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FIDUCIARY DUTY AND THE PUBLIC INTEREST

CHERYL L. WADE*

INTRODUCTION 1191
I. SUBPRIME LENDERS, SHAREHOLDERS, CONSUMERS, AND COMMUNITIES 1193
II. PREDATORY LENDERS AND THE FINANCIAL INSTITUTIONS THAT DID BUSINESS WITH THEM 1196
III. PUBLIC OPINION, DISCOURSE, AND FIDUCIARY DUTY 1203
CONCLUSION 1207

INTRODUCTION

Professor Tamar Frankel's excellent book, *Fiduciary Law*, is a thorough and comprehensive look at the fiduciary-law forest. My contribution to the Symposium on The Role of Fiduciary Law and Trust in the Twenty-First Century is one leaf on one branch of one tree in the forest that Professor Frankel so expertly navigates. In this Essay, I explore the fiduciary relationship between corporate directors and officers and the shareholders they serve. I examine how the breach of fiduciary duties owed to shareholders has the power to dramatically impact non-shareholder groups.

Professor Frankel accurately observes that "[f]iduciary duties are anchored in the interests of the parties to the relationship rather than the public's interests."[1] But her statement ignores the expansive reach and impact of fiduciary law in general and fiduciary duty breach in particular. Corporate fiduciaries' inattentiveness to the fiduciary obligations they owe shareholders can significantly impact non-shareholder constituencies. The breach of fiduciary duties owed to shareholders deleteriously impacts the public interest in some instances. Local and global communities can be affected by corporate fiduciaries' breach of the obligations they owe shareholders. In this Essay, I explore the significance of this observation in the context of subprime mortgage lending and the securitization of subprime mortgages that major financial institutions undertook in the years leading up to the 2008 financial crisis.

This Essay makes no contribution to the discussion about mortgage brokers and lenders and whether they owe fiduciary duties to consumers. The focus of this Essay is on the fiduciary duties that financial institution directors and managers owed their shareholders in the process of securitizing subprime

* Harold F. McNiece Professor of Law, St. John's University School of Law.

[1] TAMAR FRANKEL, FIDUCIARY LAW 166 (2011).

mortgages. The participation of financial institution managers in the predatory subprime lending debacle that contributed to the 2008 economic downturn harmed shareholders *and* consumers along with local and global communities. The harm to consumers and communities has proven to be deeper and more enduring than the harm to shareholders,[2] but the most salient aspect of my thesis is the fact that corporate fiduciary duty breaches have a pervasive impact beyond the shareholders to whom fiduciaries owe duties. The factual context explored in this Essay – financial institutions' involvement in the securitization of subprime loans – vividly illustrates the expansive impact of fiduciary duty breach beyond corporate shareholders.[3]

Professor Frankel makes clear that when the public interest conflicts with shareholder primacy and wealth-maximization goals, courts may enforce duties that fiduciaries owe shareholders rather than enforce fiduciaries' compliance with law and regulation that protect the public interest.[4] "When regulation supporting public needs conflict with corporate business purposes, some courts have 'opposed using concepts of fiduciary duty to attain desired public policies, even when the policies had been enacted legislatively.'"[5] Courts may defer to corporate officers and directors who fail to comply with law if noncompliance would make a great deal of money for the shareholders to whom fiduciaries owe duties.[6] The fiduciary breach that I explore in this Essay involves the failure of Wall Street fiduciaries to monitor compliance with law, but this monitoring failure does not conflict with shareholder wealth-maximization goals. When the fiduciaries of financial firms failed to fulfill their obligation to monitor compliance with laws enacted to protect the public interest, the public was harmed *and* shareholders were harmed.[7] In other words, the public interest converged and aligned with the interests of shareholders.

[2] Most shareholders have diversified portfolios so that losses from one investment are offset by gains in another. Shareholders, therefore, are typically less vulnerable than are consumers whose wealth is bound in a single investment – their homes.

[3] For another article exploring how fiduciary duty breaches harm shareholders and employees, see Cheryl L. Wade, *Racial Discrimination and the Relationship Between the Directorial Duty of Care and Corporate Disclosure*, 63 U. PITT. L. REV. 389, 389 (2002) ("[B]oards and executives breach their fiduciary duty of care owed to shareholders when they fail to investigate and monitor their employees' complaints of racism.").

[4] FRANKEL, *supra* note 1, at 166 (citing William E. Nelson, *The Law of Fiduciary Duty in New York, 1920-1980*, 53 SMU L. REV. 285, 307-12 (2000)).

[5] *Id.* (quoting Nelson, *supra* note 4, at 309).

[6] *Id.* at 166-67.

[7] *Cf.* BOCIAN ET AL., UNFAIR LENDING: THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES 5 (Ctr. for Responsible Lending 2006).

I. SUBPRIME LENDERS, SHAREHOLDERS, CONSUMERS, AND COMMUNITIES

In the introduction of her book, Professor Frankel explains that all fiduciary relationships involve the entrustment of property and power to the fiduciary.[8] Frankel's focus is on the parties in the relationship. Her work deals with the fiduciary and the party she calls the Entrustor – the person with whom the fiduciary deals and to whom the fiduciary owes duties.[9] This perspective is essential in understanding the relationship between corporate shareholders – the Entrustors – and the fiduciaries to whom they entrust property and power. But also important is the insight discussed in this Essay that focuses on the idea that so much more is entrusted to corporate fiduciaries. Even though corporate directors and managers owe them no fiduciary duty, local, national, and global communities entrust corporate leaders with inordinate amounts of power. Business leaders make hugely impactful decisions that relate to almost every important aspect of public life – from the food we eat to the medicines we take and the doctors we consult.[10] Business leaders are entrusted with shareholder investments *and* the public welfare when they pursue shareholder wealth-maximization goals.

The power that business leaders wield with respect to the public's well-being – while pursuing profits for shareholders – is vividly illustrated in the increase in subprime lending that immediately preceded the 2008 economic downturn. In the first decade of the Twenty-First Century, a disproportionately high number of people of color received predatory subprime mortgages.[11] The senior executives of several mortgage lenders pursued profits for their investors, the constituencies to whom they owed fiduciary duties, by targeting communities of color for predatory subprime mortgages.[12]

It is important, at this point, to distinguish subprime mortgages from predatory mortgages. Subprime loans extended to low-income borrowers have enabled many to finance homes that they could not otherwise purchase.[13] The

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[8] FRANKEL, *supra* note 1, at xiii.

[9] *Id.*

[10] Leaders in the private sector are also now in the business of providing essential services traditionally provided by local, state, and federal governments. In recent years, for-profit companies have established private businesses that educate our children, and run prisons and hospitals. *See, e.g.*, Cheryl L. Wade, *For-Profit Corporations that Perform Public Functions: Politics, Profit, and Poverty*, 51 RUTGERS L. REV. 323, 325 (1999).

[11] *See, e.g.*, BOCIAN ET AL., *supra* note 7, at 3 ("Several analyses . . . have shown that African-American and Latino borrowers received a disproportionate share of higher-rate home loans, even when controlling for factors such as borrower income and property location.").

[12] *See* GARY DYMSKI, UNDERSTANDING THE SUBPRIME CRISIS: INSTITUTIONAL EVOLUTION AND THEORETICAL VIEWS 17 (2010) (describing financial institutions' shift towards using subprime mortgages as providing a "'major source of revenues and perceived profits for both the investors and the investment banks'" (quoting Jenny Anderson & Vikas Baja, *Wary of Risk, Bankers Sold Shaky Debt*, N.Y. TIMES, Dec. 6, 2007, at A1)).

[13] *Id.* at 16.

interest rates of subprime loans are higher than the rates on prime loans to account for the risk that lenders take that they will not be repaid.[14] The assessment of the risk that a borrower will fail to repay the loan is based on the borrower's income level and credit history.[15] On the other hand, predatory loans involve exorbitant fees that have nothing to do with the borrower's creditworthiness. Predatory lenders steer borrowers into high-interest loans without regard to whether they can pay them, even when borrowers qualify for loans with lower interest rates and fewer fees.[16] Predatory lending involves "excessive or unnecessary fees or steer[ing] borrowers into expensive loans when they could qualify for more affordable credit. The costs and fees packed in predatory loans extend beyond reasonable risk-based pricing."[17]

There is convincing evidence that many of the subprime mortgages originated by nonbank mortgage companies and brokers were predatory loans.[18] Local, state, and federal investigations across the nation have revealed that brokers and loan originators targeted people of color for predatory subprime mortgages.[19] "In the contemporary United States mortgage loan market, the predominant fair lending issue is no longer denial of loan applications; it is instead the fact that minority homeowners pay much more in interest rates and are much more likely to get risky subprime mortgages that lead to foreclosure."[20]

People of color, particularly vulnerable to predatory lending practices because they are under-served by banks and financial institutions in the prime market, were targeted for subprime loans even when they had good credit histories. Even middle- and upper-income African Americans and Latinos were twice as likely as middle- and upper-income whites to receive high cost loans, even though they qualified for prime rate loans.[21]

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[14] *Id.* at 14.

[15] *See, e.g.*, *id.* at 13.

[16] *See* Creola Johnson, *Fight Blight: Cities Sue to Hold Lenders Responsible for the Rise in Foreclosures and Abandoned Properties*, 2008 UTAH L. REV. 1169, 1176 (2008).

[17] Nikitra S. Bailey, *Predatory Lending: The New Face of Economic Injustice*, 32 HUM. RTS. (Summer 2005) 14, 14.

[18] *See, e.g.*, BOCIAN ET AL., *supra* note 7, at 19.

[19] *See, e.g.*, Bailey, *supra* note 17.

[20] Alan M. White, *Borrowing While Black: Applying Fair Lending Laws to Risk-Based Mortgage Pricing*, 60 S.C. L. REV. 678, 678 (2009). For example, in 2004, African Americans were "four times as likely as whites to pay subprime rates on their mortgage loans." *Id.* at 683. "Latinos were over three times more likely than whites to receive subprime loans." Richard Marsico & Jane Yoo, *Racial Disparities in Subprime Home Mortgage Lending in New York City: Meaning and Implications*, 53 N.Y.L. SCH. L. REV. 1011, 1016 (2009). People of color lost between $164 billion and $213 billion during the height of the subprime lending crisis. *See* AMAAD RIVERA ET AL., FORECLOSED: STATE OF THE DREAM 2008, at vii (2008).

[21] *Predatory Lending and the Mortgage Crisis: A Modern Example of Structural Racism*, ERASE RACISM, 1 http://www.eraseracismny.org/html/library/housing/resources/published_

> African Americans received 17.6% of all home purchase loans and 38.8% of all subprime home purchase loans . . . . In contrast, whites received 36.4% of all home purchase loans and 17.0% of all subprime home purchase loans . . . . Latinos received 13.8% of all home purchase loans and 22.2% of all subprime home purchase loans . . . . Slightly more than half of all home purchase loans to African Americans (50.5%) were subprime. Only 10.7% of all home purchase loans to whites were subprime.[22]

Allegations that certain mortgage companies targeted people of color for unfair high-cost loans were made over a decade before the economic downturn. In 1996, one mortgage originator, Ameriquest, settled a suit brought by the Justice Department claiming that the company targeted women and minority borrowers for high-cost loans.[23] By the turn of the century, the corporate culture at Ameriquest was one that encouraged its loan officers, many of whom were undereducated and inexperienced, to make loans in order to generate generous profits for the company even when the transactions resulted from egregiously fraudulent practices.[24] According to two financial writers, Bethany McLean and Joe Nocera, forgery and fraud were integral components of Ameriquest's daily business practices.[25]

Ameriquest was not a public company, but other lenders who engaged in predatory practices were.[26] The Mortgage Guaranty Insurance Corporation insured many loans originated by Countrywide, a public company. The insurance company sued Countrywide, alleging that Countrywide loan officers engaged in fraudulent practices.[27] Other lawsuits were brought against

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reports/Predatory_lending_mortgage_crisis.pdf (last visited Feb. 7, 2011) (citing Les Christie, *Foreclosures Linked to Subprime Fraud*, CNNMONEY.COM (Aug. 1, 2008), http://money.cnn.com/2008/07/31/real_estate/NY_needs_more_lending_ovesight/index htm .). Some white borrowers were also inappropriately steered into high-fee, high-interest-rate loans even though they qualified for traditional mortgages. *See* BETHANY MCLEAN & JOE NOCERA, ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS 127 (2010).

[22] Marisco & Yoo, *supra* note 20, at 1015-16.

[23] *See* Kimberly Blanton, *Reilly Urges Consumers to Avoid Ameriquest*, BOS. GLOBE, Jan. 24, 2006, at D4.

[24] *See* MCLEAN & NOCERA, *supra* note 21, at 128-31 (explaining that loan officers "got a small base salary, but made most of their money on commissions – typically 15 percent of all the revenue they generated. And the perks were fabulous.").

[25] *Id.* at 130-37. Professor Frankel explains the impact of a corporation's culture on the willingness of the firm's employees to comply with law. "Lawmakers and corporate leaders adopt and spread their own culture. They may also influence society's obedience to law by their own attitude toward the law; if they criticize or disparage the law they may undermine obedience." FRANKEL, *supra* note 1, at 275.

[26] *See, e.g.*, MCLEAN & NOCERA, *supra* note 21, at 87.

[27] *Id.* at 226-28 ("In a lawsuit that would later be filed by the Mortgage Guaranty Insurance Corporation . . . investigators went back and dug up details of some of the loans

Countrywide making similar allegations of fraud. The company settled a suit brought by Elliot Spitzer, then New York State's Attorney General.[28] The Spitzer suit alleged that Countrywide had improperly pushed African American and Latino borrowers into high-cost loans.[29]

Mortgage originators such as Countrywide and Ameriquest harmed consumers in order to make money for shareholders. The mortgage lenders' shareholders did profit in the short term, but eventually huge losses hurt shareholders also. Some decisionmakers at mortgage originators like Countrywide and Ameriquest breached fiduciary duties owed to shareholders by intentionally violating the law. Board members and senior executives, if they were unaware of the violations, breached fiduciary duties owed shareholders by failing to monitor compliance with law.[30]

Title VIII of the Civil Rights Act of 1968, The Fair Housing Act (FHA),[31] prohibits discrimination on the basis of race when making or purchasing loans for purchasing, constructing, or improving a dwelling.[32] Nonbank mortgage lenders violated the FHA when they targeted African American and Latino borrowers for predatory loans.[33] The directors and managers of these nonbank lenders owed their shareholders fiduciary duties that include the duty to monitor the company's compliance with all applicable law, including the FHA. Directors and officers who breached these fiduciary duties harmed shareholders when the subprime business collapsed. Consumers were harmed also. For Ameriquest, a private company, harm to shareholders is socially insignificant. Harm to shareholders becomes more troubling for a publicly-held company like Countrywide. But, Wall Street's relationship to nonbank mortgage lenders and the participation of this nation's most venerable financial institutions in the securitization process most vividly illustrates the link between breaching fiduciary duties owed to shareholders and the impact of that breach on local, national, and global communities.

II. PREDATORY LENDERS AND THE FINANCIAL INSTITUTIONS THAT DID BUSINESS WITH THEM

The relationship between Wall Street firms such as Lehman Brothers, Bear Stearns, and Merrill Lynch, on the one hand, and predatory mortgage lenders,

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Countrywide had made during the subprime bubble.").

[28] *See Countrywide Agrees to Adopt Controls to Ensure Fair Lending*, L.A. TIMES, Dec. 6, 2006, at C2.

[29] *See* Kathleen Day, *Countrywide Reaches Deal After Bias Probe*, WASH. POST, Dec. 6, 2006, at D02.

[30] *See infra* notes 42-48 and accompanying text.

[31] 42 U.S.C. §§ 3601-3631 (2006).

[32] 42 U.S.C. § 3605; *see also* U.S. DEP'T OF JUSTICE, THE FAIR HOUSING ACT, http://www.justice.gov/crt/about/hce/housing_coverage.php (last visited Feb. 10, 2011).

[33] *See, e.g.*, John P. Relman, *Foreclosures, Integration, and the Future of the Fair Housing Act*, 41 IND. L. REV. 629, 636 (2008).

on the other, involved two aspects. First, Wall Street firms provided large loans to nonbank mortgage lenders that enabled them to make predatory loans to prospective homeowners.[34] Second, nonbank lenders were funded when they sold mortgages to major financial institutions as part of a securitization process in which investors purchased interests in pooled mortgages.[35] Wall Street firms securitized the subprime mortgages they purchased and sold the income stream to investors.[36] Mortgage lenders and brokers who engaged in fraudulent and predatory lending could not have remained in business without the help of Wall Street's venerable financial institutions.[37]

Corporate giants like Merrill Lynch, Bear Stearns, Lehman Brothers, Wells Fargo, and Goldman Sachs bought mortgages from nonbank lenders that engaged in overtly fraudulent and discriminatory practices while passing all the risks of default onto the financial institutions.[38] When huge numbers of borrowers defaulted on their mortgages, executives who ran the financial firms that had purchased and securitized the mortgages claimed that they did not fully understand what they had purchased.[39] For the most part, the nation has accepted the narratives of financial institution managers and executives who say that they could not have foreseen the economic collapse and had no way of understanding the financial forecast for the complex and pioneering transactions that were part of the subprime lending and securitization processes.

Did boards and senior managers at the Wall Street firms that securitized subprime loans breach fiduciary duties they owed their shareholders? Shareholder litigation alleging fiduciary duty breaches in the context of Wall Street's participation in subprime lending has failed to uncover the precise nature of the fiduciaries' lapses.[40] It is imperative that the nature of fiduciary obligation in this context be fully understood. Corporate directors and officers owe shareholders and the corporations for whom they serve an obligation of good faith. This obligation of good faith includes a duty to monitor corporate employees' compliance with law.[41] Professor Frankel discusses the

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[34] *See* DYMSKI, *supra* note 12, at 15.

[35] *See, e.g.*, PAUL MUOLO & MATHEW PADILLA, CHAIN OF BLAME: HOW WALL STREET CAUSED THE MORTGAGE AND CREDIT CRISIS 66 (2008) (describing nonbank lenders as "act[ing] as intermediaries in the mortgage process (using money delivered at the closing table by giants like Countrywide) . . . then [selling] it away to an investor such as Countrywide, Citigroup, Wells Fargo, or any other number of wholesale giants").

[36] *See* DYMSKI, *supra* note 12, at 15-16.

[37] *See, e.g.*, MUOLO & PADILLA, *supra* note 35, at 281.

[38] *See id.*

[39] *See, e.g.*, *id.* at 273, 283.

[40] *Cf.* Kevin LaCroix, *Subprime-Related Derivative Lawsuits: The List*, THE D&O DIARY (Apr. 8, 2008), http://www.dandodiary.com/2008/04/articles/subprime-litigation/subprime related-derivative-lawsuits-the-list/ (enumerating derivative suits filed in 2007 and 2008).

[41] FRANKEL, *supra* note 1, at 129.

monitoring obligations of corporate boards as a duty of care issue.[42] This was the prevailing view until recent Delaware decisions included monitoring obligations in the analysis of boards' good faith obligations.[43] Professor Frankel cites to scholars who took note of this shift in corporate governance analysis.[44] Courts make monitoring obligations an integral part of the fiduciary duty of loyalty when they are willing to explore whether a board's failure to monitor compliance was a bad faith lapse.[45] Boards and officers who fail to make a good faith effort to monitor compliance with law breach the fiduciary duty of loyalty. This is a significant analytical shift. Judges are much less likely to defer to business decisions or inaction that breach the duty of loyalty than they are with respect to care breaches. When a board's failure to monitor compliance with law was construed as a duty of care breach, the board's lapse was meaningless. This is because the import of corporate law's fiduciary duty of care has eroded as a result of the enactment of exculpation clauses such as Delaware's section 102(b)(7).[46] This statute allows Delaware companies to include a provision in the certificate of incorporation that limits or eliminates directors' personal liability for breaches of the duty of care.

Now that a board's bad faith failure to monitor compliance is considered a loyalty breach rather than a care breach, monitoring obligations become more significant. Professor Frankel makes clear that the Delaware monitoring cases require "a sustained or systematic failure" to exercise oversight in order to establish bad faith.[47] She explains that a board decision that results in a "[b]ad outcome is not bad faith."[48] But the emergence of a shift in analysis of monitoring breaches should inspire boards to be more vigilant about installing controls that will provide them with information about a firm's failure to comply with law.

Until recently, the corporate fiduciary's obligation to act in good faith was a nebulous concept. In shareholder litigation against The Walt Disney

[42] *Id.* at 169.

[43] *See, e.g.*, Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 560 (2008) ("Historically, a director's duty of good faith was 'subsumed in a court's inquiry into the director's satisfaction of her duties of care and loyalty.' In recent years . . . Delaware cases hinted that good faith was a freestanding duty . . . ." (quoting Arthur Fleischer, Jr. & Alexander R. Sussman, *Directors' Fiduciary Duties in Takeovers and Mergers*, *in* FIRST ANNUAL DIRECTORS' INSTITUTE ON CORPORATE GOVERNANCE 911, 918 (PLI Corp. Law & Practice, Course Handbook Ser. No. B0-021D 2003))).

[44] FRANKEL, *supra* note 1, at 129 (citing Bainbridge et al., *supra* note 43, at 559).

[45] *See* Bainbridge et al., *supra* note 43, at 561-62 (discussing how the Delaware Court recently found that a board has an affirmative duty to ensure its company's compliance with law).

[46] DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

[47] FRANKEL, *supra* note 1, at 177 (quoting Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 372 (Del. 2006)).

[48] *Id.*

Company, the Delaware Supreme Court clarified corporate law's bad faith concept.[49] The court explained that board members act in bad faith when they intend to do harm, or when directors intentionally or consciously disregard their responsibilities.[50]

Some Wall Street firms such as Merrill Lynch became subprime lenders themselves by acquiring a nonbank lending firm or by opening a subprime division.[51] Did directors and senior executives at these firms fail to fulfill their good faith obligation to monitor their employees' compliance with the FHA which prohibits discrimination in connection with mortgage regulation?

Most Wall Street firms, however, did not employ the people who dealt with borrowers and approved applications.[52] What responsibility did the financial institutions that securitized the mortgages have to ensure that the companies from whom they purchased mortgages complied with the FHA? Did financial institutions such as Citigroup, J.P. Morgan Chase, Bank of America, Merrill Lynch, Lehman Brothers, Bear Stearns, Wells Fargo, and others owe a duty to their shareholders to ensure that the nonbank lenders from whom they purchased subprime mortgages complied with the FHA, which embodies the nationally articulated public policy against housing discrimination? What about the Wall Street firms' obligation to monitor compliance with laws and regulations that prohibit consumer fraud?

With the benefit of hindsight, we now know just how risky Wall Street's involvement in the subprime market was. It seems that at the least, Wall Street boards and executives were grossly negligent when they purchased predatory mortgages without understanding that the loan officers who originated them engaged in fraudulent practices that made repayment of the loans highly unlikely. The *Disney* court, however, made clear that grossly negligent conduct does not constitute bad faith that breaches the duty of loyalty.[53] A board that behaves in grossly negligent ways breaches its fiduciary duty of care. And, as stated earlier, as a practical matter, care breaches have been rendered irrelevant under exculpation clauses such as Delaware's section 102(b)(7).[54]

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[49] *In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27, 64-66 (Del. 2006). The *Disney* case involved shareholder challenges to the Disney board's decision to hire Michael Ovitz as the company's president. After working for Disney for only fourteen months, Ovitz was terminated without cause. *Id.* at 35. He received a $130 million severance payout even though his fourteen-month tenure at Disney was replete with problems. *Id*. at 35, 42.

[50] *Id*. at 66-67 (adopting the lower court's definition of bad faith, involving conscious disregard of duties – among other things – as an acceptable but not exclusive definition).

[51] *See* MUOLO & PADILLA, *supra* note 35, at 186-203.

[52] *See, e.g.*, *id.* at 192 (describing how Bear Stearns's subsidiary, EMC, did not directly employ persons, as "[h]aving retail employees to pay would result in more full-time equivalents").

[53] *Disney*, 906 A.2d at 64-65.

[54] *See supra* note 46 and accompanying text (describing the Delaware exculpatory

Only loyalty breaches are legally significant and monitoring failures are loyalty breaches only if a board consciously disregards its responsibility. Only an *intentional* dereliction of duty or a *conscious* disregard of responsibility constitutes bad faith that breaches the duty of loyalty. Did financial institutions' boards consciously disregard their responsibilities when they purchased and securitized predatory subprime loans? Did they act in bad faith, thereby breaching their fiduciary duty of loyalty?

Here is the analytical problem. It is easily argued that these were not instances where directors consciously disregarded responsibilities. It can be said that the boards did not engage in an intentional dereliction of duty. Board members did what so many of us may have done if we served as directors: they did not fully understand the risks. The companies were making money – at least initially. Like the rest of us, the boards heard predictions about the imminent bursting of the housing bubble. But they most likely concluded that the smart executives who managed the companies would save the companies and shareholders from harm. In other words, they turned a blind eye to the inherent and irrational risks of predatory subprime lending.

There is a small but significant gap between gross negligence and conscious disregard of duty. The willful blindness doctrine fills this gap. In American (and English) jurisprudence "willful blindness" is the equivalent of actual knowledge where a person deliberately avoided information about a fact that would otherwise be obvious. Negligence or mistake will not establish willful blindness. Willful blindness is established, however, where it is shown that there was a deliberate effort to remain ignorant of the critical facts.[55]

This concept of willful blindness is potentially helpful in analyzing fiduciary duty breach, particularly with respect to the obligation to monitor compliance with law that has become part of the fiduciary duty of loyalty. Directors and officers who are willfully blind because they have made "a deliberate effort to remain ignorant of the critical facts" have engaged in an intentional dereliction of duty.[56] They have consciously disregarded their obligations. Their failure to monitor is a failure to act in good faith. They have breached their fiduciary duty of loyalty.

The complication with this analysis in the context of failure to monitor compliance with respect to mortgages purchased by the managers of financial institutions is not found in the complexity of assessing risk. Financial institution directors and senior executives knew that risk management teams were in place at their firms. Unfortunately, they turned a blind eye to the corporate culture at their firms that rendered the conclusions and analyses of risk managers irrelevant because they were ignored. Financial institution leaders claimed that they did not understand the risk of predatory lending. But

statute).

[55] Eugene S. Becker & Stephen H. Marcus, *Turning a Blind Eye: Willful Blindness as Actual Knowledge*, N.Y. L.J., Oct. 21, 2010, at 1.

[56] *Id.*

their lack of understanding was not caused by the complexity of the risks taken nor by an inability to understand them. Wall Street directors and managers did not understand the risks because they turned a blind eye to those risks. They made "a deliberate effort to remain ignorant of the critical facts" that would have revealed the excessive nature of their risk taking.[57] Take the example of Merrill Lynch. McLean and Nocera reveal that John Breit, a risk manager at Merrill who attempted to warn decisionmakers about the irrational risks inherent in continuing in the subprime business, was slowly stripped of his authority after he questioned risky trades.[58] Breit's diligence in assessing Merrill's exposure to risk resulted in his isolation from the kind of information he needed in order to adequately do his job.[59] Merrill's risk management function had become ineffective and Stan O'Neal, Merrill's CEO at the time, did not realize that the company's risk management controls had been rendered useless.[60]

One author observed that "Wall Street was afflicted with a kind of willful blindness or magical thinking. Each of the Street's five large investment banks, together with the investment banking divisions of giant global banks such as Citigroup and UBS, was fixated on doing whatever it took to maximize its short-term profits."[61] Arguably, if Wall Street boards and senior executives had not turned a blind eye, they would have discovered the accusations, investigations, and litigation, revealing serious problems with the loans they purchased from nonbank lenders. Directors and officers may have foreseen the disastrous outcome of securitizing predatory subprime mortgages. Instead, Wall Street boards and executives avoided the truth about the nonbank lenders' fraudulent and deceptive dealings with borrowers.

Circumstances at Ameriquest provide another vivid example of the willful blindness of some mortgage lenders' decision-makers. The firm hired a mortgage specialist to investigate allegations of pervasive fraud committed by the company's loan officers.[62] When interviewed by financial writers, the

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[57] *Id.*

[58] MCLEAN & NOCERA, *supra* note 21, at 236-38, 314-17 ("Though [Breit] was one of the few people left at Merrill with the knowledge and background to sniff out problem trades, he was shut out entirely."). This was dangerous because, ordinarily, "risk managers were the ones who imposed the reality checks that the traders preferred to ignore." *Id.* at 237.

[59] *See id.* at 314-17 (illustrating how Breit's deteriorating access to information made conversations with Merrill's CEO "sobering"; O'Neal "had no idea that Breit had been pushed aside").

[60] *Id.* at 316-17; *see also* GREG FARRELL, CRASH OF THE TITANS 3-7 (2010) (describing the demise of Merrill Lynch, forcing its sale to Bank of America, that was precipitated by its entry into the subprime mortgage business).

[61] SUZANNE MCGEE, CHASING GOLDMAN SACHS: HOW THE MASTERS OF THE UNIVERSE MELTED WALL STREET DOWN . . . AND WHY THEY'LL TAKE US TO THE BRINK AGAIN 133 (2010).

[62] MCLEAN & NOCERA, *supra* note 21, at 133-34.

specialist concluded that he had been "brought in to provide cover."[63] The specialist revealed that he "would record [the fraud] he found, send it to management – and nothing would happen."[64] In a subsequent employment discrimination suit, the specialist said "he was turned down for promotions, cut out of decision making, and eventually fired."[65] The specialist discovered that Ameriquest had "'engaged in massive fraud for years'. . . . '*My problem was, they did not want to know*.'"[66]

Another Ameriquest employee named Christopher Warren left the firm to start his own mortgage lending firm called WTL Financial.[67] In an online confession, Warren revealed that his new company "faked credit scores, pay stubs, and bank statements in order to sell $810 million in securities backed by his loans. *He could get away with it because Wall Street didn't care.*"[68]

Wall Street's willful blindness to the irrational risks inherent in securitizing predatory subprime loans caused significant shareholder losses. The willful blindness of the financial institutions' directors and executives breached fiduciary obligations of good faith and duties of loyalty owed to shareholders.[69] The breach of fiduciary duty also caused significant harm to the consumers who could not make excessively high mortgage payments. The shareholders who were harmed have started to recover now that Wall Street firms are earning profits again – with taxpayers' help.[70] But the consumers who were harmed by the breaches of duties that fiduciaries owed shareholders have lost homes and continue to suffer years after the economy's collapse.[71] And, as consumers lost their homes, neighborhoods were destroyed and American citizens continue to live in communities that seem to be irrevocably decimated.[72] When borrowers could not repay predatory loans, the global economy suffered as those who had invested in the pooled mortgages lost billions.[73] Harm resulting from the breach of fiduciary duties owed

[63] *Id.* at 134.

[64] *Id*.

[65] *Id*. An arbitrator later decided against the wrongful dismissal claim by the investigator, Ed Parker. *Id.*

[66] Id. (emphasis added) (quoting Parker).

[67] Id. at 136-37.

[68] *Id.* at 136 (emphasis added).

[69] *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (2006) ("Where directors fail to act in the face of a known duty . . . thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.").

[70] *See* ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM – AND THEMSELVES (2009).

[71] *See, e.g.*, Relman, *supra* note 33, at 636 ("[I]rresponsible subprime lenders left countless homeowners saddled with mortgage debts they cannot afford and no way to save their homes in a declining housing market.").

[72] *See* Johnson, *supra* note 16 at 1171.

[73] *See, e.g.*, Douglas A. McIntyre, *Typhoid Mary & Finding the Man Who Started the*

shareholders reached non-shareholder groups of consumers and communities, both local and global.

III. PUBLIC OPINION, DISCOURSE, AND FIDUCIARY DUTY

What can be done about Wall Street boards and directors who ignored the facts that evidenced the predatory nature of the subprime mortgages they purchased and the fraud that was prevalent at some of the mortgage lending firms with whom they did business? What will inspire fiduciaries to fulfill their fiduciary duties, including the monitoring obligations they owe shareholders?

Professor Frankel suggests that "public opinion [as] expressed in newspapers, television and mass interaction by electronic devices" may change the "powerful fiduciaries' misbehavior."[74] But, she explains, this is most likely to happen if that public opinion or social pressure, is "strong, loud, and persistent."[75] Frankel explains that even after the eruption of the 2001-2002 accounting scandals at companies like Enron, WorldCom, Adelphia, and Tyco, "[p]owerful fiduciaries, holding billions of the public's money, did not alter their way of thinking and behavior."[76] She writes that "[e]ven after the crash of 2008 these powerful fiduciaries have not changed their way of life and attitudes."[77] But, she notes that small changes in corporate governance have occurred because "political power and public opinion" have changed.[78]

The type of willful blindness that plagued decisionmakers at firms that purchased predatory mortgages, however, may prove impervious to change because of the nature of public opinion, political power, and social pressure in this context. The dominant discussion of predatory lending and Wall Street's involvement cannot inspire fiduciaries' fulfillment of the duties they owe. An examination of the national discourse about subprime lending in the aftermath of the economic downturn reveals why this is so.

Conservative commentators captured much of the discussion about subprime borrowers. Borrowers were labeled greedy and ignorant and were considered undeserving of home ownership.[79] Conservatives placed all of the

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Global Recession, 24/7 WALL ST. (Feb. 2, 2009), http://247wallst.com/2009/02/02/typhoid-mary-an/ ("Most economists blame the collapse of the [global] credit markets . . . on a drop in US housing prices and devaluing of subprime mortgage-backed securities.").

[74] FRANKEL, *supra* note 1, at xiii.

[75] *Id.*

[76] *Id.* at 275.

[77] *Id.*

[78] *Id.* Frankel's example of one small change in corporate governance resulting from a change in political power and public opinion is the fact that top managers at Goldman Sachs waived bonuses in 2009 after vociferous public criticism. *Id.* at 276.

[79] *See* Gretchen Morgenson, *Blame the Borrowers? Not So Fast*, N.Y. TIMES, Nov. 25, 2007, § 3, at 1 ("It has become fashionable of late to say that America's subprime borrowers themselves deserve a good part of the blame for the mortgage mess. They were either

blame for the predatory lending debacle, and even for the economic downturn itself, on minority and low-income borrowers, ignoring the predatory lending practices that precipitated the high number of foreclosures.[80] When discussing the mortgage and credit crisis that threatened our economic survival, conservative commentators, academics, and pundits attacked the borrowers while ignoring the culpability of Wall Street and nonbank lenders. Conservatives spoke of personal responsibility, or the lack thereof, on the part of borrowers who lied about their income, or borrowers who were too dumb to realize that they could not afford the homes they bought.[81] They were mostly silent, however, about the predatory lending practices of mortgage brokers and nonbank lenders and the Wall Street executives and managers who ignored the practices.

In the documentary *American Casino*,[82] an investigative journalist interviewed defectors from financial institutions and mortgage lenders and other industry insiders who revealed that in many instances the lenders, not the borrowers, lied about the borrower's income.[83] Even when borrowers did not qualify for a loan and could not repay it, predatory lenders inflated borrowers' income in order to receive the high fees that are typically earned when originating subprime loans.[84] When the borrower defaulted on a loan, the borrower lost the home, but lenders did not lose the fees they "earned" from originating the loan.[85]

Neil Cavuto of Fox News said that "[l]oaning to minorities and risky folks is a disaster."[86] Matt Drudge helped to disseminate a story that was attributed to a HUD representative claiming that 5 million defaulted mortgages in the U.S. were held by illegal immigrants. After this claim was made on a radio station, and after Drudge included a link on his website to that station, the *Phoenix Business Journal* published an article about a HUD spokesperson who said that the agency had no information about the number of illegal immigrants who

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greedy . . . or irresponsible . . . .").

[80] *Cf.* Larry Keller, *Minority Meltdown: Immigrants Blamed for Mortgage Crisis*, 133 S. POVERTY L. CTR. (Spring 2009), *available at* http://www.splcenter.org/get-informed/intelligence-report/browse-all-issues/2009/spring/minority-meltdown (explaining that many commentators blamed the Community Reinvestment Act, which encouraged lending to people living in lower-income communities).

[81] *See* William D. Cohan, *The Elizabeth Warren Fallacy*, N.Y. TIMES (Sept. 30, 2010 9:00 PM), http://opinionator.blogs.nytimes.com/2010/09/30/the-elizabeth-warren-fallacy/.

[82] AMERICAN CASINO (Table Rock Films 2009).

[83] *See Synopsis*, AMERICAN CASINO, http://www.americancasinothemovie.com/synopsis (last visited Feb. 10, 2011).

[84] Stephen Holden, *Meltdown on Wall Street, and Homeowners Left in the Lurch on Main Street*, N.Y. TIMES, Sept. 2, 2009, at C5.

[85] AMERICAN CASINO, *supra* note 82.

[86] *Cavuto Suggests Congress Should Have Warned that "[l]oaning to minorities and risky folks is a disaster"*, MEDIA MATTERS FOR AMERICA (Sept. 19, 2008, 6:28 PM), http://mediamatters.org/mmtv/200809190021.

held bad mortgages.[87] But, hours after this article appeared, Lou Dobbs interviewed a conservative radio talk show host who repeated the falsehood.[88] The day after the HUD spokesperson denied the story, Rush Limbaugh got in on the act, embellishing the facts. Limbaugh said that HUD revealed that "5 million illegal immigrants were given mortgages . . . with fake social security numbers . . . to go out and purchase homes that they didn't have to pay back."[89] Even after HUD denied this story, it was spread by bloggers, and on other radio shows and cable networks.[90]

There was little to no discussion about successful and responsible low-income borrowers in the discourse that took place in the aftermath of the economic downturn. For example, one nonprofit, Neighborhood Housing Services of Orange County, assists first-time home buyers by connecting them with banks that make CRA loans.[91] "In its 14-year history, the nonprofit has helped 1,200 families buy their first homes. Score so far: No foreclosures and a delinquency rate under 1 percent."[92] Another company, the Nehemiah Project, is in the business of building and selling homes to the working poor of New York City.[93] The repayment rates on the loans made to the buyers of almost four thousand homes are high, with only ten defaults since the business began in the 1980s.[94]

Conservative commentators also criticized Fannie Mae and Freddie Mac and the reason for creating these institutions – making home ownership possible for low-income borrowers.[95] But Fannie Mae and Freddie Mac did not lend money to risky borrowers. The two entities bought loans from private lenders, and most of the loans bought were not considered subprime.[96] Moreover,

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[87] Mike Sunnucks, *HUD Cries Foul Over Illegal Immigrant Mortgage Data*, PHOENIX BUS. J., (Oct. 9, 2008, 3:16 PM), http://www.bizjournals.com/phoenix/stories/2008/10/06/daily54 html.

[88] Keller, *supra* note 80 (describing how a San Diego talk show host appeared on *Lou Dobbs Tonight* and "cited the bogus HUD statistic as a hard fact").

[89] *Id.*

[90] *See id.*

[91] *See* Ronald Campbell, *Most Subprime Lenders Weren't Subject to Federal Lending Law*, ORANGE CNTY. REGISTER (Nov. 16, 2008), http://articles.ocregister.com/2008-11-16/business/24714017_1_subprime-loans-federal-lending-law-low-income-loans/2.

[92] *Id.*

[93] Jim Zarroli, *Low-Cost Brooklyn Housing Sees Few Foreclosures*, NPR (Oct. 20, 2009), http://www.npr.org/templates/story/story.php?storyId=113931948.

[94] *Id.*

[95] Thomas J. DiLorenzo, *The CRA Scam and Its Defenders*, LUDWIG VON MISES INSTITUTE (Apr. 30, 2008), http://mises.org/daily/2963 (describing how Freddie Mac pioneered securitization of high-risk subprime loans and how Fannie Mae pointed to Countrywide as a role model for CRA lending).

[96] *See Wall Street, Not Fannie Mae and Freddie Mac, Led the Toxic Mortgage Market*, CTR. FOR RESPONSIBLE LENDING (Jan. 26, 2011), http://www responsiblelending.org/mortgage-lending/policy-legislation/congress/wall-street-not-fannie-mae html.

private lenders originated more than eighty percent of the subprime loans made to lower-income borrowers in 2006.[97] The private sector was the engine behind subprime lending during its peak years, 2004 through 2006.[98]

Some blamed the financial crisis of 2008 on the enactment of the Community Reinvestment Act of 1977 (CRA).[99] The CRA was enacted to require banks covered by the Federal Deposit Insurance Corporation to refrain from the discriminatory practice of redlining, a practice under which banks refused to lend to minority and low-income residents.[100] The CRA was enacted to mitigate the effects of redlining. Conservatives argued that the quest for increasing home ownership among minorities and working class Americans caused the 2008 economic crisis. Larry Kudlow commented: "The Community Reinvestment Act . . . literally pushed these lenders to make low-income loans. . . . [Members of Congress's] [l]iberal, guilt[y] consciences forced banks and lenders to make lousy, substandard loans."[101] A professor of economics made the following statement: "The thousands of mortgage defaults and foreclosures in the 'subprime' housing market . . . is the direct result of thirty years of government policy that has forced banks to make bad loans to un-creditworthy borrowers."[102]

There is, however, another perspective about the value of the CRA that received far less attention in the public discourse about subprime mortgages. The CRA applies to federally-insured depository banks; it does not apply to the financial institutions, lenders, and brokers that dominated the subprime market during the last decade. For example, the nonbank mortgage companies that made eighty percent of the predatory subprime loans that defaulted were not covered by the CRA.[103] Moreover, the depository banks that are covered by the CRA were sixty-six percent less likely to make subprime loans than were

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[97] David Goldstein & Kevin G. Hall, *Private Sector Loans, Not Fannie or Freddie, Triggered Crisis*, MCCLATCHY (Oct. 12, 2008), http://www mcclatchydc.com/2008/10/12/53802/private-sector-loans-not-fannie.html.

[98] *See id.*

[99] Robert Gordon, *Did Liberals Cause the Sub-Prime Crisis?*, THE AMERICAN PROSPECT (Apr. 7, 2008), http://www.prospect.org/cs/articles?article=did_liberals_cause_the_sub prime_crisis (detailing how the "Blame-CRA theme" was discussed in many conservative forums, such as Freerepublic.com and The Cato Institute).

[100] *See, e.g.*, Randall Kroszner, *The Community Reinvestment Act and the Recent Mortgage Crisis*, *in* REVISITING THE CRA: PERSPECTIVES ON THE FUTURE OF THE COMMUNITY REINVESTMENT ACT 8, 8 (2009) ("The act required the banking regulators to encourage depository institutions . . . to help meet the credit needs of their entire community, including low- and moderate-income areas.").

[101] *Morning Joe* (MSNBC television broadcast Sept. 18, 2008), *available at* http://www.90787.com/kudlow-on-morning-joe-blaming-crisis-on-loans-to-poor-people/.

[102] Thomas J. DiLorenzo, *The Government-Created Subprime Mortgage Meltdown* (Sept. 6, 2007), http://www.lewrockwell.com/dilorenzo/dilorenzo125 html.

[103] Peter Dreier & John Atlas, *The GOP's Blame-ACORN Game*, THE NATION (Nov. 10, 2008), http://www.thenation.com/article/gops-blame-acorn-game.

nonbank lenders,[104] and the subprime loans they did make had significantly lower interest rates and were easier for borrowers to repay.[105] Banks covered by the CRA are subject to extensive federal oversight; nonbank mortgage lenders are not. The lending practices of banks covered by the CRA have been successful in that minority home ownership has increased with very low default and foreclosure rates.[106]

Professor Frankel's observation about social pressure and public opinion and their role in inspiring fiduciaries to live up to the duties and obligations they owe shareholders is inoperable in the predatory lending context. The dominant discourse on the issue constructed minority borrowers as the only irresponsible actors in the predatory lending debacle.[107] For the most part, our national discourse omitted discussion about nonbank lenders' predatory practices and the Wall Street fiduciaries who ignored them. Public opinion about these issues was formed with only a small and inaccurate part of the story. The nation blamed the borrowers and paid little to no attention to nonbank lenders and the Wall Street firms that did business with them. There was little public outrage, and no social pressure exerted with respect to predatory lending practices and the fiduciaries who ignored them. There was very little in the national reaction to inspire a change in the way financial institution fiduciaries operate.

CONCLUSION

Professor Frankel, exploring the history of corporate fiduciary law observed that "[a]s corporations grew in size and in influence over Americans' life [sic], there were arguments that management had a fiduciary relationship to the employees and communities in which the corporations operated, as well as to the nation."[108] She writes that "the balance between the shareholders' interests and those of other constituencies has changed throughout the years and is still subject to debate."[109] In this Essay, I explored fiduciary breach on the part of Wall Street directors and executives who failed to monitor compliance with law aimed at protecting the public interest. In this context, the interests of shareholders, consumers, and communities converged. The breach of fiduciary duties harmed both shareholders and the public. I do not suggest that Wall Street fiduciaries, or any other corporate fiduciary, should be deemed to owe fiduciary duties as a normative matter to non-shareholder constituencies.

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[104] TRAIGER & HINCKLEY LLP, THE COMMUNITY REINVESTMENT ACT: A WELCOME ANOMALY IN THE FORECLOSURE CRISIS 3 (Jan. 7, 2008), *available at* http://www.traigerlawb.com/publications/traiger_hinckley_llp_cra_foreclosure_study_1-7-08.pdf.

[105] *Id.* at 11.

[106] *See, e.g.*, Dreier & Atlas, *supra* note 103 ("[T]he CRA helped boost the nation's homeownership rate, particularly among black and Latino borrowers . . . .").

[107] *See supra* notes 86-98 and accompanying text.

[108] FRANKEL, *supra* note 1, at 52.

[109] *Id.* at 160.

Instead, I offer an observation that highlights the importance of Professor Frankel's work to clarify the content of fiduciary duty. In the predatory subprime lending context, a clearer understanding and articulation of the fiduciaries' duty to monitor compliance with law may have protected shareholder interests *and* the interests of the consumers and communities that were harmed.

The predatory practices common in subprime lending that helped to precipitate the economic downturn violated consumer law and anti-discrimination law that prohibits discrimination in the housing context. I focus on the lenders' violations of housing law and the fact that fiduciaries ignored noncompliance that adversely affected shareholders *and* impacted minority and low-income borrowers. My focus on minority and low-income borrowers demonstrates how two seemingly distant constituencies – shareholders, on the one hand, and low-income and minority borrowers, on the other – become interconnected when powerful fiduciaries breach duties.