INTERNAL AND EXTERNAL SHAREHOLDER LIABILITY IN THE FINANCIAL INDUSTRY: A COMPARATIVE APPROACH

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Abstract

Scholars have long debated the efficiency of limited liability and whether shareholder liability should be established under certain circumstances. Few have noted, however, that regulatory rules that essentially establish shareholder liability regimes have already emerged in the financial industry after the 2008 financial crisis. While researchers tend to study these rules from the perspective of financial regulation, this article presents the first attempt to employ the theory of the firm and limited liability to understand their rationales and their shortcomings. By doing so, this article not only offers a more nuanced and useful analysis of how to control risk-taking in the financial sector, but also yields insights on the debate on limited liability from a comparative law perspective. This article argues that whether and how shareholder liability in the financial industry should be established depends on the advantages and disadvantages of shareholder liability, which are determined by two important factors: regulatory capacity and corporate financial structure. Accordingly, there is no one-size-fits-all approach. Salient factors in the financial industry help explain why different countries adopt the liability regimes that they do and shed new light on this theoretical debate.

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I. Introduction

Limited liability has long been regarded as an essential feature of a corporation.[1] It is considered to have many benefits, including facilitating liquidity of shares, reducing monitoring costs, and promoting investment.[2] However, researchers have also identified many problems associated with limited liability—it incentivizes investors to engage in potentially hazardous activities because they do not fully internalize all costs.[3] Mainly for this reason, scholars have

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[1] John Armour, Henry Hansmann & Reinier Kraakman, *What Is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 1, 9 (Reinier Kraakman et al. eds., 2009) ("[L]imited liability has become a nearly universal feature of the corporate form."); Frank H. Easterbrook & Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 40 (1991) ("Limited liability is a distinguishing feature of corporate law—perhaps *the* distinguishing feature.").

[2] *See generally* Phillip I. Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 612 (1986); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985); Paul Halpern, Michael Trebilcock & Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L. J. 117 (1980); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967); Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 COLUM. L. REV. 1203 (2002); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 102 (1991). For more specific discussions on limited liability in the financial sector, see generally Steven L. Schwarcz, *The Governance Structure of Shadow Banking: Rethinking Assumptions About Limited Liability*, 90 NOTRE DAME L. REV. 1, 18 (2014). For a recent academic writing summarizing the costs and benefits of limited liability, see generally Henry Hansmann & Richard Squire, *External and Internal Asset Partitioning: Corporations and Their Subsidiaries, in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE (forthcoming), available at http://ssrn.com/abstract=2733862 [https://perma.cc/9TYU-YCDH].

[3] *See, e.g.*, Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L. J. 1879, 1879 (1991) ("[Limited liability] is generally acknowledged to create incentives for excessive risk-taking by permitting corporations to avoid the full costs of their activities."). While voluntary creditors can protect themselves by demanding more favorable terms with limited liability corporations, involuntary creditors,

advocated for the adoption of some kinds of shareholder liability,[4] while others disagree.[5]

In the financial industry, the problem of limited liability seems to be more severe as large financial institutions tend to undertake excessive risks.[6] When they fail, it may cause financial trouble to other financial institutions, damage the confidence of investors, and ultimately hurt the general economy.[7] Limited liability of financial institutions also creates a distributive justice concern: when excessive risk-seeking leads a financial institution to insolvency, governments sometimes decide to bail it out with taxpayers' money.[8] Investors of financial institutions thus can enjoy all the benefits while leaving some of the costs to be borne by taxpayers.[9] Because of both the efficiency and distributive justice concerns, some scholars have argued for holding shareholders liable when financial institutions fail.[10]

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such as tort victims, cannot negotiate with corporations. Thus, investors may fail to internalize the costs imposed on involuntary creditors and may over-invest in hazardous industries. *See generally id.*

[4] Hansmann and Kraakman argued against limited liability in tort cases. *Id*.

[5] *See generally* Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387 (1992) (contending curtailing limited liability in relation to torts presents insurmountable procedural obstacles); Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387 (1992) (arguing proportionate liability is infeasible as a substitute for limited liability in tort).

[6] *See* Claire Hill & Richard Painter, *Berle's Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 Seattle U. L. Rev. 1173, 1177 (2010) ("However, without adequate federal government oversight of banks, state-mandated shareholder assessments proved inadequate to control banks' excessive risk taking.").

[7] *Id.* (describing the effects of the 2008 Financial Crisis).

[8] *See id.*

[9] *See id.*

[10] Professors Macey and Miller wrote an article in the 1990s highlighting the benefits of double liability, a form of shareholder liability. *See generally* Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31, 36 (1992). Professor Jackson questioned the evidence Macey and Miller had provided. *See* Howell E. Jackson, *Losses from National Bank Failures During the Great Depression: A Response to Professors Macey and Miller*, 28 WAKE

These are not mere scholarly proposals. In recent years, many countries around the world have seriously considered imposing shareholder liability on investors of financial institutions.[11] Despite

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FOREST L. REV. 919 (1993) (arguing the data set used by Macey and Miller should have been expanded.). Professors Macey and Miller then provided new evidence. *See* Macey & Miller, *supra* ("[T]he higher losses found in Professor Jackson's expanded sample have more to do with the shortcomings of protracted liquidation proceedings than with the shortcomings of double liability."). Later in the 2000s, Professor Grossman found evidence that double liability reduced bank risks. *See* Richard S. Grossman, *Double Liability and Bank Risk Taking*, 33 J. MONEY, CREDIT & BANKING 143, 157 (2001). For a detailed discussion of double liability, see infra Section III.A.3. After the 2008 financial crisis, more researchers have joined the view that shareholder liability should be adopted to curb risk-taking in the financial sector. *See* Peter Conti-Brown, *Elective Shareholder Liability*, 64 STAN. L. REV. 409, 411–12 (2012); Hill & Painter, *supra* note 6, at 1177–79 (2010); Schwarcz, *supra* note 2.

[11] For example, the U.S. Dodd-Frank Act codified the "source-of-strength" doctrine, requiring parent holding companies of a commercial bank to serve as a "source of strength" to the bank when it faces financial distress. 12 U.S.C. § 1831o-1(a) (2012). While the source of strength doctrine has a long history, some courts have refused to enforce this doctrine before because it essentially "disregard[s] the corporat[e] status." MCorp Fin., Inc. v. Bd. of Governors of the Fed. Reserve Sys., 900 F.2d 852, 863 (5th Cir. 1990). Thus, the codification of this doctrine may provide it a stronger legal ground. For a detailed discussion, see infra Section II.A.1. As another example, Chinese regulators have set up requirements that investors of newly licensed private banks need to bear more liabilities when the bank becomes insolvent. Ouyang Jie (欧阳洁), Yinjianhui Zhuxi Shangfulin: Minying Yinhang Pobing Shidian Zidan Fengxian (银监会主席尚福林:民营银行破冰 试点自担风险)[Chairman Shang Fulin of the Banking Regulatory Commission: Private Banks Breaking Ice, the Pilot Banks Bearing Risks Themselves], Mar. 11, 2014, China Daily (人民网-人民日报) (last visited Jan. 3, 2016), http://finance.people.com.cn/money/n/2014/0311/c42877-24597581.html [perma.cc/SQ44-SW9R]. European countries have also considered adopting shareholder liability; s*ee* Paul Tucker, *Solving Too Big to Fail: Where Do Things Stand on Resolution* (Oct. 12, 2013), http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech685.pdf. For a detailed discussion, see infra Section II.

sharing the same basic agenda of using liability regimes to curb excessive risk-seeking, different countries across the globe have adopted different measures. In the United States, the Dodd-Frank Act has introduced regulatory measures that require holding companies of financial groups to bear liabilities for their subsidiaries, which is essentially a form of shareholder liability.[12] In China, regulators have allowed several new private investors to establish private commercial banks. One of the conditions for getting bank licenses is for each shareholder of the bank with above five percent equity interests to agree to compensate public depositors, should the bank become insolvent.[13] In European countries, although proposals for shareholder liability have been considered, they finally adopted a different approach—a bail-in regime in which creditors absorb losses when banks fail.[14]

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[12] While some of these measures are not entirely new and have been developed prior to the 2008 financial crisis, the Dodd Frank Act has either expanded their scope or provided new legal basis for them. *See e.g.*, 12 U.S.C. § 1831o-1(a) (2012); *see infra* Section II for a detailed discussion; *see also* Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507, 571 (1994) ("The case for using holding company obligations to solve the moral hazard problems associated with financial institutions is in many respects analogous to the argument for reversing the traditional rules of limited liability when corporations establish specialized subsidiaries to engage in high-risk activities that might impose unanticipated losses on third parties.").

[13] Minying Yinhang Faqiren Xieyi Baoguang: Chigu 5% Yishang Gudong yao Doudi 50 Wanyuan Yixia Geren Cunkuan (民营银行发起人协议曝光：持股 5%以上股东要兜底 50 万元以下个人存款) [Agreement Signed by Private Banks Promoters Exposed: Shareholders with Above 5% Shares to Pay Individual Deposits Below 500 Thousand], (last visited Jan. 3, 2016) http://wallstreetcn.com/node/210698 [https://perma.cc/2TXP-9E9Z] (reporting the first group of five private banks to obtain commercial licenses in China agreed shareholders who owning in excess of five percent of the banks share the risk of bank insolvencies).

[14] *See* Emilios Avgouleas & Charles Goodhart, *Critical Reflections on Bank Bail-Ins*, J. FIN. REG. 1, 5–6 (2015).

How do we make sense of these differing approaches? No scholar seems to have taken note of them,[15] nor has any scholar devoted significant effort to evaluate the regimes that have been developed.[16] This is a surprising and problematic omission, given the high stakes—academic, political, and economic—associated with these regimes. This article fills an important gap by presenting the first comparative and functionalist study of shareholder liability schemes for financial institutions, employing the theory of the firm and limited liability. It first develops a framework for thinking about the possible

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[15] As Professor Jackson noted, the theoretical basis for these enhanced obligations remains unclear. Jackson, *supra* note 12, at 572. Jackson found some evidence in support of the "regulatory deterioration hypothesis." *Id.* at 573. According to the regulatory deterioration hypothesis, "enhanced obligations could be understood as mechanisms enacted to offset a cyclical decline in regulatory control within the financial services industry." *Id.* However, the regulatory problem is likely to be universal. European countries and China, for example, would also face regulatory deterioration over time. However, they approach the same problem differently. *See infra* Section IV. This article argues that these different approaches can be better understood through the lens of the theory of the firm and limited liability. *Id.*

[16] In fact, most proposals for the establishment of shareholder liability in the United States before and after the 2008 financial crisis have not considered holding parent-holding companies liable for the debts of their wholly-owned subsidiaries as a form of shareholder liability. *See, e.g.*, Schwarcz, *supra* note 2, at 23; *see also* Conti-Brown, *supra* note 10, at 49; Hill & Painter, *supra* note 6, at 1173; Macey & Miller, *supra* note 10, at 32. Meanwhile, most researchers study the regulatory measures under Dodd-Frank from the perspective of financial regulation, without considering the close relationship between these regulatory measures and shareholder liability. *See, e.g.*, Viral V. Acharya et al., *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Accomplishments and Limitations*, 23 J. APPLIED FIN. 43, 48 (2011); Michael S. Barr, *The Financial Crisis and the Path of Reform*, 29 YALE J. ON REG. 91, 108 (2012) (focusing on future areas for reform); Paul L. Lee, *The Source-of-Strength Doctrine: Revered and Revisited—Part I*, 129 BANKING L.J. 771, 771 (2012); Paul H. Kupiec & Peter J. Wallison, *Can the "Single Point of Entry" Strategy Be Used to Recapitalize a Failing Bank?* 4 (Am. Enter. Inst. Working Paper No. 2014-08); Kwon-Yong Jin, Note, *How to Eat an Elephant: Corporate Group Structure of Systemically Important Financial Institutions, Orderly Liquidation Authority, and Single Point of Entry Resolution*, 124 YALE L.J. 1746, 1750 (2015).

options for shareholder liability regimes and then identifies the key factors that explain the decisions that different countries have made.

To make this analysis as vivid as possible, this article focuses most closely on the contrast between the approaches of two highly salient and quite different countries: the United States and China. Regulators in these two countries have similar goals in developing shareholder liability regimes to limit excessive risk-taking, reduce the potential burden on taxpayers, and limit the potential costs associated with shareholder liability.[17] However, the United States has adopted an "internal" shareholder liability regime, while China has adopted an "external" shareholder liability regime.[18] Compared with the internal shareholder liability regime, the external shareholder liability model interferes with the equity market of financial institutions more directly. This article's analysis allows us to better understand the rationales and shortcomings associated with different regimes. It both helps predict and explain why nations pursue different regulatory strategies and also serves as important guidance for future policy-makings.[19] Furthermore, this article sheds new light on the debate on limited liability: developments in the United States and China suggest that it is possible to establish a shareholder liability regime based on certain regulatory rules.[20] Shareholder liability may be adopted when its advantages outweigh its disadvantages under particular circumstances.[21]

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[17] Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L. J. 387, 390 (2000).

[18] *See infra* Section I.A.3 (distinguishing between internal and external shareholder liability); *see generally* Hansmann & Kraakman, *supra* note 3.

[19] The United States, for example, is considering making changes to the Dodd-Frank Act. *See, e.g.*, Glenn Thrush, *Trump Vows to Dismantle Dodd-Frank 'Disaster,'* N.Y. TIMES (Jan. 30, 2017), https://www.nytimes.com/2017/01/30/us/politics/trump-dodd-frank-regulations.html (reporting President Trump intended to roll back the Dodd-Frank Act to stimulate business). However, as discussed below, several rules in Dodd-Frank may establish shareholder liability to help reduce the likelihood of using taxpayer money to bail out financial institutions, which is one of the core principles set out in a recent Executive Order. Exec. Order No. 13,772, 82 Fed. Reg. 9965 (Feb. 3, 2017). This article contributes to a more comprehensive understanding of the regulatory rules in Dodd-Frank.

[20] In the debate of whether shareholder liability should be adopted, no scholar seems to have noticed the role of regulation. One of the main focuses of the

Part I of this article provides a theoretical discussion on limited liability and its application in the financial industry. Part II examines in detail the similarities and differences of the shareholder liability regimes recently developed in the United States and China. Part III then discusses the advantages and disadvantages of these different regimes and the factors that make shareholder liability appropriate. Part IV applies this theoretical framework to explain and evaluate why different countries and regions have adopted different regimes.

II. Theories of Limited Liability of Corporations in the Financial Industry

Limited liability has been widely adopted as the default rule for shareholders of corporations. However, it incurs costs and benefits, and must sometimes be limited for social efficiency. This section first considers the general costs and benefits of limited liability, then looks at limited liability in the financial industry.

A. The Costs and Benefits of Limited Liability

Scholars have long recognized the costs and benefits of limited liability to address efficiency concerns. Reviewing these discussions can allow us to better understand the current shareholder liability regimes.

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debate is how shareholder liability can be enforced under bankruptcy law. As this article will show, many problems associated with shareholder liability may be handled by regulation rather than bankruptcy law. For the debate on whether limited liability is efficient for general corporations, see Alexander, *supra* note 5, at 431; Grundfest *supra* note 5, at 390; Hansmann & Kraakman, *supra* note 3. For the debate on whether double liability is efficient, see Grossman, *supra* note 10, at 145; Jackson, *supra* note 10, at 921; Macey & Miller, *supra* note 10, at 3.

[21] Hansmann & Kraakman, *supra* note 3, at 1881 (finding the current system encourages reorganization to exploit limited liability); Hansmann & Squire, *supra* note 2, at 3 (reviewing the benefits and costs of corporate partitioning).

1. The Benefits of Limited Liability

Limited liability allows shareholders to partition their assets from those of the corporation, and prevents the creditors of corporations from resorting to the shareholders' personal wealth for fulfillment of the corporation's debts.[22] This arrangement is economically efficient for many reasons.

First, limited liability reduces the information costs for shareholders.[23] For simplicity, let us compare limited liability with joint and several liability.[24] Under joint and several liability, each shareholder would be held responsible for all the liabilities of the corporation they invest in.[25] Shareholders may then only invest in a corporation when they had sufficient knowledge about the corporation and could effectively monitor it,[26] since they would bear liabilities if the corporation became insolvent.[27] After investing, they would also need to constantly monitor the wealth of other shareholders, and spend resources in investigating the wealth of any new shareholders every

[22] According to Hansmann and Kraakman, limited liability is "defensive asset partitioning." *See generally* Hansmann & Kraakman *supra* note 17, at 393. Another type of asset partitioning is "affirmative asset partitioning," which partitions the assets of the subsidiaries from their parent companies. *Id.* at 394 Organizational law, including corporate law, plays an "essential" role in asset partitioning. *Id.* at 390.

[23] Hansmann & Squire, *supra* note 2, at 4 (explaining that though monitoring shareholder personal wealth and affairs and restricting shareholder membership is highly expensive, limited liability eliminates these costs).

[24] I will later discuss other types of shareholder liability, such as pro rata shareholder liability.

[25] *Id.* ("In the general partnership, partners bear joint-and-several liability for partnership debt, and a partner sued by a partnership creditor can seek contribution from her co-partners.").

[26] Mendelson, *supra* note 2, at 1218 ("If the investor were to properly manage the risk, she would have to acquire detailed information on corporate operations, potential corporate liability, and her potential individual exposure in the event of such liability."); Ribstein, *supra* note 2, at 102 (explaining without limited liability, owners of shares would have to be more active in managing and monitoring the firm.).

[27] Mendelson, *supra* note 2, at 1218.

time a transfer of shares occurred.[28] If the corporation had a dispersed ownership structure and if shareholders traded stocks frequently, these costs would be tremendously high. Limited liability, in contrast, reduces these information costs and promotes capital investment.[29]

Second, limited liability allows shareholders to transfer control more efficiently.[30] Without limited liability, wealthy shareholders may be more reluctant to purchase shares in corporations in financial distress because they would expose their personal wealth to creditors of the corporations, and have more to lose compared with less wealthy shareholders.[31] However, wealthy shareholders may possess better knowledge and expertise in running the corporations.[32] Thus, without limited liability, the market for corporate control may not operate efficiently because it does not allocate the right of control of the corporation to the person who can create the highest value.[33]

[28] Easterbrook & Fischel, *supra* note 2, at 96–97 (highlighting that, under an unlimited liability regime, investors would have to negotiate pricing with each group of shareholders depending on their personal wealth, and thus wealthy investors would have to spend even more money researching the firm's other shareholders and their ability to pay if the firm fails).
[29] REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW 10 (2d ed. 2009) (expanding how limited liability necessarily leads to asset partitioning, which in turn allows a creditor to more easily determine the value of the firm without having to factor in the owners' personal finances of, enables a firm to further "isolate different lines of business" through subsidiaries, and "facilitate tradability of its shares.").
[30] *See* Hansmann & Squire, *supra* note 2, at 5 ("Limited liability makes refinancing unnecessary because it allows ownership to change hands without altering the amount of wealth backing the firm's debts.").
[31] *Id.*
[32] *Id*. ("This surcharge on wealthy investors would discourage transfers of control to parties who might be able to run a firm (or monitor its mangers) more effectively.").
[33] Suppose, for example, a corporation has a high financial leverage and may face insolvency. Its shareholder is considering selling the corporation to two buyers. One of them is rich and the other is poor. Under a shareholder liability regime, the new shareholder may be personally liable for the debts of the corporation. The rich buyer may worry that by purchasing the corporation, she would become personally liable. The poor buyer, however, worries less about this risk because she does not have enough assets to bear personal liabilities.

Third, limited liability increases the liquidity of the equity market, by making it easier for shareholders to sell their equity interests to potential buyers.[34] Shareholders are less concerned about the wealth of other shareholders in trading their shares.[35] The prices of shares also more accurately reflect the information about the value of shares because they are not affected by the wealth of the shareholders trading them.[36]

Fourth, limited liability facilitates investment diversification,[37] which creates social value.[38] Shareholders can invest in a tiny stake in many firms and reduce overall risk exposure, without being worried

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She may file for personal bankruptcy, assuming personal bankruptcy is available. Thus, the corporation is more valuable to the poor buyer than the rich buyer simply because the poor buyer may not eventually bear liabilities. However, the rich buyer may be better at running the corporation. Thus, shareholder liability would lead to inefficient allocation of corporate ownership.

[34] Ribstein, *supra* note 2, at 99–100 ("Limited liability is a necessary condition of market efficiency because it facilitates free transferability of shares and pricing of shares according to expected cash flows.").

[35] Hansmann & Squire, *supra* note 2, at 5; *see* Ribstein, *supra* note 2, at 100 (showing how an opposing regime of personal liability encourages concern over shareholder wealth).

[36] Hansmann & Squire, *supra* note 2, at 5 ("[B]y making a share's value independent of who owns it, limited liability increases the informational value of market prices"); Ribstein, *supra* note 2, at 99–100 ("[I]t is necessary for an efficient capital market in which share prices quickly adjust to new information about traded firms and therefore provide the best available unbiased estimate of future returns. Limited liability is a necessary condition of market efficiency because it facilitates free transferability of shares and pricing of shares according to expected cash flows.").

[37] Hansmann & Squire, *supra* note 2, at 5; Ribstein, *supra* note 2, at 101 (arguing a personal liability regime reduces investors' ability to diversify, while limited liability promotes cost reduction and risk shifting).

[38] Hansmann & Squire, *supra* note 2, at 5–6 ("[W]hen a firm's shareholders are diversified, its managers can ignore unsystematic risk when deciding how to invest the firm's funds, widening the range of positive-value projects from which to select.").

that some of the firms they invest in will incur additional liabilities at an unforeseen time.[39]

Fifth, limited liability reduces information costs for creditors.[40] Although limited liability seems to protect shareholders, it is often in the creditors' interests as well. Creditors can evaluate the creditworthiness of firms without considering the wealth of the shareholders.[41] They do not need to spend numerous resources in collecting information on shareholders.[42] They can negotiate a lower interest rate with shareholders and share the surplus in social wealth created by limited liability.[43]

Sixth, limited liability simplifies the bankruptcy process. If shareholders were held liable for the debts of the subsidiaries, a bankruptcy court would need to spend significant time and resources in collecting information about the shareholders' assets and debts, especially when there are a large number of shareholders.[44] Limited liability spares these information costs and promotes social efficiency.[45]

Although limited liability offers many benefits compared to joint and several liability, researchers have pointed out that a pro rata shareholder liability rule may also provide many of the same

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[39] Henry G. Manne, *supra* note 2, at 262 ("[T]he possibility of liability arising at an unforeseen time and in an unpredictable amount would probably be too great a risk for large numbers of small investors to shoulder.").

[40] Hansmann & Squire, *supra* note 2, at 6 (arguing limited liability is able to reduce information costs because it reduces the overall set of factors creditors must analyze when making a decision to extend credit).

[41] *See id*. at 6 ("[L]imited liability provides large informational benefits to creditors only when combined with entity shielding—that is, when partitioning is symmetrical rather than asymmetrical.").

[42] *See id.*

[43] As long as limited liability creates social wealth, both creditors and shareholders can benefit from this arrangement. *Id.* at 4–6 (defining social wealth as economic efficiency and describing the benefits limited liability provides for shareholders and creditors).

[44] *Id*. at 6 ("A public company's bankruptcy would be unmanageable if the bankruptcy court had to take into account not only the company's balance sheet but also each shareholder's personal assets and debts.").

[45] *See id.* (explaining symmetrical partitioning makes bankruptcy economically more efficient by allowing debtors to quickly redeploy assets).

benefits.[46] Under pro rata shareholder liability, each shareholder is liable for an additional amount over the initial investment depending on her share of equity interests, independent of the wealth of the other investors.[47] For example, suppose two shareholders set up a corporation, each investing $100 in exchange for 50 percent of its stock. Suppose the corporation becomes insolvent and still owes $200 to creditors. Each shareholder may be required to put in an additional amount of $100 when the corporation fails. Under a pro rata shareholder liability regime, if one of the shareholders does not have enough money to pay, it does not change what the other shareholder needs to pay. This arrangement may reduce the need for each shareholder to monitor one another.[48] However, it may still incur the other types of costs discussed above. For example, some shareholders may have insufficient assets and thus lack the ability to bear their share of liabilities. In such cases, the liquidity of the equity market may still be affected, since prices still reflect the wealth of some shareholders.[49] In a bankruptcy proceeding, the court may still need to investigate the assets and debts of a large number of shareholders.[50]

2. The Costs of Limited Liability

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[46] Hansmann & Kraakman, *supra* note 3, at 1892–93 (comparing the benefits and challenges of pro rata and joint and several liability for closely held firms and finding "[they] would be hard pressed to choose between the joint and several and the pro rata rules").

[47] *Id.* at 1906 ("Under [pro rata liability], a shareholder's risk would depend only on the size of her own investment rather than on the wealth of other shareholders.").

[48] *See id.* ("[T]he only effect of pro rata liability would be a marginal increase in shareholder incentives to monitor the enterprise's expected tort losses.").

[49] *See* Hansmann & Squire, *supra* note 2, at 6 (discussing how limited liability reduces the need for creditors to monitor wealth to determine the value of equity interests).

[50] *See* Hansmann & Kraakman, *supra* note 3, at 1894 ("[E]ven impecunious shareholders may fear bankruptcy so much that they are unwilling to gamble on risky investments.").

Limited liability also incurs certain costs. The protection of limited liability incurs "agency costs of debt."[51] When shareholders are protected by limited liability, corporations may engage in activities that do not increase their overall value, but simply shift wealth from creditors to shareholders.[52] For example, debtors can invest in riskier projects. Since higher risk is usually associated with higher return, shareholders can benefit from the potential gain and share potential losses with creditors because of limited liability.[53] Similarly, debtors can incur additional debt, increasing the financial leverage, which also raises their risks and benefits shareholders.[54] These activities can be called "debtor misconduct."[55]

Voluntary creditors usually take "debtor misconduct" into account when they transact with debtors[56] and try to limit such actions using contractual covenants.[57] Thus, they need to spend significant resources designing and negotiating contract terms with debtors, which

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[51] Hansmann & Squire, *supra* note 2, at 8; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305 (1976).

[52] *See* William W. Bratton, *Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process*, 7 EUR. BUS. ORG. L. REV. 39, 48 (2006) ("[S]hareholders thus have an incentive to make an investment that decreases economic welfare, with the cost falling on the firm's lenders.").

[53] Hansmann & Squire, *supra* note 2, at 8 n.27 (discussing overinvestment and the disparate effect it has on creditors and equity holders).

[54] *See id.*

[55] *Id.* (stating that when a firm has debt, managers can shift risk onto the firm's creditors).

[56] *Id*. ("[T]he anticipation of debtor misconduct induces creditors to incur monitoring costs to prevent it . . . .")

[57] Jensen & Meckling, *supra* note 51, at 337–38 ("[I]t would be possible for the bondholders, by the inclusion of various covenants in the indenture provisions, to limit the managerial behavior which results in the reductions in the value of bonds."); Robert M. Lloyd, *Financial Covenants in Commercial Loan Documentation: Uses and Limitations*, 58 TENN. L. REV. 335, 335 (1991) ("Commercial lenders have long put financial covenants in most large loan agreements."); George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073, 1074 (1995) (discussing debt covenants in lending agreements).

incurs social costs.[58] Still, debtors may engage in socially undesirable activities, either because creditors fail to limit them or they are simply involuntary creditors who cannot effectively negotiate with the debtors. The direct and indirect social costs caused by debtor misconduct can be termed together as "agency costs of debt."[59]

In evaluating the costs and benefits of limited liability, a distinction needs to be drawn between tort and contract creditors. While voluntary creditors can use contracts to protect themselves, tort victims do not engage in negotiations with corporations.[60] Nor can they control the activities of tortfeasors. Thus, tort victims are especially susceptible to debtor misconduct.[61] Corporations may invest too little in preventing accidents and too much in hazardous activities.[62] This problem becomes more severe when corporations incur a lot of debt or dissolve before liability claims arise.[63]

3. *Internal v. External Asset Partitioning*

The costs and benefits of limited liability depend on the type of shareholder liability it is compared to. Theoretically, we can draw a distinction between two types of shareholder liability, internal and

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[58] Hansmann & Squire, *supra* note 2, at 8.
[59] *Id.*
[60] Hansmann & Kraakman, *supra* note 3, at 1919 ("Tort victims, unlike contract creditors, cannot assess the potential creditworthiness of a corporation before they are injured, much less insist on compensation for bearing the risk that they will suffer harms that the corporation's assets are insufficient to cover.").
[61] Hansmann & Squire, *supra* note 2, at 9 (discussing incorporation as a strategy to reduce recoveries for tort creditors).
[62] Hansmann & Kraakman, *supra* note 3, at 1883 ("[L]imited liability [creates] the incentive . . . for the shareholder to direct the corporation to spend too little on precautions to avoid accidents . . . [and] encourages overinvestment in hazardous industries.").
[63] *Id.* at 1884. Corporations are sometimes referred to as "externalizing machines." LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY 49 (2001). Professor Mendelson identified the same problem and proposed to use control-based liability regime to solve the same problem. *See generally* Nina A. Mendelson, *supra* note 2.

external shareholder liability, using the theory of asset partitioning.[64] Limited liability creates a form of asset partitioning,[65] which can be further divided into two types, external and internal asset partitioning.[66] Internal partitioning means separating the assets of the parent-holding company from its wholly-owned subsidiaries, usually within a corporate group, while external partitioning refers to the partitioning of assets of a corporation from its many shareholders, who do not wholly own the corporation.[67] In other words, if we regard a corporate group as one single corporation, internal asset partitioning creates "legal boundaries" within the corporation.[68] External asset partitioning, by contrast, creates legal boundaries between corporations that cannot be treated as parts of a single group.[69]

Internal shareholder liability means disregarding internal asset partitioning and ignoring legal boundaries between corporations within a corporate group.[70] For example, a financial-holding corporation may own subsidiary corporations in different financial sectors. JP Morgan Chase & Co., for example, controls a commercial bank subsidiary (JPMorgan Chase Bank, N.A), a broker-dealer firm (J.P. Morgan Securities LLC), a clearing corporation (J.P. Morgan Clearing Corp.), and many other corporations. Internal asset partitioning means the partitioning of assets between these subsidiary corporations and the parent-holding corporation.[71] A JPMorgan Chase Bank, N.A creditor thus cannot sue J.P. Morgan Chase & Co. for the debts of the subsidiary bank. Correspondingly, if the parent-holding company, J.P. Morgan Chase & Co., is held liable for the debts of its subsidiary, it can be called an internal shareholder liability regime.

Consider another example. Suppose a commercial bank is not owned by a parent-holding company, but rather by many shareholders, each owning a block of shares in the bank. External asset partitioning

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[64] *See generally* Hansmann & Kraakman, *supra* note 22.
[65] *See generally id.*
[66] Hansmann & Squire, *supra* note 2, at 1.
[67] *Id.* at 4.
[68] *Id.* at 1.
[69] *Id.*
[70] *See id*. at 4.
[71] JPMorgan Chase & Co., Annual Report (Form 10-K, Exhibit 21.1) (Feb. 29, 2008) [hereinafter List of Subsidiaries of JP Morgan Chase & Co.].

means creditors of the commercial bank cannot resort to the assets of any of its shareholders to pay off the debts of the bank, unless external shareholder liability has been adopted.[72] Clearly, external shareholder liability could be designed in more than one way. The law can, for instance, impose shareholder liability only on those holding more than 5 percent share of stocks. The liability amount can be capped at the par value of their stocks. External shareholder liability simply means the shareholders held liable do not wholly own the subsidiary corporation.

According to Professors Hansmann and Squire, more benefits are associated with external asset partitioning than with internal partitioning.[73] Accordingly, more costs are associated with external shareholder liability than internal shareholder liability. As discussed earlier, limited liability has six major benefits.[74] Internal partitioning usually only offers one of them—facilitating transfers of control.[75]

Consider again the J.P. Morgan Chase & Co. example. First, internal partitioning does not reduce the costs of monitoring other equity shareholders.[76] J.P. Morgan Chase & Co. is the parent-holding company that wholly owns its subsidiaries and consequently it has no need to monitor the wealth of other shareholders.[77] It does not even trade the stocks that it holds, at least not frequently. Thus, internal asset partitioning does not reduce information costs. Accordingly, disregarding the legal boundaries within the corporate group would not raise the costs of monitoring. Second, the liquidity of the equity market of the subsidiaries of J.P. Morgan Chase & Co. is also not an important concern, because the equity interests in these subsidiaries are not frequently traded.[78] Third, internal partitioning may theoretically allow

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[72] Hansmann & Squire, *supra* note 2, at 4 (defining external asset partitioning).
[73] *Id.* at 3 ("Like previous commentators, we argue that the case for enforcing external partitions is stronger than the case for enforcing internal partitions.").
[74] *See supra* Section I.A.1.
[75] Hansmann & Squire, *supra* note 2, at 14 ("[Internal partitioning] tend[s] to provide only one [benefit] with meaningful frequency: the promotion of efficient control transfers.").
[76] *Id.* at 10 (listing "lower inter-shareholder monitoring costs" as a benefit internal partitioning cannot provide).
[77] List of Subsidiaries of JP Morgan Chase & Co., *supra* note 71.
[78] *See* Hansmann & Squire, *supra* note 2, at 13 (explaining corporate groups are typically single businesses organized as multiple legal entities).

corporate groups to diversify their investments, although they rarely do so in practice.[79] Theoretically, a parent-holding company can hold many subsidiaries in order to reduce the overall risk exposure. Each corporate subsidiary is a distinct legal entity.[80] Thus, one of them becoming insolvent does not affect the equity value of others. However, corporate groups rarely do so, since the parent-holding company often offers intra-group guarantees to subsidiaries.[81] Fourth, internal asset partitioning does not reduce information costs for creditors of the subsidiaries, since in practice most corporations provide consolidated financial reports, and engage in intra-group guarantees.[82] Given that subsidiaries' creditors would take into account the creditworthiness of the parent-holding company, holding the parent-holding company liable does not raise the costs that these creditors need to incur.[83] Fifth, even if internal shareholder liability is not in place, when a corporate group fails, the bankruptcy cases of its members are usually consolidated.[84] Thus, internal shareholder liability does not incur additional bankruptcy costs.

The only benefits offered by internal asset partitioning is that it facilitates transfers of control.[85] Suppose that a corporate group is in financial distress. The parent-holding company wants to transfer the ownership of its subsidiary bank to another corporation. Without internal asset partitioning, wealthy investors may not be willing to assume ownership since they would be liable for the debts of the subsidiary bank, even though they may better operate the subsidiary bank and make it profitable again. Thus, internal shareholder liability hinders transfers of control and incurs certain social costs.

Hansmann and Squire have developed this distinction of internal and external asset partitioning and discussed its implication on veil-piercing and enterprise liability.[86] As this article will show, this

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[79] *Id.*
[80] *Id.*
[81] *Id.* at 12.
[82] *Id.* at 12 (listing consolidated financial reports and intra-group guarantees as practices that undercut the benefit of reduced information costs).
[83] *Id.*
[84] *Id.* at 10–11.
[85] *Id.* at 13.
[86] *Id.* at 22–25.

distinction also has an important implication for designing regulatory rules in the financial industry—at least for some countries, internal shareholder liability may be less costly to establish compared to external shareholder liability.[87]

B. Limited Liability in the Financial Industry

While theories on limited liability generally apply to all firms and corporations,[88] analysis of the social benefits of limited liability must include the characteristics of specific industries. In the financial industry, limited liability incurs high agency costs of debt.[89]

Unlike tort victims, creditors of financial institutions are voluntary creditors and can choose their counterparties.[90] They can choose to transact with financial firms with lower risks, or to negotiate more favorable terms in contracts with riskier creditors.[91] However, the special features of the financial system make limited liability very costly.[92] The state sometimes cannot allow creditors to bear losses because the collapse of systemically important financial institutions (SIFIs) may send a shockwave through the economic system and create "contagions" of collapse.[93] Thus, the government may have no choice but to bail out the creditors of SIFIs.[94] Moreover, many

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[87] *See infra* Section III.

[88] Hansmann & Kraakman, *supra* note 3, at 1921 (arguing unlimited liability should apply where the victim was unable, "prior to the injury, to assess the risks she took in dealing with the firm and to decline to deal if those risks seemed excessive in comparison with the net advantages she otherwise derived from the transaction").

[89] *See id.* at 1884 n.12.

[90] *Id.* at 1884 n.11 ("If . . . tort claimants had priority over all voluntary creditors, borrowing would not affect the incentives of the risk-neutral shareholder because lenders would demand compensation for the possibility that their loans will be used to pay tort victims.").

[91] *Id.*

[92] *See* Avgouleas & Goodhart, *supra* note 14, at 3.

[93] *Id.* (explaining why bank bail-in regimes will not eradicate the need for injection of public funds where there is a threat of systemic collapse).

[94] *Id.* at 17. Many creditors, such as pension funds and individual savers, do not have the "expertise to act as effective bank monitors" and may be "tricked

creditors of banks are public depositors, who lack expertise in monitoring banks. A deposit insurance system may be established to pay off debts to public depositors.[95] Other financial institutions may also be bailed out to prevent systemic risks.[96]

Bailouts, however, create moral hazards because they reduce the incentives of creditors to monitor the risk-seeking activities of the financial firms. Since the losses of financial institutions are borne in part by taxpayers, these institutions may undertake excessive risks because they do not fully internalize the costs.[97] There are different ways to structure bailouts.[98] One possibility is to wipe out all equity and inject capital to a corporation, which would leave all creditors intact.[99] It is also possible to impose "haircuts" on creditors' claims,[100] in which case creditors still absorb losses to some extent. Whatever methods the government chooses, the expectation for bailouts reduces the incentives of creditors to monitor the financial institutions.[101] Thus, limited liability of financial institutions creates social costs because taxpayers cannot control the financial institutions.

After the 2008 financial crisis, some scholars examined the effects of limited liability on excessive risk-taking, and reached the

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into buying bail-in-able debt." The state may need to protect them in order to strengthen their confidence in the banking system. *Id.*

[95] *Who is the FDIC?*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/about/learn/symbol/ [https://perma.cc/XN7C-45VG].

[96] FINANCIAL STABILITY BOARD, ASSESSMENT METHODOLOGIES FOR IDENTIFYING NON-BANK NON-INSURER GLOBAL SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS (2014) http://www.fsb.org/wp-content/uploads/r_140108.pdf.

[97] EUGENE N. WHITE, RETHINKING THE REGULATION OF BANKING: CHOICES OR INCENTIVES? 2 (Dec. 6, 2011) (on file with the author) (arguing financial reform should focus on changing the incentives that parties face).

[98] Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L. J. 435, 491 (2011).

[99] *See id.* at 511 ("Treasury's capital injections into major financial institutions in the fall of 2008 had aspects of a gavage investment . . . .").

[100] *Id.* at 440 (stating that one issue in bailout structure is "whether creditors of bailed-out firms can be forced to accept less than full payment (or take a 'haircut') as part of the bailout").

[101] *See* WHITE, *supra* note 97, at 2 ("[D]eposit insurance . . . expanded to protect almost all depositors who then had little incentive to monitor banks.").

conclusion that limited liability led to moral hazard.[102] Shareholders of financial institutions have incentives to pursue risks, because they share losses with creditors (or taxpayers) if investments are unsuccessful. Additionally, shareholders possess at least some control over managers of financial firms,[103] and also share a significant proportion of the profits of the firms.[104] For these reasons, many scholars argue that shareholder liability be established in the financial industry.[105]

III. The Current Shareholder Liability Regimes

Recent developments in the banking industry echo these theoretical discussions. The two largest economies in the world—the United States and China—have adopted two different types of shareholder liability regimes.[106] This section discusses the details of these two regimes and their functions in reducing the agency costs of debt and the likelihood of bailouts.

A. Internal Shareholder Liability

After the financial crisis, the United States enacted the Dodd-Frank Act to address regulatory problems and sought to avoid using taxpayers' money to bail out large financial institutions in the future.[107] Dodd-Frank adopted several measures to help achieve this goal.

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[102] Hill & Painter, *supra* note 6.
[103] Schwarcz, *supra* note 2, at 18 ("Relatively small firms, such as hedge funds, that operate in the shadow banking system are often managed directly by their primary investors.").
[104] *Id*.
[105] *Id*. at 10.
[106] *See infra* Section IV.A–B.
[107] Barack Obama, *Remarks on Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act*, 2 PUBLIC PAPERS OF THE PRESIDENT OF THE UNITED STATES 1087, 1089 (2010) (ebook) (highlighting Dodd-Frank's "clear rules and basic safeguards . . . that ensure that it is more profitable to play by the rules than to game the system" and announcing that there "will be no more tax-funded bailouts, period").

1. *The Source-of-Strength Doctrine*

The Dodd-Frank Act codifies the "source-of-strength" doctrine for the first time, although the Board of Governors of the Federal Reserve (the Board) has argued Congress intended to and did codify the doctrine in earlier statutes.[108] According to this doctrine, banking regulators "shall require a bank holding company or savings and loan holding company to serve as 'a source of financial strength' for [a] subsidiary that is . . . a depository institution."[109] The source-of-strength doctrine has a long history.[110] It first appears in the Bank Holding Company Act of 1956 (the BHC Act).[111] When an investor acquires a bank, it needs to seek approval from the Board.[112] Section 3(c)(2) of the BHC Act requires the Board to consider "the financial and managerial resources and future prospects of the company or companies."[113] The Board has invoked this doctrine many times since 1960s.[114] For example, in 1976, First Lincolnwood Corporation applied to become a bank holding company through an acquisition of the bank's voting shares.[115] The Board stated, "[a] bank holding company should provide

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[108] Leonard Bierman & Donald R. Fraser, *The "Source of Strength" Doctrine: Formulating the Future of America's Financial Markets*, 12 ANN. REV. BANKING L. 269, 269 (1993) (explaining the origin of the source of strength doctrine in a Federal Reserve Board regulation and how the Fed has read the doctrine into various Acts of Congress, though Congress did not clearly intend to codify the doctrine); Paul L. Lee, *The Source-of-Strength Doctrine: Revered and Revisited—Part II*, 129 BANKING L.J. 867, 868 (2012).
[109] 12 U.S.C. § 1831o-1(a) (2012).
[110] *See generally* Lee, *supra* note 16.
[111] 12 U.S.C. § 1842(c)(2) (2012) (requiring the Board consider financial and managerial resources of a company applying to become a BHC).
[112] 12 U.S.C. § 1842(a)(4) (2012) ("It shall be unlawful, except with the prior approval of the Board . . . for any bank holding company or subsidiary thereof, other than a bank, to acquire all or substantially all of the assets of a bank.").
[113] 12 U.S.C. § 1842(c)(2) (2012).
[114] Lee, *supra* note 16, at 773 (explaining the Board regularly addressed proposals in the BHC Act's early years, sometimes expressly invoking the doctrine and other times implicitly invoking the doctrine).
[115] First Lincolnwood Corp. v. Bd. of Governors of the Fed. Reserve Sys., 546 F.2d 718, 720 (7th Cir. 1976) ("[T]he Federal Reserve Bank of Chicago (Chicago Reserve Bank) accepted an application of First Lincolnwood to

a source of financial and managerial strength to its subsidiary bank(s)."[116] However, the Board was concerned that "the financial requirements imposed upon Applicant as a result of the acquisition debt, and uncertainty as to the source of funds for Bank's proposed capital injections, could prevent Applicant from resolving any unforeseen problems that may arise at Bank."[117] Thus, the Board denied the application.[118]

In the 1980s, the Board codified the source-of-strength doctrine in Regulation Y and expanded the scope of this doctrine.[119] In a policy statement issued in 1987, the Board stated:

> "[I]n serving as a source of strength to its subsidiary banks, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks."[120]

According to this rule, the source-of-strength doctrine also applies after an applicant has been approved by the regulatory agency to become a bank holding company and when its bank subsidiary faces financial distress.[121] Later in an important case in 1988, this doctrine was tested in court when the Board issued a Notice of Charges against MCorp, a bank holding company, requiring it to use all of its available

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become a bank holding company through the acquisition of eighty per cent or more of the voting shares of the Bank.").

[116] *Id*. at 722.

[117] *Id.* at 723.

[118] *Id*.

[119] Lee, *supra* note 16, at 775 ("[T]he Board vastly expanded the potential scope and application of the source-of-strength doctrine.").

[120] Policy Statement; Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 52 Fed. Reg. 15,707 (Apr. 30, 1987) (codified at 12 C.F.R. pt. 261).

[121] 12 C.F.R. 225.21 (2017) (detailing the activities that a bank holding company may engage in).

assets to recapitalize the subsidiary banks that face financial problems.[122] The district court ruled in favor of MCorp.[123] The Board appealed to the Fifth Circuit, which held that the Board was without authority to require MCorp to transfer funds to subsidiary banks.[124] According to the Fifth Circuit, the Board can only apply the source-of-strength doctrine in determining whether to grant approval to bank holding company applicants.[125] The Fifth Circuit held that requiring the parent holding company to transfer funds to its subsidiaries might interfere with the corporate law principles.[126] The court stated:

> "[s]uch a transfer of funds would require MCorp to disregard its own corporation's separate status; it would amount to a wasting of the holding company's assets in violation of its duty to its shareholders. Also, one of the fundamental purposes of the BHCA is to separate banking from commercial enterprises. That purpose is obviously not served if the Board is permitted to treat a holding company as merely an extension of its subsidiary bank."[127]

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[122] MCorp Fin., Inc. v. Bd. of Governors of the Fed. Reserve Sys., 900 F.2d 852, 853 (5th Cir. 1990).

[123] In re MCorp, 101 B. R. 483, 490 (S.D. Tex. 1989) (holding that in the situation "of a bank holding company with nonbank subsidiaries, accommodation of the two national interests in bankruptcy and banking requires that the bankruptcy court have primacy over the non-operations aspects of the debtor and that the Board, after participating, abide by the capital allocation and structural aspects of the debtor as determined in the bankruptcy rather than conducting its independent action").

[124] MCorp Fin., Inc. v. Bd. of Governors of the Fed. Reserve Sys., 900 F.2d 852, 861–62 (5th Cir. 1990) ("The BHCA does not grant the Board authority to consider the financial and managerial soundness of the subsidiary banks after it approves the application, and *First Lincolnwood* finds this regulatory authority lacking in the day-to-day operations of a subsidiary bank. For these reasons, we conclude that the Board is without authority under the BHCA to require MBank to transfer its funds to its troubled subsidiary bank.").

[125] *Id*. at 861.

[126] *Id.* at 863.

[127] *Id*.

However, the Supreme Court granted a certiorari review of the decision and concluded that judicial review was inappropriate until MCorp exhausted administrative appeals.[128] Thus, it did not reach the merits of the source-of-strength doctrine.[129] It remains unclear after this case whether courts would refuse to enforce the source-of-strength doctrine.[130]

In addition to its enforceability, the validity of the source-of-strength doctrine also remained unclear after the MCorp case.[131] The Federal Deposit Insurance Corporation (FDIC) has provided a statutory basis to the implementation of this doctrine.[132] The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) developed a "prompt corrective action" regime.[133] Pursuant to the provisions of the FDICIA, when an insured institution becomes under-capitalized, it must submit an "acceptable capital restoration plan" to

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[128] Board of Governors of the Fed. Reserve Sys. v. MCorp Fin., Inc., 502 U.S. 32, 44 (1991).

[129] *Id.* at 34 (concluding that the district court lacked jurisdiction and declining to reach the merits).

[130] Many scholars believe the validity of this doctrine remains unclear. Lissa L. Broome, *Redistributing Bank Insolvency Risks: Challenges to Limited Liability in the Bank Holding Company Structure*, 26 U.C. DAVIS L. REV. 936, 964 (1992–1993) ("Although the Supreme Court reviewed the case, it did not reach the question of whether the source of strength regulation was within the statutory authority of the Federal Reserve Board, and the validity of the regulation remains unresolved."); Jackson, *supra* note 12, 538–39. After the U.S. Supreme Court ruling, the Board did not terminate its administrative action against MCorp until it later injected additional capital to its bank subsidiary. Lee, *supra* note 16, at 778.

[131] Broome, *supra* note 130, at 964 ("[T]he validity of the regulation remains unresolved."); Jackson, *supra* note 12, 538–39. Michael P. Malloy, *Banking in the Twenty-First Century*, 25 J. CORP. L. 787, 814 (2000); Lee, *supra* note 16, at 778 ("Alas, there was to be no ultimate judicial determination of the breadth of the source-of-strength doctrine.").

[132] Lee, *supra* note 16, at 791 ("The legislative responses reflected in the cross-guarantee provision of FIRREA and the capital restoration plan guarantee provision of FDICIA may be seen as efforts to provide both clearer bounds for the regulated entities and easier enforcement for the regulators of sub-elements of the source-of-strength doctrine.").

[133] 12 U.S.C. § 1831o.

the appropriate banking agency.[134] In order for the plan to be approved by the banking regulatory agency, its controlling company must "guarantee that the institution will comply with the plan" and provide "appropriate assurances of performance."[135] Thus, the holding company must make a choice: it must "decide promptly whether to recapitalize the institution, sell it, or stand behind it until it recovers."[136] Once the holding company decides to guarantee the implementation of the plan, this guarantee becomes enforceable even if the holding company enters bankruptcy, in which case the FDIC's claim against the holding company is prior to other unsecured creditors of the bank holding company.[137] Thus, in order for the holding company to continue to be the owner of the subsidiary bank that is undercapitalized but before it becomes insolvent, it must agree to bear shareholder liability for the debts of the subsidiary bank.

In 1999, the Modernization of Financial Service Act (Gramm-Leach-Bliley Act) provides another statutory basis for the source-of-strength doctrine.[138] Pursuant to Section 730 of the Gramm-Leach-Bliley Act, if a holding company transfers assets to a subsidiary insured depository institution as instructed by the banking regulatory

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[134] 12 U.S.C. § 1831o(e)(2)(A).

[135] *Id.* ("Any undercapitalized insured depository institution shall submit an acceptable capital restoration plan to the appropriate Federal banking agency within the time allowed by the agency under subparagraph (D)."). However, observers have pointed out that companies with control may choose not to guarantee, although doing so would cause the capital restoration plan to fail. Lee, *supra* note 16, at 780. The liability of the controlling company is limited to the lesser of "an amount equal to five percent of the institution's assets at the time it became undercapitalized" or "the amount which is necessary to bring the depository institution into compliance with all capital standards." *Id.*

[136] Richard S. Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 339 (1993).

[137] *See* Lee, *supra* note 16, at 781. There are, however, still obstacles the FDIC must overcome in enforcing claims against the holding companies. *See id.* ("A bankruptcy court decision in 2010 relating to Colonial BancGroup, a bank holding company and Chapter 11 debtor, however, demonstrates the difficulties that may lie ahead with respect to the enforcement of the source-of-strength doctrine in bankruptcy cases.").

[138] Financial Modernization (Gramm-Leach-Bliley) Act of 1999, Pub. L. No. 106–102, 113 Stat. 1338 (1999).

agency, no party can bring a claim for the return of the assets when the holding company enters bankruptcy proceedings.[139] Although this is not an explicit codification of the source-of-strength doctrine, it implicitly recognizes this doctrine and allows the banking regulatory agency to command shareholders of insured depository institutions to absorb losses of the subsidiaries.

The codification of this doctrine in the Dodd-Frank Act provides an additional statutory basis and grants the banking regulatory agencies clear authority for enforcing claims against the holding companies.[140] The Dodd-Frank Act made it clear that the term "source of financial strength" means "the ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event of the financial distress of the insured depository institution."[141] After this statute took effect in 2011, the Board referenced this section in several of its formal enforcement actions against bank holding companies (BHCs) containing a capital plan requirement.[142] Courts are not likely to refuse to enforce the source-of-strength doctrine. In *MCorp*, the main reasons that the Fifth Circuit refused to enforce the source-of-strength doctrine was because requiring the holding company to transfer funds to the subsidiary constituted waste and would violate the fiduciary duty owed to its shareholders.[143] Given that the statute codifies the source-of-strength doctrine, the holding company has a legal duty to transfer funds to the subsidiary, which can hardly be regarded as waste or a violation of fiduciary duty. When a subsidiary bank becomes undercapitalized, banking agencies may require the holding company to inject additional

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[139] *Id.* at § 730 (clarifying the source of strength doctrine).
[140] Lee, *supra* note 108, at 871 ("They provide or purport to provide clearer avenues for enforcing a claim against a controlling party. Section 38A will simply serve as an additional statutory basis for the existing regulatory practice.").
[141] 12 U.S.C. § 1831o-1(e).
[142] Lee, *supra* note 16, at 779 (describing BHC capital requirement under Section 38 of the FDIA).
[143] MCorp Fin., Inc. v. Bd. of Governors of the Fed. Reserve Sys., 900 F.2d 852, 863 (5th Cir. 1990).

capital, essentially similar to having the holding company absorb losses and take responsibility of the debts of the subsidiary bank.[144]

2. The Single Point of Entry Strategy

Another regulatory measure developed by the Dodd-Frank Act, the single point of entry (SPOE) strategy, also make holding companies of large financial institutions take legal responsibility for the debts of the subsidiaries when they become insolvent.[145] The SPOE is developed under the Orderly Liquidated Authority (OLA).[146] One major problem with liquidating a SIFI was that regulators lacked sufficient power and authority to handle the bankruptcy of systemically important financial institutions.[147] The U.S. FDIC had power to place insured depository institutions into receivership.[148] However, many nonbank financial companies also pose significant risks to the economic system. Prior to the Dodd-Frank Act, these companies could only be resolved through bankruptcy, which may

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[144] Leonard Bierman & Donald R. Fraser, *The "Source of Strength" Doctrine: Formulating the Future of America's Financial Markets*, 12 ANN. REV. BANKING L. 269, 269 (1993) ("In essence, and in clear contradiction to traditional corporate law, the Federal Reserve has mandated a "piercing of the corporate veil" in the banking industry.").

[145] For a detailed discussion of the mechanism of SPOE, see Jeffrey N. Gordon & Wolf-Georg Ringe, *Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take*, 115 COLUM. L. REV. 1297, 1320 (2015).

[146] *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy*, 78 Fed. Reg. 76, 614 (Dec. 18, 2013) ("[T]he FDIC has been developing its capabilities for implementing the Orderly Liquidation Authority . . . . [F]or the orderly resolution of a systemically important financial institution.").

[147] FED. DEPOSIT INS. CORP. & BANK OF ENG., RESOLVING GLOBALLY ACTIVE, SYSTEMICALLY IMPORTANT, FINANCIAL INSTITUTIONS 2 (2012) [hereinafter FDIC Paper], www.fdic.gov/about/srac/2012/gsifi.pdf [https://perma.cc/5D2T-9VPY] ("In the U.S., the FDIC only had the power to place insured depository institution into receivership; it could not resolve failed or failing bank holdings companies or other nonbank financial companies that posed a systemic risk.").

[148] *Id.*

create financial disorder.[149] Title II of the Dodd-Frank Act created the OLA, which enables the FDIC to place any U.S. financial institution under receivership if it meets certain criteria.[150]

SPOE places the corporation at the top of the group in receivership when it meets certain criteria, including being in danger of default. The FDIC will transfer the assets of the holding corporation to a bridge financial holding corporation, while the equity and most unsecured liabilities of the bank holding corporation will remain in the receivership.[151] Thus, the assets in the new bridge financial corporation will likely exceed the liabilities, leaving the new corporation well capitalized.[152] Assets will be evaluated and the losses will be apportioned to shareholders and the unsecured creditors in the receivership.[153] Equity claims will likely be wiped out.[154] Debt claims will also be written down to reflect the losses in the receivership.[155] The remaining debt claims will be converted into equity claims or subordinated debt in the new operations.[156]

It remains ambiguous whether the parent-holding corporation would be compelled to provide support for the financial subsidiaries, once they become well capitalized. Some researchers suggest that they would be.[157] The regulators did not make it clear in their interpretation. However, the OLA is triggered when one of the SIFI subsidiary face the danger of default.[158] SPOE cannot resolve the financial distress

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[149] *Id*. ("The legislative frameworks and resolution regimes at the time were ill-suited to dealing with financial institution failures of this scale . . . .").
[150] *Id*. at 4.
[151] *Id*. at 6.
[152] *Id*.
[153] *Id*.
[154] *Id.* ("In all likelihood, the equity holders would be wiped out.").
[155] *Id.*
[156] *Id*. ("At this point, the remaining claims of the debt holders will be converted, in part, into equity claims that will serve to capitalize the new operations. The debt holders may also receive convertible subordinated debt in the new operations.").
[157] Gordon & Ringe, *supra* note 145, at 1299–300 (stating "serious losses at operating subsidiaries can be moved upstream to the holding company"); Kupiec & Wallison, *supra* note 16, at 3–4.
[158] *Id.* at 5.

without some advances from the parent-holding corporation to the distressed subsidiary.[159]

One example illustrating the mechanism of SPOE would be a financial corporate group consisting of a parent-holding corporation with assets of $200, equity of $50, unsecured liabilities of $100 and secured liabilities of $50. It holds $100 in the equity of the subsidiary financial institutions and has provided an intercompany loan of $100 to the subsidiary. One of the subsidiary corporations has $100 in equity, liabilities of $500 and total assets of $600. The subsidiary loses $120, and becomes insolvent. The FDIC may place the parent corporation in receivership, and write down the equity claims ($50) and unsecured liabilities ($70) to absorb the full $120 losses. The parent-holding corporation can then become well capitalized and provides support to the subsidiary.[160] The FDIC may also convert the remaining $30 in unsecured liabilities to equity in the new parent-holding corporation and allow these new equity holders to control the corporation.

It remains unclear, however, whether and how the SPOE strategy would be used to recapitalize an insolvent subsidiary bank.[161] Some scholars argue that there are some legal obstacles before the FDIC can control the bank holding corporation to support its subsidiaries.[162] The Dodd-Frank Act grants authority to the secretary of the Treasury to orderly liquidate a "covered financial company," that is "in default or in danger of default."[163] When a subsidiary bank

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[159] Jin, *supra* note 16, at 1752–53. ("Under SPOE, when a financial group is in danger of failing, the FDIC would place the parent company of that group into receivership but leave its subsidiaries out of resolution. Next, the FDIC would transfer all assets of the parent to a bridge company and leave the debt behind, creating a well-capitalized bridge company that could assist the subsidiaries as needed.").

[160] *Id.* at 1767.

[161] *See generally* Kupiec & Wallison, *supra* note 16 ("[I]n the analysis that follows, we focus on issues that arise when OLA authority and the SPOE strategy are used to recapitalize an insolvent subsidiary bank of a large BHC.").

[162] *Id.* at 5 ("There are additional features in Title II that create new financial sector risks and legal hurdles that complicate OLA's use.").

[163] 12 U.S.C. § 5383 (2012).

faces insolvency, it is unclear whether it would cause the bank holding company to be in default or in danger of default. If this condition is not met, OLA is not triggered, and thus the bank holding company would not be responsible for the debt of the subsidiary.[164] In fact, scholars have shown that the largest BHCs are likely to remain solvent even if the equity in their subsidiary banks becomes worthless.[165] One possibility is that a bank failure triggers the bank holding company's obligation to the subsidiary, under the "source-of-strength" doctrine.[166] Thus, bank holding company would be "in danger of default" when its bank subsidiary becomes insolvent.

Even if the SPOE strategy cannot be used to recapitalize banks and financial institutions under the deposit insurance protection, it still applies to other financial firms. By assigning "losses to shareholders and unsecured creditors of the holding company,"[167] the SPOE essentially allows the FDIC to hold the shareholder—the bank holding corporation—responsible for its subsidiary's debts. The shareholders and unsecured creditors of the holding company now take losses in the subsidiary bank.[168] They thus lose the limited liability protection. The SPOE strategy places the claims of the parent company's creditors inferior to the claims of the subsidiary's creditors.[169]

In developing the SPOE strategy, the FDIC issued a white paper, in which it elaborates the rationales of the strategy.[170] The FDIC white paper states that the SPOE strategy treats the losses to the banks and financial institutions as losses to the whole group.[171] For example,

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[164] *See* 12 U.S.C. § 5365(d) (2012). In this case, Title I preferred resolution strategy may still work to create shareholder liabilities, which will be discussed below.
[165] Kupiec & Wallison, *supra* note 16, at 20.
[166] For a general discussion on the source-of-strength doctrine, see generally Lee, *supra* note 16.
[167] FDIC Paper, *supra* note 147, at ii.
[168] *See id.*
[169] Jin, *supra* note 16, at 1768 ("[W]hen a financial group fails, the FDIC would subordinate the unsecured liabilities of the parent to the liabilities of the subsidiaries.").
[170] FDIC Paper, *supra* note 147.
[171] *Id.* at 1 (arguing the SPOE may offer "the simplest choice" if the "debt issued at the top of the group is sufficient to absorb the group's losses").

if a subsidiary financial institution becomes insolvent, the parent-holding corporation may remain in operation and allow the subsidiary to go bankrupt. It is true that the parent-holding corporation may also be a major creditor to the subsidiary because of the interconnected transactions between the two. Thus, the bankruptcy of the subsidiary may also significantly affect the holding corporation. However, the losses would be borne by all creditors.[172] Thus, the bank holding corporation would be better off without the SPOE strategy.

The reasoning of the FDIC resembles the arguments for piercing the corporate veil. The FDIC argues that large banking organizations are "managed as single entities, despite their subsidiaries being structured as separate and distinct legal entities."[173] According to the FDIC, financial firms "[are] highly interconnected through their capital markets activities, interbank lending, payments and off-balance-sheet arrangements."[174] These arguments seem to imply that the corporate shell of subsidiary financial institutions should be pierced because of the close connections between the holding corporation and the subsidiary.

In the United States, courts may allow a plaintiff to pierce the corporate veil when a subsidiary corporation is "merely the instrumentality of another and that the misuse of the corporate form would constitute a fraud or promote injustice."[175] The major factors considered by courts include improper control or manipulation, inadequate capitalization, intercompany transactions and "commingling of assets," and overlap in officers and directors.[176] Regulations of the financial industry largely prevent shareholders of financial firms from abusing the corporate form.[177] In fact, piercing the

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[172] *See id.*
[173] *Id.* at 2.
[174] *Id*.
[175] Escobedo v. BHM Health Assocs., Inc., 818 N.E.2d 930, 931 (Ind. 2004).
[176] Douglas G. Smith, *Piercing the Corporate Veil in Regulated Industries*, 2008 BYU L. REV. 1165, 1173–78 (2008) (listing the factors for piercing the corporate veil as corporate formalities, adequate capitalization, intercompany transactions and commingling of assets, and overlap in offices and directors).
[177] *Id.* at 1196 ("[T]ransactions among corporate entities are subject to significant regulation to ensure that these entities conduct transactions on an arms-length basis.").

corporate veil usually does not apply to financial institutions.[178] The SPOE thus creates new rules on the liability of holding companies of financial institutions.

3. Title I Preferred Resolution Plan

While the effects of OLA and SPOE on limited liability remain ambiguous, Title I of the Dodd-Frank Act is more straightforward. SIFIs with assets above $50 million are required to issue a Title I resolution plan, or the so-called "living will" to the regulators, in which they would lay out the resolution strategy that will ensure the financial stability in time of a crisis.[179] If regulators are unsatisfied with the resolution plan, they may impose more stringent regulations on the capital adequacy, liquidity, or other aspects of the SIFI.[180]

While these resolution plans differ slightly, many have stated that the bank holding company would provide support for the lead bank subsidiaries and other major operating financial subsidiaries.[181] Each SIFI has identified the core business line that needs to be maintained operative.[182] Core business lines are "those business lines of the covered company, including associated operations, services, functions and support, that, in the view of the covered company, upon failure would result in a material loss of revenue, profit, or franchise value."[183] Parent-holding companies would liquidate other assets to ensure that the core business lines would remain operative.[184]

For example, JP Morgan Chase & Co. based its resolution plan on the assumption that "material losses occur at each of

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[178] *Id.* at 1199.
[179] 12 U.S.C. § 5365(d).
[180] *Id.* at § 5365(d)(5)(A) ("[T]he Board of Governors and the Corporation may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, or any subsidiary thereof, until such time as the company resubmits a plan that remedies the deficiencies.").
[181] *E.g., infra* notes 185, 190.
[182] 12 C.F.R. § 381.2(d).
[183] *Id.*
[184] *See* 12 C.F.R. § 381.4.

JPMorgan Chase & Co., JPMorgan Chase Bank, N.A., J.P. Morgan Securities LLC and J.P. Morgan Clearing Corp and do not materially impair other material legal entities."[185] "The Resolution Plan provides that, in order to achieve the significant benefits of resolution through recapitalization, the Firm's lead bank subsidiary, JPMorgan Chase Bank, N.A. would be recapitalized."[186] It then makes it clear that "the value necessary for the recapitalization of JPMorgan Chase Bank, N.A. would come from intercompany balances owned by JPMorgan Chase & Co. and, if a receivership is commenced, any third-party claims left behind in the receivership."[187] Pursuant to this plan, JPMorgan Chase & Co., the holding company, would liquidate its assets to ensure its bank subsidiary would remain operative.[188]

As another example, Bank of America Corporation (BAC) also proposes to bear shareholder liabilities for subsidiaries in its resolution plan.[189] BAC identified 17 "Material Entities" essential to the core business lines, including Bank of America, N.A., a U.S. commercial bank.[190] According to the resolution plan, these "Material Entities" would be recapitalized by the parent-holding company, BAC, prior to its failure.[191] Only BAC would enter bankruptcy.[192] BAC also

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[185] JP Morgan Chase & Co. Resolution Plan Public Filing (July 1, 2015) at 7, available at https://www.federalreserve.gov/bankinforeg/resolution-plans/jpmorgan-chase-1g-20150701.pdf [https://perma.cc/9ZWC-QZKF].
[186] *Id.*
[187] *Id*.
[188] *Id.* ("The value necessary for the recapitalization of JPMorgan Chase Bank, N.A. would come from intercompany balances owned by JPMorgan Chase & Co. and, if a receivership is commenced, any third-party claims left behind in the receivership.").
[189] Bank of America Corporation Resolution Plan (July 1, 2015) at 7, available at https://www.federalreserve.gov/bankinforeg/resolution-plans/boa-1g-20150701.pdf [https://perma.cc/XHK9-PNTB].
[190] *Id.* ("Under the preferred resolution strategy, prior to commencing voluntary proceedings under Chapter 11 of the Bankruptcy Code, BAC would use its available resources to provide capital and liquidity to its Material Entity subsidiaries.").
[191] *Id*. These are the "Continuing Subsidiaries," including Bank of America, National Association, which "would continue to operate as open, fully-capitalized entities."
[192] *Id.*

identified several "Solvent Wind-Down Subsidiaries," which would be wound down and separated from the "Continuing Subsidiaries."[193] Thus, most subsidiaries would remain operative and would not need to fire-sell their assets at depressed prices.[194] BAC clearly stated in its resolution plan that "prior to commencing voluntary proceedings under Chapter 11 of the Bankruptcy Code, BAC would use its available resources to provide capital and liquidity to its Material Entity subsidiaries."[195]

One potential problem with Title I resolution plans is that they are not legally binding on the bankruptcy court or a receiver when financial institutions become insolvent,[196] and they can also be changed over time.[197] Although some regulators intend to make living wills actionable,[198] the effects of the resolution plans remain uncertain.[199] Moreover, resolution plans are drafted based on certain hypotheticals, which in reality may not occur.[200] Financial institutions may not successfully predict the exact macroeconomic environment, which subsidiary will come under stress, and the market value of their

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[193] *Id.*

[194] *Id.* (arguing this approach "promotes financial stability by maintaining the continuity of all of the Company's Critical Operations and Core Business Lines[,] . . . maximizes the value of BAC's investment in its subsidiaries by preserving the going-concern value of the Continuing Subsidiaries, maximizing the residual value of the Solvent Wind-Down Subsidiaries, and minimizing forced asset sales and losses typically associated with the abrupt liquidation of financial services firms").

[195] *Id.*

[196] *See* 12 U.S.C. § 5365(d)(6) (2012) ("A resolution plan submitted in accordance with this subsection shall not be binding on a bankruptcy court, a receiver appointed under subchapter II, or any other authority that is authorized or required to resolve the nonbank financial company supervised by the Board, any bank holding company, or any subsidiary or affiliate of the foregoing.").

[197] Adam Feibelman, *Living Wills and Pre-Commitment*, 1 AM. U. BUS. L. REV. 95, 98 (2012).

[198] *Id.* at 102.

[199] *Id.*

[200] Mehrsa Baradaran, *Regulation by Hypothetical*, 67 VAND. L. REV. 1247, 1311 (2014) ("Contingency plans cannot be accurately tailored now to fit future crises for a number of reasons.").

assets.[201] Finally, some scholars also question the incentives of SIFIs to draw up credible plans.[202] Managers may seek to maximize shareholder value, while holding the parent-holding company liable for the subsidiaries' debts may be an unpopular idea.

Admittedly, it still remains unclear how the rules concerning shareholder liability in Dodd-Frank Act will be enforced in the future. Some scholars have proposed to establish "liability holding companies," holding companies that own other assets and can provide support to subsidiary banks when they fail.[203] These proposals essentially provide a detailed mechanism for the source-of-strength doctrine.[204] No matter how these rules are to be implemented, the intention of the Dodd-Frank Act to require parent-holding companies to take more legal responsibility for the debts of their financial subsidiaries is quite clear.[205]

B. External Shareholder Liability

China has also developed a shareholder liability regime in recent years.[206] For a long time, state-owned banks and joint stock

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[201] *Id.* at 1311–12 (highlighting the variables preventing entities from creating accurate and permanent resolution plans); *see also* Daniel K. Tarullo, Governor, Fed. Reserve Sys., Speech at the Symposium on Building the Financial System of the 21st Century: Toward an Effective Resolution Regime for Large Financial Institutions (Mar. 18, 2010) (transcript available at www.federalreserve.gov/newsevents/speech/tarullo20100318a.htm [http://perma.cc/U99P-YZBK]).

[202] Baradaran, *supra* note 200, at 1312 (discussing the opposing goals of firm managers and regulators in the event of a crisis).

[203] *See generally* Anat R. Admati et al., *Liability Holding Companies*, 59 UCLA L. REV. 852 (2012) (proposing a new type of financial institution that can maintain high leverage while reducing the risk of expensive bankruptcy or government bailout).

[204] *Id.* at 881 ("[T]he [liability holding company] is the realization of . . . the source of strength doctrine.").

[205] *Id.*

[206] Press Release, Zhongguo Yinhang Ye Jiandu Guanli Weiyuan (中国银行业监督管理委员) [China Banking Regulatory Committee], Zi Dan Fengxian Minying Yinhang Shou Pi Shidian Mingdan Queding (自担风险民营银行首

banks controlled by local governments or state-owned enterprises dominate the commercial banking industry in China.[207] In July 2013, the State Council issued a report claiming that it would seek to allow privately owned banks that bear their own risks to be established.[208] Later in November, the third plenary session of the 18th Central Committee decided to allow qualified private investors to establish middle or small size financial institutions like banks.[209] Many social groups submitted their suggestions and proposals to the China Banking Regulatory Commission, and prompted it to implement detailed rules of this state policy.[210] The China Banking Regulatory Commission provided several criteria for granting licenses to new private banks.[211] These private banks must have sufficient capital input and the ability to bear risks.[212] They should also have a good governance structure, a clear primary business area and plan, and mechanisms to control

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批试点名单确定) [Risk of Private Banks to Determine the First Batch of Pilot List] (Mar. 11, 2014) [hereinafter CBRC Press Release], http://www.cbrc.gov.cn/chinese/home/docView/B3EEFFF20E6B476DA85B0E443BDBD88E.html [https://perma.cc/YD2A-EXC6] (announcing the pilot program composed of five private banks).

[207] Tang Shuangning, Vice Chairman, China Banking Regulatory Comm'n, Reforms of State-owned Commercial Banks In China, (Apr. 26, 2004) (transcript available at http://www.cbrc.gov.cn/EngdocView.do?docID=562 [https://perma.cc/5DXD-SKF4]) ("When the reforms started in China, the Chinese banking sector only consisted of wholly State-owned banks. In contrast, the equity owners of today's Chinese banking institutions range from the government, State-owned enterprises, private companies, shareholding corporations and foreign-funded entities.").

[208] *Id.*

[209] CBRC Press Release, *supra* note 206.

[210] *Id.* (explaining the Commission's response to community comment on the proposed framework to allow the creation of private banks).

[211] Ouyang, *supra* note 11 (clarifying the Chinese government's considerations in selecting banks to pilot the initiative).

[212] *Id.* (stating banks must have good qualifications and anti-risk capability through a perfect corporate governance structure, outstanding core business, abundant cash flow, effectively controlled risk of related party transaction, and an assumed risk of business failure).

related-party transactions.[213] The promoters must accept regulations from the regulatory committee.[214] Finally, they must establish resolution plans to deal with systemic risks, arrangements for bankruptcy and restructuring.[215]

The ownership structures of the first five private banks licensed are similar.[216] Each of the five banks licensed has at least two main investors, or promoters, one owning about 30 percent shares and the other owning 20 percent.[217] Moreover, these promoters are mostly renowned private companies with good reputations, such as Alibaba and Tencent, two large Internet companies in China.[218] Each of the five banks has promised to guarantee repayments of debts owed to individual depositors.[219] For example, Shanghai Hua Rui Bank Co., LTD, one of the first licensed private banks, disclosed that any shareholders holding above a 5 percent share of stock outstanding

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[213] *Id.*

[214] *Id.* ("Requiring the sponsor to promise that its shareholders will be supervised by the regulatory body to prevent the risk of their own risk."); *China to Pilot Five Private Banks***,** PEOPLE'S DAILY ONLINE (China), Mar. 11, 2014, http://en.people.cn/business/8562008.html [https://perma.cc/L264-C4CX] (explaining risk monitoring will be strengthened and shareholder behavior will be regulated).

[215] Ouyang, *supra* note 11.

[216] *See, e.g.*, Dong Ximiao (董希淼), Shui Jiang Keneng Kongzhi Minying Yinhang (谁将可能控制民营银行) [Who are Likely to Control Private Banks], Xinlang Xinwen Zhongxin (新浪中文中心) [Sina News] (Oct. 13, 2014), http://finance.sina.com.cn/zl/bank/20141013/145820522862.shtml [https://perma.cc/C5DA-DT85] (China) (showcasing ownership structures of the first five licensed private banks).

[217] *Id.* One possible reason for this arrangement is to create a check and balance mechanism to prevent related-party transactions that harm the financial interests of the banks to benefit the major shareholders. Another reason is to ensure that some shareholders who hold a significant block of shares are held responsible for regulatory goals.

[218] *See, e.g.*, Hei Wei, *Private Lenders Will Test the Waters of Financial Reform*, CHINA DAILY USA (Mar. 12, 2014), http://usa.chinadaily.com.cn/epaper/2014-03/12/content_17342097.htm [https://perma.cc/3FFQRMU6] ("The CRBC said the chosen companies are financially sound, have strategies to differentiate their banks in the market and are capable of hedging risks.").

[219] Minying, *supra* note 13.

would compensate each depositor up to the amount of 500,000 Renminbi (RMB) in the event of insolvency with money from their own pockets, provided that the total amount does not exceed their investments.[220]

While these regulatory measures take the form of living wills, they are essentially another version of double liability.[221] They differ from the United States model because the shareholders need not be in the same financial group, nor do they need to be the sole controlling shareholder to be held liable.[222] Apart from the private banks, the banking regulator in China also imposes shareholder liability on "Consumer Finance Companies" (CFCs).[223] These companies are financial institutions that do not accept deposits from the public, and provide loans to consumers in their consumptions (excluding housing mortgages and automobiles).[224] The Banking Regulatory Commission encourages major investors who hold over 30 percent of equity interests in CFCs to promise to provide liquidity and additional capital to the companies if they face financial distress.[225] Although the statute

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[220] *Id.*

[221] *See* Duojia Yinhang Fenfen Qidong Shengqian Yizhu (多家银行纷纷启动"生前遗嘱") [Many Banks Starting to Enact "Living Wills"], SHANDONG BUSINESS DAILY (China) (Jan. 20, 2017), http://finance.ifeng.com/a/20140122/11527094_0.shtml. [https://perma.cc/C6FY-YFJU] (indicating a "lifetime will" refers to the rapid and orderly disposal of financial institutions in the event of a substantial financial distress or failure).

[222] Frank Aquila & Sarah Payne, *Stockholder Liability: Is There a Safe Harbor?*, BLOOMBERG BNA (Dec. 17, 2012), https://www.bna.com/controlling-stockholder-liability-is-there-a-safe-harbor-by-frank-aquila-sarah-payne-sullivan-cromwell/ [https://perma.cc/N8SJ-XKJQ] (observing in the United States, there are increased risks for controlling stockholders and boards of directors in association with transactions involving controlling stockholders).

[223] Xiaofei Jinrong Gongsi Shidian Guanli Banfa (消费金融公司试点管理办法) [Regulatory Measures on Consumer Finance Companies] (promulgated by the China Banking Reg. Comm'n, Nov. 14, 2013, effective Jan. 1, 2014) http://www.cbrc.gov.cn/EngdocView.do?docID=F8E019E3397641158F0633DBC417DB46 (China) (stating the regulatory measures established by the CBRC with respect to Consumer Finance Companies).

[224] *Id.* at art. 2, art. 3.

[225] *Id.* at art. 10.

did not make it a mandatory requirement, investors are likely to agree in order to obtain licenses from the regulator.[226]

It must be pointed out that the shareholder liability regime in China is still developing.[227] It thus remains unclear at this stage how regulators will enforce these rules.[228] Moreover, these requirements do not apply to state-owned banks, and many other "joint-stock" commercial banks.[229] Although this regime is in its incipient stage, it clearly suggests that the government is considering shareholder liability as an important regulatory strategy.[230]

IV. The Advantages and Disadvantages of the Current Shareholder Liability Regimes

The recent development of shareholder liability rules suggests similar concerns in the United States and China: efficiency, distributive justice, and regulatory capacity.[231] These rules inevitably incur other problems: they raise information costs for shareholders and creditors, reduce equity and market liquidity, create barriers to

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[226] *See e.g.*, China Lianhe Credit Rating Co., Ltd., 2016 Nian Zhongyin Xiaofei Jinrong Youxian Gongsi Jinrong Zhaiquan Xinyong Pingji Baogao (2016 年中银消费金融有限公司金融债券信用评级报告) [Credit Rating Report on the Financial Debts of Zhongyin Consumer Finance Company in 2016] (Nov. 18, 2016), http://www.lhratings.com/reports/A0196-JRZQ06954-2016.pdf (showcasing the Bank of China Consumer Finance Limited's Financial Bond Credit Rating Report to display that investors comply with the Banking Regulatory Commission's statute).

[227] *See, e.g.*, Ximiao, *supra* note 216.

[228] Sara Hsu, *China's Financial Reforms Face Big Challenges*, FORBES (Jul. 18, 2016, 7:08 AM), www.forbes.com/sites/sarahsu/2016/07/18/progress-of-chinas-financial-reforms/#676ba4872043 [https://perma.cc/6LBZ-AEHJ] (stating that government intervention has fallen flat, and direct finance through debt and equity channels are highly underdeveloped).

[229] The Chinese Banking Regulatory Commission has started to require all commercial banks to develop "living wills" similar to those in the United States. However, the details of these living wills are unknown. Duojia, *supra* note 221.

[230] Xiaofei, *supra* note 223.

[231] *See supra* Sec. I, II.A.1 and notes 20, 30–33.

transfers of control, and hinder diversification of investment.[232] For shareholder liability to be effective in controlling excessive risk-seeking, a set of regulatory rules need to be developed, which also incur social costs.[233] This section examines the advantages and disadvantages of the current shareholder liability regimes compared with limited liability.

A. Advantages

By imposing additional liabilities on shareholders, the current regimes promote efficiency and alleviate equity problems caused by bail-outs.[234] They thus serve important regulatory goals when financial regulation is insufficient to curb excessive risk-seeking activities.[235]

1. Efficiency

In both the United States and China, the shareholder liability regimes may promote social efficiency by reducing the incentives of financial institutions to take excessive risks.[236] They also seek to

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[232] Hansmann & Squire, *supra* note 2, at 17 (showcasing external partitioning leading to reduced information costs, reduced need to monitor other equity holders, efficient control transfers, and shareholder diversification); *see infra* Section III.B.1 (summarizing the costs of the "shareholder liability regimes.").

[233] *See* Schwarcz, *supra* note 2, at 15 ("In the shadow banking system, the third market failure—externalities—becomes much more important. That is because the paramount concern posed by the shadow banking system is that it 'can, if left unregulated, pose systemic risks to the financial system.'"); *infra* Section III.B.2 (describing the social costs of regulatory rules).

[234] Schwarcz, *supra* note 2, at 11–12 ("[S]hareholders protected by limited liability can 'pocket the benefits generated by [their firms'] risky activities,' while the costs of those risky activities is passed on to the government through bailouts and ultimately onto taxpayers.").

[235] *Id.*

[236] *Id.* at 10 (explaining under a shareholder liability regime, shareholders would be liable for unpaid tort judgments in proportion to equity ownership of the firm, which would incentivize shareholders to monitor and avoid risky activities).

reduce the associated costs of shareholder liability.[237] Professor Steven Schwarcz listed several conditions for unlimited liability to be efficient.[238] An efficient unlimited liability regime should: (i) incentivize the investors to monitor the firm's risk-seeking activities; (ii) impose a cap on the liability to encourage investment;[239] (iii) ensure that the liabilities of each shareholder are independent of others to discourage cross-investors monitoring; (iv) increase liability only for investors who can control the firm.[240] The current shareholder liability regimes are likely to meet most of these conditions.[241]

One common feature of the current regimes is that they only hold the controller or major shareholders liable.[242] In the United States, the parent-holding companies of large financial groups are usually the sole shareholders.[243] In China, only major shareholders holding more than 5 percent equity will face additional liabilities.[244] There are certain benefits of holding just the controlling shareholder or major shareholders who can influence the decisions of financial firms liable.[245] The controlling shareholder usually has incentives to take

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[237] *Id.* at 25 ("[Redesign of shareholder liability] should minimize investor risk aversion and encourage investment by setting a cap on liability sufficient to make investors comfortable that the expected value of their potential gains should exceed . . . the expected value of their potential losses . . . .").
[238] *Id.* at 24.
[239] *Id.* at 23 ("Even fully rational investors will refuse to invest if their risk is unlimited . . . .").
[240] *Id*. at 24–25.
[241] *See supra* Section III.B. External shareholder liability may increase the costs of monitoring, because the liabilities of each shareholder are not entirely independent of others. *Id.*
[242] *See, e.g.*, Hansmann & Squire, *supra* note 2, at 21 ("Under American law, the creditor must satisfy both parts of a two-prong test: he must show (1) that the corporation served as the shareholder's mere 'alter ego,' and (2) that liability for the shareholder is necessary to avoid some injustice.").
[243] *See* Dafna Avraham et al., *A Structural View of U.S. Bank Holding Companies*, 18 ECON. POL'Y REV. 65 (July 2012).
[244] Minying, *supra* note 13.
[245] George W. Dent, Jr., *Limited Liability in Environmental Law*, 26 WAKE FOREST L. REV. 151, 166 (1991) ("[L]iability should fall on the party best able to insure because insurance broadly spreads the risk of loss . . . . Limited liability undermines these principles.").

excessive risks.[246] Holding them liable thus will reduce risk-seeking activities. Moreover, controlling shareholders also have more control of the bank.[247] Passive investors, by contrast, may not effectively influence the conduct of financial firms.[248] Finally, this arrangement avoids deterring investment because passive investors will not be affected by this rule and can hence invest safely.[249]

Additionally, the liabilities of shareholders are capped in both countries. In China, the compensation amount is capped by either the capital investment or 500,000 RMB for each public depositor.[250] In the United States, shareholders of the parent-holding company have limited liability.[251] The parent-holding company may itself become insolvent and unable to pay any additional debts.[252] This regulatory design is necessary because it encourages diversified investment in equity ownership.[253] Without such a design, investors may not be able to foresee the potential liabilities they need to bear and would be reluctant to invest because of risk aversion.[254]

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[246] Justin Fox, *Banks Took Big Risks Because Shareholders Wanted Them To*, HARV. BUS. REV., (2010) ("So shareholders have every incentive to push executives at highly leveraged firms to take big risks (and executives with big equity stakes have every incentive to take big risks).").
[247] *See* Schwarcz, *supra* note 2, at 2–3.
[248] *Id.* at 187.
[249] *Id.* at 785–86 ("Non-controlling shareholders will prefer the presence of a controlling shareholder so long as the benefits from reduction in managerial agency costs are greater than the costs of private benefits of control.").
[250] Minying, *supra* note 13.
[251] Schwarcz, *supra* note 2, at 7 ("Limited liability is now the general default rule in the United States for shareholders of banks and nonbank corporations.").
[252] Suppose the bank subsidiaries become insolvent, the parent-holding company shoulders the liabilities of the subsidiaries only to the extent it can liquidate part of its assets to support the subsidiaries. Any remaining losses would be borne by the creditors of the subsidiaries. *See supra* Section III.B.1.
[253] Mendelson, *supra* note 2, at 1218 ("As the argument goes, limited liability solves this problem by permitting the investor to manage risks by diversifying investments, rather than spending resources on monitoring.").
[254] Schwarcz, *supra* note 2, at 23 ("[A]ny redesign of limited liability should attempt not only to minimize investor risk aversion but also to make investors comfortable that the expected value of their potential gains should exceed (by a sufficient margin to encourage investment) the expected value of their

A possible counterargument to the efficiency of the current regimes is that they may reduce the incentives of creditors of financial institutions to monitor them.[255] However, because of the nature of systemic risk, the state sometimes cannot allow the failure of SIFIs to affect creditors.[256] Thus, either the state has to bail them out or the shareholders have to shoulder additional liability.[257] Either way, creditors lack sufficient incentives to monitor SIFIs.[258] Moreover, creditors do not have as the same level of control over the financial institution as shareholders do.[259] Shareholder liability thus might be a better option to curb risk-seeking activities.

2. Distributive Justice Concerns

As is shown above, limited liability generates agency costs of debt, which reduce efficiency.[260] Limited liability also creates a

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potential losses. The most effective way to accomplish that would be to set some type of cap or limit . . . on the potential liability.").

[255] Jin, *supra* note 16, at 1766 ("[T]he SPOE approach can encourage moral hazard by the creditors of the subsidiaries of a financial group: protected by the parent's creditors, the subsidiaries' creditors may not monitor the financial group's risk-taking activities.").

[256] Douglas J. Elliott, *Regulating Systemically Important Financial Institutions That Are Not Banks,* THE BROOKINGS INST. (May 9, 2013), https://www.brookings.edu/research/regulating-systemically-important-financial-institutions-that-are-not-banks/ ("One of the most obvious concerns is that when a SIFI goes under it may impose substantial, if not crippling, losses on other financial institutions and parties who are owed money by the institution. This could cascade throughout the financial system with knock-on damage to the wider economy.").

[257] Conti-Brown, *supra* note 10, at 415 ("Other candidates for risk control include creditors, the corporation itself through liquidation or government equity participation, and company directors and officers. However, out of all the possible alternatives, shareholders are for various reasons the best candidates for risk management and cost absorption.").

[258] *Id.* at 444 ("The idea that creditors will serve as effective monitors in helping firms avoid failure is a familiar concept. But the recent crisis shows its weakness.").

[259] *See id.* at 415 ("[S]hareholders are for various reasons the best candidates for risk management and cost absorption.").

[260] *See supra* note 51 and accompanying text ("The protection of limited liability incurs 'agency costs of debt.'").

distributive justice problem—particularly in the financial industry—because it gives rise to the need for bailouts.[261] Shareholder liability provides an additional source of funds and alleviates the burden on taxpayers.[262] Government support of private financial institutions raises the question of why taxpayers need to bear losses created by various financial institutions' risk-seeking activity.[263] Governments usually can spend public money for various purposes, as long as these purposes are for the public interest, even if the spending only benefits a specific group of individuals.[264] For example, governments may provide subsidies to certain private parties for green energy, education, or public health using taxpayers' money.[265] However, bailouts of financial institutions have generated more criticism than these other types of government spending.[266]

Several reasons underlie this public outrage. First, bailouts are usually provided without ex ante political processes.[267] For example, the authorization of bailouts in the 2008 financial crisis was passed during the crisis, with an understanding that the failure to rescue the failing institutions would cause long-lasting financial distress.[268]

Second, there seems to be a general social understanding that financial institutions should not obtain public funding when they themselves are the roots of economic distress.[269] Bailing out financial

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[261] Schwarcz, *supra* note 2, at 11–12.
[262] Conti-Brown, *supra* note 10, at 445.
[263] *Id.* at 411.
[264] John O. McGinnis & Michael B. Rappaport, *Supermajority Rules as a Constitutional Solution*, 40 WM. & MARY L. REV. 365, 375 (1999) ("The science of constitutions attempts to develop mechanisms that will empower the government to provide public interest goods . . . .").
[265] *Id.*
[266] Conti-Brown, *supra* note 10, at 411 ("Taxpayer bailouts . . . were the government's tool of choice during the fall of 2008. The resulting political and scholarly response has been nearly uniformly negative, with very few arguing in defense of bailouts.").
[267] Anthony J. Casey & Eric A. Posner, *A Framework for Bailout Regulation*, 91 NOTRE DAME L. REV. 479, 481, 488 (2015).
[268] *Id.*
[269] *Id.* at 483, 529, 532 ("Many critics of the government's handling of the financial crisis who believed that the government favored Wall Street argued that the government should have done more for homeowners."); Joshua Mitts,

firms is thus different from providing support for socially beneficial activities such as education and public health.[270] A society may also achieve consensus as to whether the government can use taxpayers' money to support certain activities justifiably.[271] Financial bailouts are certainly not among these activities, as the intentions of the Dodd-Frank Act suggest.[272]

Thus, governments need to obtain additional compensation in return in order to address the distributive justice concerns.[273] However, it is usually difficult for the government to charge a "consideration," because bailouts often occur at a moment when creditors are not capable of paying.[274] If the bailouts are mainly to save banks from liquidity crises, the government may sell the equity interests and recover taxpayers' money when the crisis is over.[275] However, it is sometimes hard to distinguish liquidity crises from insolvency.[276] The collapse in the value of financial instruments often results from a bubble in the pricing of financial assets, in which case it may take a

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Systemic Risk and Managerial Incentives in the Dodd-Frank Orderly Liquidation Authority, 1 J. FIN. REG. 51, 67 (2015) (explaining that financial institutions held assets that declined in value and counterparties to each other).

[270] BRUCE ACKERMAN, PRIVATE PROPERTY AND THE CONSTITUTION 116 (1977) (stating ordinary people would believe "his right to control the use of his thing is generally recognized in his everyday dealings with other well-socialized individuals").

[271] Casey & Posner, *supra* note 267, at 480 ("While many people disagree about the wisdom of these transfers, they do not regard them as illegitimate in the same way that they often regard bailouts.").

[272] ACKERMAN, *supra* note 270, at 116.

[273] Pam Selvarajah, The AIG and AIG's Prospects for Repaying Government Loans, 29 REV. BANKING & FIN. L. 363, 365–67 (2010) (discussing the government's loans to AIG during the 2008 financial crisis).

[274] Levitin, *supra* note 98, 481–82 (2011) ("The central problem for financially distressed institutions is that there is not enough money to pay everyone on time.").

[275] *Id.* at 494.

[276] Section 101 of the Bankruptcy Code defines insolvency as "[a] financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation . . . ." 11 U.S.C. § 101(32)(A) (2012). For a discussion of the distinction between illiquidity and insolvency, see Mitts, *supra* note 269, at 54 (distinguishing three types of systemic risks.).

long time for the government to claw back the funds provided to the creditors.[277] Additionally, determining the exact amount of the additional payments to creditors may be difficult during the crisis.[278] Thus, the clawback clause has its drawbacks and can only serve as a partial solution. The Dodd-Frank Act attempts to solve this problem by allowing the clawback of the additional payments to creditors to occur "as soon as practicable."[279] Theoretically, the clawback is a "consideration" for the government's financial support to the financial firms. It remains unclear whether the government can fully recover its expenses and how long it would take for the government to do so.[280]

One possible justification for bailouts is that the financial firm promises to pay a high interest rate and offer an equity interest, which can alleviate the problem of distributive justice.[281] The funding provided by the government to bailout financial firms might simply be part of a negotiated contract.[282] The interest rate and equity interest might compensate the taxpayers, because the government expected the financial firm to pay back the loans in the future and the stock value to rise after the crisis.[283] In fact, the U.S. government has been refunded

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[277] Levitin, *supra* note 98, at 450, 474.

[278] *Id.* at 479–81 (explaining loss allocation cannot become clear until firms are resolved).

[279] 12 U.S.C. § 210(o)(1)(D)(i), § 210(o)(1)(D)(ii)(II) (acknowledging the government can take back additional payments to creditors).

[280] Jin, *supra* note 16, at 1782 (discussing the advantages of the clawback arrangement in the Dodd-Frank Act).

[281] Casey & Posner, *supra* note 267, at 481.

[282] For example, in 2008, AIG was at the brink of insolvency when the market for credit default swaps started to collapse. The Federal Reserve provided AIG $85 billion facility. Meanwhile, the government would receive a 79.9 percent equity interest in AIG and the rights to veto dividend payments to common and preferred shareholders, and could retain the ownership interest even after the loan had been repaid. The interest rate was as high as 12 percent. Starr Int'l Co., Inc. v. United States, 121 Fed. Cl. 428, 431 (2015) (discussing the facts of the case concerning the government bailout of AIG); Press Release, Board of Governors of the Federal Reserve (Sept. 16, 2008), http://www.federal reserve.gov/newsevents/press/other/20080916a.htm.

[283] Pam Selvarajah, *The AIG Bailout and AIG's Prospects for Repaying Government Loans*, 29 REV. BANKING & FIN. L. 363, 367–68 (2010)

all of the money it spent in the bailouts in the 2008 financial crisis.[284] However, the government nevertheless undertook significant risks at the time, given the high probability that the taxpayers' money would not be completely returned.[285] Moreover, part of the government funding was used to pay salaries to the managers of the financial firms, which drew widespread public scorn.[286]

In sum, bailouts benefit financial institutions that create risks to the economic system. Thus, they suffer from a significant distributive justice problem. Shareholder liability reduces the burden on taxpayers and stands as an important solution to this problem.

3. *Alleviating the Burdens on Regulation*

If regulation can effectively control excessive risk-seeking, shareholder liability may not be necessary.[287] The demise of double liability in the United States best illustrates this point.[288] In the

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(discussing how AIG's shareholder equity has risen, but AIG's progress has still been minimal after AIG's bailout in 2008).

[284] *See* Richard Squire, *Insolvency vs. Illiquidity in the 2008 Crisis and the Congressional Imagination*, *Crisi Finanziaria e Riposte Normative: Verso Un Nuovo Diritto Dell'Economica?*, QUADERNI DI GIURISPRUDENZA COMMERCIALE 93 (A. Guaccero & M. Maugeri, eds. 2014) (explaining the government was uncertain it would get its money back from firms in 2010).

[285] Lauren Silva Laughlin & Richard Beales, *A.I.G.'s Big Debt to U.S. Taxpayers*, N.Y. TIMES, Jan. 26, 2010, at B2. As Joshua Mitts point out, the FDIC plans to "reorganize, not liquidate a failed firm." Mitts, *supra* note 269, at 63.

[286] Selvarajah, *supra* note 283, at 365.

[287] Jackson, *supra* note 12, at 512 ("A second rationale for enhanced obligations, which I call the 'regulatory deterioration' hypothesis, rests on a perceived inadequacy of traditional forms of regulation—such as capital requirements and restrictions on activities—to provide an adequate solution to . . . the proclivity for excessive risk-taking[] associated with all financial intermediaries. The regulatory deterioration hypothesis conceives of enhanced obligations for holding company controlled intermediaries as a partial solution to this broader regulatory problem.").

[288] *See* Macey & Miller, *supra* note 10, at 37 ("The wave of bank failures that occurred between 1929 and 1933 placed heavy strains on the double liability system and ultimately precipitated its downfall.").

nineteenth century, many U.S. states imposed double liability on bank shareholders.[289] Under the double liability regime, bank shareholders not only lose their investments when banks are insolvent, but also become liable for the par value of their investments.[290] Most states also adopted double liability for state-charted banks,[291] some adopted triple liability.[292] Some scholars argue that this regime was quite successful, and can protect the interests of the public depositors and other creditors of the banks.[293] Double liability was regarded at the time as ineffective in protecting depositors.[294] Meanwhile, the newly-developed deposit insurance regulatory regime was thought to be superior to the liability regime in preventing bank failures.[295] Financial regulation thus replaced the double liability regime and became the dominant strategy to guard against financial risks.[296]

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[289] *Id.* at 36 ("A number of states—New York, Kansas, Iowa, Indiana, Minnesota, and others–adopted double liability rules in their constitutions.").

[290] *Id.* For example, suppose a shareholder owns 100 stocks of a bank, the par value of each stock being $1. If the bank becomes insolvent, the shareholder needs to pay an additional amount of $100 to the creditors of the bank out of her own pocket, regardless of how much other shareholders would pay.

[291] *Id*. at 37.

[292] *Id*. (stating Colorado imposed triple liability). Again, suppose a shareholder owns 100 stocks of a bank, the par value of each stock being $1. If the bank becomes insolvent, the shareholder needs to pay an additional amount of $200 to the creditors of the bank out of her own pocket. The shareholder bears "triple" liability because she loses twice the par value of the stocks she invests in the bank plus the initial investment.

[293] Grossman, *supra* note 10, at 157 (arguing in some contexts, the double liability regime may have lowered risky behavior, particularly before the 1920s); Macey & Miller, *supra* note 10, at 61.

[294] Macey & Miller, *supra* note 10, at 38 ("Bolstering the objection that double liability imposed unfair harms on innocent shareholders was the widespread perception that it had failed to fulfill its intended purpose.").

[295] *Id*. ("[M]ost observers believed that government deposit insurance was a far more effective remedy for the problems of the banking system than the outmoded system of double liability—an evaluation that seemed to be borne out by the success of federal deposit insurance at stopping bank runs.").

[296] *Id.*

However, deposit insurance regulation also has significant problems.[297] The deposit insurance fund, usually operated by the government, promises to repay public depositors their money if the bank fails, and charges a premium from the bank.[298] It suffers from the moral hazard problem just as any private insurance does: it reduces depositors' incentive to select banks and request higher interest payments from riskier banks.[299] Moreover, deposit insurance lacks many mechanisms that private insurance can adopt to curb the moral hazard problem.[300] For one thing, the deposit insurer cannot exclude some banks from its protections.[301] When the deposit insurer finds that a bank is too risky to insure, it cannot simply stop insuring it. Doing so would send the signal to the market that the bank is failing, which would cause a bank run.[302] If the insurer continued to insure against the bank's risks, however, it would create a moral hazard: the bank could continue to operate with high risk without sufficient punishments.[303] Similarly, the deposit insurer's ability to set a risk-based premium is limited.[304] Requiring riskier banks to deposit higher premiums would further weaken the banks' financial conditions and undermine their ability to withstand risks.[305] In a word, once a commercial bank is licensed by the state regulator and gains the

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[297] *See generally* Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring and the Market for Bank Control*, 88 COLUM. L. REV. 1153 (1988) ("The current regulatory scheme governing the behavior of banks greatly reduces the efficacy of both these sets of constraints.").
[298] Richard S. Carnell, Jonathan R. Macey & Geoffrey P. Miller, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS, 327 (4th ed. 2009) (describing the FDIC's fee schedule for bank premiums).
[299] *Id.* at 326–28.
[300] *Id.*
[301] *Id.* ("It has little by way of exclusions: an investor who during the 1980s deposited money at a deeply insolvent thrift institution, knowing that the thrift verged on failure, received the same insurance coverage as anyone else.").
[302] *Id.*
[303] *Id.* ("Risky banks have less reason to fear runs and less need to pay interest rates commensurate with their riskiness . . . . Indeed, banks can best exploit the value of deposit insurance by taking greater risks than they otherwise would.").
[304] *Id.* at 328.
[305] *Id.* at 329.

protection of deposit insurance, the state's ability to discipline the banks becomes limited. The moral hazard problem may eventually lead the deposit insurer to pay more than the premium it collects.

Another major type of banking regulation, the capital adequacy ratio, also faces certain problems.[306] One of the major problems with this regulation is the difficulty in determining the appropriate ratio.[307] Several economists have argued that regulators should impose higher capital adequacy requirements.[308] Banks, however, have argued fiercely against this proposal,[309] based on the claims that it would reduce lending and prevent economic recovery.[310] While a detailed discussion of the substantial arguments in this debate is beyond the scope of this article, it suffices to point out that shareholder liability may alleviate the difficulties of setting appropriate capital adequacy ratio ex ante, by adjusting liabilities of the shareholders ex post.[311]

The recent development of shareholder liability reflects the understanding that regulation is insufficient in curbing the risk-seeking activities of financial institutions. The 2007–2008 financial crisis

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[306] *See*, *e.g.*, Anat Admati et al., *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Socially Expensive* 58 (Rock Center for Corp. Governance, Working Paper Series No. 161, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2349739 ("An ever-present and important challenge in capital regulation is therefore determining on an ongoing basis the appropriate set of institutions or, better, activities that should be regulated.").

[307] *Id.*

[308] *See id.* at 57.

[309] *Id*. ("Both bank shareholders and bank managers have some strong incentives to maintain high leverage and to resist increased equity capital requirements.").

[310] *Id*.

[311] Conti-Brown, *supra* note 10, at 414 ("Elective shareholder liability resolves the impasse by allowing SIFIs to make those costs concrete: should their own internal assessments of increased capital requirement show that there are efficient benefits from leverage that outweigh the taxpayer costs of bailouts—both direct and indirect—then SIFIs can appropriately dismiss increased capital without forcing the costs of their private failure on taxpayers.").

shattered people's belief in financial regulation in the United States.[312] Banks pursued high risks with newly-developed complex financial instruments without violating any regulation.[313] The government was forced to bail out several large financial institutions, which further strengthened the public's belief that the risks would eventually be borne by the government.[314] In this scenario, financial institutions can attempt to benefit themselves by seeking higher risks.[315] After the 2007–2008 financial crisis, governments in different countries reflected on their regulations and developed new measures to handle systemic risks.[316] The effects of these methods still remain to be seen.[317] Shareholder liability is more likely to be adopted when the public realizes the weaknesses in various types of financial regulation.[318]

Compared with the United States, the regulatory capacity of the banking regulator in China is relatively weak. China did not establish a deposit insurance regulation until 2015.[319] According to this regulation, the insurance premium each bank submits is determined based on the bank's risk.[320] In its quarterly report, the central deposit regulator, the People's Bank of China, admits that it takes time to

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[312] *See generally* George G. Kaufman, *Bank Failures, Systemic Risk, and Bank Regulation*, 16 CATO J. 17 (1997) (discussing how public fear of financial crisis is a result of lack of knowledge, and in times of crisis many people often have trouble distinguishing between factual explanations and "folklore explanations").

[313] Barr, *supra* note 16, at 95 ("The financial sector, under the guise of innovation, piled risk upon ill-considered risk. Financial innovations outpaced the capacity of managers, directors, regulators, rating agencies, and the market as a whole to understand and respond.").

[314] *See id.* at 96.

[315] *Id.*

[316] *Id.* at 97–99 (discussing the new regulatory methods, including disregarding the legal form, imposing stricter capital ratio requirement on systemically important banks, and concentration limits).

[317] Acharya et al., *supra* note 16, at 46.

[318] *See* Jackson, *supra* note 12, at 614.

[319] Cunkuan Baoxian Tiaoli (存款保险条例) [Deposit Insurance Regulation] (promulgated by the State Council, Feb. 17, 2015, effective May 1, 2015).

[320] *Id*.

gradually develop its capacity in determining the premium based on the risk of each bank.[321]

B. Disadvantages

While the shareholder liability regimes in the United States and China both address the agency costs of debt and the equity concerns of bailouts, they still incur certain costs.[322] This section will discuss the social costs associated with the two regimes.

1. The Costs of Internal and External Shareholder Liability

As mentioned earlier, we can draw a distinction between internal and external shareholder liability.[323] Internal shareholder liability undermines internal asset partitioning but preserves external asset partitioning—only the parent-holding company is responsible for the debts of its wholly owned subsidiaries.[324] Under external shareholder liability, shareholders need to bear liabilities even though they do not wholly own the corporation.[325] The U.S. model of shareholder liability is a typical internal shareholder liability regime, while the China model is an external shareholder liability regime.[326] While both regimes curb excessive risk-taking, they involve different social costs. As Hansmann and Squire illustrate, external asset partitioning confers more benefits than internal asset partitioning.[327] It is thus important to examine the different costs associated with internal and external shareholder liability in the financial industry.

The first concern about shareholder liability is that it sometimes gives rise to the need for each shareholder to monitor other

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[321] MONETARY POLICY ANALYZING COMMITTEE OF THE PEOPLE'S BANK OF CHINA, REPORT ON CHINESE MONETARY POLICY IMPLEMENTATION 27 (2017).
[322] *See supra* Section III.B.
[323] *See supra* Section I.A.3.
[324] Hansmann & Squire, *supra* note 2, at 1.
[325] *Id.*
[326] *See supra* Section II.
[327] Hansmann & Squire, *supra* note 2, at 17.

shareholders.[328] Under internal shareholder liability, the parent-holding company has no need to monitor other shareholders, since it wholly owns the subsidiary financial institution.[329] Under external shareholder liability, the problem is more complicated. Consider the regime in China as an example. While the amount of liabilities of each shareholder is capped, the liabilities that one shareholder is responsible for may still be dependent on other shareholders.[330] Suppose a private bank has two major investors, A and B. A becomes insolvent. The amount of liabilities that B would need to bear may be the amount of B's initial investment. If, however, both shareholders are solvent, it is possible that B would bear a smaller amount of liabilities. Thus, external shareholder liability incurs information costs to some extent—B needs to monitor the financial status of other shareholders, even though the amount of liabilities is capped.

Second, both internal and external shareholder liability may hinder transfers of control.[331] Both types of shareholder liability may deter rich shareholders (who can better control and operate financial institutions) from purchasing shares from poor shareholders, given that the rich shareholders may need to bear more liabilities.[332] Such liabilities would be a windfall to the creditors of the firms.[333] Although both internal and external shareholder liability regimes may design some cap on the amount of liabilities, some shareholders may become insolvent and unable to take responsibility of the debts of the financial institution. The extent to which creditors can recover their losses thus depends on the wealth of shareholders.[334]

For similar reasons, external shareholder liability reduces the liquidity of the equity market, because the value of the shares depends on who owns them. The share prices thus would be difficult to

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[328] *See* Easterbrook & Fischel, *supra* note 2.
[329] *See id.* at 93–97.
[330] Minying, *supra* note 13.
[331] *See* Hansmann & Squire, *supra* note 2, at 5.
[332] *Id.*
[333] *Id.*
[334] Statistics show the recovery rate in the United States was 51 percent under the double liability regime in the 20th century, suggesting in many cases, shareholders did not fully bear the liabilities. *See* Macey & Miller, *supra* note 10, at 34.

define.[335] This problem arises even when the liabilities of each shareholder are independent of each other. By contrast, internal shareholder liability does not interfere with the liquidity in the equity market of the parent-holding company.

The fourth concern of shareholder liability is the need for shareholders to diversify their investments.[336] Under the internal shareholder liability regime, equity holders of the parent-holding companies can diversify their investments because they do not bear additional liabilities. External shareholder liability could also exempt small investors from liabilities. For example, in China, external shareholder liability usually only applies to major shareholders who hold above 5% of equity interests in the banks.[337] However, external shareholder liability may require several major shareholders to maintain their shares of interests, thus preventing them from diversifying their investments. Such regulation is necessary to ensure that large investors are available to absorb the losses. Thus, external shareholder liability may limit diversification to some extent.[338]

Fifth, shareholder liability increases the information costs of creditors in monitoring the financial institutions.[339] This cost is likely to be higher under an external shareholder liability regime. In making a transaction with a subsidiary corporation of a corporate group, creditors usually consider the consolidated financial report of the

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[335] The effect of unlimited liability on the liquidity of equity has not been fully tested by empirical evidence. Some scholars argue that it reduces liquidity, while others argue that unlimited liability does not significantly impact the liquidity and transfers of shares. *See* Halpern, Trebilcock & Turnbull, *supra* note 2; Hansmann & Kraakman, *supra* note 3; *see also* Peter Grossman, *The Market for Shares of Companies with Unlimited Liability: The Case of American Express*, 24 J. LEGAL STUD. 63, 64 (1995). However, in the financial industry, to ensure shareholders can maintain sufficient assets to serve as a source of strength, regulations may be imposed on stock transfers, which certainly affects the liquidity of the stocks of financial institutions.

[336] *See* Hansmann & Squire, *supra* note 2, at 5; Ribstein, *supra* note 2, at 101.

[337] *See* Avgouleas & Goodhart, *supra* note 14, at 12.

[338] For a discussion of the benefits of portfolio diversification, see generally *Modern Portfolio Theory*, INVESTOPEDIA, www.investopedia.com/walkthrough/fund-guide/introduction/1/modern-portfolio-theory-mpt.aspx [https://perma.cc/V564-LQB5].

[339] *See* Hansmann & Squire, *supra* note 2, at 6.

whole financial group.[340] They do not need to incur further costs when internal shareholder liability is adopted. In an external shareholder liability regime, however, creditors need to monitor the major shareholders who hold above 5% shares in the bank subsidiary, which may be costlier. Moreover, creditors may face significant uncertainty as to whether the state would bail out the financial institutions, and over how many losses they need to absorb when the institution becomes insolvent. Creditors could also incur significant costs in handling these uncertainties.

Sixth, shareholder liability complicates the bankruptcy process.[341] Additional information concerning the assets and debts of the shareholders needs to enter the bankruptcy proceedings.[342] Perhaps owing to this problem, regulators, not courts, enforce the liability regimes in the United States and China.[343] In the United States, the FDIC takes control of the parent-holding company and writes off the equity and unsecured debt to the extent necessary to prevent bank failures.[344] In China, the regulator also takes responsibility for developing the shareholder liability regime.[345] These enforcement mechanisms reduce the costs of identifying dispersed shareholders and determine the liabilities of each of them. However, enforcement by regulators also incur certain costs, which will be discussed in the below sub-section.[346]

To sum up, external shareholder liability may incur higher costs compared with internal shareholder liability: it interferes with the

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[340] *Id.* at 13.
[341] *See id.* at 6–7 (discussing how limited liability simplifies the bankruptcy process).
[342] *Id.*
[343] *See supra* Section II.A.1–II.B.
[344] *See* FDIC Paper, *supra* note 147, at 2, 6.
[345] Investors of private banks make commitments to the Chinese Banking Regulatory Commission, promising to bear additional liabilities when the bank fails. The regulator also actively engages in developing regulatory measures that ensure the shareholders can be held liable, although it is still unclear how shareholder liability will be enforced in practice. *See* China Banking Regulatory Commission, http://www.cbrc.gov.cn/showyhjjinedx.do (last visited Sept. 26, 2017) [https://perma.cc/7PVS-GBFW].
[346] *Supra* Section III.B.

equity market of financial institutions, increases the information costs for shareholders and creditors, and incurs higher bankruptcy costs.

2. *The Costs of Associated Regulations*

As discussed above, shareholder liability aims to curb excessive risk-taking, and reduce the likelihood and extent of bail-outs.[347] However, it still faces some problems and needs certain regulations to be effective. Thus, shareholder liability operates together with a set of regulatory measures in both the United States and China.[348] These regulations may incur additional social costs.

a) Regulation on Shareholders

The shareholder liability regime in the United States relies on the financial strength of the shareholder—the parent-holding company.[349] This regime also will not be effective for parent-holding companies without sufficient capital and unsecured liabilities. Moreover, shareholders may act strategically, for example, by shifting the debt to the subsidiaries.[350] Thus, for the current internal liability regime to meet its goals, regulators need to monitor the parent-holding company. Regulators eventually need to extend banking regulation to these controllers.

The regime in China regulates all major shareholders.[351] Regulators imposed requirements on the financial strength of share-holders and a limitation on the number of major shareholders that can be targeted in times of emergency to provide support for the bank subsidiaries when the bank becomes insolvent.[352] Holding share-holders liable may be particularly difficult in China since its courts lack experience in handling banking institution bankruptcies. Several

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[347] *Supra* Section III.A.
[348] *See supra* Sections II.A.1, II.B.
[349] Mitts, *supra* note 269, at 74.
[350] *Id.* at 78 ("[M]anagers might accumulate high levels of off-balance sheet contingent debt to make it more difficult for prudential regulators to detect these efforts to shift debt to subsidiaries.").
[351] *See* Minying, *supra* note 13; Jie *supra* note 7.
[352] *See* Minying, *supra* note 13; Jie *supra* note 7.

problems may arise. For example, it is sometimes difficult to determine the amount of the bank's liabilities.[353] It may take a long time to identify the shareholders, investigate their wealth, and determine their shares of liabilities.[354] Enforcement of China's shareholder liability regime may also expend significant resources.[355] When a bank has widely dispersed shareholders, enforcing individual shareholder liabilities would be even more difficult. Apart from enforcement costs, the shareholder liability regime faces the problem of distinguishing active and passive investors. Any liability system should not deter equity investments by passive shareholders who do not control the banks. It also needs to consider different types of shareholders, such as shareholders who have already sold their shares and institutional shareholders who merely hold stocks for others. These questions need to be answered and determined in specific cases and contexts. The liability regime must achieve a balance between expeditious treatments of the liability and provide sufficient compensation for bank creditors, which often creates uncertainty as to the amount they can recover.[356] These difficulties may justify China's decision to regulate shareholders ex ante rather than using bankruptcy law ex post.

As discussed above, it is necessary to provide large financial institutions with liquidity immediately upon the institutions' insolvency, so as to restore the confidence of the market.[357]

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[353] Mitts, *supra* note 269. Although these problems may be addressed by the court system, they become more severe in developing countries like China that lacks an effective judiciary system. For a discussion on how the court may handle these problems, see Macey & Miller, *supra* note 10, at 39.

[354] *Id*.

[355] *See* Hansmann & Kraakman, *supra* note 3, at 1899 ("An obvious way to discharge such a duty would be to bond the assets available to satisfy a tort judgment—for example, by purchasing retroactive liability insurance for the firm shortly after the establishment of a liability date.").

[356] *See* Macey & Miller, *supra* note 10, at 38 (indicating the double liability regime before the Great Depression led to bank runs).

[357] Fillipo Occhino, *Central Bank Lending in a Liquidity Crisis,* FED. RESERVE BANK OF CLEVELAND (Apr. 13, 2016), www.clevelandfed.org/en/newsroom-and-events/publications/economic-commentary/2016-economic-commentaries/ec-201602-central-bank-lending-in-a-liquidity-crisis.aspx [https://perma.cc/VB23-V92D] (mentioning the central bank can resolve a

Bankruptcy procedures thus would be inappropriate, making more ex ante regulations necessary to ensure the availability of financial support in emergency circumstances. The current SPOE strategy in the United States requires the holding company to maintain a certain amount of liabilities that can be converted to equity when necessary,[358] which may cause inefficiency when the parent-holding companies have no business need to maintain long-term liabilities.[359]

External shareholder liability requires regulators to impose restrictions on the transfers of shares in the equity market, which may further intensify the limits on liquidity, transfers of control, and diversification of investments.[360] In China, shareholders are under tight regulations to ensure their financial strength.[361] The problem with these regulations is that they create a significant barrier to entry in the equity market of commercial banks and significantly reduce competition in the industry.[362] In China, there has long been a tendency for private enterprises to demonstrate potential for growth to gain preferential treatment in regulations.[363] Small firms do not gain access to the lucrative financial industry.[364] The Banking Regulatory

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liquidity crisis by directly lending to banks and gaining public confidence as the value of banks' assets recovers).

[358] Kupiec & Wallison, *supra* note 16, at 7 ("To prevent the need for OLF assessments, parents BHCs must have a substantial amount of unsecured debt that can be converted into receivership certificates as part of the SPOE recapitalization plan.").

[359] *Id*.

[360] *See* Hansmann & Squire, *supra* note 5, at 5 (explaining that limited shareholder liability increases share liquidity because there is less concern about the wealth of those investing).

[361] *E.g.*, Minying, *supra* note 13; Jie *supra* note 7.

[362] *See* Hansmann & Squire, *supra* note 5, at 5.

[363] *See* Curtis Milhaupt & Wentong Zheng, *Beyond Ownership: State Capitalism and the Chinese Firm*, 103 GEO. L. J. 665, 694 (2015) ("The overriding primacy placed on sustained economic growth has enabled some private firms to obtain special benefits from the state by demonstrating the potential to deliver that growth.").

[364] Lucy Hornby & Gabriel Wildau, *China Moves to Back Small Rural Businesses*, FIN. TIMES (Aug. 6, 2015), www.ft.com/content/52e4480e-2093-11e5-ab0f-6bb9974f25d0?mhq5j=e5 [https://perma.cc/GPV6-4UPU] ("Small

Commission only granted licenses to a few large corporations that have strong financial performance.[365] This tendency gives rise to the worries that small firms are unjustly treated.

b) Regulations on Diversification of Investments

To maintain sufficient capacity to rescue insolvent financial subsidiaries, shareholders also need to diversify their investments and invest in other assets that do not have correlated risks with subsidiary banks. Professor Richard Squire distinguishes different sources of systemic risks: (1) interconnectedness of different firms, (2) correlation of prices of financial assets, and (3) liquidity shortages.[366] The 2008 financial crisis was initiated by the collapse in the value of credit default swaps (CDS) after the market boomed for many years. A CDS is an unregulated over the counter (OTC) derivative.[367] Purchasers of a CDS gain protection against default of certain securities, many of which during the financial crisis were backed by sub-prime loans.[368] Many large financial institutions like Lehman Brothers were sellers of CDS and provided payments when the underlying securities defaulted.[369] When the bubble of the housing market popped, the

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and micro enterprises and rural companies are starved of credit in China, partly due to the small scale at which they borrow and partly due to their lack of collateral.").

[365] *E.g.*, Gabriel Wildau, *Alibaba Affiliate Wins Approval For Bank Licence*, FIN. TIMES (Sept. 29, 2014), https://www.ft.com/content/605c26bc-47d3-11e4-ac9f-00144feab7de [https://perma.cc/UGR8-CVA2].

[366] *See* Squire, *supra* note 284 at 101; *see also* Mitts, *supra* note 269, at 61.

[367] U.S. FIN. CRISIS INQUIRY COMM'N, *Conclusions of the Financial Crisis Inquiry Commission* in THE FINANCIAL CRISIS INQUIRY REPORT, at xxiv (2011), fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

[368] Squire, *supra* note 284, at 101. Synthetic CDOs are similar financial instruments that allow the purchaser and sellers to bet on the performance of certain mortgage-backed securities, which cause similar problems.

[369] *See generally* Heather Landy, *Lehman Credit-Default Swap Payout Could Climb as High as $365 Billion*, WASH. POST (Oct. 11, 2008), http://www.

sudden leap of CDS prices led these financial institutions to insolvency.[370] Facing liquidity shortages, these financial institutions were forced to sell assets at prices well below their face values, leading to a spiral drop of CDS prices and causing financial problems to other, interconnected institutions.[371] The Financial Crisis was thus a crisis of liquidity shortages.[372]

In order to support insolvent subsidiaries when they face liquidity shortages, parent-holding companies may need to liquidate part of their other assets and inject capital to the subsidiaries. However, selling part of their businesses may also harm market confidence and contribute to the cascading collapse of the prices of the assets if they are closely related to the assets of their subsidiaries.[373]

Thus, shareholder liability can only be effective when the default of the parent company is less harmful to the market than the failure of the subsidiary. Scholars have expressed doubts about whether the new measures of Dodd-Frank can truly end bailouts in the future.[374] One problem with the current regime is that the United States still insists on a separation of finance and commerce, which prevents commercial companies from holding banks and BHCs from holding stocks in commercial companies.[375] This separation limits the extent to which financial conglomerates can diversify their risks, and has led some scholars in the United States to propose abandoning this separation.[376] One argument for the separation is to prevent related-

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washingtonpost.com/wp-dyn/content/article/2008/10/10/AR2008101003050.html [https://perma.cc/VVU6-RMMB].

[370] *See* Squire, *supra* note 284, at 101 (indicating forced asset sales could lead to falling prices, which could put firms into insolvency).

[371] *See id.* at 100.

[372] *See generally id.* The Financial Crisis was like the typical bank runs that were common until the 1930s. However, the Financial Crisis was a run on the non-banks that, unlike conventional banks, weren't regulated.

[373] Mitts, *supra* note 269, at 65.

[374] *See generally id.* (considering the implications of Dodd-Frank).

[375] For a detailed discussion, see Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 32 (1991) (recounting the historical background for the separation between finance and commerce).

[376] *See generally* Mehrsa Baradaran, *Reconsidering the Separation of Banking and Commerce*, 80 GEO. WASH. L. REV. 385 (2012).

party transactions—i.e. a commercial company obtaining loans at a favorable rate from a related bank.[377] A second argument is that the commercial company may incur high risks that jeopardize the safety of the bank. Moreover, the United States is still deeply skeptical about the concentration of large corporate power.[378] Mark Roe has documented how this ideology influenced the development of corporate finance in the United States, preventing financial institutions from holding concentrated positions in corporations and leading in turn to the dispersed ownership structure.[379] These concerns on self-dealing, safety of the commercial company, and concentration of power are all valid. However, under the separation of commerce and banking, financial conglomerates in the United States can only diversify their assets to a certain extent.[380] In times of emergency, financial groups may liquidate other businesses to provide capital to save the core business line.[381] It remains to be seen whether the parent-holding companies can effectively liquidate their assets during a crisis without causing further damage to market confidence and liquidity.[382]

By contrast, the shareholder liability regime in China allows more diversification because different shareholders may have different

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[377] *See* Avraham et al., *supra* note 243, at 67 (July 2012). ("This separation is intended to prevent self-dealing and monopoly power through lending to nonfinancial affiliates and to prevent situations where risk-taking by non-banking affiliates erodes the stability of the bank's core financial activities, such as lending and deposit-taking").

[378] Roe, *supra* note 375, at 32.

[379] *See generally id*.

[380] *See id.* at 10 (describing the benefits of diversification that have led corporations to becoming the dominant form of enterprise organization).

[381] PROMONTORY FIN. GRP. LLC & SULLIVAN & CROMWELL LLP, RECOVERY AND RESOLUTION PLANNING: SOME PRACTICAL CONSIDERATIONS (2011), https://www.promontory.com/uploadedFiles/Articles/Insights/PFG-RecoveryWP-FINAL%20FINAL.pdf [https://perma.cc/V27J-VJCT] ("While the first choice is normally to sell non-core assets or business, it may be necessary to sell some of the core business assets (e.g., unencumbered liquid asset portfolios of capital markets businesses or credit card assets) in order to generate liquidity to offset crisis outflows.").

[382] Baradaran, *supra* note 200, at 1312 (2014) ("In the event of a real crisis, many experts state that there will not be buyers available to absorb these assets—that is, buyers other than the Federal Government.").

risks that cancel out with each other. In China, major shareholders of banks operate in different sectors of the economy, and there is no division between commerce and finance.[383] The shareholders thus have more diversified assets that they can liquidate to rescue insolvent banks and reduce the likelihood of bailouts. The major cost in the Chinese regime, however, is created by potential self-dealing activities between banks and commercial companies.

C. Determining Factors in Evaluating the Advantages of Shareholder Liability

The magnitude of the advantages of shareholder liability and the disadvantages incurred by internal and external shareholder liability may differ across jurisdictions, depending on a series of factors. One important factor is the corporate financial structure. The "Law and Finance" literature has provided illuminating views on the relationship between ownership structure and corporate law.[384] In countries with sophisticated corporate law that can duly protect investors and reduce agency costs due to managers' misconduct, dispersed ownership structure is more common because shareholders can diversify their assets and reduce risks.[385] In countries without sufficient protection for investors, however, concentrated ownership structures are more common and the controlling shareholders are usually reluctant to sell their shares.[386] The conclusion of the Law and Finance literature remains contested.[387] However, it still suggests that

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[383] *See* Liping Xu & Yu Xin, *Thorny Roses: The Motivations and Economic Consequences of Holding Equity Stakes in Financial Institutions for China's Listed Nonfinancial Firms*, 10 CHINA J. OF ACCT. RES. 105 (2014).
[384] Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (considering the relationship of ownership structure and corporate law).
[385] *Id*. at 1116.
[386] *Id*. ("[A] very high ownership concentration may be a reflection of poor investor protection.").
[387] Other factors, such as political ideology, might have played a role in the forming of ownership structure in some countries. *See generally* Roe, *supra* note 375 ("We shall examine the ideas of opinion leaders and political actors, and the content of major political investigations, leasing us to speculate on a political explanation for corporate structure."); s*ee also* Ronald J. Gilson,

in some countries with a dispersed ownership structure, liquidity, transfers of control, and diversification of investments are more important concerns.[388] External shareholder liability may incur higher costs when corporations have dispersed ownership structures because it interferes with the equity market directly.[389] Although it is still possible for the government to regulate the corporate financial structure, for example, by forcing investors of banks to hold a block of shares rather than diversify their investments,[390] such regulation may be too costly for some jurisdictions to adopt.[391] By comparison, in countries where concentrated ownership is more common, shareholders do not diversify their investments and frequently transfer corporate control.[392] They thus have less to lose when they establish external shareholder liability. Internal shareholder liability also depends on a special form of corporate structure—it can only be established where banks operate in large financial groups.[393] To compel private financial firms to form such financial group may create other social costs.[394] The decision to establish shareholder liability regimes thus needs to consider the corporate financial structure and its underlying efficiency reasons in a given jurisdiction.

Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, 119 HARV. L. REV. 1641, 1653 (2006).

[388] *See* Gilson, supra note 387, at 1648 ("Under this analysis, controlling shareholder systems will be characterized by weak equity markets—too much liquidity tied up in control blocks—and by large differences in the value of controlling and minority blocks as a result of private benefit extraction by the controlling shareholder.").

[389] *See* Roe, *supra* note 375, at 12 (finding where most corporations are held by thousands of dispersed shareholders the costs of monitoring the corporation are generally too high to incentivize any shareholder to take on that responsibility at the subsequent cost of a mismanaged corporation).

[390] *See id.* at 18.

[391] *See id.* at 15 (finding there are generally very few suitors for whom a block of control is a legal and financial possibility).

[392] *See* Gilson, *supra* note 387.

[393] *See* Hansmann & Squire, *supra* note 2, at 2 (defining internal liability as the partitioning of assets between members of a single corporate group).

[394] *Id.* at 10.

A second factor influencing efficiency of shareholder liability is regulatory capacity. As discussed, one of the advantages of shareholder liability is it alleviates burdens on regulation.[395] Different countries have different regulatory institutions and administrative capacities. Developed countries with sophisticated regulations may be less likely to use shareholder liability to curb excessive risk-seeking activities because of the potential costs it creates.[396] For example, regulators in these countries may have developed knowledge about how best to regulate. They may have the ability to collect sufficient information and to monitor the financial institutions. In developing countries where regulatory capacity is relatively weak, regulators lack knowledge about how best to regulate financial institutions and shareholder liability is more likely to be developed compared with developed countries with stronger regulatory capacity.

V. *Explaining the Decisions of Different Countries and Regions*

Corporate finance and regulatory capacity may explain the decisions made by different regions and countries. Here, I will attempt to use these factors to understand the rules developed in the United States, China and Europe.

A. The United States

In the United States, financial firms, like most corporations, display a pattern of dispersed ownership.[397] The literature on law and finance has documented how legal protection of investors facilitates this structure and enables investors to diversify their investments.[398]

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[395] *See* Jackson, *supra* note 12, at 512 (finding that placing the cost burdens of financial risk upon companies lessens the financial burden upon the government and regulators); s*ee also* discussion *supra* Section III.A.3.
[396] *See supra* Section II.
[397] *See* Roe, *supra* note 375, at 17–22 (detailing regulations which mandate that financial firms must be limited in the size of their corporate ownership stakes); Gilson, *supra* note 386, at 1645 ("[T]he United States . . . is characterized by companies with widely held shareholdings.").
[398] *Cf.* La Porta et al., *supra* note 383 at 1116.

Political ideologies have also contributed to the dispersed ownership structure.[399] Thus, an external shareholder liability regime would significant intrude on this ownership structure and would be too costly for the United States.

The United States builds the internal shareholder liability regime on a dispersed shareholding structure and large financial conglomerates. It does nothing to disturb the ownership structures of the parent-holding companies of financial groups. The financial groups in the United States operate as conglomerates, holding subsidiaries in different markets conducting different businesses.[400] Since the businesses of subsidiaries are largely unrelated, conglomerates can diversify their investments and reduce the overall risk exposure.[401] Conglomerates were once popular and embraced by investors in the 1960s.[402] However, this enthusiasm waned in the 1980s.[403] Many studies show that conglomerates do not create significant value for shareholders.[404] Meanwhile, some evidence suggests managers might have conducted acquisitions and developed conglomerates for their private benefit.[405] However, diversification remains an important concern for mergers and acquisitions.[406]

While conglomerates were discredited in many industries, they became increasingly prevalent in the financial industry and came to be known as "universal banks."[407] One reason for the rise of these

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[399] *See* Roe, *supra* note 375, at 11.

[400] DAVID J. RAVENSCRAFT & F.M. SCHERER, MERGERS, SELL-OFFS, & ECONOMIC EFFICIENCY 37 (1987).

[401] Brian Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 30 (2008).

[402] *Id.* at 16 ("The U.S. experienced its third merger wave in the late 1960s . . . and [a] distinguishing feature of this merger wave was the prevalence of diversifying or 'conglomerate' mergers.").

[403] *Id*, at. 26.

[404] RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 339 (2d ed. 1995) ("[S]tudies that reach the consistent conclusion that firm-level diversification reduces firm value.").

[405] *Id.* at 346–47.

[406] *See* Cheffins & Armour, *supra* note 400, at 17–19 (discussing the continuation of conglomerate formation during the 1980s).

[407] Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis,* 41 CONN. L.

conglomerates was that they provided better services to clients and thus achieved economies of scale.[408] Another reason was the increasing need for stability.[409] The Banking Act of 1933, alternately referred to as the Glass-Steagall Act, established the separation of commercial banks and investment banks.[410] The Federal Reserve Board opened loopholes in this separation in the 1980s, beginning a process that eventually allowed Citicorp, a bank holding company, to merge with Travelers, an insurance company, in 1998.[411] The separation of commercial and investment banking was eventually lifted in 1999, when Congress enacted the Gramm-Leach-Bliley Act (GLBA),[412] which permitted BHCs to register as financial holding companies (FHC) and to engage in a variety of financial activities besides commercial banking.[413] While GLBA was partly driven by efficiency concerns, such as allowing banks to achieve economies of scale and to provide "one stop shopping" services,[414] it also considered the benefits of diversifying financial risks to promote safety.[415] During the financial crisis, the government forced the consolidation of banks, making them substantially larger.[416] Large BHCs own commercial banks, broker dealer firms, clearing corporations, and asset

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REV. 963, 975–76 (2009) ("More than 5,400 mergers took place in the U.S. banking industry from 1990 to 2005, involving more than 5.0 trillion in banking assets.").

[408] *Id.* at 973.

[409] *Id*. The need for international competition may also have played a role. *See id*.

[410] Wilmarth, *supra* note 407, at 972 ("The Banking Act of 1933 (popularly known as the 'Glass-Steagall Act') built a legal firewall that separated commercial banks from the securities industry.").

[411] *Id.* at 972.

[412] *Id*.

[413] Avraham et al., *supra* note 243, at 3 (describing the GLBA's alteration of the BHC Act to allow a BHC to register as a FHC).

[414] Wilmarth, *supra* note 407, at 973 (summarizing GLBA supporters' arguments).

[415] *Id*.

[416] Jonathan C. Lipson, *Concentration, Complexity, and Capture: An Institutional Analysis of Dodd-Frank's Orderly Liquidation Authority*, BANKING & FIN. SERVS. POL'Y REP. 1, 3 (2015).

management firms.[417] The rise of financial conglomerates was at least partly driven by regulatory decisions.[418]

The development of conglomerates has made new strategies of bank resolution possible and more convenient for regulators to enforce. It is relatively easy to identify the owner of large financial institutions without discouraging investment by passive dispersed investors.[419] More importantly, BHCs serve as an easy target for liability shifting. Regulators do not have to chase numerous dispersed shareholders for liabilities, which saves tremendous administrative costs.[420] Moreover, by tying financial firms with different businesses together, financial conglomerates may diversify their investments and reduce volatility.

In the twentieth century, the United States once had a double liability regime, which required shareholders to bear additional liability.[421] Some scholars argue that the United States should reintroduce this regime.[422] However, the corporate financial structure in the United States has changed significantly since then.[423] Moreover, large financial institutions have outgrown their counterparts in the twentieth century, making many of them too big to fail.[424] Although external liability might have worked well in the twentieth century, such regimes

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[417] *See id.* (explaining the concentration of large institutions increased as a result of the financial crisis).
[418] Wilmarth, *supra* note 407, at 973 (describing how the GLBA repealed certain anti-affiliation provisions in Glass-Steagall, "so that commercial banks could affiliate with securities firms and insurance companies within a financial holding company structure").
[419] *See* Lipson, *supra* note 416, at 4 ("Frequently, large financial firms are connected to one another through shared ownership in these entities or interests in the assets these entities hold.").
[420] *See id.*
[421] Hester Peirce & Robert Greene, *Rethinking the Volcker Rule*, MERCATUS CTR. (Jan. 2013), https://www.mercatus.org/publication/rethinking-volcker-rule [https://perma.cc/9WZS-KA6B]. This rule was changed with the introduction of Glass-Steagall.
[422] *Id.*
[423] Wilmarth, *supra* note 407, at 975 ("As a consequence of the bank merger wave, the share of U.S. banking assets held by the ten largest banks more than doubled, rising from twenty five percent in 1990 to fifty-five percent in 2005").
[424] *Id.*

may face more challenges today. Bank failures need to be handled more quickly to prevent contagions of financial risks.[425] It thus may be necessary to impose regulations on shareholders ex ante, which may hinder the transfers of shares, reduce liquidity, and limit diversification in investments in the equity market.

Finally, despite the 2008 financial crisis, the United States still has sophisticated regulatory agencies with expertise regulating commercial banks.[426] The need for shareholder liability thus may not be as strong as in developing countries such as China.[427] These factors may make internal shareholder liability easier to develop in the United States.

B. China

The advantages of internal shareholder liability over external shareholder liability are less significant in China than in the United States. Most corporations in China have concentrated ownership, probably due to a lack of protection of investor rights.[428] Moreover, China has been regulating bank ownership to prevent self-dealings and to ensure the safety of commercial banks, which has significantly limited the liquidity of the equity markets, and transfers of control.[429] Each transfer of above 5 percent equity interests in banks needs to be approved by the Banking Regulatory Commission or its local branches.[430] Only shareholders with strong credit ratings and good financial performance records can invest in commercial banks.[431] Thus, China has adopted regulations which ensure the stability of the financial system, hinder transfers of control, reduce liquidity, and limit

[425] *See* Avgouleas & Goodhart, *supra* note 14, at 21–22.
[426] *See supra* Section II.A.
[427] *See supra* Section II.B.
[428] *See generally* La Porta et al., *supra* note 383.
[429] Zhongzi Shangye Yinhang Xingzheng Xuke Shixiang Shishi Banfa (Xiuding) (中资商业银行行政许可事项实施办法（修订）[Implementary Measures in Administrative Licensing of Domestically Owned Commercial Banks] (promulgated by the Banking Regulatory Commission, June 5, 2015, effective June 5, 2015), art. 10–11.
[430] *Id.* at art. 39.
[431] *Id.* at art. 9.

diversification regardless of whether the external shareholder liability is adopted. Since China has made the stability of the financial system its top priority, the costs of external shareholder liability are relatively less significant.

In China, the banking industry has long been dominated by state-owned banks, which take orders directly from the state.[432] The regulatory regime has a short history, and the regulatory capacity in regulating private banks may be relatively weak.[433] Therefore, it is not surprising that China undertook external shareholder liability, imposing strict constraints on private investors.

C. Europe

The policy decisions made by European countries after the financial crisis further illustrate that in deciding to adopt a shareholder liability regime, policy makers need to consider corporate financial structures. In the post financial crisis era, Europe has developed a bail-in regime through the Bank Recovery and Resolution Directive (BRRD).[434] Government authorities may recapitalize insolvent banks by wiping out liabilities or converting them into equity claims without triggering a bankruptcy process when banks are insolvent.[435] Certain liabilities are excluded from being bailed-in, such as deposits protected by a deposit guarantee scheme, salaries, taxes, pensions, short-term interbank lending, claims of clearing house, client assets, and secured liabilities.[436] Shareholders are not required to inject capital into insolvent banks. Losses of banks are instead absorbed at least partly by

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[432] *See* Shuangning, *supra* note 207.
[433] *See supra* Section II.B.
[434] Avgouleas & Goodhart, *supra* note 14, at 4–6 (describing the bail-in approach and how the new legal scheme forced banks to internalize and assume the costs of risky investment behavior).
[435] *Id*. at 8–10 (arguing that triggering the bail-in process may "generate a capital flight and a sharp rise in funding costs," which could be "damaging and disruptive" to "wider market confidence," while bailouts may be more effective because taxpayers cannot easily flee).
[436] Bank Recovery and Resolution Directive, 2014/59/EU of the European Parliament and of the Council of 15 May 2014, art. 44(2) and 108(a), 2014 O.J. (L 173) 198, 207.

creditors before a Member State uses public resources to recapitalize the banks.[437] Scholars have expressed worries that bailing-in creditors may have significant impacts on other financial institutions and market confidence.[438] Creditors whose claims are converted into equity may face liquidity shortages and need to "fire-sell" their assets to raise cash, which may cause other firms to report losses,[439] unless their assets are not related to the banks'. Moreover, it remains unclear whether creditors can effectively monitor the banks and curb their risk-seeking activities.

Although Europe faces the problem of excessive risk-taking by banks, similar to the situation faced in the United States and China, it has not adopted any form of shareholder liability. The benefits of shareholder liability in curbing risk-taking may be insufficient to offset the costs in Europe. Europe could not adopt internal shareholder liability, because European banks do not operate as subsidiaries in financial conglomerates.[440] Paul Tucker, Deputy Governor Financial Stability of the United Kingdom, acknowledges that the SPOE in the United States is a significant innovation in financial regulation that allows top-down resolution,[441] and that requiring a parent-holding company to serve as a source of strength could alleviate the burden of

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[437] Avgouleas & Goodhart, *supra* note 14, at 4 ("In these new schemes, apart from the shareholders, the losses of bank failure are to be borne by *ex ante* (or *ex post*) funded resolution funds, financed by industry levies, and certain classes of bank creditors whose fixed debt claims on the bank will be commonly converted to equity.").
[438] *Id*.
[439] Squire, *supra* note 284, at 100 ("[F]orced asset sales can both result from, and lead to, cash shortage, with falling prices pulling otherwise solvent firms into bankruptcy").
[440] *See* Directive 2014/59/EU, of the European Parliament and of the Council of 15 May 2001, recital 4, 2014 O.J. (L173) 190, 191 (establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations No 1093/2010 and No 648/2012, of the European Parliament and of the Council).
[441] Tucker, *supra* note 11, at 2.

banking regulation.[442] He argues that European countries have not adopted the United States model because their banks have different ownership structures.[443] Although some scholars have argued that Europe should modify its regulatory regimes to force banks to change their structure to incorporate the SPOE strategy,[444] these proposals have not been implemented.

Should Europe develop external shareholder liability? From an efficiency perspective, the cost may be too high. Firms in Europe display a variety types of ownership structures. Several of the largest banks in Europe, including HSBC Holdings, BNP Paribas, Deutsche Bank, for example, have dispersed ownership structures.[445] Most of their shareholders are institutional investors.[446] When a bank becomes financially distressed, it may be too costly to require institutional shareholders, who hold no more than a 1 percent share of the distressed institutions stocks, to put in additional capital to save the institution from being insolvent, while any ex ante regulations would reduce the liquidity in the equity market and prevent these institutional investors from diversifying their investments. Even for smaller banks, European countries may consider it more important to maintain the liquidity of the equity market of banks, promote free transfers of control, and encourage diversification of investments by bank shareholders. European countries also may not be willing to impose too many regulations on shareholders *ex ante* as China has. Enforcing

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[442] *Id.* at 3 ("[T]he amount of equity that a host regulator requires to be held in a subsidiary over and above the Basel minimum may vary according to whether it is part of an 'SPE group' in which the parent/holding company is a source of strength through resolution.").

[443] *Id.* at 2 ("[M]ost US bank and dealer groups are, through an accident of history, organised [sic] in way that lends them to top-down resolution on a group-wide basis.").

[444] Gordon & Ringe, *supra* note 145, at 1364 (explaining why scholars argue to incorporate the SPOE strategy in Europe, but concluding "the structure of European banks must change in order for SPOE strategy to be effective").

[445] *See e.g.*, *Shareholder Structure of Deutsche Bank*, DEUTSCHE BANK, https://www.db.com/ir/en/shareholder-structure.htm [http://perma.cc/FUQ3-78PW]; *see also Share Ownership of BNP Paribas*, BNP PARIBAS, https://invest.bnpparibas.com/en/share-ownership [http://perma.cc/5RC-2WN8].

[446] *See e.g.*, *Shareholder Structure of Deutsche Bank*, *supra* note 445; *see also Share Ownership of BNP Paribas*, *supra* note 445.

external shareholder liability thus may be difficult in an emergency. In short, external shareholder liability requires significant regulation on bank ownership structure, which incurs significant costs that Europe may not want to bear.

VI. Conclusion

While some scholars have long debated about the costs and benefits of shareholder liability, they have largely ignored the different types of shareholder regimes already in place across the globe. This article examines two shareholder liability regimes in the financial industry—internal and external shareholder liability—and shows it is entirely possible to develop shareholder liability regimes with certain regulations. These regimes have many benefits—they promote efficiency and alleviate distributive justice concerns in the financial industry. This article further illustrates that whether and how to establish shareholder liability should depend significantly on regulatory capacity and corporate financial structures in different countries. These two factors may explain the different regulatory decisions made by the United States, China, and European countries.

This article has significant theoretical implications for the debate on limited liability. It examines two important shareholder liability regimes in detail and explains how nations' decisions to establish these regimes are affected by different factors. Although this discussion focuses on the financial industry, the conclusion may potentially extend to other industries where limited liability may cause externalities to the society. For example, when corporations create substances that are toxic to the environment, shareholders may be held liable.[447] The analysis of efficiency, distributive justice and regulatory concerns, and the intimate relationship between shareholder liability and corporate finance discussed in this article may serve as guidance for the future design of shareholder liabilities in other countries and other regulated industries.

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[447] *See* Rita Cain, *Shareholder Liability under Superfund: Corporate Veil or Vale of Tears*, 17 J. LEGIS. 1, 4–5 (1991) ("Courts have held, however, that the shareholders of companies that owned hazardous sites are directly liable under the owner/operator provision of CERCLA, without piercing the corporate veil of the site-owning company.").