
RESPONSE

HOW TO AVOID IMPLEMENTING TODAY'S WRONG POLICIES TO SOLVE YESTERDAY'S CORPORATE GOVERNANCE PROBLEMS

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In response to Barry E. Adler & Marcel Kahan, *The Technology of Creditor Protection*, 161 U. PA. L. REV. 1773 (2013), and Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907 (2013).

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INTRODUCTION

According to Edward Rock, the issue that has concerned scholars and practitioners of corporate governance and corporate law for decades, namely, the principal-agent problem between shareholders and managers, has been solved.¹ It is yesterday's problem and has already been addressed through a combination of increased shareholder activism and intensified executive remuneration. We should recognize this and move on to confront today's problem. Rock asserts that today's problem is the reemergence of an issue that used to be center stage in corporate law, namely, the conflict between shareholders and creditors. It is this conflict, rather than the shareholder-manager debate, that should be the focus of our attention going forward.²

Barry Adler and Marcel Kahan take Rock's thesis as a starting point for proposals to address the shareholder-creditor conflict.³ They argue that the problem is creditors' inability to recover losses sustained as a consequence of firm misconduct in, for example, incurring excessive risks or additional debt liabilities that undermine the claims of earlier creditors.⁴ They believe that liability for such actions should rest with shareholders and subsequent creditors, rather than management, since these were the parties that encouraged and incentivized management to undertake them. They therefore argue that creditors should have the right to seek recovery from shareholders and later generations of creditors in compensation for their losses. In effect, they are proposing that creditors should be able to pierce the corporate veil and impose liability through direct claims against shareholders and subsequent creditors.⁵ This will, according to Adler and Kahan, discourage shareholders and creditors from promoting these damaging actions in the first place.⁶

These thought-provoking and important Articles raise several fundamental questions about the nature of the corporation and the design of corporate governance and corporate law. The first question is whether

¹ See Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1926 (2013).

² *Id.* at 1926-29.

³ Barry E. Adler & Marcel Kahan, *The Technology of Creditor Protection*, 161 U. PA. L. REV. 1773 (2013).

⁴ *Id.* at Part III (discussing various deficiencies in remedies that are currently available to creditors).

⁵ *Id.* at Part IV.

⁶ See *id.* at 1803-04 (detailing the limiting effect that recovery against shareholders and subsequent creditors has on inefficient investment).

Rock's assertion that the traditional principal-agent problem has been solved and can be laid aside is correct. The second question, if he is right, is whether the creditor-shareholder conflict is the next issue that should be addressed. Finally, are Adler and Kahan then correct in suggesting that the problem's resolution lies with shareholders and new creditors instead of with management, and should the problem then be addressed by allowing the affected parties to recover from shareholders and later creditors?

This Response argues that Rock is fundamentally right in recognizing that we are using today's policy tools to address yesterday's corporate governance problems and that the traditional principal-agent issue is no longer the primary concern. Furthermore, an excessive preoccupation with this one issue has aggravated and caused, rather than rectified or extinguished, existing deficiencies of the corporation. Rock is therefore making an important contribution to the corporate governance debate by alerting us to this deficiency in the corporate governance literature.

Adler and Kahan are also right to seek a resolution of the distortions through realigning incentives. Their suggestion of allowing creditors, under certain circumstances, to recover damages sustained from shareholders and other creditors is interesting and could play an important role in enabling corporations to expand the set of contractual relations that they can establish with their creditors and shareholders.

This Response suggests that Rock should go further in recognizing the consequential nature of the problem that he identifies. It is but the tip of the iceberg, and in focusing on the tip Rock could cause us to crash into the mass that lies hidden below the surface. The problems created by an excessive preoccupation with principal-agent matters are an illustration of this, but so too are Adler and Kahan's proposals, which in turn risk creating new distortions.

To properly address the problem that both Articles have correctly identified, we need an approach that recognizes the corporation's full complexity and its potential to resolve its own failings without resorting to further private litigation or public regulation. To understand the strengths and weaknesses in Rock's and Adler and Kahan's proposals, we first need to put their important contributions in the context of the existing debate.

I. THE PRINCIPAL-AGENT DEBATE

Since Berle and Means,⁷ increasing attention has been devoted to the consequences of the separation of ownership and control in dispersed shareholder corporations caused by the divergence of the shareholders' and managers' interests.⁸ Corporate governance in this traditional context has most recently been associated with the failures of institutions during the financial crisis.⁹ Egregious managerial conduct resulted in excessive risk-taking that undermined the solvency of financial institutions to the detriment of shareholders as well as creditors and governments. The solutions required to address this included better stewardship by shareholders; more accountability of management to the owners; a closer alignment of executive remuneration with corporate performance; and stronger oversight by auditors, risk management committees, and risk officers. The common theory was that by bringing managerial interests closer in line with those of shareholders, the management's reckless conduct could have been avoided.

In fact, in all likelihood the corporate governance failure was a result of exactly the opposite—an excessively close alignment of managerial interests with those of shareholders led management not to act in an uncontrolled fashion, but to respond recklessly to the incentives provided by shareholders. In holding “put options” on a firm, shareholders are the beneficiaries of excessive risk-taking because they derive benefits from the upside gains from risk-taking but impose the costs of failure on creditors. In highly leveraged institutions such as banks, shareholders benefit from the increased risk-taking, which augments the value of their call options on the firm. Banks that engage in high-risk investments benefit their shareholders by transferring wealth from their creditors to their shareholders.¹⁰

⁷ ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

⁸ For good surveys of the corporate governance literature, see Marco Becht et al., *Corporate Governance and Control* (Eur. Corporate Governance Inst., Working Paper No. 02/2002, 2005), available at <http://ssrn.com/abstract=343461>, and, for a more recent summary, STEEN THOMSEN & MARTIN CONYON, *CORPORATE GOVERNANCE: MECHANISMS AND SYSTEMS* (2012).

⁹ For a survey of the literature on bank governance and performance, see Marco Becht et al., *Why Bank Governance Is Different*, 27 *OXFORD REV. ECON. POL'Y* 437 (2011).

¹⁰ See Andrea Beltratti & René M. Stulz, *The Credit Crisis Around the Globe: Why Did Some Banks Perform Better?* 25 (Fisher Coll. of Bus., Working Paper No. 2010-03-005, 2011), available at <http://ssrn.com/abstract=1572407> (finding, in a study of financial institutions, that “banks with a more shareholder-friendly board took more risks that worked out poorly”); Ing-Haw Cheng et al., *Yesterday's Heroes: Compensation and Creative Risk-Taking* 30 (Eur. Corporate Governance Inst., Working Paper No. 285/2010, 2012), available at <http://ssrn.com/abstract=1502762> (concluding that “shareholders' goals determined the riskiness of financial firms' strategies and that improving governance would not restrain risk-taking”).

This is a specific example of the general conflict between shareholders and creditors that Rock describes, namely, the misalignment of interests between the two parties. Creditors with fixed claims on firms wish them to maintain conservative, low-risk investment policies; as residual claimants, shareholders prefer high-risk investments, particularly when equity markets allow them to diversify their firm-specific risks across a large number of shareholdings. This conflict becomes more acute as leverage and the value of shareholders' put options increase.

In this context, as corporate governance—in its traditional manifestation of aligning shareholder and managerial interests—is strengthened, the problem becomes more—not less—acute. The stronger the alignment of managerial remuneration with shareholder earnings, the greater the incentive on management to make the high-risk investments that shareholders wish to see implemented. Far from alleviating the source of the financial crisis, conventional policy prescriptions are therefore destined to intensify it.¹¹ Not only, in Rock's terms, have we solved yesterday's corporate governance problem, but in the process we have created today's.

Neither of the resultant problems—the debt overhang and wealth transfer problems described in Section III—is new, and both have been extensively discussed.¹² However, such has been the force of the shareholder lobby that we have lost sight of the other conflicts that pervade the corporation. The creditor–shareholder conflict is but one of many others, and in the process of reestablishing its significance, it is important to appreciate that it is by no means the only, or indeed necessarily the most, important one.

II. THE SHAREHOLDER–SHAREHOLDER CONFLICT

While the agency problem remains paramount, academic attention has shifted over the last decade to a different conflict between large and small (i.e., majority and minority) shareholders. Much of the recent corporate law literature has sought to strengthen the rights of minority shareholders against the pursuit of private interests by majority shareholders. This is

¹¹ See, e.g., Renée B. Adams & Hamid Mehran, *Bank Board Structure and Performance: Evidence for Large Bank Holding Companies*, 21 J. FIN. INTERMEDIATION 243, 245 (2012) (finding that board independence is not related to firm performance); Daniel Ferreira et al., *Boards of Banks* 8 (Eur. Corporate Governance Inst., Working Paper No. 289/2010, 2012), available at <http://ssrn.com/abstract=1620551> (“[B]anks with more shareholder-oriented governance structures take more risks.”).

¹² See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 343-51 (1976) (exploring the role of agency in corporate wealth maximization); Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 147-49 (1977) (reviewing corporate debt policy theories).

regarded as critical to the participation of minority shareholders in capital markets.

There is a still more important conflict among shareholders that is rising to the forefront in both academic and policy debates: the conflict between short- and long-term shareholders. Some regard “short-termism” as a particularly serious deficiency of Anglo-American capital markets.¹³ The problem of short-termism exists where market inefficiencies compel shareholders who only hold their shares for short periods of time to encourage companies to exploit overvalued investments to the detriment of long-term shareholders.¹⁴ A preoccupation with short-term returns by some investors will therefore have consequences for firms’ real (i.e., physical and human capital) investment policies.

In essence, both the majority–minority and the short–long term conflicts are manifestations of a generic problem that, in the absence of complete markets for which there are securities corresponding to all the potential states of the world, there will be a lack of unanimity amongst shareholders regarding the policies, both real and financial, that a firm should be pursuing. The creditor–shareholder conflict is a further extension of this generic problem to a context in which it is impossible to write complete contracts between the two parties. In essence, these conflicts are inherent to the corporation. As the shareholder–creditor case illustrates, seeking to rebalance the interests of one party not only undermines the position of the other party but also likely generates conflicts with third parties. So, for example, resolving the agency problem intensifies the creditor–shareholder conflict, and resolving the creditor–shareholder conflict might well exacerbate both the agency and majority–minority shareholder problems by weakening the power of shareholders and, in particular, minority shareholders.

This example demonstrates the unintended consequences that corporate governance reforms can cause, and it warns against prescriptive recommen-

¹³ See, e.g., JOHN KAY, DEP’T FOR BUS., INNOVATION & SKILLS, THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING: FINAL REPORT 9, 14 (2012), available at <http://bis.gov.uk/assets/biscore/business-law/docs/k/12-917-kay-review-of-equity-markets-final-report.pdf> (defining “[s]hort-termism” as “the natural human tendency to make decisions in search of immediate gratification at the expense of future returns” and concluding that it “is a problem in UK equity markets”).

¹⁴ See Patrick Bolton et al., *Executive Compensation and Short-Termist Behaviour in Speculative Markets*, 73 REV. ECON. STUD. 577, 598 (2006) (“In a speculative stock market, incumbent shareholders have a shorter horizon and align the manager’s horizon to theirs by weighing the CEO’s compensation more heavily on short-term stock price performance.”); Patrick Bolton et al., *Pay for Short-Term Performance: Executive Compensation in Speculative Markets*, 30 J. CORP. L. 721, 743 (2005) (suggesting that “directors, just as CEOs, should be encouraged to take a more long-term perspective”).

dations that seek to impose the highest standards of corporate governance. There is no universally applicable manual for good corporate governance. Tradeoffs must be made to reflect the particular circumstances of each company. This is not to say that, because the corporation is riddled with conflicts, nothing can or should be done, but only that careful consideration needs to be given to the underlying causes of the conflicts and to the appropriate solutions, which may not lie in either law or regulation. It is against this background that we should consider Rock's and Adler and Kahan's specific suggestions that the most serious problem in corporate governance is currently the conflict between creditors and shareholders, and the appropriate solution is to allow recovery by creditors against shareholders and other creditors.

III. THE CREDITOR–SHAREHOLDER CONFLICT

The creditor–shareholder conflict is a debt overhang problem. There is outstanding debt that is exposed to the risk of corporate failure. However, unlike shareholders, creditors are protected by contract through covenants and collateral as well as the servicing of interest and principal. Private contract rather than public law is therefore viewed as the primary mechanism for resolving the creditor–shareholder conflict. Where there are externalities in the form of potential systemic crises resulting from individual firm failures, then public regulation may be required to internalize externalities. Absent such externalities, private contracting should be adequate.

In practice, however, the power to enforce contractual provisions on debt contracts is limited. The financial crisis revealed the extent to which covenants were ineffective in preventing banks from substantially raising their financial exposure through increasing leverage and engaging in high-risk investments.¹⁵ Creditors have three forms of protection: equity capital, interest rate margins, and the refusal to lend. The price of inadequate creditor protection is higher costs of capital and credit rationing, as manifested by the collapse of credit markets in the post–financial crisis era.

The strongest incentive on companies to desist from engaging in wealth transfers at the expense of creditors is their desire to access credit markets at low costs of finance. Companies that cannot demonstrate credible mechanisms for doing this pay the price in terms of the costs and availability of

¹⁵ See, e.g., Noel Yahanpath & SzeKee Koh, *Strength of Bond Covenants and Bond Assessment Framework*, 6 AUSTRALASIAN ACCT. BUS. & FIN. J., no. 2, 2012, at 71, 81–86 (recording the weakness of covenants in New Zealand bond issues between 2001 and 2007).

credit.¹⁶ The fact that the incidence of poor corporate governance is ultimately borne by users rather than suppliers of credit reflects the high elasticity of supply relative to demand for credit, in particular amongst small corporate borrowers. Investors have a vast array of alternative forms of investment; borrowers, in general, have comparatively limited sources of finance. In that regard, the welfare effects of ex post renegeing through wealth transfers in credit markets might be modest—at least for the suppliers rather than the users of credit—in comparison to those of other stakeholders who face more inelastic supply schedules.

IV. THE STAKEHOLDER–SHAREHOLDER CONFLICT

Creditors are not the only stakeholders who are poorly protected by contract. The same applies to most stakeholders in the firm—employees, suppliers, and customers. They have some contractual protection through employment, supply, and purchase contracts, respectively, but in each case the level of protection is limited. Furthermore, while the ex post exposure of these parties might be similar to that of creditors, their ex ante vulnerability is frequently greater. Unlike financial investors who can readily take their capital elsewhere, employees, suppliers, and customers often have limited choice ex ante as well as ex post. They are therefore less able to respond to the possibility of contractual violations through, for example, refusal to supply or purchase. The incidence of wealth transfers is more likely to be borne by these other stakeholders than either shareholders or creditors to the firm.

The implication is that once one considers parties beyond shareholders, the costs of poor corporate governance are less likely to be borne by creditors than other stakeholders. While Rock is therefore correct in concluding that creditor–shareholder conflicts are now more serious than those between shareholders and management, he should perhaps have gone on to consider the other parties that are potentially more at risk from wealth transfers than creditors. Alternatively, one should extend Rock’s concerns about creditors beyond financial forms of credit to creditors more broadly defined, including employees, suppliers, and purchasers.

Having concluded that Rock might well be correct in suggesting that the main focus of corporate governance should move beyond shareholder–manager relations to those between shareholders and creditors broadly

¹⁶ See Gordon J. Alexander et al., *What Does Nasdaq’s High-Yield Bond Market Reveal About Bondholder–Stockholder Conflicts?*, 29 FIN. MGMT. 23, 36 (2000) (recording a “divergence in the returns of bonds and stocks when cumulative excess stock returns are negative”).

defined, the next question is what should be done about it. In particular, are Adler and Kahan right to conclude that the stakeholder–creditor conflict should be addressed by seeking redress from shareholders and other creditors?

V. SEEKING LEGAL REDRESS FOR WEALTH TRANSFERS

Adler and Kahan see the problem of wealth transfer against creditors as originating with shareholders. While executives might be the people who execute the transactions, they are doing so under incentives and encouragement from the firm's owners. The shareholders should therefore bear the consequences of their actions, and it is from shareholders that compensation and redress should be sought. For example, where a company pays a dividend that undermines the financial resilience of a firm, shareholders might be required to return the dividend that contributed to the firm's failure as compensation for the losses that the creditors sustained. This would discourage shareholders from promoting such conduct. Likewise, to the extent that firms raise their levels of leverage by issuing additional debt, the new creditors who have benefited at the expense of existing ones should be required to pay compensation in the event of a corporate failure. New creditors should essentially return the benefits they have accrued at the expense of existing creditors.

There is a clear appeal in a proposal that enhances the accountability and liability of those responsible for promoting reckless conduct by corporations. The spirit of the analysis of the financial crisis and the subsequent proposed corporate governance reforms described above was that the failures are being wrongly ascribed to executives. The shareholders benefited from exploiting the put option of shares in their portfolios, and it was they, rather than the executives, who therefore promoted excessive risk-taking and leverage. One should therefore shoot the originator, not the executor.

Furthermore, since the wealth transfer problem and the shareholders' put option derive from limited liability, there is an attraction in being able to realign incentives and correct distortions by piercing the corporate veil and requiring shareholders and the creditors who have enriched themselves at the expense of earlier creditors to pay compensation for their ill-begotten gains.

The Adler and Kahan proposals therefore appear to be justified by the underlying nature of the failure, the fairness of requiring compensation to be paid, and the correction of incentives that it achieves. The sentiment of seeking to penalize corporations for their failure to consider the consequences of their actions on adversely affected parties is a worthy one. Nevertheless, their proposal is not without its concerns. It will add to the

mountain of contractual complexity that already weighs down on corporate America. The enforcement of provisions against later creditors and shareholders would be difficult. To what extent did the issue of subsequent debt alleviate or contribute to the ultimate demise of a corporation? Was the investment that the firm undertook a fundamental cause of the corporate failure? Did shareholders implicitly or explicitly promote the risk-taking that failed? These are rich pickings for lawyers but poor prospects for corporations.

It is very unclear whether the right approach to an identified contractual or market failure is to find a contractual solution. It might be better to recognize that their proposal's initial failure is to rely on contractual approaches as a solution to a problem that is inherently not amenable to contractual solutions. It is not a question of whether a contractual resolution could be found for the problem—a contractual solution can be found for most problems—but whether a contractual remedy is the best or most appropriate one.

The example that Adler and Kahan discuss of a dividend payment that left the firm with unreasonably small capital, a form of fraudulent conveyance, and a violation of covenant in a loan agreement, is a case in point. If the dividend did not leave the firm with unreasonably small capital then it might be justified on the grounds that it assisted the firm with raising new equity capital. The fact that the firm subsequently failed is not a reason for presuming that this was the wrong course of action or could not be justified *ex post*. However, concern about being able to demonstrate this justification in a court might discourage a firm from paying the dividend in the first place. Furthermore, the notion of requesting a shareholder to return a dividend, even within a limited time period, is problematic. The current shareholders may not be the same as those who received the dividend, and both might be different from those who were shareholders at the time that the decision to pay the dividend was made.

At the heart of the problem lies a failure of the corporation to take account of the interests of the parties with whom it is transacting. Creditors are but the tip of the iceberg of stakeholders who are exposed to excessive risk-taking by the corporation. The ability to impose remedies for losses sustained by employees is potentially as significant for the efficient operation of the corporation as those incurred by creditors. However, the ability to impose retroactive adjustments on other parties, be they shareholders, later creditors, later employees, or suppliers, is troublesome.

The generic problem that Rock identifies is one of contractual violations, which, in the face of financial failure, cannot be rectified except by the

types of solutions that Adler and Kahan propose, including seeking direct compensation from the offending parties. This threat afflicts a range of stakeholders in addition to creditors, and it results in either increases in their costs of employment or the entire withdrawal of their services. The greatest welfare costs are borne by the stakeholders with the fewest alternative uses for their services.

VI. REMEDYING CONTRACTUAL FAILURES

The failure is one of corporations being able to assure their various constituencies of their commitment to uphold rather than default on agreements. The commitment potentially comes from two quarters: first from the owners, the shareholders, and second from their agents, the board of directors.

The level of commitment that shareholders provide is measured in the capital that they subscribe to the corporation in the form of retained earnings and new equity. As is now widely understood, a fundamental cause of the wealth transfers in the financial crisis was the low levels to which capital provisions in banks had fallen in the immediate pre-crisis period.¹⁷ Capital is a fundamental requirement for shareholders to be able to demonstrate credible commitments to their stakeholders. But it is not sufficient.

The innovation of the corporation was in allowing equity in aggregate to be committed through the creation of permanent capital while requiring no single shareholder to be committed through the provision of liquid capital markets. This system allows shares to be traded in secondary markets while leaving the primary funding of corporations unaffected.

Initially, this had little direct impact on the conduct of firms since the majority of equity capital remained under the control of a small number of predominantly family owners. Over time, as families sold out, control as well as ownership of firms shifted into the hands of investors with no long-term commitment to the corporation. Therefore, while capital is committed, control is not, and increasingly it has passed to shareholders with short holding periods. The commitment problem that shareholders face is analogous to that of governments, namely, an inability to bind their successors.

One solution to the shareholder commitment problem is to delegate the running of the organization to the board of directors. Some argue that boards of directors should perform the function of mediating between the

¹⁷ See, e.g., INDEP. COMM'N ON BANKING, INTERIM REPORT: CONSULTATION ON REFORM OPTIONS 20-21 (2011) (U.K.) (tracing the causes of the financial crisis in the United Kingdom).

claims of different parties, thereby providing the commitment to stakeholders that short-term shareholders are unable to offer.¹⁸

While in principle boards can perform this function, in practice this commitment mechanism has also been undermined by the erosion of the board's delegated authority. This is where corporate governance reforms, in seeking to rectify agency problems, have had their most insidious effects. It is not simply that they have aggravated creditor-shareholder conflicts; they have undermined the ability of boards to provide the commitments to stakeholders that short-term shareholders are incapable of supplying. A combination of the emergence of markets for corporate control, shareholder activism, and reduced periods of executive tenure may have ameliorated agency problems, but at the expense of extinguishing the ability of boards of directors to offer credible commitments.

The problem that underlies the emergence of creditor-shareholder conflicts that Rock identifies is an erosion of commitment by either shareholders or boards of directors, and it afflicts the corporation more generally than just in its relations with its creditors. Its emergence has driven Adler and Kahan to propose remedies breaching the boundaries of the firm in seeking direct redress against offending parties. While this might be appropriate in a limited range of circumstances, it is a serious price to pay, and it fails to address head on the central question of how to reestablish corporate commitment.

VII. REESTABLISHING CORPORATE COMMITMENT

In one sense, the financial crisis was a large contractual failure. No doubt there were numerous violations of covenants and collateral requirements, and, where there were not, contractual terms could have been made more precise. Recovery for losses could have been sought directly from shareholders or particular classes of creditors. But that misses the point. The problem would not and could not have been solved by adjustments to contract or methods of enforcing contracts. Nor could it have been corrected by public law or regulation alone. Of course there were systemic failures that required better and tougher regulation, but the concerns about the LIBOR scandal were not essentially about their systemic consequences or the need for statutory solutions as against self-regulation. The public opprobrium that greeted these events reflected a widespread sense of

¹⁸ See, e.g., Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 410-14 (2001) (discussing how the options theory undermines shareholder primacy and the principal-agent model).

betrayal of the trust that was placed in organizations that were often previously held in high regard. The crisis revealed the extent to which corporate attitudes and conduct were motivated by the narrow self-interest of the shareholders and executives involved.¹⁹

Trust cannot be created or reestablished through private contract or public law, and until both economics and law appreciate this fact and address what needs to be done, both fields will err in the nature of the policy prescriptions that they propose. At one level, one might believe that trust is merely a reflection of the nature and quality of the individuals involved. But it is clearly incorrect to suggest that all that is required is to have more morally upright shareholders. The nature of organizations themselves can promote or undermine their ethical conduct. Institutions can have moral characteristics which are at variance from those of the individuals involved. To date, we have failed to understand how and why.

This is an issue I address in depth elsewhere,²⁰ and it would be a distraction from the subject of the Articles under discussion for me to synthesize such a substantial subject here. All that I will do is note that the nature of the ownership, board control, and stated values of an organization can bear critically on this issue. They determine the extent to which a firm can credibly commit to parties such as its creditors. In particular, they point to the importance of capital and the volume of capital commitment, as defined by the length and breadth as well as depth of capital. Rather than piercing the veil to seek redress from shareholders and creditors, they suggest strengthening what is held within, rather than outside, the corporate form.

The problem of the relation of the corporation to its related parties is analogous to that of the landlord and tenant. The landlord sees a tenant who has no interest in anything other than to trash the property and therefore does as little as possible to invest or improve it. The tenant sees a landlord whose sole interest is to drive the tenant out at the earliest opportunity to sell the property at a profit. Both put as little as they can into the property. The solution is not to make their other assets liable or to strengthen landlord-tenant regulation, but to establish the basis on which both parties wish to put as much back into the property as possible.

The importance of this stems from the fact not only that the alternative contractual and regulatory remedies are ultimately infeasible, but also that

¹⁹ See Luigi Zingales, *The Role of Trust in the 2008 Financial Crisis*, 24 REV. AUSTRIAN ECON. 235, 246-48 (2011) (linking a loss of trust in financial organizations to exacerbating factors of the 2008 financial crisis).

²⁰ COLIN MAYER, *FIRM COMMITMENT: WHY THE CORPORATION IS FAILING US AND HOW TO RESTORE TRUST IN IT* (2013).

they are undesirable. As noted above, corporations inherently entail bundles of conflicts between different parties whose resolution can only be achieved at the expense of the interests of particular groups. The way in which these conflicts should be resolved varies appreciably depending on the circumstances and activities of the organization. Attempts to impose particular contractual or regulatory solutions might improve the functioning of some organizations, but at the expense of others.

So, for example, while the primary deficiency of the U.K. economy, and possibly to a lesser extent the U.S. economy, is one of commitment and short-termism of shareholders, that is not the main problem of most continental European or Asian economies. Their greater concerns are with the conflict between dominant and minority investors, rather than between short- and long-term shareholders. In many developing economies, protection of other stakeholders, including the claims of creditors and the rights of employees, is a more substantial issue. Attempts to suggest that there are universal panaceas are destined to fail. Even within countries, there is a need for variety rather than homogeneity of solutions and corporate forms.

CONCLUSION

In summary, Rock is exactly right in concluding that there is a need to rebalance the corporate governance and law debate away from the agency problem. He is also right in suggesting that the shareholder-creditor conflict is another major issue that needs attention and may well have been exacerbated by a preoccupation with the shareholder-manager conflict. Indeed, the nature of the issue which Rock is raising is broader still than shareholder-creditor conflicts and encompasses a wide range of other parties to the firm, some of whom are more vulnerable than creditors.

Adler and Kahan are also right in pointing to contractual default and the inability of firms to make amends in the presence of financial failure as lying at the heart of the problem. Indeed, since the problem of contractual failure is so pervasive and impinges on so many parties, not just particular classes of creditors, seeking ways of reducing their frequency and mitigating their consequences is of critical importance. Rather than devising mechanisms for affected parties to seek redress for losses, we should address the problem at its source and examine institutional mechanisms for promoting confidence and trust between the relevant parties to the firm. This approach emphasizes the need to strengthen what resides within, as well as what can be claimed outside, the boundaries of the firm.