Corporate Risk-Taking and Public Duty

Posted by Steven L. Schwarcz, Duke University School of Law, on Tuesday, September 1, 2015

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Editor's Note: Steven L. Schwarcz is the Stanley A. Star Professor of Law & Business at Duke University School of Law. This post is based on a draft article by Professor Schwarcz, available here.

Although corporate risk-taking is economically necessary and even desirable, it can also be harmful. There is widespread agreement that excessive corporate risk-taking was one of the primary causes of the systemic collapse that caused the 2008-09 financial crisis. To avoid another devastating collapse, most financial regulation since the crisis is directed at reducing excessive corporate risk-taking by systemically important firms. Often that regulation focuses on aligning managerial and investor interests, on the assumption that investors generally would oppose excessively risky business ventures.

My article, Misalignment: Corporate Risk-Taking and Public Duty, argues that assumption is flawed. What constitutes "excessive" risk-taking depends on the observer; risk-taking is excessive from a given observer's standpoint if, on balance, it is expected to harm that observer. As a result, the law inadvertently allows systemically important firms to engage in risk-taking ventures that are expected to benefit the firm and its investors but, because much of the systemic harm from the firm's failure would be externalized onto other market participants as well as onto ordinary citizens impacted by an economic collapse, harm the public.

Pragmatically, regulators cannot control the myriad harmful externalities that result from corporate risk-taking. But excessive risk-taking that causes the failure of a systemically important firm can trigger a domino-like systemic collapse of other firms or markets, leading to widespread unemployment and poverty. Regulation should try to control that risk-taking. Post-financial-crisis regulation attempts to control that risk-taking without interfering with corporate governance because financial regulation of corporate governance is thought to weaken the wealth-producing capacities of the firm. Non-governance financial regulation is certainly important. The article shows, however, that it is, and inevitably will be, insufficient to control the excessive corporate risk-taking that causes systemic externalities.

The article then examines whether regulating corporate governance could help to control that risk-taking, without weakening corporate wealth-producing capacity. It concludes that managers of systemically important firms should not only have their traditional corporate governance duty to investors but also a duty—which the article calls a "public governance duty"—not to engage in excessive risk-taking that could systemically harm the public. Such a duty would help to align private and public interests. It also would help to correct another critical regulatory failure—that non-governance financial regulation usually lags financial innovation. That regulatory lag occurs because non-governance financial regulation often depends on regulators precisely understanding the particular design and structure of financial firms, markets, and other related institutions at the time the regulation is promulgated. The problem, though, is that the design and structure are constantly changing. The public governance duty, in contrast, would overcome that time lag. If the firm is proposing to engage in a risky project that represents financial innovation, its managers either have or, to fulfill their governance duties, should try to obtain the most current information about the innovation and its consequences.

The proposed public governance duty is designed to avoid weakening corporate wealth-producing capacity. The duty merely requires managers to price in potential systemic costs when deciding on a given risk-taking project. This recognizes that a firm's wealth production to society should be assessed net of systemic public harm. The article's analysis of the public governance duty also informs the larger debate over corporate governance models. The analysis shows that such a duty should not be inconsistent with corporate governance law and theory. It also explains why systemic externalities should count in limiting corporate governance autonomy (and freedom of contract).

The public governance duty is designed to be practical, to minimize its impact on existing corporate governance. For example, managers can perform the duty using information they already know, with one exception: the systemic costs if the firm fails. Because government financial regulators are likely to know much more about those costs than the firm's managers, the article proposes that regulators estimate and periodically update those costs as part of the (existing) process of designating a firm as systemically important. The article also examines other practical concerns, including how its public governance duty should be legally imposed, how managers should assess and balance the public costs and private benefits of a risk-taking activity, how the public governance duty should be enforced, and to what extent managers performing that duty should have the traditional protection of a business judgment rule as a defense to liability. The last issue is especially significant because qualified managers are unlikely to want to serve without that protection. The article argues that business-judgment-rule protection is needed to encourage that service but that, because of conflicts of interest, the rule should be applied slightly differently to managers performing a public governance duty. That different application should not, however, unduly expose managers to liability, nor should it require courts to exercise inappropriate discretion.

The proposed public governance duty should significantly reduce, but it could not completely prevent, the excessive risk-taking that causes systemic externalities. Even if imperfect, however, that duty should constitute a first step towards shaping corporate governance norms to begin to take the public into account.

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