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Strict liability for bank leadership: Unnecessary and unwise

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The clawback provision in the proposed RECOUP Act is unnecessary and unwise, and not supported by historical precedent.

In a recent opinion piece in the *Washington Post*, former FDIC Chair Sheila Bair and leading British bank historian Charles Goodhart argued in favor of the executive compensation clawback provision in the proposed RECOUP Act, which we analyzed here. The provision would grant the FDIC authority to recoup up to two years of compensation from any senior executive of a failed bank or a parent holding company who was responsible for the bank's failed condition. The provision would exclude senior executives of community banks with $10 billion or less in total assets and their parent holding companies.

Compensation that could be recouped would include "incentive-based compensation, equity-based compensation, severance pay, golden parachute benefits, or compensation that is granted or vested based wholly or in part upon the attainment of any financial reporting measure or other performance metric, and any profits realized from the purchase or sale of securities of the depository institution or depository institution holding company."

Bair and Goodhart provide three principal arguments for the clawback provision.

- First, the FDIC needs to have the authority to recoup compensation from senior executives of large, failed banks that were "grossly mismanaged" like Silicon Valley Bank, Signature Bank and First Republic Bank.
- Second, it is unfair for the rest of the banking system to bear the cost of any bank losses caused by such gross negligence. To put that argument in context, the FDIC is currently in the process of shifting the cost of the losses of these three banks to the largest surviving U.S. banks through special assessments for the Deposit Insurance Fund, which we analyzed here.[1] Some or all of these increased costs could be passed on to bank customers.
- Finally, Bair and Goodhart state that "[t]he only argument advanced against the measure was that expanded liability for bankers would make it harder to attract people to work there." Their response to that argument is that "unlimited liability was the norm for bank executives during much of the 19th century, and this did not deter quality individuals from entering the banking profession. Instead, unlimited liability for bank executives inspired the kind of trust which in turn brought in more investors and depositors."

There are at least two problems with these arguments.

The FDIC already has the authority to recoup compensation from senior executives of insured banks for losses caused by their gross negligence.

Under Section 11(k) of the Federal Deposit Insurance Act, the FDIC has the authority to hold senior executives personally liable for any damages to a failed bank caused by their gross negligence. Such damages could include an amount equal to two years of compensation or more. The principal difference between this provision and the clawback provision in the proposed RECOUP Act is that existing law specifies a gross negligence standard of care, and the

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RECOUP Act is silent on the standard of care.

In contrast, the RECOUP Act includes an express standard of care for the enhanced authority it would give the FDIC to remove senior executives from office. That standard of care is "gross negligence" in one of the new removal provisions and having engaged in "grossly negligent, reckless, or willful conduct" in the other new removal provision. So long as *Chevron* deference remains the law of the land,[2] the existence of an express standard of care in the removal provisions and silence in the clawback provision leaves the FDIC free to argue that this difference in the text implies that Congress intended for the clawback provision to have a strict liability standard of care or to delegate to the FDIC the discretion to specify the standard of care, which includes the discretion to specify a strict liability standard. That argument would be very difficult to overcome so long as *Chevron* is the law of the land.

Unlimited liability was never the norm for bank shareholders or executives in the United States.

Unlimited liability was certainly the norm for bank shareholders and executives **in England** during much of the 19th century. But that was because virtually all private banks, country banks and joint stock company banks in England were organized as general partnerships. As such, both their shareholders and senior executives were general partners with unlimited personal liability for their bank's losses.[3] Unlimited liability was **never the norm in the United States**. Instead, virtually all U.S. banks were chartered as banking corporations from the dawn of the Republic. For example, the Bank of New York, which is the first state-chartered bank in the United States that is still standing, was chartered as a banking corporation by the New York State legislature in 1791.[4] Bank executives were liable only for losses caused by their negligence or gross negligence.[5] Bank shareholders were similarly liable only for losses up to the nominal amount of their investments or, between the Civil War and the Great Depression, double those investments.[6]

The risk that the FDIC could construe the clawback provision in the RECOUP Act to have a strict liability standard of care subject to *Chevron* deference will certainly deter many able and responsible people from serving as bank executives. This deterrence would be particularly likely and undesirable when the banking regulators are encouraging troubled banks to replace certain bank executives with more capable people who could save the bank from failing. If executives being hired precisely to save a troubled bank from failure believe they could be held strictly liable for failing to save the bank, it will be exceedingly difficult to convince them to accept the responsibility.

Though the provision limiting the clawback provision to senior executives who were "responsible" for the failed condition is a recent addition to the bill, that provision only ensures that liability would be limited to senior executives who caused the failed condition. It would not require the showing of any fault based on a specified standard of care, like negligence or gross negligence, once causation was established.

At a minimum, Congress should amend the clawback provision in the RECOUP Act to specify a standard of care consistent with U.S. historical precedent, meaning negligence or gross negligence, not strict liability.

In short, the proposed new power to recoup compensation from senior bank executives is unnecessary. The FDIC already has the authority to recoup compensation from senior bank executives for damages caused by their gross negligence. A strict liability standard of care is inconsistent with the historical standard of care for bank executives in the United States, which has been a negligence or gross negligence standard. If Congress nevertheless decides to enact the clawback provision in the RECOUP Act, it should specify a standard of care consistent with this historical precedent – that is, either a negligence or gross negligence standard of care.

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[1] FDIC, *Special Assessment Pursuant to Systemic Risk Determination* (Apr. 2, 2024).

[2] *See Chevron v. Natural Resources Defense Council*, 467 U.S. 837 (1984).

[3] *See, e.g.*, James William Gilbart, *The History of Banking in America* pp. 78-81 (1837) (arguing that unlimited liability for bank shareholders and executives was the norm for banks in England because they were organized as general partnerships and that this made them safer than U.S. banks which were organized as chartered banking corporations with limited liability); Ernest Sykes, *Banking and Currency* pp. 96-97 (1905) (same with respect to English banks).

[4] An Act to Incorporate the Subscribers to the Bank of New York, ch. 37, 1791 N.Y. Laws 360-364.

[5] *See, e.g.*, Julie Andersen Hill & Douglas K. Moll, *The Duty of Care of Bank Officers and Directors*, 68 Ala. L. Rev. 965 (2017); *Atherton v. FDIC*, 519 U.S. 213 (1997); N.Y. Banking Law § 7015.

[6] *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 Wake Forest L. Rev. 31, 35-38, 35 n.20 (1992).

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