1995

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ARTICLES

THE NOTIONAL BUSINESS JUDGMENT RULE IN BANKING†

Patricia A. McCoy*

In the corporate law literature, the notion still persists that the business judgment rule cuts across industry lines with monolithic force. While a few commentators have cited banking as an industry in which the business judgment rule has contracted, the majority has dismissed the banking cases as an aberration and an unimportant one at that.1 Having

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relegated banking to the backwater, scholars thus have failed to grasp the vast extent to which courts have second-guessed decisions of bank directors on the merits in negligence cases for the past hundred years. More importantly, this oversight has made scholars blind to the insights that this rich experience affords into assumptions about the business judgment rule.

The most important assumption is that substantive judicial regulation of corporate decisions would inject too much risk aversion into the boardroom. A sister assumption is that courts, if they regulate board conduct at all, normally impose monitoring duties in lieu of substantive regulation. Commentators also assume that to the limited extent courts override the business judgment rule, they do so solely with respect to extraordinary corporate decisions such as mergers, asset sales, and other potential changes in management control. All three of these assumptions have taken on a life of their own, notwithstanding the recent revamping of the


American Law Institute’s *Principles of Corporate Governance*,\(^3\) due to a lack of any systematic analysis of case outcomes in specific industries.\(^4\)

When this analysis is performed in banking, each of these assumptions proves incorrect. For over a century courts have scrutinized a wide array of substantive bank decisions for negligence out of concern for undue risk to depositors and deposit insurance funds.\(^5\) In fact, courts regulated substantive bank director decisions through the common law decades before they began to peruse bank decisions for procedural flaws. Further, very few banking decisions can be characterized as “extraordinary” in the sense of involving contests for corporate control.\(^6\) Rather, the cases which have received the greatest judicial scrutiny over the past century focus almost exclusively on day-to-day decisions, particularly decisions on lending.\(^7\)

Most significant, however, is what the banking industry’s experience says about avoiding risk aversion, the classic justification for the business judgment rule. As the thrift and bank crisis of the 1980s showed, far from inducing undue caution in the banking system, the judiciary’s stabs at common law regulation were ineffective in halting losses from imprudent

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3. 1 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS §§ 4.01(a), (c) (1992).
5. For an analysis of the economic and political forces that triggered substantive regulation of banking by the judiciary and whether those forces make banking “special,” see Patricia A. McCoy, *A Political Economy of the Business Judgment Rule in Banking: Implications for Corporate Governance* (manuscript on file with author).
6. The paucity of court cases challenging bank mergers and changes in management control is not surprising. Hostile takeovers in banking have been rare and friendly mergers have tended to play out in the regulatory arena due to the need for statutorily-mandated regulatory approvals. See HELEN A. GARTEN, WHY BANK REGULATION FAILED: DESIGNING A BANK REGULATORY STRATEGY FOR THE 1990s 58, 86-88 (1991). With the growth of interstate banking, however, there has been a recent upswing in hostile bank merger bids. See Saul Hansell, *Wave of Mergers is Transforming American Banking*, N.Y. TIMES, Aug. 21, 1995, at A1.
7. The focus on lending is explained by the fact that until recently, “the effect of regulatory control was to confine the banking industry to the deposit-lending business.” GARTEN, supra note 6, at 39.
thrift and bank decisions. Whatever can be said about this latest banking debacle, undue risk aversion was not a problem. Thus, when viewed against the backdrop of the judiciary's long involvement in substantive bank regulation, last decade's events raise interesting questions about the risk aversion rationale.

To begin, the lengthy experience with judicial regulation of the banking industry suggests that over the long run, substantive common law rules will fall into disuse unless they are adopted by courts in a substantial number of states. In turn, many states will not replicate such rules except in rare instances where industry practice or bank system catastrophes create support for the rules. Moreover, even where support exists, the judiciary's aversion to financial analysis will hamstring the regulatory techniques at its disposal.

Thus, while the short-term effect may be to induce undue risk aversion on a local basis, there is little evidence that substantive judicial regulation of the banking industry induces undue risk aversion in the long run. The common law frailties that caused judicial attempts at regulation to break down — particularly the "race to the bottom" — are common to all industries. In this respect, the banking experience cuts across industry lines and suggests that long-term concerns about undue risk aversion are overblown.

Consequently, the past century's experience in the banking industry presents a valuable case study of the effects of substantive regulation of board decisions through the common law. The results of that experience help provide answers to several questions. First, to what extent does the business judgment rule remain alive in the banking industry and why? Second, what regulatory techniques have courts used or avoided and

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9. The current judicial backlash against last decade's cases overriding the business judgment rule with respect to bank directors is simply the latest swing in this historic cycle. See infra notes 182, 185, 187. In 1993 and 1994, seven federal district courts reportedly denied negligence recovery against financial institution directors on business judgment rule grounds. See FDIC and RTC Challenge BBLN Tally Of PL Cases, Claim Winning Records on Merits, supra note 1, at 1, 5-7. Most of those decisions are unreported. See id. Recent court decisions ruling against plaintiffs in many bank director liability cases on collateral issues such as the statute of limitations and insurance policy exclusions also provide evidence of this cycle. See id. at 3.

10. This article uses the terms "judicial regulation" and "common-law regulation" interchangeably to refer to judicial oversight of bank board decisions through judge-made negligence rules that do not adopt codified standards as the duty of care.
why? Third, which of these techniques succeeded and which failed? Fourth, what explains the respective successes and failures? Fifth, what happens when judicial regulation fails? Sixth, to what extent is the banking experience instructive with respect to other industries? And seventh, what does this experience teach about the avoidance of risk aversion rationale? This article seeks to address these questions in the course of examining the evolution of the business judgment rule in the banking industry.11

I. DOCTRINAL FORMULATIONS

In suits against corporate directors for negligence, the duty of care prescribes substantive decisions that the fabled "ordinarily prudent" director would not have made. The classic statement to this effect appears in the 1891 banking case of Briggs v. Spaulding,12 where the United States Supreme Court defined the duty of care as the care "which ordinarily prudent and diligent men would exercise under similar circumstances," taking into account "the restrictions of the statute and the usages of business."

The duty of care thus implies that board decisions will be penalized if they are stacked up against the fact-finder's conceptions of objective prudence or industry practice and found wanting.

11. This article discusses the business judgment rule as it applies to banks, savings and loan institutions, credit unions, trust companies, mutual savings banks, and the like. Where appropriate, the word "bank" will be used to designate all such financial institutions, regardless of their type.


The cases formulate the "ordinary prudence" standard in different ways. See generally Marcia M. McMurray et al., Special Project, An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule, 40 Vand. L. Rev. 605, 607-08 (1987). Some cases require the care that an ordinarily prudent person would take in his or her own business affairs. See Hun v. Cary, 82 N.Y. 65, 71 (N.Y. 1880); Marshall v. Farmers' & Mechanics' Sav. Bank, 8 S.E. 586, 590 (Va. 1889). Others, such as Briggs, require directors to exercise the care of an ordinarily prudent person in similar circumstances, i.e., that of an ordinarily prudent director. See Briggs, 141 U.S. at 152; Neese v. Brown, 405 S.W.2d 577, 581 (Tenn. 1964). Today, a majority of states has passed statutes codifying the Briggs "prudent director" standard. See McMurray, supra at 608 & n.15 (citing statutes); see also 1 American Law Institute, supra note 3, § 4.01(a); Revised Model Business Corp. Act § 8.30 (1984).
The business judgment rule seeks to temper concerns that the duty of care will make directors unduly risk-averse by immunizing many of the substantive board decisions that the duty of care might otherwise prescribe.\(^4\) Under the business judgment rule, disinterested board decisions, based on calculated risks that turn out wrong, are exempt from liability for negligence.\(^5\) In order to qualify for business judgment rule protection, the disputed decision must have satisfied the duty of loyalty\(^6\) and complied with applicable laws, corporate charters, and by-laws.\(^7\) Assuming those prerequisites are met, the business judgment rule shields honest but arguably imprudent board decisions from negligence liability.

That said, it begs the question to assume that the business judgment rule applies with full force in every industry and every case. The true reach of the business judgment rule in any industry cannot be determined until the decisions that do and do not merit latitude have been ascertained. When that analysis is performed for the banking industry, it is evident that courts have nullified the business judgment rule with respect to a surprisingly wide range of bank lending practices.

II. Substantive Common Law Regulation

One of the fastest-held beliefs about the business judgment rule is that substantive board outcomes are not regulated by common law negligence

\(^{14}\) See Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983); Muller v. Planters' Bank & Trust Co., 275 S.W. 750, 752 (Ark. 1925); Eisenberg, supra note 13, at 343-44.

\(^{15}\) Cary, 82 N.Y. at 70; see also, e.g., FDIC v. Wheat, 970 F.2d 124, 131 n.13 (5th Cir. 1992); Joy, 692 F.2d at 885; Wheeler v. Aiken County Loan & Sav. Bank, 75 F. 781, 783-85, 787-89 (C.C.D.S.C. 1896); Wynn v. Tallapoosa County Bank, 53 So. 228, 239 (Ala. 1910); Litwin v. Allen, 25 N.Y.S.2d 667, 727 (N.Y. Sup. Ct. 1940); Spering’s Appeal, 71 Pa. 11, 24 (Pa. 1872).

Recent banking cases have clashed over whether the business judgment rule is a defense or an element of the plaintiff’s cause of action. Compare, e.g., RTC v. Heiserman, 839 F. Supp. 1457, 1463 (D. Colo. 1993) (the business judgment rule “is an affirmative defense to an ordinary negligence claim”) with FDIC v. Brown, 812 F. Supp. 722, 724 (S.D. Tex. 1992) (the rule “is not merely a defense” but “is a rule of substantive law” that imposes affirmative burdens of pleading and proof on plaintiffs).


\(^{17}\) Briggs, 141 U.S. at 146. But see FDIC v. Benson, 867 F. Supp. 512, 522 (S.D. Tex. 1994) (granting summary judgment for directors on grounds that illegal or ultra vires acts do not constitute negligence); Warren v. Robison, 57 P. 287, 291 (Utah 1899) (stating: “[i]f, however, directors, acting in good faith, and with reasonable care, skill, and diligence, nevertheless fall into a mistake, either of law or fact, they will not be liable for the consequences of such mistake”).
rules, save in instances of rank "irrationality." At least in the banking industry, the cases belie that analysis. In banking, the judiciary has regulated a variety of substantive bank practices through negligence law for over a century. In doing so, courts have experimented with a range of regulatory techniques. Their decisions provide a wealth of data on the success of those techniques and their effect on boardroom conduct.

A. Minimum Rationality: Lack of Profit Potential

The one aspect of judicial substantive bank regulation that the corporate law literature has probed consists of a handful of cases, notably *Hun v. Cary* and *Litwin v. Allen,* that struck down bank decisions for lack of "minimum rationality." These cases earned the sobriquet "minimum rationality" because they sought to stamp out transactions that were patently irrational from the bank's or depositors' point of view: i.e., transactions with no apparent profit potential on their face.

The "profit potential" standard had a certain appeal, which some believed was the implicit promise of a safe harbor. Many assumed that boards approving transactions with no profit potential could expect substantive judicial scrutiny, while boards approving transactions with at least some profit potential could safely expect none. But when this distinction proved too difficult to administer in banking, substantive judicial regulation expanded to embrace potentially profitable bank decisions as well.

The earliest minimum rationality case was *Hun v. Cary,* where the directors of a savings bank on the brink of insolvency voted to build an imposing new headquarters with depositor funds. Condemning that decision as "a case of improvidence, of reckless, unreasonable extravagance," the court held the directors liable. Essentially, *Hun* was a classic instance of waste. The headquarters' stated justification — to attract new depositors — made no economic sense if the bank doors were about to shut. Obviously, there could be no profit potential in so extravagant a capital expenditure when the institution was on the verge of financial collapse. That being the case, *Hun* made potential profitability a minimum requirement of a bank director's duty of care when approving transactions.

18. 82 N.Y. 65 (N.Y. 1880).
20. See authors cited infra at note 34; Eisenberg, *supra* note 13, at 345-46.
21. 82 N.Y. 65 (N.Y. 1880).
22. Id. at 78-79.
23. See Dooley, *supra* note 2, at 480 n.60; Dyson, *supra* note 1, at 370.
Litwin v. Allen,24 decided sixty years after Hun, established the same proposition on considerably more ambiguous facts. In Litwin, the directors of Guaranty Trust25 voted to buy Missouri Pacific 5 1/2% subordinated debentures from Missouri Pacific's parent company, Alleghany Corporation.26 Because the debentures were convertible to stock, Alleghany feared losing control of Missouri Pacific to Guaranty Trust.27 Consequently, Alleghany insisted on an option to repurchase the debentures — a "call" — at the original sales price within six months. Guaranty Trust agreed to the call but failed to obtain a corresponding "put": an option to resell the debentures to the issuer at a favorable preset price if the price of the debentures fell.28 Afterwards, the debentures dropped in value, Alleghany declined to exercise its call, and Guaranty Trust's shareholders sued its directors.29

The Litwin court condemned the call transaction as negligent because, during the six-month life of the option, Guaranty Trust bore the risk of capital loss with no prospect for capital gain.30 Calling banking "a business affected with a public interest,"31 the court ruled that the directors had a responsibility to invest depositors' and shareholders' funds in vehicles with at least the potential for profit.32 Not to do so, the court implied, would violate the legitimate expectations of depositors and investors who had entrusted their funds to the bank.33 Thus, Litwin seconded the proposition that where a bank transaction has no discernible profit potential, it is economically irrational and thus impermissible.

In the half century since Litwin, its soundness on the facts has been rightly challenged.34 True, the directors signed away the right to poten-

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25. Historically, New York trust companies such as Guaranty Trust have been regulated under New York banking laws. See N.Y. BANKING LAW art. I, § 2 (Consol. 1994) and legislative history; id. arts. III, III-B.
27. Id. at 692.
28. See id. at 694-95 (discussing the details of the debenture transaction).
29. See id. at 676, 691-92 (commenting on the drop in value and the subsequent lawsuit).
31. Litwin, 25 N.Y.S.2d at 697.
32. Id. at 699 (holding that directors will be liable for transactions that are "so improvident, so risky, so unusual and unnecessary as to be contrary to fundamental conceptions of prudent banking practice").
33. See id. at 697 (discussing the public trust people have in banks).
34. See Bishop, supra note 1, at 1098; Dooley, supra note 2, at 480 n.60; Dyson, supra note 1, at 370; Palmiter, supra note 1, at 1380-81; David M. Phillips, Managerial Misuse of Property: The Synthesizing Thread In Corporate Doctrine, 32 RUTGERS L. REV. 184, 206.
tial market appreciation for six months while retaining the risk of loss. But the matter did not end there. Even without a put, the transaction might have been potentially profitable if the directors had bargained for some other consideration, such as higher interest or a collateral financial benefit. And in fact, they did: after all, Guaranty Trust was entitled to 5½% interest. Whether the Litwin court failed to grasp this fact or purposely imposed a stiffer duty of care out of conflict-of-interest concerns remains unclear.

These uncertainties are testament to the fact that it is no easy thing to pinpoint lack of profit potential from the bench, even with the benefit of hindsight. For this reason, later courts shied away from this type of financial analysis in banking cases, leaving Hun and Litwin in splendid isolation. One sign of the “minimum rationality” doctrine’s demise is the fact that another class of bank transactions with no direct profit potential — interest-free check overdrafts to outside customers — almost never is penalized by the bench. Arguably, such overdrafts flunk a potential profitability test because they are loans without interest or formal terms for repayment. Nonetheless, most courts have treated disinterested overdrafts leniently, preferring to view them as a low-risk, “tied” product that could attract a potentially profitable upswing in deposits. The fact that

35. See Soderquist, supra note 34, at 38, 45-46.
36. See Dooley, supra note 2, at 480 n.60.
37. See Soderquist, supra note 34, at 39.
38. See Bishop, supra note 1, at 1098; Dyson, supra note 1, at 370; Palmiter, supra note 1, at 1380-81; Phillips, supra note 34, at 206-07. Those concerns inhered in the fact that the buyback arrangements served other financial interests of Guaranty Trust’s affiliates. Guaranty Trust was a bank affiliate of J.P. Morgan & Company, while Alleghany was the principal holding company for the tottering Van Sweringen railroad system. Phillips, supra note 34, at 206. J.P. Morgan & Company had invested heavily in the Van Sweringen businesses and obviously had an interest in preserving its investment by staving off the financial collapse of the Van Sweringen empire. See id. at 206-07; Palmiter, supra note 1, at 1380.
39. See, e.g., Wynn v. Tallapoosa County Bank, 53 So. 228, 240 (Ala. 1910) (recognizing a “uniform and long-continued acquiescence of the officers and committees of a bank” in allowing cashiers to act alone in allowing check overdrafts).
40. See id. at 239; Scott’s Ex’rs v. Young, 21 S.W.2d 994, 998 (Ky. 1929); Pryse v. Farmers’ Bank, 33 S.W. 532, 533 (Ky. 1895); Williams v. McKay, 18 A. 824, 839 (N.J. Ch. 1889); Wallace v. Lincoln Sav. Bank, 15 S.W. 448, 454-55 (Tenn. 1891). But see Campbell v. Watson, 50 A. 120, 142 (N.J. Ch. 1901) (refusing to apply the business judgment rule to shelter the approval of worthless loans that were meant to cover a bank president’s sizable overdrafts and that obviously involved self-dealing).

Check overdrafts are one of the few lending topics that federal regulators (with the notable exception of the Office of Thrift Supervision) have declined to supervise except insofar as such overdrafts violate restrictions on loans to one borrower and insider loans. The Office of Thrift Supervision specifically permits check account overdrafts up to stated aggregate limits per thrift. See 12 C.F.R. §§ 545.46-545.47 (1995). For restrictions on check
courts do not even ask if overdrafts are potentially profitable shows how moribund the "minimum rationality" test has become.

But it would be a mistake to assume from this state of affairs that courts abandoned substantive regulation of the banking industry altogether when the potential profitability test proved unworkable. To the contrary, other bank cases, some of which were decided around the time of Litwin and Hun, used even more intrusive means of judicial review. They did so by condemning bank practices that were potentially profitable but nonetheless were deemed by courts to be unduly risky. In certain cases, these holdings took the form of activity bans. Other cases declined to ban activities but required risky activities to incorporate risk management safeguards.

This development had two significant consequences. It destroyed the business judgment rule as a screening device that protects a class of bank transactions from review — those that are disinterested and potentially profitable — because even potentially profitable transactions are now subject to scrutiny. At the same time, the judiciary's inherent difficulties in assessing risk, designing safeguards, and enforcing those safeguards nationwide eventually resulted in increased federal codification of bank loan standards. The fate of judicial bans on discrete bank activities is an important example of this development.

B. Common Law Activity Bans

In the main, American courts have been reluctant to outlaw entire lines of bank business. Some courts did so, however, where they perceived the risk of loss from certain potentially profitable activities, such as securities underwriting and construction loans, as unduly high.

This approach paralleled the prudent man rule in trust law which postulated that safe — and conversely unsafe — investments existed and could be identified. But as modern portfolio theory points out, the problem with this approach is that as risk declines, so do average re-


Conversely, courts condone check overdrafts even though they do not directly generate profit because overdrafts are considered low-risk and valuable in attracting other, profitable business. See supra note 40.

See Bevis Longstreth, Modern Investment Management and the Prudent Man Rule 74 (1986).
Business Judgment Rule

turns. Consequently, activity bans have the effect of either artificially limiting revenues or pushing banks into other equally risky activities that may be less familiar to regulators. Additionally, activity bans are nearly impossible to sustain over any appreciable period of time because companies outside of banking — and banks in states that do not observe the bans — exploit their freedom from such bans to gain competitive advantage. For these reasons, common law attempts to impose activity bans have largely failed.

1. Securities Underwriting

Prohibitions against securities underwriting are the most obvious example of bank activity bans. At the federal level, such bans historically have been imposed by statute and have their origins in the National Banking Act of 1864. The first state forays in this area, in contrast, were initiated by the bench. The fate of state common law regulation in this area provides valuable insights into the difficulties of risk management by the judiciary.

The National Banking Act of 186444 formed the backdrop for subsequent state court activity in the area of securities underwriting by banks. In 1897, the Supreme Court, in California Bank v. Kennedy,45 held that the National Banking Act barred national banks from stock ownership and thus from firm-commitment underwriting.46 Until the 1933 passage of the Glass-Steagall Act, however, this ban did not apply to state-chartered banks. Thus, before Glass-Steagall, securities underwriting by state-chartered banks and thrifts was left to the aegis of the states.

Before 1933, state courts made no significant attempt to interfere with securities underwriting activities by banks, with the single exception of New York. In 1909, in Gause v. Commonwealth Trust Co.,47 the New York Supreme Court held that the New York Banking Law did not permit state banks to underwrite securities. This decision was relied upon in subsequent cases, and the New York Supreme Court has consistently maintained that state banks may not engage in underwriting activities.

45. 167 U.S. 362 (1897).
46. Id. at 366-67 (discussing the National Banking Act and the limits it places on banks buying stock in industrial corporations). National banks could conduct underwriting activities through their securities affiliates. Id.; see also II MALLOY, supra note 43, § 7.2, at 7.13-7.19 (commenting on the events leading up to the National Banking Act’s restrictions on securities dealing by banks).
47. 89 N.E. 476 (N.Y. 1909).
York Court of Appeals forbad trust companies from underwriting stock offerings because it considered securities underwriting overly hazardous: 

"[A trust company's] authority to buy and sell stocks and bonds does not authorize it to indulge in hazardous promoting schemes, although it may hope from the successful launching of such schemes to make large commissions and receive large bonuses." In the judgment of the court, an undeniably high profit potential did not justify securities underwriting due to an equally high potential for loss. Thus, Gause instituted a judicially-crafted activity ban designed to advance capital preservation at the expense of potential profit maximization.

Other states chose to ignore Gause, however, and continued to permit their state-chartered institutions to engage in securities activities. In tandem with the National Banking Act's securities restrictions on national banks, the effect was to increase the competitive advantage of state-chartered institutions in states with less stringent standards. Thus, rather than following the lead of the National Banking Act and Gause, sister states retained their more liberal regulatory regimes in order to confer a competitive advantage on their home institutions.

That political calculus did not change until the onset of the Great Depression. After concluding that bank underwriting activities had helped to trigger the worst string of bank failures in the nation's history, Congress, in the Glass-Steagall Act, mandated a firewall between commercial banking and securities underwriting. Significantly, Congress applied parts of that firewall both to national banks and their state-chartered counterparts.

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48. Id. at 483; see also id. at 482 (discussing cases that support this proposition); Davidge v. Guardian Trust Co., 96 N.E. 751, 754 (N.Y. 1911) (stating that trust companies cannot "become the guarantor of the indebtedness or business of others"); Jenison v. Citizens' Sav. Bank, 25 N.E. 264, 265 (N.Y. 1890) (noting that "[s]peculative contracts entered into for the sale or purchase of stock by a savings bank... subject to the hazard and contingency of gain or loss, are ultra vires"); Sistare v. Best, 88 N.Y. 527, 533 (N.Y. 1882) (same). But see O'Connor v. Bankers Trust Co., 289 N.Y.S. 252, 270-72 (N.Y. Sup. Ct. 1936) (while normally a "bank may not engage in the guaranty business," it may join a consortium of other banks guaranteeing deposits if necessary to avoid a domino effect if another member bank fails), aff'd, 1 N.Y.S.2d 641 (N.Y. App. Div. 1937), aff'd, 16 N.E.2d 302 (N.Y. 1938).

49. Gause, 89 N.E. at 483 (discussing the permissibility of hazardous transactions).


52. See II Malloy, supra note 43, §§ 7.2-7.2.1, at 7.6-7.30. That firewall consists of four prohibitions. Sections 5(c), 16, and 21(a)(1) prohibit national banks and state-chartered financial institutions from underwriting corporate securities or otherwise dealing in them for their own accounts. 12 U.S.C. §§ 24 (Seventh), 335, 378(a)(1) (1994); see also
Glass-Steagall is an important early example of federal codified standards supplanting the business judgment rule in banking. As such, Glass-Steagall presaged two important conceptual shifts in bank regulation. First, Glass-Steagall foreshadowed the massive transfer of bank oversight from the states to the federal government that was achieved by passage of the Financial Institutions Reform, Recovery and Enforcement Act (hereinafter “FIRREA”) and the Federal Deposit Insurance Corporation Improvement Act (hereinafter “FDICIA”). Second, Glass-Steagall transformed the source of applicable law from common law rules with limited geographical effect to federal code-based standards having nationwide applicability, a trend that has accelerated in recent years.

Both changes were designed to overcome the inherent inability of courts — both state and federal — to enforce common law restrictions on bank activities outside their jurisdictions. The period before Glass-Steagall showed that where restrictions have less than comprehensive binding effect, neighboring states will decline to adopt similar restrictions in order to gain competitive advantage. Hence, with relatively few exceptions, efforts to supplant the business judgment rule in banking with affirmative legal limits on board conduct have evolved toward federal, code-based standards.

Glass-Steagall is doubly instructive as an example of the limited shelf life of activity bans. Although Glass-Steagall is still on the books, its practical force has been sapped over time as federal courts and agencies have relaxed its provisions through repeated reinterpretation. The cumulative effect of these rulings has been to permit bank affiliates (and in some cases banks themselves) to act as discount brokers, place commer-

§ 355; II Malloy, supra note 43, § 7.2.1, at 7-29-7.32. Section 20 prohibits member banks of the Federal Reserve from affiliating with investment banks, defined as any entity “engaged principally in the issue, flotation, underwriting, public sale, or distribution . . . of stocks, bonds, debentures, notes, or other securities . . . .” 12 U.S.C. § 377 (1994). Section 21 bars anyone who distributes or underwrites corporate securities from accepting deposits. § 378(a)(1). Finally, Section 32 prohibits management interlocks among member banks and officers, directors, and employees of securities firms. § 78. Professor Mark Roe attributes Glass-Steagall’s resort to bans in part to anti-Wall Street political sentiment: “[I]t’s at least plausible that those who aspired to control financial abuses could have used other means, such as disclosure, case-by-case attack, and prohibition of dangerous transactions between the intermediary and the firm, instead of a ban on large ownership itself. Given the anti-finance rhetoric, it’s plausible that part of the reason well-meaning regulators often opted for across-the-board bans went beyond the severity of the financial abuses, but depended on the political rhetoric they heard in the background.


cial paper, arrange private placements, market mutual funds, and engage in certain underwriting activities.55

These rulings are a direct response to the success of brokerage houses and mutual funds in siphoning off bank deposits since the 1970s.56 At its inception, Glass-Steagall proceeded on the assumption that banks did not have to compete with Wall Street because Wall Street would not compete for the retail deposits of banks. But in the 1970s, Wall Street dashed that premise by luring depositors away with money market accounts offering double-digit returns. As the deposit bases of financial institutions shrank, it became clear that Congress could not insulate banks from competition by the securities industry through the expedient of artificial, statutory firewalls.57 Nor could banks be exposed to competition from the securities industry without being able to market securities products themselves. The result, therefore, has been a gradual loosening of Glass-Steagall’s strictures.

As Glass-Steagall shows, it is not enough to regulate through codified, national standards. The choice of regulatory techniques is also key. For the reasons just discussed, activity bans are especially prone to succumb to market forces and thus are disfavored by most courts.

2. Loans To New Business Ventures

Glass-Steagall consciously was designed to take American banks out of the securities industry and make lending their principal business.58 Yet even in the domain of lending, a few courts experimented with activity bans where they deemed the risks of specific types of lending unduly high. A prime example consists of loans to start-up ventures.

New business loans present undeniably high levels of risk, at least insofar as repayment depends on operating revenues. For this reason, courts have split over the propriety of loans to start-up ventures, both recently and in the past. This split reflects conflicting philosophies as to appropriate judicial techniques for managing the inherent risk in new business loans.

55. See Garten, supra note 6, at 2, 5-6, 65; II Malloy, supra note 43, §§ 7.2.2-7.2.4, 7.3.4-7.3.7; see also Mark J. Roe, A Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10, 17-18 (1991).


57. See Garten, supra note 6, at 8-14.

58. See id. at 10, 39.
Some courts flatly condemned such loans as negligent, based on the view that an outright ban is the only effective way to avoid undue risk. In the 1918 case of *Magale v. Fomby*, for example, shareholders sued bank directors for loans made to a new cannery that never showed a profit. According to the Arkansas Supreme Court, the loans were negligent, notwithstanding the directors' belief that "the business would be successful." Specifically, the court stated:

> It is not shown, however, that any of . . . [the directors] had had any experience in operating a canning factory. It turned out to be a hazardous business, and one that requires skill and experience on the part of those managing it in order to make it a success. . . . The directors loaned large sums of money to an enterprise which depended entirely upon its profits for a repayment of the loan.

More recently, in the 1989 case of *FDIC v. Robertson*, bank directors were held liable for loans to three new businesses that had "no proven track record of success."

Conversely, other courts have refused to prohibit loans to new businesses for fear of stifling economic growth. In *FDIC v. Stanley*, for instance, the court relieved bank directors of liability for uncollectible loans to new farms and commercial businesses. According to the court, the fact that the borrower’s business was new and had not turned a profit did not form grounds for liability as long as the loan was adequately secured and the borrower’s financial indicators were improving. Thus, *Stanley* repudiated a flat ban on bank loans to start-up ventures in favor of risk management through traditional techniques such as collateralization.

59. 201 S.W. 278 (Ark. 1918).
60. Id. at 278-79.
61. Id. at 280.
62. Id. The court undoubtedly was influenced by the fact that the cannery loans consumed nearly 60% of the bank's capital. Id. Nevertheless, the court affirmed dismissal of the complaint as barred by the statute of limitations. Id. at 281; see also Cosmopolitan Trust Co. v. Mitchell, 136 N.E. 403, 409 (Mass. 1922) (holding bank loans to "persons without credit, without business reputation and without financial resources . . . highly imprudent"); cf. Williams v. Fidelity Loan & Sav. Co., 128 S.E. 615, 622 (Va. 1925) (directors' decision to expand into consumer automobile loans immediately after World War I would have been negligent if the company had been a bank and depositors' funds had been at risk).
64. Id. at *6-*7, *9-*10, *17, *19-*20 (discussing the bank loans to these three unproven businesses).
66. Id. at 1294-95, 1299-1305.
67. Id.
In 1992, federal bank regulators adopted final guidelines on real estate loans that track the *Stanley* court's approach and appear to permit loans to new developers so long as there are adequate independent assurances of repayment, such as personal guarantees and sufficient collateral. The Clinton Administration's interagency policy statement on credit availability for small- and medium-sized businesses goes one step further and actively encourages loans to new businesses that can provide objective assurances of repayment.

Like an outright ban, the *Stanley* approach cuts back on the business judgment rule but does so with a scalpel rather than a cleaver. Bans like those in *Magale* and *Robertson* gave no credence to the social utility of new business financing. *Stanley*, in contrast, recognized that such loans may have significant potential benefits in the form of new jobs, innovative products, added bank revenue, and the like, and sought to achieve those benefits through risk management.

As the early 1990s "credit crunch" debate shows, where the potential benefits of an activity are sufficiently high, market demand and pressure from the banking industry will erode bans on those activities. It is nearly impossible for courts to enforce activity bans against banks under those circumstances in the long run. Thus, the modern tack has been to permit risky but potentially beneficial loans subject to strict underwriting guidelines.

3. *Land Development Loans*

A handful of state courts also experimented with activity bans on loans for the acquisition and development of land by commercial developers (sometimes known as acquisition, development, and construction or "ADC" loans). The abject failure of such bans became abundantly clear by the 1980s.

At the federal level, commercial real estate loans by national banks have long been subject to regulation under the National Banking Act. Until 1992, however, federal law did not directly regulate similar activi-

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70. Real estate loans by national banks historically have been subject to loan-to-value requirements, which sometimes were as strict as 50%. See 12 U.S.C. § 371(a) (1994); 12 U.S.C.A. § 371(a), Historical and Statutory Notes, at 183-88 (1994); Eugene Nelson White, The Regulation and Reform of the American Banking System, 1900-1929, 23 (1983).
ties by state-chartered banks, except for loans that implicated restrictions on loans to insiders and single borrowers. In the breach, a handful of older state cases specifically addressed the legality of loans by state-chartered banks to commercial developers for the acquisition and development of raw land.

Commercial real estate loans were a major source of losses in the thrift and bank crisis of the 1980s. But concerns about such loans are hardly new. For example, in 1889 in Williams v. McKay, the New Jersey Chancery Court condemned a loan to develop land as negligent where repayment hinged on appreciation of the land. Two other cases also addressed the repayment issue before the 1980s. All three cases resolved the issue by banning real estate loans that depended on future land appreciation.


72. See Alliance Fed. Sav. & Loan Ass'n v. FHLBB, 782 F.2d 490, 493 (5th Cir.) (affirming an agency order putting a thrift institution into receivership), modified on other grounds, 790 F.2d 34 (5th Cir. 1986) (per curiam). The court attributed its decision in part to the fact that "more than 75% of [the thrift's] . . . loan portfolio involved major speculative construction, land acquisition, and commercial real estate loans, many of which were of substandard quality." Id. Alliance Federal catalogued the dangers inherent in many commercial real estate loans made in the 1980s, including pressure to make large numbers of substandard loans due to the receipt of brokered deposits; the approval of unsecured loans to borrowers whose other loans were delinquent and whose ability to pay the loans was never verified; loan-to-value ratios at or above 100%; and inflated and poorly documented appraisals. Id. at 493-94; see also 59 Fed. Reg. 29,486 (1994); R. Dan Brumbaugh, Jr., The Collapse of Federally Insured Depositories — The Savings and Loans as Precurso 95, 121, 123 (1993) (discussing effect of low net worth on propensity to make risky ADC loans); Garten, supra note 6, at 120; Lawrence H. White, Why Is the U.S. Banking Industry in Trouble? Business Cycles, Loan Losses, and Deposit Insurance, in The Crisis in American Banking 12-13 (Lawrence H. White ed., 1993) (discussing role of bad ADC loans in failures of the 1980s and early 1990s). Similar problems were evident in FSLIC v. Williams, 599 F. Supp. 1184 (D. Md. 1984), subsequent opinion, 622 F. Supp. 132 (D. Md. 1985), aff'd in part and rev'd in part on other grounds sub nom. FSLIC v. Reeves, 816 F.2d 130 (4th Cir. 1987). In Williams, the court denied defendant thrift directors' summary judgment motions in response to FSLIC's allegation that defendants were liable for approving construction loans where fees and interest were funded out of the proceeds of the loan. Id. at 1191, 1216.

73. 18 A. 824 (N.J. Ch. 1889).

74. Id. at 830.

75. See Michelsen v. Penney, 135 F.2d 409, 426 (2d Cir. 1943); Medford Trust Co. v. McKnight, 197 N.E. 649, 659-60 (Mass. 1935) (holding bank directors liable for "large construction loans").

76. Michelsen, 135 F.2d at 426; Medford Trust Co., 197 N.E. at 659-60; McKay, 18 A. at 830.
The crux of these holdings was that where existing equity was insufficient to assure repayment, banks should not lend money in the hope of future appreciation.\textsuperscript{77} That, of course, is always the case for land development loans because recovery is predicated on appreciation due to development, not on the value of the undeveloped land. Obviously, however, these three isolated holdings were powerless to deter large losses in the 1980s from real estate development loans made by insured financial institutions.\textsuperscript{78}

The common law's failure to remedy the problem of losses from commercial real estate loans prompted Congress to seek a legislative solution. The solution was forged in FDICIA, enacted in 1991, in which Congress specifically directed federal banking regulators to "adopt uniform regulations prescribing standards for" real estate loans.\textsuperscript{79} The final regulations and guidelines appeared on December 31, 1992 and imposed strict requirements for such loans, including added repayment assurances and stiff loan-to-value ceilings of sixty-five to eighty-five percent.\textsuperscript{80}

Thus, commercial real estate loans are one more area in which state court attempts to regulate banks, and specifically attempts to impose activity bans, failed miserably. There are several apparent reasons for this failure. The demand for commercial real estate loans by banks was so strong that banks and states had every incentive to circumvent outright judicial bans on those loans. Furthermore, circumvention was relatively easy, since Williams v. McKay and its ilk had no binding effect outside the jurisdictions in which they were decided. Even in those jurisdictions, it was easy to distinguish those holdings on their facts. Thus, market forces

\textsuperscript{77} See Michelsen, 135 F.2d at 426 (holding workout techniques negligent because "the hope that partial recovery on the old debt might be increased could be based only on a speculation that real estate values would rise").


\textsuperscript{79} 12 U.S.C. § 1828(o) (1994); see also 12 U.S.C. § 371(a) (1994) (permitting national banks to make real estate loans subject to § 1828(o)).

and the inherent limitations of common law regulation doomed initiatives by a handful of state courts to regulate this area.\textsuperscript{81}

The 1992 federal guidelines solved the problem of piecemeal regulations by imposing standards with nationwide effect. Beyond that, the guidelines are significant for eschewing any attempt to impose an activity ban. Instead, the guidelines chart a middle course by permitting commercial real estate loans where the developer can post substantial cash or other equity and agrees to personal guarantees and other assurances of repayment.

This response to the judiciary's unsuccessful experimentation with activity bans in banking leads to several observations. The first bears on the judiciary's competence to fashion restrictions on board conduct as a matter of common law. Bright-line restrictions, such as activity bans, are appealing to some courts because these restrictions are easy to formulate and administer. The effectiveness of such bans, however, is highly questionable.

As the experience with common law activity bans shows, their effectiveness is hampered, in part, by the limited enforcement capability of the common law. Courts are an appropriate forum for enforcing the business judgment rule, at least so far as the rule seeks to assure the absence of governmental intervention, because the judiciary's role in that circumstance is to permit rather than restrain economic activity. But where individual industry conditions make legal restrictions on board behavior necessary or desirable,\textsuperscript{82} limitations on precedential effect make it impossible for courts to fashion common law restrictions with nationwide reach.\textsuperscript{83} In turn, the more permissive jurisdictions exploit their sister states' restrictions, generating internal pressure within the restrictive states to circumvent the few activity ban cases on the books.

As this suggests, the economic and social utility of banned activities (or at least their potential utility) generates a market demand that is virtually impossible for the legal system to cork. Just as it is ineffective for one state to ban a risky activity when other states will not follow suit, it is equally ineffective for Congress to apply such a ban to national banks without also applying it to state-chartered banks. Similarly, an industry-wide activity ban ultimately will fail if other, unaffected industries are

\textsuperscript{81} See White, supra note 70, at 24-25 (noting that weaker state limits on real estate loans gave state banks a competitive advantage over national banks).

\textsuperscript{82} See McCoy, supra note 5, at 8-28 (discussing such conditions in the banking industry).

\textsuperscript{83} The only court capable of doing so would be the United States Supreme Court and its ability in that respect is severely limited by prohibitions against federal common law. See generally O'Melveny & Myers v. FDIC, 114 S. Ct. 2048, 2054-55 (1994).
able to siphon off customers by offering the banned services. The consequent danger is that the regulated institutions will be left in a weakened financial state.

To a lesser extent, of course, the same criticism may apply to other regulatory techniques short of activity bans. But activity bans are particularly hard to enforce due to their capacity for overkill. That overkill makes courts and legislators in sister jurisdictions disinclined to adopt such bans because of the lost jobs and revenues such bans portend. It also means that the unregulated competitors have a proportionally greater competitive edge because competition turns on the sheer ability to provide a product rather than the terms on which that product is offered.

Accordingly, most courts that have reined in the business judgment rule in banking have rejected activity bans in favor of less intrusive regulatory techniques. As courts moved away from bright-line tests such as bans, however, their resolve and competence to fashion workable rules similarly waned.

C. Other Common Law Regulatory Techniques

1. Quotas And Quota Substitutes

In place of activity bans, some courts groped toward quotas, or at least something suggesting quotas, to supervise activities they considered too risky. This movement is best seen in the area of loan diversification.

Limits on loans to one borrower were some of the earliest American restrictions on bank lending. At the federal level, such restrictions date back over 130 years, when Congress barred national banks, in the Currency Act of 1863, from lending more than ten percent of their unimpaired capital and surplus to a single borrower. Today these limits


These limits on national banks are still in effect, albeit in a modified form. The Garn-St. Germain Depository Institutions Act of 1982 increased federal lending limitations to 15% of unimpaired capital and surplus for loans that are not fully secured, on top of which an additional 10% may be loaned to any one borrower for loans fully secured by readily marketable collateral. 12 U.S.C. § 84(a) (1994); see also 12 C.F.R. §§ 32.3, 32.4 (1995); 59 Fed. Reg. 6593 (1994). National bank directors face personal liability for participating in or assenting to violations of the limits. See 12 U.S.C. § 93(a) (1994); Del Junco v. Conover, 682 F.2d 1338 (9th Cir. 1982), cert. denied, 459 U.S. 1146 (1983).
serve as “exceedingly crude devices” for ensuring diversified loan portfolios.85

Far from providing a statutory model, however, the federal loan-to-one-borrower provisions became a springboard for state-chartered institutions to boost their competitive advantage. It took state courts over forty-five years to even begin incorporating analogous guidelines into the common law standard of care. In the meantime, state-chartered banks were able to outcompete their national bank counterparts by offering larger aggregate loans to local businesses.

In Pocomoke City National Bank v. Crockett,86 for example, the Maryland Court of Appeals affirmed a lower court verdict for a thrift’s directors despite the fact that they had lent almost half of the institution’s meager assets to the thrift’s vice president.87 The court had no difficulty holding that the directors’ lending decision deserved deference under the business judgment rule.88

Over the same period, however, Arkansas and Indiana courts overrode the business judgment rule to hold overconcentrations of credit negligent as a matter of common law. Thus in Bailey v. O’Neal,89 the Arkansas Supreme Court affirmed a directed verdict for the plaintiff-depositors, in part because nearly half of the bank’s assets had been loaned to a local businessman and his lumber company.90 The court reasoned that the directors “must have known that, if the Kelley companies increased their indebtedness, it would mean the insolvency of the bank.”91 Similarly, in Castetter v. Barnard,92 an Indiana appeals court reversed a verdict in

85. Scott, supra note 84, at 707-08 n.124.
86. 125 A. 712 (Md. 1924).
87. See id. at 716.
88. See id. at 713-16; see also Wheeler v. Aiken County Loan & Sav. Bank, 75 F. 781, 783 (C.C.D.S.C. 1896) (holding that bank directors were not liable in a shareholder suit, despite criticizing the directors’ decision to loan one-third of the thrift’s capital to a prominent local merchant as “unwise and hazardous”).
89. 122 S.W. 503 (Ark. 1909).
90. Id. at 505.
91. Id.; cf. Creamery Package Mfg. Co. v. Wilhite, 233 S.W. 710, 711-12 (Ark. 1921) (discussing directors’ duty of care in case charging that the directors loaned funds “to individuals and corporations in sums greatly in excess of 30 per cent. of the capital stock of said bank”; case dismissed for lack of standing to sue). To the same effect was Magale v. Fomby, 201 S.W. 278 (Ark. 1918), where the Arkansas Supreme Court stated in dicta that the directors of a county bank had been negligent for lending 60% of the bank’s capital to a start-up cannery. Id. at 280. Despite the lesson of the Magale case, the Arkansas legislature did not enact a loan-to-one-borrower statute for state-chartered institutions until 1927. See Ark. Code Ann. § 23-32-901 (Michie 1992); 1927 Ark. Acts No. 174, § 3 (discussed in Doyle Dry Goods v. Doddrige State Bank, 298 S.W. 863, 865 (Ark. 1927)); see also 1931 Ark. Acts No. 252, §§ 1, 2.
92. 183 N.E. 681 (Ind. App. 1934).
favor of an officer of a failed state bank for lending "almost one-third of the capital stock of the bank" to borrowers who were known to be insolvent. With the onset of the Great Depression, an increasing number of states began to enact loan-to-one-borrower statutes and numerous states have such statutes today.

Today, common law attempts at regulation in this area have been superseded by a checkerboard of state and federal statutes and regulations. The same loan-to-one-borrower limitations that apply to national banks now apply to federally insured savings and loan institutions. The contrary is true in the case of state-chartered banks, however, where federal regulators defer in part or in whole to state law. For state member banks, the Federal Reserve Board waives federal lending limits "where State law establishes a lending limit . . . that is lower." The FDIC has gone even further and abolished federal loan-to-one-borrower restrictions for all insured non-member state banks, regardless of whether parallel state laws exist.

This history is interesting in several respects, not the least of which is the use of federal statutes as templates for common law rules. Hypothetically, the lending limit provisions for national banks could have furnished a model for common law regulation by the states. But for almost a half-century after enactment, state courts consistently ignored national bank lending limit provisions. Even when loan-to-one-borrower problems at certain institutions became so egregious that state courts could not ignore


94. See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, BANKING STUDIES 286-87 (1941); Scott, supra note 84, at 707-08 (noting that the limits on loans to one borrower range from 10 to 25% of a bank's capital and surplus); John A. Skiles, Comment, Individual Personal Liability of Bank Directors for Negligent and Excess Loans, 7 NOTRE DAME L. REV. 185, 195-96 (1931) (discussing state and federal statutes, and noting their loan-to-one-borrower provisions).

95. See, e.g., 12 U.S.C. § 84(a); N.C. GEN. STAT. § 53-48 (1995); TEX. REV. STAT. ANN. art. 342-507 (West 1995); N.Y. BANKING LAW § 103(1) (McKinney 1995); see also Scott, supra note 84, at 727 (describing differences between state and federal statutes).


98. 58 Fed. Reg. 64,460-61 (1993). Previously, federal loan-to-one-borrower limitations did not apply to state non-member banks insured by the Bank Insurance Fund. The new rule extends the same treatment to state non-member banks insured by the Savings Association Insurance Fund. Id. at 64,461.
them, none of the courts that penalized those loans embraced a test as demanding as the federal statutory limit for national banks.\(^9\)

Why this fierce resistance to wholesale incorporation of the federal lending limits? Obviously, much of the explanation lies in perceived limitations on judicial authority and competence. Many state court judges undoubtedly believed they lacked a mandate to incorporate numerical federal guidelines into the common law when their legislatures had not seen fit to adopt those guidelines by statute.

Nonetheless, federal lending limits did leave their mark on state courts and legislatures.\(^10\) After all, many states eventually did adopt mandatory loan diversification in some form, if not in the federal law's exact particulars. For the most part, however, state courts and legislatures acted only when forced to by bank crises or especially notorious bank failures, most notably during the Great Depression. In the meantime, the limited applicability of federal lending limits for national banks created economic incentives for state courts and legislatures to delay adopting lending limits as long as politically feasible.

Conversely, the judiciary's propensity to hint at loan diversification quotas without embracing them outright motivated state legislatures to take action. The appeal of statutory lending limits lies in their seemingly easy-to-apply quantitative formulas. Nonetheless, every court that penalized loan overconcentrations rejected mathematical formulas in favor of the usual \textit{ad hoc} assessments that common law courts employed. The upshot was that banks affected by those rulings had little if any guidance about how much diversification was necessary in order to avoid exposure. The ensuing confusion put pressure on the states to enact quantitative lending limit statutes.\(^101\) As this phenomenon occurred, the common law rulings fell into disuse.

Internal inconsistency proved to be another drawback of common law regulation. Some courts have recently condemned loans made outside of an institution's geographical trade area as negligent.\(^102\) But if loan diver-

\(^9\) \textit{E.g.}, Seiffert v. State, 501 S.W.2d 124, 127-28 (Tex. Crim. App. 1973) (finding that the state's borrowing limit applied to single, and not aggregate, loans). \textit{But see id. at 129-30} (Douglas, J., dissenting) (suggesting that such a construction runs afoul of the federal statute, which provided the model for the state); State Nat'l Bank v. Tittle, 183 S.W.2d 720, 723 (Tex. 1944) (refusing to combine loans made to an individual and a corporation even where the individual handed the proceeds over to the corporation).


\(^101\) \textit{See supra} notes 91, 94-95.

sification, the goal of the common law limitations on loans to one borrower, is desirable, then geographical restrictions undermine that goal by making a higher proportion of an institution's assets captive to downturns in local economies, as happened in Texas and California in the 1980s. Consolidation of regulatory policy in Congress and the executive branch can help eliminate some, if not all, of these inconsistencies.103

For these reasons, the law of lending limits has repudiated common law rules in favor of codified, quantitative standards. At the same time, federal lending limit law incorporates a deference to state law that is uncharacteristic of most modern lending regulation. This is a rare example in lending of federal bank regulators deferring to state law rather than exercising their statutory power to impose stricter federal regulations across the board. While the FDIC reserves the right to reinstate federal restrictions "provided that there is a safety or soundness basis to do so,"104 only time will tell if the FDIC's deference to state law standards will trigger the "race to the bottom" that has been typical of state lending regulation in the past.

103. That said, regulatory policy in this area is hardly free from inconsistency. The holdings in the cases just discussed emanate from litigation positions of the federal government designed to maximize recovery. In contrast, the 1992 federal real estate loan regulations and guidelines take a decidedly more neutral stance and simply require financial institutions to "[i]dentify the geographic areas in which the institution will consider lending" and "set limits for real estate loans by . . . geographic market . . . ." Interagency Guidelines for Real Estate Lending Policies, 57 Fed. Reg. 62,896 (1992); see 12 C.F.R. pt. 563, subpt. D, app. A (1995) (discussing geographic market area conditions); 60 Fed. Reg. 35,674, 35,679 (1995) (noting that lenders should consider "the nature of the markets in which loans will be made").

104. 58 Fed. Reg. 64,461 (1993). In lifting federal lending restrictions on insured nonmember banks, the FDIC gave as its principal reason: "Congress could have imposed on all state banks a loan to one borrower limit . . . but did not do so when it enacted FIDCIA." Id. This is reminiscent of statements from the early 1980s when officials of the Federal Home Loan Bank Board erroneously maintained that they did not have authority to issue regulations restraining state-chartered thrifts from engaging in high-risk activities. See GAO, THIRT FAILURES: COSTLY FAILURES RESULTED FROM REGULATORY VIOLATIONS AND UNSAFE PRACTICES 75 (June 1989); GAO, FAILED FINANCIAL INSTITUTIONS: REASONS, COSTS, REMEDIES AND UNRESOLVED ISSUES 32 (Jan. 13, 1989); see also GAO, FAILED THRIFTS, INTERNAL CONTROL WEAKNESSES CREATE AN ENVIRONMENT CONDUCTIVE TO FRAUD, INSIDER ABUSE, AND RELATED UNSAFE PRACTICES 30 (Mar. 22, 1989); Lincoln Sav. & Loan Ass'n v. FHLBB, 670 F. Supp. 449, 451-52 (D.D.C. 1987), aff'd, 856 F.2d 1558 (D.C. Cir. 1988). The only difference is that the FDIC maintains it has authority to impose federal restrictions but chooses not to exercise that authority. See 58 Fed. Reg. 64,461.
2. **Mandatory Loan Terms**

In addition to supervising the makeup of overall loan portfolios, for years common law courts have dictated to bank boards the substantive terms of individual loans. The effect of these rulings has been to insert judicially-mandated, prophylactic terms into the structure of individual loans.

**Collateral parity** — For over a century, courts have scrutinized bank loans for evidence of sufficient collateral. As a general rule, courts have required collateral equal to the face amount of the loan, i.e., one-to-one parity between the loan value and collateral. Conversely, where loans appeared adequately secured at the time of approval, courts have

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105. See FDIC v. Wheat, 970 F.2d 124, 129 (5th Cir. 1992) (affirming judgment against bank director who approved a $125,000 loan based solely on a personal guaranty); Gamble v. Brown, 29 F.2d 366, 375 (4th Cir. 1928) (stating that “it was reasonable to believe that the property was sufficient security for the loan”), *cert. denied*, 279 U.S. 839 (1929); Wheeler v. Aiken County Loan & Sav. Bank, 75 F. 781, 784 (C.C.D.S.C. 1896) (rendering verdict for directors accused of failing to perfect security on loans); FDIC v. Robertson, No. 87-2623-S, 1989 U.S. Dist. LEXIS 9292, at *15, *19 (D. Kan. July 24, 1989); First Nat'l Bank v. Keller, 318 F. Supp. 339, 348 (N.D. Ill. 1970) (stating that “[b]ank records offered by defendant demonstrate . . . that the value of the collateral for the initial secured loans to all three corporations exceeded the amount of the loans”); Wynn v. Tallapoosa County Bank, 53 So. 228, 239-41 (Ala. 1910) (reversing judgment against cashier in part because of lack of proof of unsecured loans); Castetter v. Barnard, 183 N.E. 681, 686 (Ind. App. 1932) (affirming verdict that unsecured loan was negligent); Scott’s Ex’rs v. Young, 21 S.W.2d 994, 998-99 (Ky. 1929) (absolving directors on one note that “was secured by a mortgage on real estate” and on another that “was secured by an insurance policy and a personal surety”); Litwin v. Allen, 25 N.Y.S.2d at 709 (N.Y. Sup. Ct. 1940) (noting that the collateral was “found by the defendants to have a value more than sufficient for the purpose” of securing the loan); Broderick v. Marcus, 272 N.Y.S. 455, 461 (N.Y. Sup. Ct. 1934) (stating that the bank “disregard[ed] . . . all sound banking principles” in making “speculative, unsecured and improvident loans”); Williams v. Fidelity Loan & Sav. Co., 128 S.E. 615, 621 (Va. 1925) (affirming verdict for loan company’s officers and directors after examining testimony that collateral was carefully scrutinized for adequate security); *cf.* Alliance Fed. Sav. & Loan Ass’n v. FHLBB, 782 F.2d 490, 494 (5th Cir.) (affirming agency decision to put institution into conservatorship where the institution had made $540,000 in unsecured commercial loans), *modified on other grounds*, 790 F.2d 34 (5th Cir. 1986) (per curiam); First State Bank v. FDIC, 770 F.2d 81, 82 (6th Cir. 1985) (affirming FDIC cease-and-desist order based partially on allegations that respondents “extend[ed] credit that was not adequately secured”); Williams v. McKay, 18 A. 824, 835-38 (N.J. Ch. 1889) (ruling that an investment in commercial paper based solely on personal guarantees was imprudent).

106. See, e.g., Keller, 318 F. Supp. at 348 (finding that the value of the collateral did initially exceed the amount of the loans); Litwin, 25 N.Y.S.2d at 709 (commenting that the defendants did pay heed to the value of the collateral offered to secure the loans). *But see* Starrels v. First Nat’l Bank of Chicago, 870 F.2d 1168, 1171-72 (7th Cir. 1989) (holding that loans with no collateral fell within business judgment rule); Noble v. Baum, No. CV 89 0265 920 S, 1991 Conn. Super. LEXIS 1231, at *2, *7, *40-*41 (Conn. Super. Ct. May 6, 1991) (holding business judgment rule protected bank loans made with no borrower equity).
refused to assess liability for losses occasioned by subsequent declines in collateral value.

Decisions that scrutinized insufficient security on the loan’s face usually involved bank directors who approved such loans in hopes that the collateral would appreciate sufficiently by maturity to assure repayment. Early decisions in this area were split. A few early cases held directors responsible for losses from secured loans where the principal exceeded the face amount of the security, unless bank by-laws permitted the loans. Other cases invoked the business judgment rule to shield board decisions to approve inadequately secured loans where the decisions were made in anticipation that economic conditions would improve.

Today this debate has been resolved in favor of caution. Modern cases hold that inadequate security on the face of a loan constitutes negligence, irrespective of by-laws. In addition, the 1992 federal regulations on

107. See, e.g., Citizens Bldg. Loan & Sav. Ass’n v. Coriell, 34 N.J. Eq. 383, 397 (N.J. Ch. 1881); cf. Spering’s Appeal, 71 Pa. 11, 20, 24-25 (Pa. 1872) (affirming dismissal of complaint against directors for loans made upon “very doubtful collaterals” where counsel had advised them that the loans were authorized under the corporate charter). In the analogous case of Michelsen v. Penney, the Second Circuit affirmed a judgment against directors in part because they salvaged the bank’s junior mortgage on a foreclosed office building at high expense, “even though the offices were only half rented and despite the fact that the Miami real estate boom had burst and the bank was already gorged with real estate.” 135 F.2d 409, 422 (2d Cir. 1943); see also infra notes 114-15 and accompanying text (discussing the Hun decision).

108. In McRoberts v. Spaulding, directors who made inadequately secured farm loans during the 1920 depression were absolved even though the value of the collateral remained stagnant and the loans went into default. 32 F.2d 315, 316-17 (S.D. Iowa 1929); accord Litwin v. Allen, 25 N.Y.S.2d 667, 677, 720-21 (N.Y. Sup. Ct. 1940) (declining to hold bank directors liable for granting loans in October 1930 based on anticipated increases in the borrowers’ earnings, noting defendants “did not expect” a continuing decline, “but on the contrary definitely expected the tide to turn”); cf. Wallace v. Lincoln Sav. Bank, 15 S.W. 448, 451 (Tenn. 1891) (overturning a judgment against directors for their erroneous decision to delay the sale of foreclosed properties in the false hope of a better market).

109. See FDIC v. Robertson, No. 87-2623-S, 1989 U.S. Dist. LEXIS 9292, at *13-*14, *16, *20 (D. Kan. July 24, 1989); cf. Alliance Fed. Sav. & Loan Ass’n v. FHLBB, 782 F.2d 490, 494-96 (5th Cir.) (affirming agency decision to put institution into conservatorship where “the real and personal property securing [certain] . . . loans had been determined to be largely of no value”), modified on other grounds, 790 F.2d 34 (5th Cir. 1986) (per curiam).

Courts do not consider all unsecured loans negligent. Both judges and bank regulators have provided scant guidance on this issue. For example, in Scott’s Ex’rs v. Young, the Kentucky Supreme Court held that directors who made a $2,700 unsecured loan to a bank cashier earning $160 per month were not negligent, noting: “[M]oral character, business integrity, and thrift play no small part among business men in determining the soundness and prudence of a transaction.” 21 S.W.2d 994, 998 (Ky. 1929) (citing Wallace v. Lincoln Sav. Bank, 15 S.W. 448 (Tenn. 1891)). Similarly, in Atherton v. Anderson, the court stated in dictum that “[m]uch depends upon the financial worth and moral character of the borrower. He might unquestionably be solvent and if so there is no absolute duty to take
real estate loans require banks and thrifts, in assessing collateral adequacy, to "monitor conditions in the real estate market . . . to ensure that [their] real estate lending policies continue to be appropriate for current market conditions."110 Thus, bank directors today must heed current market conditions in evaluating collateral sufficiency; they cannot approve inadequately secured loans on the gambit that collateral values will improve.

Where directors have discharged that duty, courts have been loath to penalize them for unexpected declines in the economy. Almost invariably, older cases absolved bank directors for approving adequately secured loans whose collateral subsequently declined in value due to deflation.111 This limitation on director liability continues to be true today.112 These holdings flow from the long-held precept that mistaken predictions about collateral because there is no necessity for it . . . ." 99 F.2d 883, 895 (6th Cir. 1938); see also Starrels, 870 F.2d at 1171-72; First Nat'l Bank v. Keller, 318 F. Supp. 339, 348 (N.D. Ill. 1970) (holding unsecured loans not negligent where one was "a joint obligation" of three individuals and the other was "guaranteed by another of the individuals"); Noble, 1991 Conn. Super. Ct. LEXIS 1231, at *2, *7, *40-*41. Current federal regulations require collateral solely for real estate loans. See infra note 125 and accompanying text.

110. 12 C.F.R. §§ 34.62(c), 208.52(c), 365.2(c), 563.101(c) (1995).

111. See Wheeler v. Aiken County Loan & Sav. Bank, 75 F. 781, 784 (C.C.D.S.C. 1896) (ruling that loans that appeared sound when made, but that went into default due to the "extreme financial stringency and panic of the summer and fall of 1893" and a "fall in the price of cotton," were not negligent); Milburn v. Martin, 76 S.W.2d 952, 954-55 (Ark. 1934) (reversing verdict against the bank directors for bank failure where the bank would have remained open "but for the total collapse of all values, which was not peculiar to that locality"); Ford v. Taylor, 4 S.W.2d 938, 940 (Ark. 1928) (reversing judgment against directors where most of the loans challenged were "made in more prosperous times and to persons who were regarded as good when these loans were made" but who were unable to pay following a "crushing depreciation in values"); Muller v. Planters' Bank & Trust Co., 275 S.W. 750, 751 (Ark. 1925) (finding no liability because "while most of [the] securities were of little value at the time of the liquidation, they were good at the time the loans were made, and . . . the losses occurred by reason of general depreciation in property values"); Gallin v. National City Bank, 273 N.Y.S. 87, 102 (N.Y. Sup. Ct. 1934) (rejecting "plaintiffs' contention . . . that the directors, in the exercise of ordinary care, should have foreseen the fact that the market was likely to crash" on October 28, 1929); Spering's Appeal, 71 Pa. 11, 20, 24 (Pa. 1872) (affirming dismissal of complaint against directors for loans that went into default due to market crash immediately preceding the Civil War); cf. Williams v. Fidelity Loan & Sav. Co., 128 S.E. 615, 622 (Va. 1925) (ruling in favor of finance company directors who expanded into automobile consumer financing only months before the 1920 depression).

112. See FDIC v. Stanley, 770 F. Supp. 1281, 1300-01 (N.D. Ind. 1991) (finding directors not liable for uncollectible loans because the drought, livestock disease, business downturns, and marital problems that caused the borrowers to default were unforeseeable), aff'd sub nom. FDIC v. Bierman, 2 F.3d 1424 (7th Cir. 1993).
future events, such as business and economic trends, will receive blanket protection under the business judgment rule.\textsuperscript{113}

In sum, at common law, where the collateral originally was equal in value to the loan, bank directors could safely assume that current economic conditions would hold and did not have to consider possible economic downturns. The only banking decision to the contrary was \textit{Hun} v. \textit{Cary},\textsuperscript{114} in which the New York Court of Appeals condemned a decision to buy a lot at fair market value because the possibility of falling land values made the investment unduly speculative. The court noted:

It matters not that the trustees purchased this lot for no more than a fair value, and that the loss was occasioned by the subsequent general decline in the value of real estate. \textit{They had no right to expose their bank to the hazard of such a decline}. If the purchase was an improper one when made, it matters not that the loss came from the unavoidable fall in the value of the real estate purchased.\textsuperscript{115}

Significantly, \textit{Hun}'s idea that directors should answer in damages for adequately secured loans or investments that expose a bank "to the hazard of a decline" has never gained currency, either in the courts, Congress, or among bank regulators, and no federal law imposes such a requirement today.\textsuperscript{116} By no means, however, is such a requirement inconceivable. Economic booms and busts are a well-documented fact, and bankers are well-advised to anticipate them in long-range planning. So

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\textit{Hun} is factually distinguishable from most other cases on this subject because the directors knew the bank was headed into insolvency and nevertheless gave construction the go-ahead. \textit{Compare} 82 N.Y. at 75-77 with cases cited \textit{supra} in notes 111-12. \textit{See also} Dooley, \textit{supra} note 2, at 480 n.60; Dyson, \textit{supra} note 1, at 370. Thus, the trustees' decision in \textit{Hun} was unreasonable based on current financial data, even without taking a potential economic decline into account. The fact that \textit{Hun} involved a mutual savings bank also helps explain its outcome. \textit{See} McCoy, \textit{supra} note 5, at 39-43.

116. If, however, collateral values drop sufficiently to endanger safety and soundness, regulators can attempt to redress the problem through a cease-and-desist order. \textit{See} Bank of Dixie v. FDIC, 766 F.2d 175, 176 (5th Cir. 1985) (stating that "although these loans were adequately secured when made, the value of the collateral securing these loans, contrary to the expectations of management, had declined so that the loans were no longer adequately protected"); \textit{cf.} [Anonymous] v. FDIC, 619 F. Supp. 866, 867 n.2 (D.D.C. 1985) (noting that, in agency suspension and prohibition proceedings, FDIC had alleged that bank loans "were inadequately protected by the current sound worth of the borrower or the collateral pledged").
\end{flushright}
why, as a matter of law, excuse directors from anticipating such cycles? In part it is because the length and depth of booms and troughs are difficult to predict.\textsuperscript{117} Furthermore, the specter of liability for possibly erroneous predictions could paralyze bank boards. For these reasons, federal regulators instead have sought to address concerns about fluctuating business cycles by increasing assurances of repayment at the outset, both through higher loan-to-value ratios and personal guarantees.\textsuperscript{118}

Conversely, the rule that borrowers post collateral equal to the face amount of the loan at the time of approval experienced surprising longevity in contrast with other judicially-crafted bank regulatory rules. Unlike most common law efforts at bank regulation, this rule was widely adopted by state courts, cut across all regions of the country, and displayed unparalleled staying power.

Why? In part, it is because judicial collateral rules, unlike profit potential analyses, activity bans, or loan diversification standards, derive directly from traditional bank underwriting norms.\textsuperscript{119} Thus, courts did nothing more than enforce industry standards when they articulated collateral rules. This same dynamic also helped suppress the usual competitive pressures to loosen the rules, because significant segments of bankers had reason to urge regulators to enforce collateral rules against bankers who threatened to deviate. Finally, the collateral rules were easy to administer, at least until recently, because most courts gave directors the benefit of the doubt absent proof of inadequate collateral.\textsuperscript{120} Thus,
although the collateral rules might appear to require courts to engage in economic analysis, courts used evidentiary rules to avoid wading into that sticky area.

Despite the longevity of judicial collateral rules, ultimately, they too were trumped by federal code-based standards in the form of loan-to-value ratios. Such ratios seek to mitigate the effects of future downward business trends by raising the amount of required collateral as a buffer against possible later declines in collateral value. The judiciary's inability or unwillingness to tackle the very real problem of downswings in business cycles, and thus collateral values, ultimately doomed this most enduring of substantive judicial rules.

**Loan-to-value ratios** — Loan-to-value ratios are a variation on the principle of collateral parity, one that requires the collateral to exceed loan value by a stated percentage. Calculated by dividing the loan amount by the value of the collateral, the purpose of loan-to-value ratios is twofold. First, they help ensure that borrowers have sufficient equity in a project so they have strong incentives not to walk away from a loan. Second, they protect against economic downturns by ensuring that collateral values will remain sufficient for repayment even if the collateral declines in value.

National banks have long been subject to loan-to-value ratios under the National Banking Act. State legislatures, however, were slow to adopt such measures for state-chartered banks. Until recently, no reported case held that excessive loan-to-value ratios formed a basis for suit, and even recent cases have been divided. In contrast, the 1992 real estate guidelines address this issue in detail for state and federal financial institutions alike. Those guidelines embrace stiff ratios ranging

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123. *See* WHITE, *supra* note 70, at 24. Before 1914, Minnesota was the only state that had adopted loan-to-value limits. *Id.* at 23-24.

124. *Compare* Rahn, 854 F. Supp. at 491 (ruling that "the business judgment rule ... does not protect" loan-to-value calculations based on allegedly inflated data) *with* Stahl, 854 F. Supp. at 1591 (directing verdict, on business judgment rule grounds, for director defendants who approved commercial loans without proof of sufficient borrower equity); *cf.* Alliance Fed. Sav. & Loan Ass'n v. FHLLBB, 782 F.2d 490, 494 (5th Cir.) (affirming agency order putting association into conservatorship due in part to major construction loans with 100% loan-to-value ratios; "[t]hese loans had little or no cash equity and Alliance thus assumed the total risk"), *modified on other grounds*, 790 F.2d 34 (5th Cir. 1986) (per curiam).
from sixty-five percent for loans on undeveloped land to eighty-five percent for loans on improved property.\footnote{125}

As with loan-to-one-borrower limits, courts proved noticeably queasy about setting quantitative standards for loan-to-value ratios. In one sense, the judiciary’s hesitancy in this regard is curious, since the many cases requiring parity in collateral amount to holdings that the ratio of a loan to its collateral cannot exceed one hundred percent. This hesitancy, though, is best understood as a reflection of the judiciary’s traditional refusal to engage in the regulation of future business cycles. A one-hundred-percent ratio simply seeks to assure repayment based on currently ascertainable business conditions; a ratio of anything less seeks to assure repayment in the event of a future economic decline. In the latter situation, courts apparently do not consider themselves competent to determine how low those ratios have to be in order to afford reasonable protection. Accordingly, both out of concern for judicial competence and to achieve nationwide effect, the formulation of loan-to-value ratios has fallen, by default, to Congress and federal bank regulators.

**Bans on junior liens** — As a supplement to collateral parity rules, courts also tried to enhance repayment assurances by regulating junior liens, largely through the familiar device of bans. Nineteenth-century courts reviewing negligence complaints were divided over the prudence of securing loans with already-encumbered property. In 1881, in *Citizens Building, Loan & Savings Association v. Coriell*,\footnote{126} for example, the New Jersey Court of Chancery declined to hold directors liable for loans secured solely by junior mortgages (in one instance, an eighth and a ninth), reasoning that the association’s constitution and by-laws did not require first liens.\footnote{127}

Only eight years later, however, in *Williams v. McKay*,\footnote{128} the same court rejected junior mortgages as negligent, stating: “[A]n important element in the consideration that leads to the condemnation of an investment may be that its security was impaired by large prior incumbrances.”\footnote{129} The *Williams* court held that second and third mortgages were negligent because there was insufficient value left after the

\footnotesize{\begin{itemize}
  \item \footnote{125} 12 C.F.R. pt. 34, subpt. D, app. A (1995); id. pt. 208, app. C; id. pt. 365, app. A; id. pt. 563, subpt. D, app. A. The guidelines permit financial institutions to exceed the loan-to-value limits “based on the support provided by other credit factors,” as long as the aggregate value of such loans does not exceed 100% of total capital. \textit{Id.}
  \item \footnote{126} 34 N.J. Eq. 383 (N.J. Ch. 1881).
  \item \footnote{127} \textit{Id.} at 384-88, 390-93.
  \item \footnote{128} 18 A. 824 (N.J. Ch. 1889).
  \item \footnote{129} \textit{Id.} at 830.
\end{itemize}}
first lien to satisfy the junior mortgages.\textsuperscript{130} As the court pointed out, to preserve the collateral in the event of default, the bank would have to buy out the senior liens at a higher price than the original loan and possibly in excess of the property’s value.\textsuperscript{131}

Recent decisions have followed Williams and condemned bank loans that are secured by junior liens.\textsuperscript{132} In contrast, the 1992 federal real estate guidelines take a more flexible approach by requiring loan officers to subtract the value of senior liens before calculating loan-to-value ratios, rather than prohibiting junior liens outright.\textsuperscript{133}

The treatment of junior liens is one more area where judicial propensity for bright-line rules resulted in outcomes that were needlessly harsh. There is nothing wrong with a junior lien \textit{per se} if sufficient value is left after subtracting the senior lien. Evidently uncomfortable with such economic analyses, however, courts banned junior liens outright, placing undue constraints on credit availability in the process. Apparently, administrative agencies, by virtue of their financial expertise, consider themselves better equipped than courts to fine-tune legal rules so that economically rational junior liens are permitted, while economically irrational junior liens are filtered out.

\textbf{Bans on specific forms of security} — The same propensity toward bans that afflicted judicial regulation of junior liens also afflicts the new set of court decisions on appropriate forms of bank collateral. Early state courts rarely troubled themselves with the form that security took.\textsuperscript{134} In

\begin{itemize}
\item \textsuperscript{130} Id. at 830-34.
\item \textsuperscript{131} Id. at 830-31; accord Michelsen v. Penney, 135 F.2d 409, 421-22 (2d Cir. 1943).
\item \textsuperscript{132} FDIC v. Stanley, 770 F. Supp. 1281, 1292-93, 1296-98, 1313-14 (N.D. Ind. 1991), aff’d sub nom. FDIC v. Bierman, 2 F.3d 1424 (7th Cir. 1993); FDIC v. Robertson, No. 87-2623-S, 1989 U.S. Dist. LEXIS 9292, at *4, *14, *17 (D. Kan. July 24, 1989), \textit{modified on other grounds}, 1989 U.S. Dist. LEXIS 13017 (D. Kan. Oct. 23, 1989); cf. Alliance Fed. Sav. & Loan Ass’n v. FHLBB, 782 F.2d 490, 495 (5th Cir.) (affirming agency decision to put institution into conservatorship where lender had a second mortgage on one loan and a fifth lien on another), \textit{modified on other grounds}, 790 F.2d 34 (5th Cir. 1986) (per curiam); Bank of Dixie v. FDIC, 766 F.2d 175, 176 n.1, 177-78 (5th Cir. 1985) (affirming FDIC holding that “loans... which were secured by collateral subject to substantial senior liens” were unsafe and unsound).
\item \textsuperscript{134} In \textit{Citizens Bldg., Loan & Sav. Ass’n v. Coriell}, a rare contrary example, the court considered excusing bank directors for approving shareholder loans, in violation of the association’s constitution, that were secured solely by securities and not by real estate. 34 N.J. Eq. 383, 394-96 (N.J. Ch. 1881). Despite the charter violation and obvious conflict-of-interest overtones, the court was inclined against liability because the loans were permitted under the original by-laws (which also violated the constitution) and because a majority of the other shareholders supposedly had acquiesced in the practice. Id. Ultimately, however, it imposed liability because the by-laws had been amended to prohibit the loan. Id. at 396-98.
\end{itemize}
the past five years, however, an increasing number of courts have condemned discrete types of loan collateral as unduly risky. Recent courts have imposed liability for collateral consisting of stock in a closed corporation, inventory and accounts receivable in a start-up corporation, and heavy manufacturing equipment such as bulldozers that "depreciate rapidly and . . . are subject to vandalism and theft." The 1992 real estate lending regulations approach this topic considerably more flexibly and permit real estate loans to be secured by insured deposits, financial instruments and bullion, as well as any other collateral with a quantifiable value in which the lender has perfected a security interest.

As in the area of junior liens, the case law in this area has been plagued by overkill. It is easy to envision situations, for example, in which stock in an established, successful closed corporation would be more than sufficient collateral for a bank loan. Nevertheless, the judiciary's propensity has been to prohibit whole classes of collateral categorically, making certain valuable collateral off-limits and artificially hampering credit availability in the process. Courts that have tread in this area have exhibited a near phobia about incorporating economic analysis into the common law rules. As a result, in the credit crunch of the late 1980s and early 1990s, it fell to expert regulatory agencies to fashion rules that mandate individualized economic analyses in lieu of the judiciary's categorical bans.

**Bans on pre-funded interest** — In the 1980s, real estate development loans commonly were structured so that the early years of interest would be prepaid out of the loan proceeds pending the completion of construction. Such clauses were used to finance undercapitalized developers whose principal source of repayment was future revenues from the project itself. This practice was not new and courts had tolerated it for de-

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In 1984, in *FSLIC v. Williams*, however, a court imposed negligence liability for the first time in a case involving pre-funded interest. Bank regulators now frown on such clauses and the 1992 federal real estate loan guidelines advise banks to formulate internal standards "for the acceptability of and limits on the use of interest reserves." Despite recent attention to the danger of pre-funded interest clauses, federal regulators and most courts, apart from *Williams*, have not seen fit to prohibit them, apparently having concluded that such clauses have sufficient potential usefulness when combined with other payment guarantees. Federal regulators even have avoided specifying substantive standards for the use of such clauses, instead requiring financial institutions to set those standards themselves under the eye of bank examiners. This approach has the benefit of enlisting industry support and expertise. Its drawback, however, lies in possibly lax standards and murky liability if institutions set their standards too low. Thus, while federal regulators have occupied the field, the lack of any substantive code-based rule means that common law negligence standards could continue to play a role. What those standards would be, however, remains unclear.

140. For example, see Litwin v. Allen, 25 N.Y.S.2d 667 (N.Y. Sup. Ct. 1940), which declined to find liability on the following facts:

Recognizing the fact that loan interest was to be provided for the first year out of the proceeds of the loan so as to make it easier for the borrowers, by giving time for the development of income on the real estate, they still felt that the borrowers would be able to pay interest thereafter. This belief was justified in their eyes by the appraisers' earnings estimates on the real property, among other things.


142. *Id.* at 1191; *FSLIC v. Williams*, 622 F. Supp. 132, 133 (D. Md. 1985). In *Williams*, *FSLIC* had charged the defendants, among other things, with "deducting interest and fees from undisbursed loan funds rather than requiring the borrowers to pay those charges," and "taking charges into income when they had not been paid by the borrower." 599 F. Supp. at 1191. See also *FDIC v. Schreiner*, 892 F. Supp. 869, 876 (W.D. Tex. 1995) (holding that extending "additional funds to pay the interest on past due credit" was potentially negligent).


and could be anything from the ban suggested in *Williams* to deference under the business judgment rule.

3. Creditworthiness Determinations

The recent trend of the cases discussed so far has been to require that loans incorporate substantive safeguards. Where those safeguards are adopted, courts give bank directors considerable latitude in determining a loan applicant's creditworthiness. For instance, in two recent cases, courts denied recovery where banks approved loans despite weak financial statements because other factors about the borrowers increased the prospects for repayment.\(^{145}\) Thus, the business judgment rule still is followed today in the inherently subjective domain of credit determinations. If a director can support a subjective creditworthiness determination with objective evidence of favorable financial indicators, courts appear reluctant to second-guess the loan decision. This state of the law can be expected to continue as long as loan regulations remain flexible with respect to risk assessment.

4. Loan Administration

The final example of substantive judicial regulation of day-to-day bank board decisions concerns the area of loan administration. The judiciary has intervened in two areas in this regard, the administration of collateral and bank treatment of delinquent loans.

\(^{145}\) In a split verdict in *FDIC v. Stanley*, the court noted that a weak financial statement alone is not grounds for negligence if other factors about the borrower give assurances of repayment. 770 F. Supp. 1281, 1288-89, 1295-96, 1313-14 (N.D. Ind. 1991), aff'd *sub nom.* *FDIC v. Bierman*, 2 F.3d 1424 (7th Cir. 1993). Thus, the *Stanley* court ruled for the defendants on certain farm and small business loans where, despite high debt loads and losses, the applicants had significant equity in land or showed improving trends in revenues and debt reduction. *Id.* at 1294-95, 1299-1300, 1304.

Likewise, in *Washington Bancorporation v. Said*, the court rejected FDIC claims that the directors of the National Bank of Washington acted negligently in approving a $10 million credit line to a prominent law firm that disbanded a year later. 812 F. Supp. 1256 (D.D.C. 1993). The FDIC's negligence charge proceeded solely from the fact that the directors had not obtained the law firm's first quarter financial statements before extending credit. *Id.* at 1269. Labeling that omission irrelevant, the court observed the directors had relied on the law firm's "more-than-adequate prior year financial statements" as well as an averment by one of the law firm's managing partners that no material change in the firm's financial status had occurred. *Id.* The court further noted that: (1) the firm had repaid its prior credit line in full; (2) the prior year financial statements showed sufficient assets and revenues to repay the loan; (3) the bank had recourse against the firm's partners and their personal assets were sufficient to insure repayment; and (4) there were no red flags that the firm was in danger. *Id.* at 1263-64, 1269-70.
a. Collateral Administration

Over the years, a handful of courts have addressed the need to perfect and retain security interests. Somewhat surprisingly, given the judiciary’s emphasis on sufficient collateral, most older rulings erred on the side of laxity. Most of those courts gave directors latitude in whether to perfect security interests and release those interests before repayment.146 The one early contrary decision, Williams v. McKay,147 penalized the premature release of security before repayment.148 Today, the 1992 federal real estate regulations require bank lenders to perfect security interests and courts treat the failure to do so as negligence.149

The older cases illustrate the difficulty of achieving consistent judicial enforcement even of well-imbedded common law standards of care. The small number of cases in this vein, in comparison with the large number of cases imposing liability for insufficient collateral,150 seems to suggest that most courts frowned on board decisions to squander security. Nevertheless, before the 1980s, the few decisions that specifically addressed this issue largely went the other way and courts in other jurisdictions were powerless to prevent those rogue rulings. Thus, federal agencies were compelled to intervene after inconsistent judicial enforcement threatened to gut otherwise sensible common law rules.

146. An early case to this effect was Wheeler v. Aiken County Loan & Sav. Bank, 75 F. 781 (C.C.D.S.C. 1896), in which a shareholder sued the bank’s directors for delinquent loans to an important local merchant. Id. at 783. The directors were charged, among other things, with refusing to record a mortgage on the merchant’s property because they believed “it would injure [the merchant’s] credit.” Id. at 784. In the eyes of the court, that was a matter for the board’s business judgment; “the failure to record the real estate mortgage did not entail a loss of more than $500 or $600, and was induced by the honest belief that the credit of the debtor, and therefore his ability to pay the whole debt, would be promoted . . . .” Id. at 787; see also Castetter v. Barnard, 183 N.E. 681, 686 (Ind. App. 1932) (noting that a cashier had the right to renew a secured note without requiring continued security); Spering’s Appeal, 71 Pa. 11, 20 (Pa. 1872) (affirming dismissal of complaint against directors despite their “vain attempt to sustain their credit . . . [by sacrificing] securities and collaterals”).

147. 18 A. 824 (N.J. Ch. 1889).

148. Id. at 834.


150. Compare supra notes 106-07, 109 with note 146 and accompanying text.
b. Actions on default

The judiciary's oversight of bank responses to loan arrearages is interesting in two respects. First, the judiciary's approach mixes bans on forbearance with broad deference to workout efforts after foreclosure, a channeling device that is designed to force banks to put nonperforming loans into collection. Second, this is one of the few areas of common law banking regulation in which bans comport with industry custom and thus largely work.

(1) Bans on forbearance

Historically, courts have given directors wide berth in handling loans in arrears. That discretion included whether to institute collection efforts at all. More recently, however, courts have instituted bans on loan forbearance, broadly defined as actions designed to postpone collection of a nonperforming loan.

The first such forbearance technique involves the extension or renewal of delinquent loans. Extensions and renewals pose the concern that delays could result in reduced recoveries while masking defaults on the financial institution's books. For this reason, courts in New Jersey and Virginia in 1889 held bank directors liable for renewing loans in arrears instead of demanding immediate repayment. 151 For virtually a century after those decisions, however, other courts continued to invoke the business judgment rule to protect bankers from liability for renewals, so long as the loans appeared collectible when originally made. 152

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151. Williams v. McKay, 18 A. 824, 838 (N.J. Ch. 1889); Marshall v. Farmers' & Mechanics' Sav. Bank, 8 S.E. 586, 587-88, 591-92 (Va. 1889). Some commentators explain Marshall as a case that would have imposed liability on duty of loyalty grounds had the evidence been stronger. See Lawrence M. Friedman, A History of American Law 452 (1973); Phillips, supra note 34, at 204-08 (noting that the renewals were for check overdrafts by the bank's president, the bank's cashier, and one of its directors). Additionally, Marshall involved a savings bank where, unlike commercial banks, depositor interests were paramount. See McCoy, supra note 5, at 39-43.

152. Ford v. Taylor, 4 S.W.2d 938, 940-41 (Ark. 1928) (noting that "the renewals of such loans appear to have resulted from bad judgment only . . . "); Castetter v. Barnard, 183 N.E. 681 (Ind. App. 1932). In reversing the trial court's finding of negligence as to a loan, the Castetter court stated, "[t]he fact that . . . [the cashier] accepted renewals of the note without security or failed to press the same for collection at maturity out of consideration for his father is insufficient to predicate a breach of the bond thereon." Id. at 686; see also Smith v. First Nat'l Bank, 290 S.W. 346, 346-47 (Ky. 1926) (reversing judgment against director for recommending bad loan that was renewed repeatedly).
Today, some courts deem extensions and renewals negligent. Recently, however, in *Washington Bancorporation v. Said*, the court deferred to a forbearance decision where collection would reduce the prospects for recovery. There, a bank officer won summary judgment on the defense that he did not call a loan to a law firm because it would have thrown the firm into bankruptcy. Thus, *Washington Bancorporation* reflects a lingering deference to the officer's choice of workout techniques where justifications for forbearance exist.

In sum, extensions and renewals are generally viewed with disapproval, tempered by a willingness to tolerate forbearance in rare, justifiable circumstances. Interestingly, the 1992 federal real estate regulations and guidelines do not supplant this law, or remedy the past century's hiatus in enforcement, by imposing an independent, substantive standard. Rather, the rules are procedural and simply require federally insured institutions to adopt internal policies on extensions for real estate loans. With regulatory standards lacking, the common law may continue to dominate substantive standards of conduct for bank directors in this area.

In a related vein, courts were hesitant to adjudge additional loans to defaulting borrowers as negligent, particularly loans to tide over prominent businessmen. In *Wheeler v. Aiken County Loan & Savings Bank*, the court relied on the business judgment rule to exonerate directors who had advanced funds to the largest local merchant "for the purpose of postponing impending failure," despite its belief that "this was not good banking." Similarly, in *Litwin v. Allen*, the court refused to fault bank directors for making substantial new advances to a pair of prominent millionaires who could not repay past loans.

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153. See FDIC v. Mijalis, 15 F.3d 1314, 1324-25 (5th Cir. 1994); FDIC v. Schreiner, 892 F. Supp. 869, 875-76 (W.D. Tex. 1995) (holding loan rollovers potentially negligent); FDIC v. Robertson, No. 87-2623-S, 1989 U.S. Dist. LEXIS 9292, at *14-*19 (D. Kan. July 24, 1989); cf. Bank of Dixie v. FDIC, 766 F.2d 175, 176 n.1 (5th Cir. 1985) (affirming FDIC cease-and-desist order against a bank in part due to charges that "loans had been renewed or their due dates had been extended without collection in cash of interest due").


155. *Id.* at 1270 (refusing to hold bank official responsible for a deliberate decision to forestall collection from a prominent customer).

156. *Id.* (noting that the directors consulted with other creditors).


158. 75 F. 781 (C.C.D.S.C. 1896).

159. *Id.* at 784. Professor Tamar Frankel has described this risk "as old as banking itself." See Tamar Frankel, *Corporate Directors' Duty of Care: The American Law Institute's Project on Corporate Governance*, 52 GEO. WASH. L. REV. 705, 713 (1984).


161. *Id.* at 724, 726-28 (explaining that "[s]ecured loans made in good faith for the purpose of tiding the borrower over a time of financial embarrassment are not, for that
Other Depression-era cases, however, condemned advances to delinquent borrowers as negligent.\textsuperscript{162} Today, at least in the case of real estate loans, such advances are contrary to the 1992 federal rules requiring borrowers to be capable of adequately servicing their debts.\textsuperscript{163} Like bans on extensions and renewals, bans on advances to delinquent borrowers are justified in all but the most unusual cases. Such bans comport with industry practice\textsuperscript{164} and employ a technique that is familiar to the courts. Similarly, the bright-line nature of such bans makes them easy for bankers to follow without the need for counsel. Accordingly, courts may continue to play an important role in formulating and administering such bans.

(2) Workout Techniques Following Foreclosure

Once boards institute foreclosure, courts give them wide discretion to dispose of foreclosed property. Assuming there are no statutory violations, courts penalize workout efforts only where the disputed decisions are certain to compound losses. Otherwise, loan workout decisions are one of the last great remnants of the business judgment rule in bank lending.

Courts consistently have declined to impose liability for decisions to liquidate foreclosed assets that result in losses.\textsuperscript{165} Similarly, courts have refused to penalize decisions to hold foreclosed property in hopes that the market would improve, instead of selling it immediately.\textsuperscript{166}
Courts also have deferred to board judgment where the foreclosed collateral consisted of a business that required cash infusions to remain a going concern. At least two reported decisions have refused to condemn bank directors for authorizing further cash outlays to operate a foreclosed business. In *Atherton v. Anderson*, the United States Court of Appeals for the Sixth Circuit stated that where the foreclosed collateral "is a manufacturing establishment whose value depends substantially upon uninterrupted operation, we think implied power exists to continue such operation for a time providing the primary purpose of the bank is to save its debt rather than to speculate in future profits, and there is reasonable prospect of realization." And while eventual plans to sell with a "reasonable prospect of realization" were key, the decision of how long to operate before losses had to be cut was left to the directors' business discretion.

A similar result occurred in *Gallin v. National City Bank*, which approved a board decision to salvage loans to the Cuban sugar industry by operating sugar mills instead of liquidating them. In the judgment of the court, the "final test [was] one of fact, not of law": Was the salvage operation, though incidentally involving acts of management or improvement, in fact carried on in good faith to render the properties valuable to secure liquidation of the debts? Or was it in fact a mere cover to enable the bank to engage in a business for ulterior purpose? The court exonerated the directors for approving the salvage operation because the directors "were convinced that the bank and its stock holders would lose more by walking away from Cuban sugar loans than by attempting to save them."

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for a better market, the bank's officers did what the most prudent and sagacious would have done at the time, and under the same circumstances"). For national banks, the maximum time that foreclosed real estate may be held is prescribed by statute. See 12 U.S.C. § 29 (1994); 12 C.F.R. §§ 34.81-34.87 (1995) (prescribing various methods of determining the holding period).

167. 86 F.2d 518 (6th Cir. 1936), rev'd on other grounds, 302 U.S. 643 (1937) (per curiam).
168. Id. at 525 (citing cases).
169. Id.
171. Id. at 104-07.
172. Id. at 105 (noting that the burden was on the plaintiffs to show that the capital was advanced for ulterior purposes).
173. Id. at 105-06 (finding that "the salvage efforts were important in collecting the $66 million debt] . . . [and] the mere fact that the mills operated enabled merchants to make payments that would otherwise have been impossible"). In contrast, courts have found negligence where bank operation of foreclosed businesses violates a state statute. See *Stone v. Rottman*, 82 S.W. 76, 78-79, 83-85 (Mo. 1904).
Each of these decisions properly awarded deference because the directors faced uncertainty about which course would cut or magnify losses. In contrast, courts have come down harshly on workout techniques that are certain to increase losses, particularly when those decisions entail additional injections of cash. Courts routinely hold bank directors negligent for decisions to buy out a senior mortgage at an increased loss simply to preserve a junior mortgage.\footnote{Michelsen v. Penney, 135 F.2d 409, 421-22 (2d Cir. 1943); Williams v. McKay, 18 A. 824, 830-31 (N.J. Ch. 1889).} Similarly, in \textit{Michelsen v. Penney},\footnote{135 F.2d 409 (2d Cir. 1943).} a bank officer was held liable for attempting to revive a defaulting corporate borrower by subscribing to an additional $200,000 in the company's stocks and bonds.\footnote{Id. at 425-26.} Since the Depression, federally insured banks have been prohibited from such bail-out investments under the Glass-Steagall Act.\footnote{12 U.S.C. §§ 24 (Seventh), 335, 1831a (1994); 12 C.F.R. pts. 333, 362 (1995).}

Subject to these exceptions, loan workouts remain one of the few areas in bank lending where board decisions still receive deference from courts and federal regulators. The law in this area is primarily judge-made with relatively little policing under federal statutes or regulations. That is not because there is assurance that deference works (in the sense of maximizing recovery). Rather, deference is most likely due to the fact that federal bank regulators confront the same uncertainty and judgment calls when disposing of foreclosed property in their capacity as conservators or receivers. Accordingly, the common law, and specifically the business judgment rule, continues to play a pre-eminent role in loan workout efforts.

In sum, the business judgment rule has contracted significantly in the realm of bank lending. Most aspects of bank lending are now subject to substantive judicial review. The most significant exception in the lending area involves creditworthiness determinations, assuming, of course, that the relevant information has been gathered and analyzed. Most workout methods also receive protection under the business judgment rule, as do interest-free check overdrafts to disinterested customers. Additionally, courts have generally abstained from imposing duties of care for certain areas of banking concern other than lending, such as deposit-taking and capital adequacy. Several conclusions can be drawn from the judiciary's century-long experiment with substantive bank board regulation.

First, with two prominent exceptions, the judiciary has veered away from incorporating economic or financial analysis into common law liability tests. The first exception consists of the collateral parity cases, where...
courts for years side-stepped the problem of financial analysis by taking evidence of collateral parity at face value.\textsuperscript{178} The second exception consists of the "minimum rationality" cases such as \textit{Hun v. Cary}\textsuperscript{179} that bar transactions with no potential for profit. But after the controversial liability holding in \textit{Litwin v. Allen},\textsuperscript{180} many questioned the judiciary's competence to distinguish potentially profitable transactions from unprofitable ones. As a result, at least in banking, the minimum rationality cases fell into virtual disuse. Significantly, this experience did not cause courts to conclude that the "minimum rationality" cases chilled bank board decisions. Instead, courts searched for other ways to regulate risky banking practices.

In search of workable methods, a few courts experimented with bans on specific activities or classes of collateral.\textsuperscript{181} The appeal of such bans lies in their bright-line approach. But as the record in banking makes clear, activity bans eventually fly apart in the centrifuge of market forces. The major problem is that when one state adopts a ban based on national bank precedents, sister states almost never copy it because preserving the status quo gives home-chartered banks a competitive advantage over institutions in the stricter state. Bans are doubly unpopular because they outlaw potentially valuable services when lesser regulation might suffice. In addition, bans can create an unlevel playing field by subjecting affected financial institutions to customer raids by non-bank firms in the banned industry.

Consequently, most courts rejected activity bans in favor of other common law regulatory techniques. Those techniques, however, were plagued by the same "race to the bottom" problem as the state court activity bans.\textsuperscript{182} Most failed for a variety of other reasons as well. Some, such as judicial loan-to-one-borrower limitations and loan-to-value rulings, were so vague and uncertain that legislatures overrode them by en-

\textsuperscript{178} See supra notes 105-20 and accompanying text (discussing the collateral parity rule).
\textsuperscript{179} 82 N.Y. 65 (N.Y. 1880).
\textsuperscript{180} 25 N.Y.S.2d 667 (N.Y. Sup. Ct. 1940).
\textsuperscript{181} See supra notes 42-83 and accompanying text.
\textsuperscript{182} The latest example consists of recent bank director liability holdings in Texas and elsewhere to the effect that the business judgment rule is displaced only in circumstances entailing at least gross negligence, defined as a "complete abdication of responsibilities," a "fail[ure] to exercise judgment," \textit{ultra vires} acts, self-dealing, or fraud. RTC v. Acton, 844 F. Supp. 307, 313-16 (N.D. Tex. 1994), aff'd, 49 F.3d 1086 (5th Cir. 1995); accord FDIC v. Harrington, 844 F. Supp. 300, 305-07 (N.D. Tex. 1994); RTC v. Hovnanian, Civ. No. 94-450 (HLS), 1994 U.S. Dist. LEXIS 19359, at *16-24 (D.N.J. Oct. 11, 1994). See also supra note 9; Doré, supra note 1, at 179 n.190 (cataloguing new state statutes applying gross negligence standard to actions brought by the FDIC); Stevens & Nielson, supra note 1, at 194-208 (same).
acting quantitative statutory tests. Other tests that were easy to
administer and follow, particularly the collateral parity rules, lapsed into
irrelevance because they did not account for the effects of possible future
business downturns. Still others succumbed because they were stronger
medicine than the problem required.

Due to these and other enforcement problems, judicial attempts to reg-
ulate substantive bank board decisions have withered on the vine. As it
turned out, the problem with substantive bank regulation by the courts
was as much underenforcement as overenforcement, due to geographic
limits on the reach of common law rules. In an effort to correct this prob-
lem, federal code-based standards with nationwide effect have preempted
almost every banking topic that the common law duty of care sought to
supervise.\textsuperscript{183} This shift to code-based standards similarly alleviated local
concerns with overenforcement by substituting quantitative standards for
vague common law tests and individualized financial analyses for outright
activity bans. At the same time, the new codified standards take a leaf
from the common law experience that common law rules work best when
derived from industry practice. Hence, there is a new emphasis on
“growing” industry standards by requiring banks to formulate and follow
their own underwriting procedures and internal controls. This new em-
phasis is plainly evident both from recent federal regulations and the new
monitoring duty cases.

\section*{III. Procedural Common Law Regulation}

In one sense, judicially-imposed monitoring duties in the banking in-
dustry are nothing new. For over one hundred years, courts have re-
peated \textit{Briggs'} adage that bank directors have a “duty of reasonable
supervision” that “includes something more than officiating as figure-
heads.”\textsuperscript{184} Until recently, this duty mostly meant showing up at meetings,
hiring decent managers, and heeding warning signs.\textsuperscript{185} In the past five

Riegle) (explaining that FIRREA “placed important new restrictions on State powers.
Prior to FIRREA’s enactment, State law alone provided the only limitations on the powers
of State-chartered thrifts. . . . In several States, those limitations were not very substan-
tial”); cf. Lawrence G. Baxter, \textit{Administrative and Judicial Review of Prompt Corrective
increased formality in federal banking regulation).

\textsuperscript{184}. Briggs \textit{v}. Spaulding, 141 U.S. 132, 165 (1891); \textit{accord} RTC \textit{v}. Young, 93 Civ. 6531
(LMM), 1995 U.S. Dist. LEXIS 13383, at *3 (S.D.N.Y. Sept. 14, 1995) (observing that to
“obtain the benefit of the business judgment rule,” directors have a duty to monitor bank
management).

\textsuperscript{185}. \textit{See}, e.g., \textit{Barnett}, supra note 71, at 5-6, 11-13. Two recent, controversial cases
appear to override the traditional duty to heed financial warning signs. In FDIC \textit{v}. Stahl,
years, however, courts repeatedly have held directors liable for disregarding or altogether dispensing with underwriting standards and internal controls. The three principal areas that have undergone scrutiny are underwriting procedures, deliberative processes, and loan administration.

Until recently, most courts placed little importance on underwriting procedures and routinely excused failures to adopt them or to monitor compliance. But in the aftermath of last decade's bank and thrift crisis, the judiciary's hands-off attitude toward procedural safeguards evaporated. Over the past five years, numerous courts have ruled that the failure to establish or comply with underwriting procedures can give rise to liability in bank director negligence cases. Similarly, the 1992 real es-

854 F. Supp. 1565, 1570-71 (S.D. Fla. 1994), and FDIC v. Benson, 867 F. Supp. 512, 520-25 (S.D. Tex. 1994), courts recently relied on the business judgment rule in declining to hold directors negligent for failing to correct loan problems flagged in supervisory agreements or reports of examination. These cases are wrongly decided, most importantly because they perversely encourage directors to resist taking corrective measures when they are notified of violations. See FDIC v. Bierman, 2 F.3d 1424, 1433-34 & n.9, 1436 (7th Cir. 1993) (explaining that "[r]eliance arguments are especially weak when regulators have told directors to take action"); FDIC v. Daniel, No. 1: 92-CV-347, 1995 U.S. Dist. LEXIS 6940, at *10 & n.7 (E.D. Tex. Apr. 11, 1995) (holding that repeated failures to comply with bank examiner recommendations could constitute gross negligence); RTC v. Norris, 830 F. Supp. 351, 360 (S.D. Tex. 1993) (refusing to dismiss negligence claim because plaintiff had "alleged the type of 'prolonged failure to exercise oversight or supervision' that falls outside the business judgment rule as a failure to exercise any judgment"). Additionally, Benson involved serious self-dealing charges that would not merit business judgment rule protection in any case. 867 F. Supp. at 522-23 (discussing illegal insider loans, in violation of 12 U.S.C. § 1972 and 12 C.F.R. § 215, and check overdraft violations by insiders, in violation of 12 U.S.C. § 375b); see also supra note 16 and accompanying text (discussing the duty of loyalty).

In Gamble v. Brown, for example, the directors prevailed even though the court deemed it "no doubt irregular to discount the note [at issue] without securing the approval of the discount committee or of the board." 29 F.2d 366, 380 (4th Cir. 1928), cert. denied, 279 U.S. 839 (1929). More recently, in First National Bank v. Keller, a bank director was absolved for approving worthless loans "without the required prior approval of the Loan and Discount Committee and without the knowledge of any other Bank director or officer." 318 F. Supp. 339, 347 (N.D. Ill. 1970). Banking cases lagged behind general corporate law in this respect.

The only significant exception to this pattern in banking was Gilson v. Cambridge Savings Bank, where the court declined to enforce a loan contract because only one member of the board of investment had certified the value of the collateral, not two. 62 N.E. 728, 728-29 (Mass. 1902); cf. Gause v. Commonwealth Trust Co., 89 N.E. 476, 478-79, 480-84 (N.Y. 1909) (holding a contract invalid where board failed to approve it, in violation of state statute and by-laws). Gilson, however, turned on violations of state statute. 62 N.E. at 728.

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187. See Bierman, 2 F.3d at 1436-37 (holding that "[d]irectors are also charged with knowledge of the loan policies in effect during their watch"); FDIC v. Wheat, 970 F.2d 124, 129 & n.11 (5th Cir. 1992) (affirming negligence judgment against bank director who approved a loan in violation of loan procedures that he himself had drafted); Eureka Fed. Sav. & Loan Ass'n v. American Casualty Co., 873 F.2d 229, 234 (9th Cir. 1989) (noting that
tate loan regulations require banks and thrifts to establish detailed lending and compliance procedures for all real estate loans. ¹⁸⁸

A second and related line of cases scrutinizes the deliberative process in loan decisions. In older cases, if there was "nothing in the record to show whether . . . loans were collectible apart from the collateral," courts generally treated these loans as valid unless other information in the loan application raised doubts about collectibility. ¹⁸⁹ In contrast, recent courts have faulted bank directors for failing to obtain, verify, or sufficiently analyze financial and other information about borrowers before approving loans.¹⁹⁰ The 1992 real estate loan guidelines track these cases and re-


¹⁸⁹ Gause, 89 N.E. at 480; see Keller, 318 F. Supp. at 348 (relieving bank director of liability for negligence even though "[t]here was little evidence offered as to the soundness of the loans to these borrowers").

¹⁹⁰ For instance, in FDIC v. Robertson, a bank director was assessed with a multimillion dollar judgment for "fail[ing] to obtain current, accurate financial information" about borrowers and failing to verify or analyze financial information that was provided before approving and renewing loans. 1989 U.S. Dist. LEXIS 9292, at *4, *7-*8, *14-*18; see RTC v. Eason, 17 F.3d 1126, 1133 (8th Cir. 1994) (affirming jury verdict for defendant directors based partly on sufficient review of loan documentation); FDIC v. Schreiner, 892 F. Supp. 869, 875-77 (W.D. Tex. 1995) (denying director defendants summary judgment on business judgment rule grounds where FDIC presented evidence of shoddy loan application analysis); Gladstone, 1995 U.S. Dist. LEXIS 11619, at *5, *9, *36-*37 (holding failure to analyze repayment prospects adequately not protected by business judgment rule); RTC v. Gravee, No. 94 C 4589, 1995 WL 75373, at *1, *5 (N.D. Ill. Feb. 22, 1995) (denying motion to dismiss gross negligence claim for failing to verify loan information); RTC v. Rahn, 854 F. Supp. 480, 491 (W.D. Mich. 1994) (denying summary judgment for defendants where evidence showed they approved residential construction loan without obtaining
quire banks to analyze "all relevant credit factors," including cash flow, creditworthiness, collateral value, the amount of borrower's equity, other sources of repayment, and additional guarantees.191

The final line of cases goes beyond the approval process and examines loan administration post-approval. Earlier cases did not concern themselves with administration of loans.192 More recently, however, in FDIC v. Robertson,193 a director was held liable for failing to establish a loan repayment plan.194 Modern directors have been faulted as well for approving loan disbursements "without completing adequate inspection reports to show that the disbursements were warranted."195 The 1992 real estate loan rules expand these holdings and require federally insured in-

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192. In Pocomoke City National Bank v. Crockett, for example, the Maryland Court of Appeals ruled for the directors despite what it termed "glaring" irregularities in crediting the proceeds of a disputed note to someone other than the payee. 125 A. 712, 714-16 (Md. 1924); see Wheeler v. Aiken County Loan & Sav. Bank, 75 F. 781, 787, 789 (C.C.D.S.C. 1896) (excusing procedural irregularities in failing to record a mortgage on real estate of a borrower who later defaulted).
194. Id. at *14-*19; see Schreiner, 892 F. Supp. at 875-77 (holding that failure to establish loan repayment program was potentially negligent); cf. First State Bank, 770 F.2d at 82 (affirming FDIC cease-and-desist order based in part on charges that the bank "fail[ed] to establish and enforce programs for the repayment of loans . . ."); Bank of Dixie v. FDIC, 766 F.2d 175, 176 & n.1, 177 (5th Cir. 1985) (same).
stitutions to establish detailed internal procedures for the administration of real estate loans.\textsuperscript{196}

This new emphasis on procedural safeguards and deliberative processes in bank director liability law mirrors a similar shift in corporate law at large.\textsuperscript{197} Yet in some respects, it is surprising that the courts did not embrace mandatory bank procedural safeguards sooner, given their early forays into substantive bank regulation. If courts were concerned about undue intrusion into bank board decisions, and if monitoring duties are less intrusive than substantive rules, why then did earlier courts reject monitoring duties while adopting substantive rules?

The answer lies in the judiciary's evolving perceptions of the role played by bank directors. In the early nineteenth century, bank directors commonly made the final decision on loan applications. That function began to be delegated to bank officers in the mid-1800s.\textsuperscript{198} Today, bank boards almost never review loan applications, given the volume and time-sensitivity of most bank loans.

Judicial perceptions of how the loan process worked lagged far behind, however, and did not catch up for decades. In the meantime, when courts imposed direct substantive duties on directors, they did so in the belief that directors were the ones who made final decisions on loans. Later, when courts began to incorporate into the law the realization that most bank directors had nothing to do with approving individual loans, it became apparent that the only fair way to hold directors liable for violation of the judiciary's substantive standards was to hold them legally responsible for incorporating those rules into internal underwriting standards and monitoring compliance.\textsuperscript{199} In this regard, it is significant that when procedural holdings expanded in the 1980s, substantive judicial regulation

dated appraisals); Norris, 830 F. Supp. at 355, 360-61 (refusing to dismiss gross negligence claims based in part on directors' alleged failure to monitor loan disbursements properly).


\textsuperscript{197} See generally Victor Brudney, The Independent Director — Heavenly City or Potemkin Village?, 95 Harv. L. Rev. 597, 632 (1982) (discussing the board's duty to monitor management so as to protect shareholders); Cohn, supra note 2, at 609 (discussing scholarly literature debunking myth that outside directors are hands-on managers); Eisenberg, supra note 13, at 329, 332-36 (explaining action that is reasonably necessary to satisfy monitoring requirements); Melvin A. Eisenberg, Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants, 63 Cal. L. Rev. 375, 378-80 (1975) (discussing practical constraints on boards' ability to manage); Frankel, supra note 159, at 710-12 (arguing that courts adjust directors' duty of care to take their time constraints into account).

\textsuperscript{198} See I Fritz Redlich, The Molding of American Banking: Men and Ideas 17-20, 55-64 (Johnson Reprint Corp. 1968) (1951); II Redlich, supra, at 12.

\textsuperscript{199} See Garten, supra note 6, at 93.
also continued to expand. Thus, far from supplanting substantive judicial regulation of bank lending, the new procedural cases supplement it.

In other respects, the procedure cases reveal a new philosophy, one that gives banks latitude to adopt and interpret their own substantive underwriting standards in lieu of imposing those standards from above. This philosophy applies most noticeably to bank decisions that fall in the interstices of the substantive rules and is best exemplified by the 1992 real estate lending rules. In several key respects, the 1992 rules eschew substantive rules in favor of standards requiring banks to adopt their own procedures addressing a detailed list of mandatory factors. In this sense, the emphasis on procedural safeguards represents a distinct innovation in regulatory techniques, away from externally imposed rules toward ones that are internally generated.

This latter development is a reaction to the fact that judicially mandated rules do not work well unless they are modeled on traditional bank industry practices and have some internal support from the banking industry itself. By pressing banks to adopt detailed internal procedures, the hope is that the banking industry as a whole will tighten its standards, thereby generating internal industry pressure for enforcement.

There are possible advantages to this philosophy. First, it helps avoid the danger that outside regulators will impose overly onerous rules that disregard business realities. Second, it capitalizes on the power of at least partial industry consensus in achieving enforcement. Finally, assuming industry standards improve, those standards will establish new substantive standards for tort liability.

At the same time, this philosophy poses decided risks. Lax underwriting procedures were a serious problem in the recent past. Thus, absent external pressure, there is little reason to expect banks to adopt effective procedures and internal controls in the future. Such pressure can come from several sources, most notably from bank examiners, outside auditors, bank counsel and D&O insurers. But all of these monitors have their limitations, the most important being that they generally review bank decisions after the fact and after any harm already has accrued. In

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200. The 1980s and 1990s ushered in a slew of new holdings condemning loans outside a bank’s customary lending area, unduly risky collateral, pre-funded interest clauses, non-recourse loans, and extensions in lieu of default. See supra notes 102, 135-37, 141-44, 153 and accompanying text.

201. For example, in lieu of imposing substantive standards, the guidelines require insured financial institutions to identify geographic areas in which they will lend and to formulate internal limits on the use of nonrecourse loans, interest reserves, and loan forbearance. See supra notes 103, 143-44, 157 and accompanying text. The rules even give banks latitude under certain circumstances to depart from loan-to-value ratios. See supra note 125.
addition, each of those monitors is subject to external pressure, either from the regulated banks, competitors, or other forces. Thus, because effective external oversight is not assured, regulatory requirements that substitute process for substantive standards may prove to be no standards at all.

IV. Conclusion

When the judiciary’s regulation of bank decisions through negligence law is analyzed, the results refute a number of commonly-held assumptions about the business judgment rule. In the banking industry, the “minimum rationality” decisions were merely a prelude to substantive judicial oversight of potentially profitable decisions. Similarly, monitoring duties followed substantive regulation instead of supplanting or preceding it. Contrary to expectations, the banking industry also is replete with instances of judicial supervision of day-to-day decisions.

Above all, the banking experience affords valuable insights into the central rationale for the business judgment rule, i.e., the avoidance of risk aversion. The business judgment rule proceeds on the assumption that corporate directors will be overly risk-averse if they face negligence liability for decisions that are honest but mistaken. Put differently, the rule assumes that directors will consciously reduce the amount of risk they are willing to accept where state courts have assessed directors with liability for risky decisions in the past.

The opposite, however, proved true in banking. By the 1980s, court decisions imposing liability for breach of the duty of care, and thus in derogation of the business judgment rule, had been on the books for years. Nonetheless, the existence of those cases did not deter disastrous banking practices in the 1980s. To the contrary, scores of bank directors acted as if those cases did not exist.

This suggests that in a state-law duty-of-care regime, director liability holdings may not inject risk aversion into boardroom behavior over the long term. Furthermore, many of the reasons that explain this phenomenon in banking apply to other industries at large. Most industries are subject to the same competitive pressures that militate against widespread adoption of isolated state-law liability holdings and that ultimately cause those holdings to fall into disuse. Similarly, the regulatory techniques at the judiciary’s disposal are prone to the same inadequacies no matter what industry is involved. To this extent, then, the banking industry’s experience is instructive for industries across the board.

At the same time, the banking experience raises the question whether other factors motivating the judiciary’s regulation of substantive banking
decisions are so unique as to be inapplicable to other industries. Commentators have so assumed, without examining the economic fundamentals of the banking industry or the common law's enforcement rationales in any rigorous sense.

Certainly the judiciary's increasing activism in the common law regulation of banks (and the fact that common law regulation almost always triggers statutory regulation when it fails) suggests that banking is "special" in some way. That is the beginning of the inquiry, however, not the end. Before one can conclude that banking is special, the economic incentive structure of the industry must be dissected and the reasons for judiciary's activism in this area discerned. Following that, it is necessary to ask whether any of the factors that prompted the judiciary to embark on common law regulation in banking exist to some extent in other industries. If so, it is worth examining the business judgment rule more closely in those industries to determine if the rule contracted or was supplanted by other regulatory mechanisms. By the same token, other regulated industries should be scrutinized to determine the extent to which regulation displaced the business judgment rule and, if so, why.

The banking industry's banishment to the netherworld of thought about business judgment rule was a serious oversight. The divergent evolutionary path of the business judgment rule in banking yields a cornucopia of unexpected insights regarding the effects of the rule's contraction. Still further insights may emerge when the reasons for that divergent path are examined.