executives. The problem is not necessarily, or at least not exclusively, that top executives are ordering minions to commit crimes while keeping their own hands clean.[117] Top executives don't usually act as mob bosses; if they do, the federal government has tools to go after them.[118] The more fundamental challenge is that top executives often do things that aren't themselves yet criminal. More often, senior management creates the culture, environment, and opportunities for organizational misconduct down the road.[119]

Viewed against the backdrop of these substantive and enforcement challenges, it becomes easier to understand that the lack of prosecutions coming out of the Global Financial Crisis need not be accident or conspiracy. The

AND FINANCIAL MISDEALING 59, 71-75 (Jennifer Arlen, ed., 2018).

114 *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 262, 266 (1999); *see also* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 779–80 (1972).

115 *See* W. Robert Thomas, *Corporate Criminal Law Is Too Broad—Worse, It's Too Narrow*, 53 ARIZ. ST. L. REV. 199, 225 (2021) (collecting examples).

116 GARRETT, *supra* note100, at 81-84.

117 *But see* Cindy R. Alexander & Mark A. Cohen, *New Evidence on the Origins of Corporate Crime*, 17 MANAGERIAL & DECISION ECON. 421 (1996) (finding that agency costs positively correlate with corporate misconduct); *see also* Arlen, *Evolution of Director Oversight*, *supra* note 92. Although we ultimately diverge from Arlen's proposed response to this concern, see *infra* at nn. 154-157, we agree with the underlying concern that agency costs between the firm and its executives, and between directors and officers, create space for bank executives to commit both crimes and non-criminal negligence that nevertheless produces widespread, systemic harms to the financial sector. *See* Buell, *Criminally Bad Management*, *supra* note 113, at 61.

118 *See, e.g.*, 18 U.S.C. §§ 1961–68 (racketeering).

119 *Cf.* Cindy R. Alexander & Mark A. Cohen, *Why Do Corporations Become Criminals? Ownership, Hidden Actions, and Crime as an Agency Cost*, 5 J. CORP. FIN. 1, 30 (1999) ("Even where the culprits are lower-level employees, corporate crime does not appear to be a random event beyond top management's control.").

criminal law is poorly suited to go after senior executives for their roles in bringing about corporate harm.[120] To be sure, at the margins prosecutors may have been too cautious or deferential in pursuing cases against high-profile individuals.[121] But prosecutors were generally responding to the criminal law as it exists, rather than as how many might imagine it to be.[122] The challenge of using individual enforcement to shore up corporate enforcement is that our traditional, fault-centric regimes of individual enforcement are poorly calibrated to reach or punish the individuals who are positioned to create the circumstances that eventually give rise to widespread organizational misconduct.

C. We Shouldn't Create Criminal Liability Just to Imprison Bankers

As the prior sections illustrate, the prospect of criminal punishment is unlikely to offer much in the way of deterrence. One might be tempted, then, to create new criminal prohibitions or procedures in order to bypass these structural impediments to executive liability.[123] However, to do so successfully—that is, in a manner intended to achieve optimal deterrence under the hybrid model—would almost certainly require doing violence to the criminal law truism that individuals should be held responsible only for misconduct they wrongfully commit.[124]

One conclusion that some scholars have reached after the Global Financial Crisis is that federal criminal law needs to be reformed, expanded, or relaxed to make it easier to prosecute bankers. Haugh, for example, offers several proposals for increasing convictions, including holding more individuals responsible, focusing on CEOs, and utilizing a national task force.[125] For his part, Peter Henning proposes creating a new criminal statute to enhance personal accountability for harmful business outcomes.[126] Here, Henning draws inspiration from other countries that proved to be comparatively more aggressive in prosecuting bankers for fraud and other financial crimes coming out of the crisis.[127]

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[120] See Buell,*supra* note 113, at 61 ("There is a clear relationship between corporate management, indeed bad corporate management, and corporate crime . . . . It is not one, however, that lies within the boundaries of conventional concepts of criminal liability.").

[121] *See* JESSE EISINGER, THE CHICKENSHIT CLUB: WHY THE JUSTICE DEPARTMENT FAILS TO PROSECUTE EXECUTIVES 56–57 (2018).

[122] *See* BAER, *supra* note 81, at 14-17.

[123] *See generally id.* at 107-33 (discussing methods for closing the gap between liability and detection).

[124] *See generally* Buell, *supra* note 120, at pp. 75-80 (detailing "severe limitations of American criminal law, as both a positive and normative matter, as a tool for imposing individual liability on corporate managers for running firms in ways that enable and fail to discourage criminal violations by employees").

[125] Haugh, *supra* note 101, at 187–96.

[126] Peter Henning, *A New Crime for Corporate Misconduct*, 84 MISS. L.J. 43, 50 (2014).

[127] *Id.* at 43, 50, 82; *see* Justin Rex & Adam Panas, *Prosecuting White-Collar Financial Crime: The Contrasting Cases of the US, Spain, and Ireland in the Aftermath of the 2008 Global*

For starters, we ought not subject bank executives to criminal sanctions for bank failures in the absence of proof of truly criminal conduct. In other words, no criminal sanctions should attach for the mere collapse of a bank with no other evidence of criminal wrongdoing. Criminalizing the fact of being an executive of a failed bank would run afoul of bedrock criminal law principles by administering criminal punishments in the absence of potentially both a *mens rea* and an *actus reus*.[128] It doesn't follow from the fact of a bank collapse that its executives thereby engaged in behavior that we would normally identify as criminal. At best, we can guess that they engaged in behavior that might have created the conditions for other unlawful behavior down the road. It might be bad managerial practice to foster, contribute to, or fail to dismantle a bad corporate culture. And at the margins, it constitutes a breach of one's fiduciary duties.[129] But there is a large distance between that and imprisonment. Furthermore, it is entirely possible that the executive of the collapsed bank did nothing wrong at all. Sometimes bad things, including financial catastrophes, just happen, even in the absence of wrongdoing.[130] Given these facts, holding bank executives criminally responsible for mismanagement—or for horribly bad luck—would strain the criminal law far past its foundational commitments. To this point, we are aware of no federal or state statute criminalizing merely being an executive of a failed bank.

What about criminalizing bank collapses that are wrongfully caused by the executive? In one sense, we support this idea—at least under some descriptions. Of course, all the action rests on what sorts of behaviors count as wrongful. For the reasons described above, we expect that adequately deterring the incremental moral hazard problem will require holding executives responsible for conduct that is not easily criminalized. Likewise, we could stipulate new prohibitions to capture the situations of interest—for example, a crime of "negligent management resulting in a bank run."[131] But while this approach might shrink the responsibility gap, it would do so by straining liberal commitments to avoid

Financial Crisis, 29 IND. J. GLOB. L. STUD. 27, 57-59 (2022).

[128] Mere membership is not by itself an action. *Cf.* Lambert v. California, 355 U.S. 225, 228–29 (1957) (holding that passive behavior cannot be criminalized absent notice of a duty to act). Admittedly, there are narrow exceptions for public-welfare offenses; for example, a supervisor can be held vicariously criminally liable for crimes carried out by her employees under the "responsible corporate officer" doctrine. Bragg et al., *supra* note 109, at 525-26. But the exception here proves the rule: the responsible corporate officer doctrine provides an extremely narrow path to charge executives only in certain industries for the crimes of their subordinates that involve minor health and public safety infractions—and, even with these constraints, the doctrine has long been a subject of criticism for running afoul of criminal law's basic legality principles. *Id*. at 529-30; *see* Buell, *Responsibility Gap*, *supra* note TK, at 481-84.

[129] *See* Robert Bird, Caremark *Compliance for the Next Twenty-Five Years*, 58 AM. BUS. L.J. 63, 109-12 (2021); Jennifer G. Hill & Roy A. Shapira, *Accountability for Flawed Corporate Culture*, 51 J. CORP. L. **23-33 (forthcoming).

[130] Indeed, one worry with bank runs is that they trigger failures in otherwise healthy, well-managed banks. *See supra* Part I.

[131] *See* Henning, *supra* note 127.

punishment in the absence of blameworthy wrongdoing. Absent good evidence that criminal liability is the only way to avoid bank runs—a proposition for which we have no evidence—we agree with the general instinct not to try to criminalize our way out of a problem.[132]

Finally, some proposals suggest ameliorating these concerns by using harsh punishments as a last resort. Polinsky and Shavell, for example, argue that executives should be fined, and imprisoned only if they don't pay.[133] However, reframing incarceration as a backup sanction does not solve these concerns and arguably creates problems of its own for the standard deterrence story. There is a tendency among economic theorists to treat incarceration and monetary fines as interchangeable sanctions.[134] There's nothing wrong with this approach for purposes of modeling rational incentives. But neither should this assumption be taken seriously as a matter of public policy, at least not without grappling with the liberal commitments that it brackets for the sake of analytic crispness.[135] Debtors' prisons have long been abandoned in our criminal legal system.[136] It is an unfortunate trend that some municipalities have enacted criminal law policies partially reinvigorating this practice;[137] for our part, we are reluctant to endorse a policy solution that reintroduces a practice of jailing those who cannot pay their debts.

More fundamentally, criminal conviction and punishment sit poorly with the policy aims of this project. Our ambition is not to visit retribution upon evil executives—or rather, our ambition is not to constrain deterrence just to those circumstances where retribution against evil executives would otherwise be apt. Rather, we are proposing sanctions designed to distribute costs onto officers as a means of counteracting the additional moral hazard brought about by other banking reforms. What we are objecting to is the use of imprisonment for its own sake—a sort of stylized debtors' prison.[138] Insofar as we want to reach conduct

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[132] *See* DOUGLAS HUSAK, OVERCRIMINALIZATION: THE LIMITS OF THE CRIMINAL LAW 3 (2007).

[133] Polinsky & Shavell, *supra* note 72, at 239–41.

[134] *See, e.g.*, Becker, *supra* note 76, at 179-80; Posner, *supra* note 73, at 410-14.

[135] *See* Don Herzog, *Review: Externalities and Other Parasites*, 67 U. CHI. L. REV. 895, 912 (2000).

[136] *See generally* Nino C. Monea, *A Constitutional History of Debtors' Prisons*, 14 DREXEL L. REV. 1, 4 (2022) (tracing the gradual rejection of debtors' prisons in the United States).

[137] *See generally* Christopher D. Hampson, *The New American Debtors' Prison*, 44 AM. J. CRIM. L. 1 (2017) (arguing that municipalities systematically jail their citizens for failing to pay low-level monetary penalties, producing in effect a modern analogue to historical debtors' prisons).

[138] Criminal law can impose fines too, in which case some of the force of our objections about imprisonment would fall away. But the criminal law turns out to be a terrible tool for imposing fines. Criminal law imposes heightened proof standards, making conviction less likely than a civil suit. Khanna, *supra* note 90, at 1512. Criminal penalties face statutory and constitutional limitations that civil penalties do not. *See* U.S. CONST. amend. VIII. And while there is expressive value to criminal conviction, fines tend to undermine, rather than reinforce, the sorts of messages we might hope for criminal punishment to express. Dan M. Kahan, *What Do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591, 621 (1996); W. Robert Thomas, *The Conventional Problem with Corporate Sentencing (and One Unconventional Solution)*, 24

that traditionally falls well outside the purview of the criminal law, we think it is a mistake to divorce the institution entirely from its existing foundations to meet our specific needs in the banking context. Serious harm does not require serious misconduct; it can arise accidentally, or negligently.[139] Holding people accountable for that harm is hard, and sometimes we cannot make someone entirely internalize the costs of their shortcomings. The status quo, we worry, does too little to internalize those costs on bankers. But if we want to insist that prison is reserved for bad conduct, and not bad outcomes, then we would be reluctant to relax central limitations on the use and propriety of the criminal legal system to get to that point. Besides, as Parts III and IV demonstrate next, there are plenty of alternative sanctions that better comport with civil standards of liability and that can improve the incremental moral hazard problem in banking.

III. Designing a Sanctions Regime for Negligent Bankers

If criminal punishment is not a reliable response to excessive risk-taking that leads to bank collapse, then what alternatives are left? Can we still use *ex post* sanctions—specifically, civil fines or other monetary sanctions—to mitigate the increased moral hazard? We think so.

Part III outlines the broad contours of such a proposal, confronting three foundational questions along the way. First, what conduct merits a sanction? Should liability be strict, or should liability attach only when there is some kind of negligence, fault, or breach of a duty? Second, must the executive cause a bank collapse, or is it enough merely to have made that collapse more likely? And are sanctions appropriate only if a bank actually collapses, or should parties be held liable for circumstances short of an outright collapse? Third, what magnitude of sanctions should executives face?

A. Fault Standards: Strict Liability, Negligence, or Gross Negligence

Our proposal is to mitigate moral hazard by imposing monetary sanctions on bank executives. To reiterate, this is not an issue of retribution or corrective justice; this is all about deterrence. As with any discussion of how to design an optimal regime of deterrence, including one as here of *ex post* sanctions, we need to address what will trigger the sanction. Again, because we are focused on an *ex post* deterrence regime, the trigger question can be broken into two parts: what liability rule will be applied (negligence, strict liability, or something else) and what will trigger the application of the liability rule (the causation of harm, the increase in the risk of harm, or something else). In this section we address the choice of liability rule, specifically, which rule is most likely to optimize *ex ante*

NEW CRIM. L. REV. 397, 412-15 (2021).

[139] As we have said, we encourage the use of criminal law where the conduct in question by executives rises to the level of existing standards of criminality. We just find the likelihood of those conditions being present to be small. And while one might consider imposing criminal monetary sanctions that target the sort of negligence that concerns us, it seems unlikely that the value of the "criminal" label would overwhelm the costs, particularly since our proposal makes civil sanctions uninsurable. *See infra* Part III.C.

care.[140] As before, we are not trying to reinvent the wheel here: the incentive structures underpinning negligence and strict liability regimes are well-studied.[141] Indeed, under specified conditions, either strict liability or negligence could provide incentives for optimal care by bank executives. Selection between the two, then, turns primarily on the underlying epistemic and economic conditions.

A negligence standard is, for deterrence purposes, superior to a strict liability rule, all else equal, when the efficient standard of care is relatively easy to identify but the potential harm is comparatively hard to predict.[142] Under a negligence regime, a rational agent will invest in prevention up to the point of the standard of care, recognizing that any further investment in prevention will be poorly spent because it does not provide extra liability protection.[143] After all, once the standard of care is met, the agent is free of any prospective liability, which can strengthen the incentive to satisfy the standard, especially if the manner in which the courts will apply the standard *ex post* is uncertain and if the actor is risk averse. This discontinuity—the all-or-nothing nature of the liability it imposes—is the secret deterrence sauce of the negligence standard.[144] By contrast, a strict liability rule tends to be preferable in the opposite setting—that is, when damages are predictable, but the standard of care is hard to determine.[145] Under these circumstances, the agent also will invest in prevention up to but not beyond the point that doing so cost-effectively reduces the prospect of liability.[146] As in the negligence case, any further expenditure would be inefficient, reducing

[140] *See* Steven Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1, 1-2 (1980). Tort scholarship, where these deterrence principles have been worked out in the greatest detail, distinguishes "care levels" and "activity levels." Optimizing both is essential in settings involving corporate-caused harm. *See id.* We focus on care levels in this section for reasons we explain further below.

[141] We use the term "negligence" to describe an agent's failure to meet the relevant duty of care, whatever that standard turns out to be. A more precise description would be "a duty-based liability regime." *See* Arlen & Kornheiser, *supra* note 64, at 687-688 (referring to duty-based standards). For readability, we use these terms interchangeably unless where otherwise specified. However, references to negligence should not be read to import tort law's specific account of negligence uncritically into the banking context.

[142] *See* ROBERT D. COOTER & ARIEL PORAT, GETTING INCENTIVES RIGHT: IMPROVING TORTS, CONTRACTS, AND RESTITUTION 26-28 (2014) ("[I]f obtaining accurate information about external costs is cheaper for official than obtaining accurate information about socially optimal behavior, then they should control activity by pricing it [as with a strict liability rule]. If the converse is true, then they should control the activity by sanctioning it [as with a negligence standard]."). As Cooter and Porat point out, this conclusion is like the claim in the literature on regulating pollution. *Id.* at 28 n. 11 (citing WILLIAM J. BAUMOL & WALLACE E. OATES, THE THEORY OF ENVIRONMENTAL POLICY (1988); and Martin L. Weitzman, *Prices vs. Quantities*, 41 REV. ECON. STUD. 477 (1974).

[143] *See* Shavell, *supra* note 140, at 2.

[144] *See* Shavell, *supra* note 140, at 21; Cooter & Porat, *supra* note **Error! Bookmark not defined.**, at 14-15.

[145] *See* Cooter & Porat, *supra* note **Error! Bookmark not defined.**, at 21.

[146] *See* Shavell, *supra* note 140, at 1-3.

the expected cost of damages by less than the amount spent now on prevention.[147] So again, under certain conditions, either standard produces optimal care.

But what about the special circumstances that arise when the regulated party is judgment proof? Here, deterrence theory recommends a negligence standard over strict liability.[148] The rationale is intuitive: a strict liability *ex post* regime of sanctions has no hope of incentivizing the regulated party to invest sufficiently in prevention because the cost internalization is necessarily capped by the value of the party's reachable assets.[149] The regulated party will tend to underinvest in care.[150] A duty-based standard such as negligence has a better chance at optimizing care, because of the all-or-nothing nature of the standard: if the regulated party satisfies the standard, they are totally off the hook. This can be enough to induce something approaching optimal care, even if the regulated party is judgment proof, depending on the value of their assets, the costs of precaution, and the probability of the liability-triggering event. Thus, the presence of a judgment proof party can counsel in favor of negligence over strict liability.

Finally, worth considering here are the enforcement and political costs associated with each regime. We've already seen that corporate enforcement is difficult. Some of those reasons are unique to the criminal law: the challenge of meeting heightened proof and procedural standards, the difficulty of establishing specific intent, and the unlikelihood of showing that all elements cohered in a single executive.[151] However, many enforcement challenges carry over to the civil context and interact with the choice of liability standard. Strict liability generally imposes lower enforcement barriers: an agent is responsible whenever the triggering condition is met.[152] Negligence is more difficult to prove, and thus more costly to enforce, because it requires a further determination that the agent fell short of her duty in connection to the triggering condition.[153]

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[147] *See id.*

[148] Shavell, *supra* note 71, at 45 (noting that potential injurers "may have too little incentive to take care to reduce risks" if they are judgment proof and face a regime of strict liability, because their maximum liability is the amount of their assets, but that "[t]his problem . . . is less pronounced" under a negligence standard owing to the all-or-nothing nature of such a rule). Giuseppe Dari-Mattiacci and Barbara Mangan challenge this conventional wisdom, arguing that strict liability might be the preferable regime even for judgment-proof defendants once certain concerns related to causation are added to the model. Giuseppe Dari-Mattiacci & Barbara M. Mangan, *Disappearing Defendants Versus Judgment-Proof Injurers*, 75 ECONOMICA 749, 754 (2008). We take up these results in the next section.

[149] Shavell, *supra* note 70, at 47.

[150] *Id.* at 45.

[151] *See supra* Part II.C.

[152] *See* Khanna, *supra* note 90, at 1510.

[153] A general conclusion in the deterrence literature, then, is that, whereas negligence presents higher administrative costs per case, strict liability results in more cases. Which has lower overall administrative costs is unclear, or so the argument goes. Louis Kaplow & Steven Shavell, *Economic Analysis of Law*, *in* 3 HANDBOOK OF PUBLIC ECONOMICS 1665, 1673-74 (A.J. Auerbach & M. Feldstein eds., 2002). As mentioned, negligence also introduces epistemic uncertainty insofar as an individual might not be confident *ex ante* that his or her

But strict liability's lower enforcement barriers come with a political cost. Strict liability has long been criticized on both efficiency and fairness grounds precisely because it holds agents responsible even if they exercised seemingly adequate care.[154] Strict liability, then, brings with it a certain institutional risk for enforcement officials, who may be reluctant to take advantage of the otherwise favorable culpability regime.[155] Both of these costs are worth taking seriously given the context. Compared to the general population, bank executives are more likely to be high-wealth, high-status individuals.[156] Consequently, they are better situated both to invest heavily in their legal defense (thus driving down the value of a negligence regime) and their political defense (thus increasing the cost of a strict liability regime).

Ultimately, we believe that the totality of circumstances points in favor of a negligence standard over a strict liability rule.[157] Despite their income and social

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behavior falls outside the auspices of negligence.

[154] *See*, *e.g.*, Richard A. Posner, *Strict Liability: A Comment*, 2 J. LEGAL STUD. 205, 217-20 (1973); Alan Schwartz, *The Case Against Strict Liability*, 60 FORDHAM L. REV. 819, 820 (1992); *see also* Jennifer Arlen & Lewis A. Kornhauser, *Battle for Our Souls: A Psychological Justification for Corporate and Individual Liability for Organizational Misconduct*, 2023 U. ILL. L. REV. 673, 725-27.

[155] For an object lesson, see DOJ's implementation of corporate compliance standards. Eisinger, *supra* note 121, at 56-57; *see also* Thomas, *supra* note **Error! Bookmark not defined.**, at 916-18.

[156] *See, e.g.*, Rica Dela Cruz & Xylex Mangulabnan, *CEO Pay Ratios Rise at Most Large US Banks in 2022; JPMorgan Logs Highest Ratio*, S&P GLOBAL (Aug. 8, 2023), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/ceo-pay-ratios-rise-at-most-large-us-banks-in-2022-jpmorgan-logs-highest-ratio-76868650.

[157] Jennifer Arlen has argued for a different approach to oversight liability. First, Arlen argues that sanctions for corporate misconduct should primarily be imposed on directors rather than officers, reasoning that directors face fewer conflicts of interest and are better positioned to act dispassionately when wrongdoing is uncovered. Arlen, supra note 92, at 199. Officers, by contrast, may benefit directly from misconduct or fear repercussions such as termination, which could inhibit their willingness to take corrective action. We acknowledge the merits of this argument. However, in the banking context, we maintain that imposing liability on officers is not only appropriate but essential. Bank executives are the ones making high-stakes, day-to-day decisions—such as whether to concentrate the bank's deposit base in a single sector like venture-backed tech, or to ignore glaring interest rate risks in the economy. These are not abstract strategic calls; they are operational decisions with immediate systemic consequences. While we do not rule out extending oversight liability to directors as well, our focus here is on the decision-makers whose actions most directly raise or mitigate systemic financial risk.

Second, Arlen proposes that oversight liability should be governed by a bad faith standard, augmented by an affirmative duty to gather and assess compliance-related information. Her concern is that negligence-based liability might lead to over-deterrence—discouraging beneficial risk-taking or prompting inefficient over-investment in compliance. *Id.* at 203-04. We agree that such risks must be taken seriously and that hindsight bias is a danger. But we believe that in banking, a negligence standard applied to executive conduct is both more effective and more administrable. The kinds of failures we envision as actionable—ignoring internal risk warnings, mismanaging interest rate exposure, or allowing dangerously concentrated portfolios to persist—are not ambiguous or borderline judgments. They are failures to meet basic professional standards of care in a highly regulated environment. That status, executives even at the largest banks are all but guaranteed to qualify as judgment proof when it comes to the damages of a bank collapse. If the massive sums involved in banking crises are any indication,[158] executives will not have anywhere near enough money to cover that magnitude of losses. In short, the central limiting constraint that any banker sanction regime will face is the defendant's ability to pay, which points toward a negligence rule.[159]

Before we fully recommend a negligence approach over strict liability, however, we should address the topic of activity levels. The torts-deterrence literature has long distinguished between "care levels" and "activity levels."[160] If the former captures how carefully a party engages in a given activity, the latter captures how much a party engages in the that same activity, holding care levels constant. Industrial disasters and mass torts are quintessential examples justifying the need to optimize both levels. Achieving the socially optimal outcome requires not only that the widget maker take reasonable care to minimize the risk of environmental harm to the community, but also that the price of the company's widgets reflect their full marginal costs, including the remaining expected costs of accidents, which tend to reduce the amount of the activity.

This result—simultaneously optimizing care and activity levels of the corporation—can be achieved in the environmental or tortious harm context with a strict liability rule, which forces the corporation to bear all the external harms its widgets cause.[161] Negligence, by contrast, excuses the corporation from liability if it takes reasonable care, even though reasonable care does not fully eliminate the risk of harm. (The production of widgets can cause substantial environmental harm even if there is no negligence by the corporation.) Put differently, the negligence standard allows the corporation to externalize to

said, we also recognize that Arlen's refined conception of bad faith, particularly when paired with a duty to proactively gather information, brings her framework closer in substance to ours. Her version of bad faith, like our version of negligence, imposes accountability for inaction in the face of known or knowable risks. The difference, in our view, is largely one of emphasis and threshold.

[158] *See supra* note 84.

[159] Some may wonder whether it is possible to prove negligence in the banking context, since bankers must take risks. Risk-taking is part of the job, so what could be the standard of care? Who is the reasonable banker? Empirically speaking, we believe this problem is solvable. In the 2023 Banking Panic, for example, only a few banks looked like Silicon Valley Bank, mixing astronomically high levels of uninsured depositors with large exposures to fixed-income securities and poor interest-rate risk management. There were only a few banks in this camp; thousands of banks were in the other camp. *See* Jeffery Y. Zhang, *Too Scared to Use: Living Wills and Orderly Liquidation of Too-Big-to-Fail Financial Institutions*, 111 IOWA L. REV. (forthcoming) 1, 37 (showing SVB as a unique outlier). Similarly, in the Global Financial Crisis, only a handful of banks had (very) poor risk management. *See* Nicholas K. Tabor & Jeffery Y. Zhang, *Capital, Contagion, and Financial Crises: What Stops a Run from Spreading?*, 2020 COLUMB. BUS. L. REV. 575, 626-28 (observing that runs were strongest on institutions most similar to Lehman Brothers).

[160] *See, e.g.*, Shavell, *supra* note 140, at 10.

[161] Shavell, *supra* note 140, at 2.

others the residual (unpreventable) risk of environmental or tort harms caused by widget production, potentially leading to excessive activity levels. The tendency of a negligence standard, but not a strict liability rule, to lead to socially excessive levels of certain types of risk-creating corporate activity is a strong argument for adopting a strict liability rule in those settings.[162]

This activity-level case for strict liability, however, does not easily fit the banking context. First, the idea of full internalization of the social costs of a bank run to those few banks and bankers whose initial decisions provoke the chain reaction is wholly unrealistic. Imposing such a draconian penalty would discourage almost anyone from going into banking, and we do need bankers. In addition, it is not clear that we would even want to achieve activity-level deterrence with respect to banking decisions in the same way that we would with production of widgets. If the total social marginal cost of the next (safely designed) widget, including the marginal expected cost of a mass tort or environmental disaster that the widget represents, exceeds their benefit, then reducing widget production—even not producing widgets altogether—is welfare enhancing.[163] By contrast, it is not clear that the same conclusion applies to banking given the essential role that banking plays to the entire economy. True, some specific loans are not socially cost-justified. But holding all banks and bankers strictly liable for any bank run would have a much broader disruptive effect on the structural function that banks play in our economy. Without the activity-level argument for strict liability in the banking context, which is a primary reason given for choosing strict liability over negligence outside of the banking context,[164] the case for a negligence standard is strengthened.

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[162] For example, one can make an argument for holding product manufacturers strictly liable for product-caused injuries to consumers in part based on this activity-level effect. *See, e.g.*, WILLIAM A. LANDES & RICHARD POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 294 (1987) (reaching that conclusion); and SHAVELL, *supra* note 53, at 50 (same). *See also* Hanson & Logue, *supra* note **Error! Bookmark not defined.**, at 173 (making the case that strict liability without a defense of contributory negligence may be the social-welfare-maximizing rule for many consumer product accidents, because of the presence of moral-hazard-inducing first-party insurance for consumer product accidents). Note that a complete version of this analysis would also consider the effect of strict liability and negligence on the care and activity levels of potential victims. Shavell, *supra* note 140, at 1-2. But we ignore that here on the theory that most victims, both in industrial accident cases (average homeowners or consumers) and in bank runs (average taxpayers), can or will do little, via changes in care or activity, to alter the risks in question.

[163] A standard activity-level model in law and economics holds that a product should be supplied only up to the point where its marginal social cost (MSC) equals its marginal social benefit (MSB). When the expected external harms associated with producing an additional unit—such as the probability-weighted accident costs the product imposes on third parties—push MSC above MSB, continued production generates net social loss, and the socially efficient outcome may be for the product to decline in quantity or exit the market entirely. See Steven Shavell, Economic Analysis of Accident Law Steven P. Croley & Jon D. Hanson, *What Liability Crisis? An Alternative Explanation for Recent Events in Products Liability*, 8 Yale J. Reg. 1, 71–72 (1991) (setting out the standard MPC–MSC–MSB analysis and illustrating that production beyond the MSC = MSB point produces deadweight loss).

[164] See sources cited supra note 162.

Our endorsing a negligence standard is not to deny that there would be benefits to a strict liability approach in this context. For example, a strict liability regime would in some ways be easier to administer. There would be no need to engage in the determination of fault, for instance. It would be enough to have a causal trigger, which would result in the automatic payment of the sanction by the relevant executives. Furthermore, it is not necessarily the case that a strict liability regime would result in crushing liability. That could be avoided simply by imposing a cap on the potential sanction—some multiple of the executives' annual compensation, say. However, because such a sanction would be imposed whenever there is a triggering event, such as a collapse of the bank or constructive collapse, whether the executives could have done anything to prevent the event or not, the risk to executives would be substantially higher under a strict liability regime than under a negligence-based regime with the same damage cap. In the absence of generous liability insurance coverage, few, if any, qualified candidates would seek to be bankers if the position carried with it the risk of unpreventable financial hardship that strict liability would entail. Further, it is unclear whether property and casualty insurers would be willing to provide coverage for sanctions imposed on a strict liability basis—not at a price that executives would be willing and able to pay.[165] By contrast, under a negligence-based regime, bank executives can minimize the risk of sanctions by behaving in ways that are consistent with the standard of care.[166] And again, the adoption of all-or-nothing fault-based liability standard has the advantage of strongly incentivizing bank executives to take reasonable care, because doing so eliminates their risk of liability.[167]

Whatever a duty-based liability requires, we are of the view that a higher standard, such as gross negligence, imposes too narrow a standard to provide a credible deterrent.[168] As discussed more fully in Part IV, the Federal Deposit Insurance Act authorizes the FDIC to bring an action against a failed bank's directors or officers "for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross

[165] The price of such coverage would be considerably higher than the price of coverage for negligence-based sanctions, because of the larger scope of liability, given no requirement that fault need be shown. On the other hand, insurance for strict liability sanctions are somewhat less likely to be struck down as violative of public policy, since they need not be triggered by wrongdoing on the part of the bankers. See infra text around footnote 213, discussing liability coverage for government sanctions and the application of the public policy doctrine. As our argument in the text suggests, one reasonable alternative to our negligence-based approach would be an approach that combined strict liability with damage caps and either mandated or subsidized D&O insurance that expressly includes coverage for these government sanctions.

[166] As we say infra in the text below, the reasonable banker should focus on whether an executive disregarded basic obligations of prudent banking under conditions of foreseeable stress.

[167] On the insurability of personal liability, see *infra* Section III.C.

[168] *But see* Randall D. Guynn et al., *Davis Polk Discusses RECOUP Act's Clawbacks of Failed-Bank Executives' Compensation*, CLS BLUE SKY BLOG (Apr. 11, 2024), https://clsbluesky.law.columbia.edu/2024/04/11/davis-polk-discusses-recoup-acts-clawbacks-of-failed-bank-executives-compensation/.

negligence) including intentional tortious conduct."[169] The line between ordinary negligence and gross negligence can be blurry at the margins,[170] but gross negligence is generally reserved for behaviors involving malice, "willful or wanton misconduct," or "reckless disregard" for "known," "obvious," and "extreme" risks to others.[171] Gross negligence thus imposes a far higher requirement than existing models assume. To the extent we aim to incentivize executives to avoid excessive risk-taking, it does little good to hold them accountable only for the most egregious risk-taking.[172]

One valid concern, of course, with a negligence standard is vagueness. How is a court or regulator to decide when a bank executive's decision was negligent? This is always a tricky question, wherever standards are used instead of rules. But we imagine that the decisionmaker would rely on well-accepted standards within the industry for what constitutes reasonable executive decision-making in a comparable role. (Indeed, there are thousands of banks in the United States, so it would not be difficult to find a reasonable comparison group.) To make the negligence standard administrable and predictable, courts and regulators could identify whether the executive failed to address clear, well-understood categories of prudential risk. Just from the SVB episode alone, examples of such failures might include: (1) holding long-duration fixed-income securities while explicitly removing hedges on interest rate risk in a rising-rate environment; (2) failing to monitor or diversify away from an overconcentrated depositor base, particularly when many depositors are uninsured and operate in correlated sectors; (3) repeatedly ignoring or downplaying warnings from internal risk managers, auditors, or supervisors. These are not novel or marginal risks. We do not expect courts to second-guess normal business judgments. Instead, the inquiry should focus on whether an executive disregarded basic obligations of prudent banking under conditions of foreseeable stress.

B. Causation Standards, Liability Triggers, and Sanctions

1. Causation Standard

The central downside of a duty-based liability rule concerns the attendant costs of enforcement. As discussed in the criminal context, if the prospect of enforcement is low enough, executives might not have reason even to bother performing up to the prevailing standard of care; whatever the substantive legal

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169 12 U.S.C. § 1821(k); Atherton v. FDIC, 519 U.S. 213, 226-27 (1997).

170 W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 34, at 212 (5th ed. 1984); *cf.* Edwin H. Byrd III, Comment, *Reflections on Willful, Wanton, Reckless, and Gross Negligence*, 48 LA. L. REV. 1383, 1383 (1988) ("The terms 'willful,' 'wanton,' 'reckless,' and 'gross negligence' are all frequently used in the law to describe certain types of conduct, but it is difficult to articulate clearly what those types of conduct are.").

171 RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 2 cmt. a (A.L.I. 2010).

172 A better approach, we think, is to treat evidence of gross negligence or intentional misconduct as grounds for a higher-than-baseline penalty. *See infra* Section III.B.3.

standard is, the threat of a sanction would pose only a paper worry.[173] To this point, Dari-Mattiacci and Mangan's view of the judgment proof defendant concerns the way the traditional models discount the impact of causation rules.[174] Once liability requires a showing that the defendant's negligence caused harm, they argue, the comparative benefit of a duty-based liability standard disappears.[175]

We agree that a bad causation rule can sink an otherwise good liability standard. However, we see this as a reason to be judicious when designing a duty-based sanctions regime. For starters, we do not adopt the causal requirement most common to tort law, according to which bank executives would be found liable only when their negligence factually causes a bank collapse.[176] This standard strikes us as too demanding for some of the reasons already described.[177] If bankers can be sanctioned for their negligent banking decisions only if a regulator can prove that the decision in question was a but-for cause of an actual bank run, the sanction would rarely (perhaps never) be triggered, and the deterrent effect would be minimal. Adopting such a legal standard fails to grapple with the actual job assignment of being a bank executive—or, indeed, a senior leader of any major organization.

On the other hand, neither do we think it prudent to jettison causation entirely or to hold bank executives responsible for the negligence of others.[178] After all, the focus here is on creating incentives for bankers to avoid making banking decisions that *cause* bank runs. But if our goal is to incentivize executives, it needs to be the case that the conduct in question is something they can control, through altered care or activity. Thus, we want some version of a causal connection to be required if the thing we want to regulate is behavior that increases the probability of the bank failing.

As a middle ground, we think something equivalent to "prospective causation" strikes the right balance.[179] Whereas backwards-looking, counterfactual approaches toward causation focus on whether an individual's negligence was a necessary condition for the outcome, prospective causation focuses instead on whether the same action merely increased the likelihood of this type of injury occurring.[180] Applied here, we recommend liability and sanction for an executive if and when their negligence substantially increased the

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[173] *See supra* notes 100-112.
[174] Dari-Mattiacci & Mangan, *supra* note 148, at 749–51.
[175] *Id.* at 759.
[176] *See* RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 29 (A.L.I. 2010).
[177] *See supra* Part II.C.
[178] This is not to meant to rule out liability for an executive's negligent supervision of other employees. *Cf. supra* note **Error! Bookmark not defined.** (defining the responsible corporate officer doctrine).
[179] *See* Omri Ben-Shahar, *Causation and Foreseeability*, *in* 2 ENCYCLOPEDIA OF LAW AND ECONOMICS 644, 645-48 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000) (collecting citations).
[180] *See id.* at 646-47.

risk of the type of harm that happened or that might have happened—such as a bank collapse. This approach maintains a "causal link" between the executive's failure to meet their duty and the harm we are concerned about, without demanding an implausibly tight connection.[181]

This prospective causation standard is satisfied when an executive's conduct substantially increases the probability of institutional failure or a similar harm, regardless of whether that conduct was itself tortious. For instance, a decision to remove hedges on interest rate risk might not be tortious. But doing so (a) when the bank's portfolio is heavily into long-term, fixed-rate securities and (b) at a time when interest rates are going up could satisfy the causation standard if that exposure proved critical to the bank's collapse. Similarly, an executive's failure to act on consecutive risk management recommendations—perhaps because they were buried in a larger report or downplayed by staff—might not make the executive liable. But if that failure significantly heightened the institution's vulnerability to a liquidity crisis that later materialized, the causation element would still be met. In short, the inquiry into prospective causation focuses on whether the executive's conduct materially contributed to the conditions that made failure likely, not whether it was the factual or proximate cause of the bank's collapse.

2. Liability for Actual and Constructive Bank Failures

We've argued thus far that executives should be held liable when their negligence substantially contributes to a banking collapse. But what should count as a bank collapse for liability purposes? In other words, what event should trigger the liability and sanctions discussion outlined above?

The first candidate for a triggering condition is an obvious one: the bank has failed, and the FDIC has taken the bank into receivership. The upside of using FDIC receivership as a triggering condition is that it is clearly defined and easy to observe. For illustration, on March 10, 2023, the California Department of Financial Protection and Innovation shut down Silicon Valley Bank and appointed the FDIC as receiver.[182] Two days later, the New York State Department of Financial Services similarly shut down Signature Bank and designated the FDIC as receiver.[183] These actual collapses would clearly trigger our liability regime.

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[181] *See* Guido Calabresi, *Concerning Cause and the Law of Torts: An Essay for Harry Kalven, Jr.*, 43 U. CHI. L. REV. 69, 71 (1975) (coining the term "causal link" in reference to proximate causation).

[182] Press Release, *FDIC Acts to Protect All Depositors of the Former Silicon Valley Bank, Santa Clara, California*, FDIC (Mar. 13, 2023), https://www.fdic.gov/news/press-releases/2023/pr23019.html (announcing the transfer of "substantially all assets of the former Silicon Valley Bank of Santa Clara, California, to a newly created, full-service FDIC-operated 'bridge bank'").

[183] *Failed Bank Information for Signature Bank, New York, NY*, FDIC, https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/signature-ny.html (last visited Jan. 1, 2025).

However, an outright failure should not be the *only* trigger. Many failed banks are "bailed out" prior to technically failing and being taken into receivership by the FDIC.[184] But from a deterrence perspective, executives running bailed-out banks should not escape our sanctions regime merely because regulators averted disaster at the last moment. Thus, a second trigger we recommend is a bank's receiving emergency government assistance, issued to prevent that bank's failure. Crucially, we limit this trigger to assistance provided in response to that bank's own financial difficulties, as contrasted with government assistance responding to systemic financial difficulties. From 2008 through 2023, Credit Suisse experienced a series of scandals, including losses in its investment arm from the collapses of Archegos Capital and Greensill Capital in 2021.[185] In addition, the bank experienced a significant exodus of assets from its wealth management business in late 2022.[186] These repeated mismanagements left Credit Suisse vulnerable to any banking panic, which resulted in the Swiss Federal Council exercising its emergency powers to bail out the bank.[187] Despite there being no actual bank collapse, these facts would also trigger our regime. In sum, our regime holds bank executives responsible for both actual bank collapses and constructive bank collapses—that is, the collapse that was likely to occur absent timely government intervention.

Two quick caveats in adopting this latter, government-intervention trigger. The first is whether our framework applies when a bank requests access to the Federal Reserve's discount window to borrow funds directly from the Federal Reserve (the discount window is the Federal Reserve's standing facility where illiquid but not insolvent banks can seek emergency loans). After all, in some sense, the bank is seeking government intervention by requesting emergency liquidity assistance from the central bank.[188] Our answer is an emphatic "no." Bank executives should not be discouraged—certainly not more than they already are[189]—from using the discount window as it is designed. One

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[184] *See, e.g.*, *Bank Term Funding Program*, BD. OF GOVERNORS OF THE FED. RSRV. SYS., https://www.federalreserve.gov/financial-stability/bank-term-funding-program.htm (last visited Jan. 1, 2025).

[185] *See* Julia Kollewe, *Credit Suisse 'Seriously Breached' Obligations on Greensill, Says Regulator*, THE GUARDIAN, https://www.theguardian.com/business/2023/feb/28/credit-suisse-greensill-swiss-bank-finma (last updated Feb. 28, 2023, 7:24 PM EST).

[186] Johann Scholtz, *Credit Suisse Hit by Massive Outflows*, MORNINGSTAR (Apr. 24, 2023, 10:18 AM), https://www.morningstar.co.uk/uk/news/234400/credit-suisse-hit-by-massive-outflows.aspx. *But see* Steven Kelly, *Y2K23's Y2K Moment: Blaming the Internet for Bank Runs*, FT ALPHAVILLE (Feb. 5, 2024), https://www.ft.com/content/74a7ec7c-cd7e-4e69-8af0-21dead706855.

[187] *See* Anshuman Daga*, What Happened at Credit Suisse and How Did It Reach Crisis Point?,* REUTERS*,* (Mar. 18, 2023), https://www.reuters.com/business/finance/credit-suisse-how-did-it-get-crisis-point-2023-03-16/.

[188] *Cf.* Dietrich Domanski & Vladyslav Sushko, *Re-thinking the Lender of Last Resort: Workshop Summary*, *in* BIS PAPERS NO. 79, RE-THINKING THE LENDER OF LAST RESORT 1, 3, 4 (2014) (explaining the central bank's role as the lender of last resort).

[189] Historically, banks have hesitated to borrow from the Federal Reserve's discount window out of concern that the market will punish them for doing so. *See, e.g.*, Mark Carlson &

fundamental role of a central bank is to be a "lender of last resort" and provide liquidity to banks who are solvent but illiquid.[190] We do not want a regime that detracts from a central bank's primary purpose.

Neither would our government-intervention trigger extend to include system-wide government interventions. To explain: after the failures of Silicon Valley and Signature Bank became public, nationwide panic set in. Government officials believed that contagion would spread and harm the entire banking sector. So, the Federal Reserve activated its emergency powers under section 13(3) of the Federal Reserve Act to create the Bank Term Funding Program.[191] Technically, the Bank Term Funding Program "offers loans of up to one year in length to banks, savings associations, credit unions, and other eligible depository institutions pledging any collateral eligible for purchase by the Federal Reserve Banks in open market operations."[192] In other words, the Federal Reserve now provides a safety net for every bank in America. That's a system-wide government intervention. Is every bank executive in America subject to our sanction regime? Of course not. System-wide interventions used for the purpose of quelling a crisis are scoped out from our government-intervention trigger because most of those banks were well run. The problem with banking, as seen repeatedly throughout history, is that a few bad, poorly run banks can shake the confidence in an entire system and cause it to suddenly crash.

3. Calibrating Sanctions for Negligent Bankers

With the broad contours of a deterrence regime in place, we now describe how to think about setting the magnitude of the sanction for negligent bankers. We proposed a financial sanction that, as a baseline, would be equivalent to a banker's total compensation for up to the previous five years. This five-years'-worth-of-compensation baseline is just a placeholder for the true amount that empirical research determines to be optimal. The true figure would consider both (1) the amount of harm caused (or that could have been caused in the case of a government-intervention trigger), which is in a sense the amount of the externality, and (2) the need to avoid scaring off all qualified bank executives. That said, a five-year baseline is not wholly arbitrary; five years is the average duration of a business cycle in the United States.[193] In other words, a bank executive will have had time to see an entire business cycle through—the up and the down. That provides enough time for the executive's decisions to play out.

Jonathan D. Rose, *Stigma and the Discount Window*, FEDS NOTES (Dec. 19, 2017), https://www.federalreserve.gov/econres/notes/feds-notes/stigma-and-the-discount-window-20171219.html.

[190] David T. Zaring & Jeffery Y. Zhang, *The Federal Reserve's Mandates*, 108 MINN. L. REV. 333, 394 (2023) (discussing the Federal Reserve's role as the lender of last resort and its discount window operations).

[191] *Bank Term Funding Program*, *supra* note **Error! Bookmark not defined.**.

[192] *Id.*

[193] *See* VICTOR ZARNOWITZ, *The Regularity of Business Cycles*, *in* BUSINESS CYCLES: THEORY, HISTORY, INDICATORS, AND FORECASTING 232, 235 (1992). A business cycle marks an expansion and a recession in the economy.

And our proposal takes an expansive view of executive compensation. Compensation would be calculated to cover all the prominent forms of compensation that are provided to executives—wages, stocks, stock options, housing, private-school tuition, private jets, and everything in between.[194]

We describe this penalty as a baseline, again, to emphasize that calculating its magnitude should be sensitive to facts on the ground—and, specifically, attempts to avoid its impact. For example, executives may respond to this regime by pushing to frontload their compensation packages, comparable to how professional athletes seek upfront guarantees because salaries in subsequent years are uncertain.[195] For another, an executive might attempt to avoid responsibility by taking on further excessive risks once collapse becomes increasingly likely. That is, if it begins to look as if collapse is becoming increasingly likely, at some point the executive will have little to lose from taking greater investment risks, which have the very small but non-zero chance of improving the bank's financial picture.[196] Or, an executive might retire strategically to capture the short-term benefits of risky decisions, leaving his or her successor to face the long-term, destabilizing consequences. (Our liability framework would apply to former executives as well.)

This discussion is not the place to anticipate every evasive strategy. We simply note that a five-year lookback period of total compensation is the default setting. This default rule should be flexible to account for, say, a finding that the negligent actions began more than five years back, or that compensation was awarded in a manner to evade sanctions. To complement this approach, we further recommend augmenting the basic sanction with a treble clause, which would impose triple the baseline fine should the enforcer prove gross negligence, intentional conduct, criminal behavior, or equivalent misconduct.[197]

In sum, we advocate for a sanction calibrated according to an executive's total compensation, defined as broadly as possible.[198] When calibrating the

[194] *See, e.g.*, Joshua Franklin & Imani Moise, *Top Wall Street Banks Paid Out $142bn in Pay and Benefits Last Year*, FIN. TIMES (Jan. 19, 2022), https://www.ft.com/content/9bdef7a6-69f1-4f42-b27d-74dd34db4804; *see also, e.g.*, Rami Grunbaum, *Cash-Poor Bill the Butcher Paid for CEO's Fancy Queen Anne Home*, SEATTLE TIMES (updated Oct. 15, 2014), https://www.seattletimes.com/business/cash-poor-bill-the-butcher-paid-for-ceorsquos-fancy-queen-anne-home/ (showing that a company helped its CEO purchase real estate for personal use).

[195] *See, e.g.*, Conner Christopherson, *The Art of NFL Contracts Part 1: The Basics*, SPORTS ILLUSTRATED (May 9, 2020), https://www.si.com/nfl/chiefs/gm-report/the-art-of-nfl-contracts-part-1-the-basics.

[196] We would include here behavior designed to prevent government takeover after the point of inevitability. *See* Buccola, *supra* note 50, at 10 (explaining what happens as a firm approaches insolvency).

[197] This is the standard deterrence rationale for punitive damages. The prospect of treble damages is further valuable from a deterrence perspective because enforcement is not guaranteed or guaranteed to succeed, which means that the expected cost is less than that sticker price of the fine. *See supra* note 75.

[198] As it stands, our account does not depend on the sanctions being paid to any specific party; what matters from a deterrence perspective is that executives face the prospect of having to

magnitude of the sanction, we look back five years from the trigger date (i.e., when the bank failed or when the bank received government assistance). Notably, these calculations provide a default setting which can be revised on a case-by-case basis. We are under no delusions: this is a serious penalty. But again, the fine described here is meant to calibrate executives' incentives. The magnitude and long lookback period of our proposal mirror the severity of the outcome that we are trying to avoid.

C. Reforming Directors and Officers Insurance

In the previous sections, we made the deterrence case for adopting a regime of *ex post* monetary sanctions for negligent bank executives in the form of financial penalties calibrated to a multiple of their total compensation. The point of such a regime, and its five-year lookback sanction, is to create *ex ante* incentives for bank executives to conform their conduct to a prescribed standard of care, which in turn will be designed to maintain financial stability. For such a sanctions regime to be effective however, the executives must expect that, in the event of a triggering event, they will in fact be required to pay. If, however, the executives can shift that cost from themselves to an insurance company, through a liability insurance contract of some sort, the incentive effect of our proposed regime could be weakened if not eliminated.

This point is straightforward. Risk-averse individuals pay premiums to insurance companies in exchange for a contract that shifts the risk of certain defined losses from the insured to the insurer.[199] For example, Directors and Officers (D&O) liability insurance covers executives for any losses (including damages, settlements, judgments, and defense costs) resulting from claims made for wrongful acts.[200] "Wrongful acts" are typically defined to include any alleged breach of duty committed by the director or officer in their capacity as such.[201] The insurer in turn spreads the risk of such losses over the entire pool of D&O insureds; meanwhile, some fraction of the risks gets reinsured, which spreads the risk even more broadly. If we assume for the sake of argument that this insurance covered bank executives for the sanctions that would be imposed under our proposed regime, the potential moral hazard effect is obvious: unless the premiums for this coverage were calculated to reflect the risk of sanctions associated with the executive's investment decisions, the *ex ante* incentive effect of the threatened *ex post* sanctions would be undermined. To make the point clearly, if we imagined that all bank executives were charged the same premium, irrespective of risk, and that the sanctions were fully covered, the sanction would have essentially zero deterrence effect.

Of course, liability insurance premiums, including D&O liability insurance premiums, do not ignore differences in risk among their insureds. Insurance

pay them. For consideration of where sanctions should be paid, see Part IV below.

[199] TOM BAKER, KYLE D. LOGUE & CHAIM SAIMAN, INSURANCE LAW AND POLICY: CASES AND MATERIALS 3-6 (5th ed. 2021).

[200] *Id.* at 515.

[201] *Id.* at 516.

companies have a financial incentive to charge premiums that reflect something approximating the expected risk each insured presents. To the extent insurers engage in that sort of risk-based pricing, it can counteract the moral hazard effect of insurance coverage.[202] But there are substantial costs to such risk segregation, such as the costs of monitoring executives' decision making, which limits insurers' willingness to do it.[203] Further, even if the costs of such risk segregation were zero, D&O insurers' interest in creating incentives to reduce a sanction-triggering event would never be aligned with society's interests in reducing the risk of financial instability or bank runs, since the insurers' liability, at most, would be limited to the amount of the sanction, which, as we have made clear, is far less than the amount of the potential societal losses at stake.[204] Further, D&O insurance companies in particular, while they do engage in risk-based pricing of their insurance, have been reluctant to engage in the sort of direct monitoring of executives that one would expect if they were going to act as an effective private regulator of risk.[205] It seems very likely that, should our proposed sanctions regime be enacted and were D&O insurance to cover that sanction, moral hazard would be the result.

Even if the presence of insurance is likely to undermine the beneficial incentive effects of our proposed sanctions regime, some might posit that it nevertheless makes sense to permit such coverage to be purchased, if only to avoid discouraging anyone from being willing to become a banker. This is part of the reason that we permit D&O liability insurance: even if there is some moral hazard effect, permitting such insurance protects the assets of executives, which greases the wheels of commerce. Indeed, one of the canonical findings of early

[202] In addition to risk-based pricing, insurers have other tools to align the incentives of insureds with insurers, including deductibles, copayments, and exclusions. For a general discussion of all the ways insurers can counteract moral hazard, see KENNETH S. ABRAHAM, DISTRIBUTING RISK 44-63 (1986); Tom Baker & Thomas O. Farrish, *Liability Insurance and the Regulation of Firearms*, *in* SUING THE GUN INDUSTRY 292-93, 296, 312 (Timothy D. Lytton ed., 2005); and Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197, 205-08 (2012).

[203] For a discussion of why the tools that insurers use to counteract moral hazard are imperfect, see Ben-Shahar & Logue, *supra* note 202, at 202. See also Kenneth S. Abraham & Daniel Benjamin Schwarcz, *The Limits of Regulation by Insurance*, 98 IND. L.J. 215, 235-44 (2021).

[204] *See* Ronen Avraham & Ariel Porat, *The Dark Side of Insurance*, 19 REV. L. & ECON. 13, 14 (2023).

[205] *See* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' and Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1808, 1813 (2007) (concluding that, while D&O insurers do price risk, they "do almost nothing to monitor" the corporations or executives they insure, thereby contributing to moral hazard and providing only diffuse loss prevention incentives). In the context of D&O insurance in particular, insurers are unwilling to monitor executive decisions because corporate executives resist it and are likely to switch to another company if they are required to undergo insurer monitoring. *Id*. at 1809-11. Moreover, monitoring banks has another layer of challenges. The banking industry is notoriously opaque, and it is so by design. *See* GARY B. GORTON, MISUNDERSTANDING FINANCIAL CRISES: WHY WE DON'T SEE THEM COMING 45-58 (2012) (describing the critical role of secrecy in banking). Thus, insurers might be prohibited from accessing all the relevant information even if they wanted to monitor.

economic analysis of insurance was that, notwithstanding the problem of moral hazard, social welfare is maximized by the presence of at least some insurance coverage for risks, though probably not full coverage.[206] The intuition here again is that, while insurance dulls incentives to minimize losses, it also distributes across larger groups of insurance risks that would otherwise be concentrated on individuals; so we need to split the difference with partial coverage.

With respect to insurance against civil monetary fines in particular, however, economists have shown that, under particular assumptions, this tradeoff can best be achieved by reducing the amount of the sanction and banning liability insurance.[207] In other words, to achieve the optimal balance between creating incentives to minimize bank executive negligence and creating incentives for bank executives to be willing to take on the job of running banks, we recommend two steps: First, ban liability insurance for the new banker sanction. Second, set the amount of the sanction under our proposed regime at an amount that will not discourage bankers from taking on the job. We have suggested five years' worth of compensation as a default, but that is just a starting point.

Before we go through the trouble of enacting a new (presumably federal) ban on liability insurance coverage for negligent bank sanctions, we might want to ask the following question: to what extent does existing federal or state law already prohibit such coverage? For starters, note that federal law prohibits FDIC-regulated institutions themselves from purchasing liability insurance that covers payments of civil monetary fines.[208] Those rules, however, do not expressly apply to liability insurance purchased by the bank executives themselves to cover civil monetary fines imposed on them personally. Because most insurance law is state law, the question then becomes whether the various state insurance regulatory regimes forbid this type of insurance.[209] We are not aware of any state statutes that directly address the question, which means that the insurability of such sanctions would depend upon the application of each state's public policy doctrine.

Under basic principles of insurance law, courts applying insurance contracts will not enforce coverage that they deem to be in clear violation of that state's public policy.[210] For example, it is often said that courts will not enforce coverage against losses caused intentionally, owing to the potential moral hazard effects.[211]

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[206] *See* Mark V. Pauly, *The Economics of Moral Hazard: Comment*, 58 AM. ECON. REV. 531, 531-35 (1968).
[207] *See* A. Mitchell Polinsky & Steven Shavell, *The Optimal Tradeoff Between the Probability and Magnitude of Fines*, 69 AM. ECON. REV. 880, 885-86 (1979).
[208] *See* 12 U.S.C. § 1828(k)(6); 12 C.F.R. § 359.1(l)(2)(i); s*ee also Director and Officer Liability Insurance Policies, Exclusions, and Indemnification for Civil Money Penalties*, FDIC (Oct. 10, 2013), https://www.fdic.gov/news/financial-institution-letters/2013/fil13047.html.
[209] With respect to at least certain types of monetary fines, the FDIC has taken the position that D&O insurance provides coverage for officer liability. *See infra* Part IV.A.
[210] *See generally* TOM BAKER, KYLE D. LOGUE & CHAIM SAIMAN, *supra* note 194, at 447-49 (discussing public policy as applied to liability insurance coverage).
[211] *See id.*; Erik S. Knutsen, *Fortuity Victims and the Compensation Gap: Re-Envisioning Liability Insurance Coverage for Intentional and Criminal Conduct*, 21 CONN. INS. L.J. 209,

It remains an open question whether insurance coverage against governmental fines or penalties would be considered a violation of state public policy doctrines.[212] The vast majority of jurisdictions have not directly addressed the issue. In the handful of states that have addressed the issue, at least one seems to permit coverage for civil fines, and the others seem to limit their prohibition to situations involving intentional or even criminal wrongdoing or, in one case, drunk driving specifically.[213]

Some lessons can be drawn from the insurability of punitive damages in tort cases, a topic on which many states have taken a position.[214] Some states prohibit liability insurance coverage against punitive damages on public policy grounds;[215] however, those prohibitions often depend, implicitly or explicitly, on the insured's having intentionally caused the loss in question. Other jurisdictions expressly allow insurance for punitive damages without limitation.[216]

Because our new proposed sanction would be tied to the negligence of bank executives, rather than to their intentional wrongdoing, insurance coverage for such penalties might be considered enforceable. Negligence-based penalties do not carry the same level of moral opprobrium that penalties for intentional wrongdoing do; nor does insurance for the former create as much of a moral hazard concern as insurance for the latter.[217] Both factors cut in favor of enforceability. Moreover, if the penalties are considered civil rather than criminal, that too would cut in favor of insurability.

In sum, while the question remains unsettled, it is possible that insurance against negligent banker sanctions would be enforced by courts. Therefore, if our negligent-bank sanction is adopted, one solution would be to expand the federal rule prohibiting the sale of liability insurance to banks (or FDIC-regulated institutions) from buying liability insurance coverage for civil fines to apply to bankers as well.

IV. Implementing an Effective Sanctions Regime

Part III sketched the parameters of a new liability regime that would sanction negligent bankers when their failure to exercise appropriate care substantially contributes to an actual or near collapse. The fundamental motivation of this sanction is to better align the bank executive's *ex ante* incentives with the social

235-36 (2014).

[212] Kenneth S. Abraham, *The Insurability of Civil Fines and Penalties*, 58 TORT TRIAL & INS. PRAC. L.J. 405, 406 (2023) ("Only a few jurisdictions have addressed the question thus far, and even these decisions do not have definitive breadth; they can easily be understood to leave a number of issues open."); *see also Insurability of Fines and Penalties*, MARSH MCLENNAN (May 10, 2022), https://www.marsh.com/bw/services/financial-professional-liability/insights/insurability-of-fines-and-penalties.html (noting that the law in many countries remains unclear on the insurability of civil fines and penalties).

[213] *See* Abraham, *supra* note 212, at 416-17 (surveying state case law).

[214] *Id.* at 418-19.

[215] *Id.* at 420-21.

[216] *See id.* at 420.

[217] *See id.* at 412-16.

goal of maintaining system-wide financial stability. Targeting executive compensation in this manner would move the needle in the right direction.

But how to implement our sanctions into law? Here we discuss three possible paths forward: (a) revising the Federal Deposit Insurance Act, (b) opening enforcement powers up to private actors akin to *qui tam* actions, and (c) reforming executive compensation packages.

A. Revise the Federal Deposit Insurance Act

One means of implementing the principles discussed above would be by improving existing legislation—namely, by revising the Federal Deposit Insurance Act (FDIA). Section 11(k) of the FDIA already empowers the FDIC to bring an action against bank executives of a failed bank.[218] However, today's version of Section 11(k) is, at best, an imperfect mechanism for inducing executive compliance. Moreover, the FDIC's enforcement strategy for this provision runs counter to the recommendations of Part III; if anything, the FDIC enforces Section 11(k) in near exactly the opposite manner from what our model recommends.

1. Substantive Reforms

Revisions to the statutory language could substantially strengthen Section 11(k)'s bite. There are some easy fixes to Section 11(k) that follow directly from the discussion above. For starters, we would recommend clearly specifying the liability conditions, while relaxing the current "gross negligence" liability standard to ordinary negligence.[219] In addition, Congress should revamp the penalty calculations, as well as the insurance recommendations, along the lines described in Part III.

Harder problems arise with respect to improving the enforcement of even a revised Section 11(k) regime. With that in mind, we consider two further issues: the FDIC's current enforcement approach and further substantive reforms designed to ease the enforcement burden by shifting burdens of proof concerning specific elements of the action.

2. A New Enforcement Strategy for Section 11(k)

A revised Section 11(k) has great potential if implemented according to the deterrence principles underlying the analysis in this Article. However, although the FDIC does in fact regularly bring enforcement actions under Section 11(k), its enforcement strategy is not conducive to deterring moral hazard.

According to the Congressional Research Service, the FDIC has "entered into nearly 1,000 settlement agreements with officers, directors, and other

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[218] 12 U.S.C. § 1821(k).
[219] *See id.* (attaching liability "for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined under applicable State law").

professionals related to losses suffered by failed [banks]" since 2008.[220] While this may seem to be an impressive statistic, it overlooks the centrality of D&O insurance coverage to the FDIC's enforcement decisions. As one law firm observes, "[a]fter the bank fails, the FDIC typically sends out a notice letter of impending regulatory scrutiny and a possible full investigation of the institution before the bank's D&O policy expires. This notice is sent to the bank's D&O carrier, but it is also sent to the directors and management who may have culpability."[221] And as observed by another law firm, "[b]ecause the FDIC only pursues litigation where the potential recovery outweighs the costs of investigation and litigation, the available limits of D&O insurance to fund a settlement or a judgment is an important consideration."[222] In short, the FDIC uses Section 11(k) to sanction banker misconduct only to the extent that any monetary penalty it imposes will be covered entirely by the banker's insurance policy.

Indeed, the presence of, and extent of coverage provided by, D&O insurance plays such a large role in the settlement process with individual bankers that, in 2013, the FDIC issued an "Advisory Statement on Director and Officer Liability Insurance Policies, Exclusions and Indemnification for Civil Money Penalties."[223] In that statement, the agency warned that "directors and officers may not have insurance coverage and may be personally liable for damages arising out of civil suits relating to their decisions and actions." This advice speaks to a fundamental disagreement between this project and current policy. What the FDIC viewed (and views) as a flaw is precisely what allows for incentives to be aligned. Parts I–III establish and reiterate this basic point about deterrence: if individual executives do not have "skin in the game," they will not adjust their behavior accordingly. Settling with executives only and to the extent that D&O insurers can be made to pay up is not the best way to reduce moral hazard. As we stated previously, the way in which the FDIC enforces Section 11(k) is almost the exact opposite of what our theoretical model recommends.

In fairness to the FDIC, we understand why the agency might prefer a settle-with-executives-and-collect-from-insurers strategy. Section 11(k) claims arise in a context in which the FDIC has likely had to deploy insurance funds to address

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[220] DAVID H. CARPENTER & JAY B. SYKES, CONG. RSCH. SERV., LSB10946, SILICON VALLEY BANK'S FAILURE AND POTENTIAL DIRECTOR/OFFICER LIABILITY (2023).

[221] Vedder Price, Bank Failure: For Directors and Officers, There Is No Makeup Exam 2 (2010), https://www.vedderprice.com/-/media/files/vedder-thinking/publications/2010/09/financial-services-report/files/financial-services-report/fileattachment/financial-services-report.pdf.

[222] Daniel H. Simnowitz, White and Williams LLP, The FDIC Prepares to Throw Down: Issues For D&O Insurers to Consider 2 (2011), https://www.whiteandwilliams.com/media/alert/7_FDIC%20Prepares%20to%20Throw%20Down_Issues%20for%20DO%20Insurers%20to%20Consider.pdf.

[223] *Director and Officer Liability Insurance Policies, Exclusions, and Indemnification for Civil Money Penalties*, FDIC (Oct. 10, 2013), https://www.fdic.gov/news/financial-institution-letters/2013/fil13047.html ("D&O liability insurance is an important risk mitigation tool for financial institutions, and it is vital for directors and senior executives to fully understand the protections and limitations provided by such policies.").

the bank's failures; collecting from D&O insurance is one (albeit small) way to replenish spent funds. But this strategy simply isn't socially optimal to the extent that it limits enforcement to all and only circumstances in which insurers, not executives, will be responsible for covering a sanction.[224] In deploying Section 11(k), the FDIC operates under the assumption that bank runs will inevitably occur and therefore it wants to lower the cost to its deposit insurance fund. On this assumption, the FDIC (correctly) believes that insurers will be able to pay more than individual bankers to help the FDIC's insurance fund. We do not operate under this assumption. In our view, what would be more cost-effective—to the FDIC and, more importantly, to the country—is to reduce the frequency of bank runs in the first place.

B. Empower Private Actors or Other Agencies to Act

A revised Section 11(k) has the potential to align closely with the deterrence principles outlined in this Article. However, we are mindful of the regulatory obstacles that might continue to stymie enforcement. It is one thing to notice that the FDIC follows a misguided (in our account) enforcement philosophy for reining in banking executives; it is another thing to change enforcement strategies in a durable way.[225] There are alternatives worth considering.

One option, of course, would be to relocate enforcement authority away from the FDIC and either toward another financial regulator or toward the Justice Department. At least for the moment, however, we do not see particular reason to suspect that these other institutions would be qualitatively better enforcers than the FDIC. The Federal Reserve, for example, has its own enforcements powers against individual bankers. But, as Lin and Menand document, the Federal Reserve seems even less interested in bringing actions against individual bankers than does the FDIC.[226] And while the Justice Department has more resources dedicated to enforcement, it also has a much wider ambit. Meanwhile, the Justice Department's enforcement practices tend to be more sensitive to Administration priorities than some other regulatory bodies.[227]

Instead, Congress might consider opening enforcement powers up to private actors.[228] One option would be expanding Section 11(k)—or a new, comparable

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[224] To be clear, our objection is not to the idea of settlement in principle. Under any regime, parties will always have incentives to settle so long as there is any uncertainty about litigation giving rise to differences in the parties' assessments of the outcome of adjudication. Here, for example, a settlement should approximate the value of the sanction discounted by the probability that the court or other decisionmaker will find them liable (lower litigation costs). That's all optimal—so long as the bankers' own assets are on the hook, and not the insurers.

[225] *See* CONTI-BROWN & VANATTA, *supra* note 16 (discussing supervisory cultures).

[226] Lin & Menand, *supra* note 14, at 33-34 n.142.

[227] *See supra* notes 104-107 and accompanying text. Meanwhile, the Justice Department has its own enforcement pathologies, particularly with respect to misconduct carried out by or through financial institutions. *See* JOHN C. COFFEE JR., CORPORATE CRIME AND PUNISHMENT: THE CRISIS OF UNDERENFORCEMENT 15-76 (2020); GARRETT, *supra* note 100, at 19-81.

[228] The language of Section 11(k) invites this possibility. *See* 12 U.S.C. § 1821(k) (referring to "any civil action by, *on behalf of, or at the request or direction of* the Corporation"

statute—to private enforcement akin to a *qui tam* action, which would allow private citizens to act as private attorneys general in enforcing, for a price, an action against negligent bankers who substantially contributed to a bank collapse.[229] Congress has been wary of creating *qui tam* lawsuits—just a handful of authorizations currently exist—with the False Claims Act providing the most well-known example.[230] This scheme would provide regulators the opportunity to intervene in actions where appropriate, or otherwise to leave enforcement entirely to the private actor; in either case, the extra enforcement resources would increase the deterrent effect of the underlying sanctions regime.

Alternatively, Congress might consider recognizing a private right of shareholders, enabling them to sue bank executives under the principles outlined in this Article. This approach, however, promises to be more complicated to the extent that it more clearly risks supplanting matters of corporate regulation and governance long the province of state corporate law. While it is true that the federal government has been a check on state corporate law,[231] this level of intervention would likely require a major reworking of the underlying deterrence principles outlined in Part III. To this point, the extent to which shareholders already have a comparable remedy is unclear. There is likely to be an overlap in the factual preconditions that might give rise to shareholder complaints. Ultimately, however, a shareholder suit is likely to be more different than similar: the duty of care is not the same as negligence, damages are not the same as a fine, etc.[232]

C. Compensation Reform and Executive Clawbacks

Finally, we might incentivize or require banks themselves to adopt compensation packages designed to produce substantively the same result as our proposed sanction. Several scholars have recently called for such an approach, endorsing the mandatory use of equity compensation packages as a way of more closely aligning the incentives of bankers with their banks.[233] Others have called for executive compensation clawback provisions designed to recoup funds from executives. We consider each of these in turn.

(emphasis added)). However, other *qui tam* actions contain much clearer authorization provisions.

[229] *See* Christina Orsini Broderick, Note, *Qui Tam Provisions and the Public Interest: An Empirical Analysis*, 107 COLUM. L. REV. 949, 956 (2007) (cataloging statutory authorizations of *qui tam* actions in federal law).

[230] False Claims Act, 31 U.S.C. § 3730(b)(1); *see* United States, ex rel. Polansky v. Exec. Health Res. Inc., 599 U.S. 419, 424-25 (2023) (discussing the history and operation of a *qui tam* action).

[231] *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 622-23 (2003) (discussing federal enforcement interventions into state corporate law). *But cf.* Oren Bar-Gill, Michal Barzuza & Lucian Bebchuk, *The Market for Corporate Law*, 162 J. INST. & THEORETICAL ECON. 134, 134 (2006) (modeling intrastate competition for corporate charters).

[232] A bigger obstacle, at least from an enforcement perspective, might be the firm's ability to zero out damages for a breach of the duty of care. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2025).

[233] *See supra* note 9.

1. Equity Compensation for Executives

Some might reasonably ask, "Why not just force every bank executive to receive their compensation in the form of bank stocks? Wouldn't that solve your incentive misalignment problem?" Indeed, under such a regime, the bank executive would have a tremendous amount of "skin in the game" to make sure the bank was solvent and operating smoothly.[234] Selling shares in the bank would be the only way to obtain money to pay for consumption.

While this is an attractive idea on paper, we believe it suffers from two shortcomings.[235] The first concerns talent retention. We still want people to run banks. We don't want to make the role so unattractive that banks cannot find executives. It might prove difficult to attract talent (i.e., to hire bank executives) if they cannot be paid regularly in wages. Only a select group of potential candidates—that is, those who are already wealthy—would be likely to take the job. This is another reason why we shy away from an all-equity proposal and focus on sanctions equivalent to total compensation.

Second and more important is the limited reach of an all-equity proposal. Of the 4,000-plus banks operating presently in the United States, only a small fraction is publicly traded.[236] We do not want a situation in which only a small subset of bank executives is covered by our proposed regime. We want *all* bank executives to have better-aligned incentives. Moreover, while large, publicly traded banks deservedly receive plenty of popular and regulatory attention,[237] they are not the only source of financial stability risk in the United States. As Kress and Turk have noted, most banking crises in the United States stem from the failure of many small institutions—a "too many to fail" phenomenon.[238] Particularly where small banks are more likely to be the source of risk we seek to ameliorate, we cannot then have a framework that fails to cover most bank executives in America.

To be clear, mandatory equity compensation would not address moral hazard arising at privately held banks, which cannot easily compensate executives through equity or debt. But that does not mean that equity compensation is a bad idea in the public context. Pairing one or several of the reforms above with an

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[234] *See* Michael S. Barr, Vice Chair for Supervision, Fed. Rsrv., Speech at the American Enterprise Institute: Why Bank Capital Matters (Dec. 1, 2022) ("Higher levels of capital mean that a bank's managers and shareholders have more 'skin in the game'—and have incentives to prudently manage their risks—because they bear more of the risk of the bank's activities.").

[235] A third shortcoming, mentioned above and discussed in the context of clawbacks, concerns the recent track record of these compensation reforms becoming mired in years, even decades, of regulatory purgatory.

[236] According to the FDIC's historical bank dataset, there were 4,414 insured commercial banks operating in the United States in 2025. *See BankFind Suite: Bank Failures & Assistance Data*, *supra* note **Error! Bookmark not defined.**.

[237] *See, e.g.*, Omarova, *supra* note **Error! Bookmark not defined.**, at 2495-96 (discussing the too-big-to-fail problem with large banks); *see also* Jeremy C. Kress, *Modernizing Bank Merger Review*, 37 YALE J. ON REG. 435, 439-40 (2020) (noting the financial stability risks associated with large bank mergers).

[238] *See* Kress & Turk, *supra* note 21, at 651.

equity compensation package, Congress could empower regulators to offset any sanction by the amount of equity compensation paid out.[239] Another approach would be to provide banks with the opportunity to opt out of our proposed sanction regime through its selection of compensation packages.[240] As a first pass, either the bank and its executives agree in advance that a certain percentage of the executives' compensation will be in the form of equity in the company (non-transferable for some set amount of time), or they opt into our new fault-based sanctions regime.

2. Compensation Clawbacks

Another pathway toward aligning executive compensation with the firm's interest in bank stability is through a compensation clawback.[241] Compared to equity compensation, clawbacks have the virtue of being able to impact all bank executives, rather than just those whose banks can pay them in stock. Nevertheless, clawbacks are likely to suffer some of the same impediments to adoption as other compensation reforms.

At its most basic, a compensation clawback does what it says: it claws back compensation.[242] Historically, clawbacks were envisioned as a creature of contract law.[243] On this view, a clawback provision is one of many levers that a firm might use in its executive compensation package to align the individual managers' incentives with those of the firm.[244] And, as against this metric, early compensation clawbacks showed positive results.[245] For example, several studies find that firms choosing to include clawbacks in their compensation packages have managed more stable governance practices, and that more stringent clawback provisions correlate with better risk management outcomes.[246]

However, the features that make compensation clawbacks effective have also proven to be their limiting factor. Unsurprisingly, clawbacks are unpopular

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[239] Or, more simply, our proposal could be to impose a fine equivalent to 100% of five years' non-equity compensation, subject to trebling the entire compensation package.

[240] Our thanks to our colleague, Vic Khanna, for pressing this point.

[241] *See* Deniz Anginer, Jinjing Liu, Cindy A. Schipani & H. Nejat Seyhun, *Why Do Banks Fail Together? Evidence from Executive Compensation*, 29 FORDHAM J. CORP. & FIN. L. 503, 538-42 (2024) (discussing a role for compensation clawbacks in compensation reform).

[242] *See, e.g.*, *Compensation Clawback Policies - What the Board Needs to Know*, PWC, https://www.pwc.com/us/en/services/governance-insights-center/library/compensation-clawback-policy.html (last visited Jan. 23, 2025).

[243] *See* Stuart L. Gillan & Nga Q. Nguyen, *Clawbacks, Holdbacks, and CEO Contracting*, 30 J. APPLIED CORP. FIN. 53, 53-54 (2018).

[244] *See id.* at 3-6.

[245] *See*, *e.g.*, Lilian H. Chan, Kevin C.W. Chen, Tai-Yuan Chen & Yangxin Yu, *The Effects of Firm-Initiated Clawback Provisions on Earnings Quality and Auditor Behavior*, 54 J. ACC. & ECON. 180, 181 (2013).

[246] *See, e.g.*, Michael H. R. Erkens, Ying Gan & B. Burcin Yurtoglu, *Not All Clawbacks Are the Same: Consequences of Strong Versus Weak Clawback Provisions*, 66 J. ACCT. & ECON. 291, 291-93 (2018); Yin Liu, Huiqi Gan & Khondkar Karim, *Corporate Risk-Taking After Adoption of Compensation Clawback Provisions*, 54 REV. QUANTITATIVE FIN. & ACCT. 617, 618-20 (2020).

with executives.[247] Ever in the search for executive talent, firms overwhelmingly prefer more manager-friendly incentives (e.g., bonuses and stock options) as a means of overcoming the core principal-agent problem at the heart of corporate governance.[248] Even those firms with a clawback policy on the books have proven reluctant to take advantage of it.[249] Thus, in practice, firms rarely exercise the contractual right even when they have it.[250]

Where does that leave us? On the one hand, compensation clawbacks seem like a promising tool for mitigating moral hazard. But on the other, firms are reluctant to include them in their executive contracts, much less to use them in practice. This market failure, one might think, is ripe for government intervention. And indeed, beginning in the early 2000s, the federal government started to wade into the clawbacks space.[251]

Responding to accounting scandals in the early 2000s, the Sarbanes-Oxley Act of 2002 (SOX) outlines the nascent regulatory framework for compensation clawback provisions.[252] SOX's clawback rule, Section 7243, applies only to CEOs and CFOs of public companies, and can be enforced only through SEC action.[253] The provision is triggered by an "accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws."[254] Notably, Section 7243 does not require that the senior executives themselves be personally responsible for the mistake.[255] At the same time, Section 7243 imposes a significant time restriction on what can be clawed back: the regulation has a lookback period of only one year. [256] Put another way, Section 7243 is designed to make it as though a CEO or CFO was compensated based on accurate information, rather than allow them to remain "over-compensated" because of a material misstatement.[257] Thus, a SOX clawback should not be understood as a sanction; it is more appropriately understood as a disgorgement of incorrectly awarded compensation during a one-year period.

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[247] *See* Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. CORP. L. 721, 733 (2011) ("Forcing a current executive to return excess pay would obviously impose a financial cost on the executive.").
[248] *See id*. at 733.
[249] *See id.*; *see also* Erkens, Gan & Yurtoglu, *supra* note 246, at 295-97 & app. b (identifying different characteristics, including degrees of enforceability, across strong and weak clawbacks). Ilona Babenko, Benjamin Bennett, John M. Bizjak, Jeffrey L. Coles & Jason J. Sandvik, *Clawback Provisions and Firm Risk*, 12 REV. CORP. FIN. STUD. 191, 192-94 (2023) (finding that clawback provisions are associated with reduced firm risk).
[250] *See* Fried & Shilon, *supra* note 247, at 742.
[251] *See id.* at 730.
[252] Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7243 (2012).
[253] *See* Fried & Shilon, *supra* note 247, at 730.
[254] 15 U.S.C. § 7243(a).
[255] In practice, however, the SEC has deployed the SOX clawback sparingly, and almost exclusively in cases where the executive was personally convicted of fraud. *See* Fried & Shilon, *supra* note 247, at 731.
[256] 15 U.S.C. § 7243(a).
[257] *See* Fried & Shilon, *supra* note 247, at 730.

In the aftermath of the Global Financial Crisis, the Dodd-Frank Act sought to build upon and expand this SOX framework.[258] Incredibly, the SEC has only just recently—*fifteen* years after Dodd Frank's enactment!—finalized its rules, which instructs securities exchanges to require that listed firms develop some version of a no-fault executive clawback provision.[259] This newly finalized regulatory implementation of Dodd-Frank's clawback provision, Rule 10D-1, expands the scope of its SOX counterpart in several ways.[260] First, the provision covers all material misstatements, whereas SOX's clawback applies only to a subset of them (so-called "Big R" restatements).[261] Second, Rule 10D-1's lookback period is longer—three years, instead of one year—and applies to both current and former executives.[262] Third, Rule 10D-1's trigger is automatic, whereas clawbacks under SOX require SEC action.[263]

Finally, the Department of Justice has recently inserted itself into the world of compensation clawbacks. As part of the 2023 "Monaco Memo" and related guidance memos,[264] the DOJ announced a pilot program that would treat the existence of a firm's executive compensation clawback policies as grounds for granting the firm cooperation credit, and a possible reduction in fines, against an ongoing criminal investigation.[265] The DOJ does not promulgate regulations on executive compensation; unlike the prior examples, there is not a specific clawback provision either that the government can deploy or that firms must adopt into their employment contracts.[266] Nevertheless, current DOJ guidance for its pilot program indicates that firms should develop a compensation policy for the purpose of clawing back compensation earned by executives who have

[258] Dodd–Frank Wall Street Reform and Consumer Protection Act § 956, Pub. L. No. 111-203, 124 Stat. 1376, 1904 (2010). Not discussed here is a similar provision contained in the 2008 Troubled Assets Relief Program (TARP). *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §§ 101-36, 122 Stat. 3765, 3767-800 (2008) (codified as amended at 12 U.S.C. §§ 5211-41).

[259] 17 C.F.R. § 229.402 (2024) (executive compensation).

[260] Harold S. Bloomenthal & Samuel Wolff, *Recovery of Executive Compensation Under Dodd-Frank: Introduction*, *in* 1 SECURITIES LAW HANDBOOK § 15:48 (2025).

[261] David I. Walker, *The SEC's Compensation Clawback Loophole*, 118 NW. U. L. REV. ONLINE 45, 50 (2023).

[262] *See id.*

[263] *See id.*

[264] *See* Bloomenthal & Wolff, *supra* note 260.

[265] U.S. DEP'T OF JUST., THE CRIMINAL DIVISION'S PILOT PROGRAM REGARDING COMPENSATION INCENTIVES AND CLAWBACKS 2 (Mar. 3, 2023), https://www.justice.gov/criminal-fraud/file/1571941/download. For the roots of this policy, W. Robert Thomas, *The Ability and Responsibility of Corporate Law to Improve Criminal Fines*, 78 OHIO ST. L.J. 601, 645-53 (2017); see also see John C. Coffee, Jr., *Crime and the Corporation: Making the Punishment Fit the Corporation*, 47 J. CORP. L. 963, 976-81 (2022) (proposing conditions of probations targeting executive compensation).

[266] *See generally* U.S. DEP'T OF JUST., CRIM. DIV., EVALUATION OF CORPORATE COMPLIANCE PROGRAM (last updated Sept. 2024), https://www.justice.gov/criminal-fraud/page/file/937501/download (describing general best practices without clear guidance on specific clawback procedures).

subsequently been found guilty of criminal misconduct.[267] And further, the DOJ has stated that merely having a clawback policy on the books will not suffice to earn cooperation credit; firms must demonstrate that the policy is used.[268]

As with equity compensation, we are open to compensation clawbacks to the extent they can further deter bank executives from acting negligently. To that end, a suitable clawback regime must have the following properties: (1) the clawback is triggered by something approximating the negligence rule sketched in Part III, (2) the amount of compensation available to be clawed back is large enough to create meaningful *ex ante* incentives, (3) the clawback is not insurable, and (4) it is mandatory.

Drawing from existing proposals, there are several steps that might make such a sanction easier to administer. In that spirit, one approach would be to require a portion of executive compensation be kept in escrow to make clawing back more administratively practicable. Another would be to motivate directors to adopt and exercise clawback provisions in employment contracts as a substitute for waiting for agency action. For example, one could impose the fine on a bank's board of directors but allow them to reallocate costs to senior executives.[269] Or, similar to the DOJ's pilot program, one could impose a fine on the firm, allowing the bank to discount its liability by whatever amount it is able to collect back from executives.[270]

As with some of the other proposals, the biggest obstacles seem to be with the limits of federal regulatory intervention more than with the theory behind a clawback itself. As discussed, Dodd Frank already contains provisions that speak to executive compensation at banks—and yet, fifteen years later, we are still awaiting regulatory adoption. Similarly, the implementation of Dodd Frank's compensation clawback provisions—ones not limited to banking, but instead applicable to securities violations—took fifteen years. And regulatory delay might simply be the price of good policy: to the extent that compensation reforms require a more detailed, subtle policy implementation, it might be more difficult for Congress to legislate over regulators. But, at least by comparison, reforming Section 11(k) or creating an equivalent new enforcement statute seems to be the kind of change that is likely to succeed without waiting decades for regulatory sign-off.

Conclusion

Designing a credible corporate sanctions regime has long been at the forefront of scholarly ambitions and policymakers' agendas. This endeavor is

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[267] U.S. DEP'T OF JUST., *supra* note 265, at 2.
[268] *Id.* at 2 n.3.
[269] Thomas, *supra* note 265, at 645–53.
[270] U.S. DEP'T OF JUST. CRIM DIV. CORP. ENFORCEMENT, REPORT ON THE PILOT PROGRAM REGARDING COMPENSATION INCENTIVES AND CLAWBACKS (Nov. 22, 2024), https://www.justice.gov/criminal/corporate-enforcement-note-compensation-incentives-and-clawback-pilot.

even more pressing now given the recent wave of financial panics experienced in the United States and around the world.

It is time to bring personal accountability back into the picture by pairing regulatory improvements with a credible sanction regime for bank executives. We have described here a framework in which a well-designed negligent banker sanction—one without an insurance backstop—can bring reassurance by shifting the prospect of liability onto the group best situated to prevent it: bank executives. Implementing this framework of shifting more responsibility back onto the decisionmakers in the C-suite could lead to the financial stability desperately sought by policymakers.