Chapter Six

Ethics in Financial Management

Financial management is a function within a corporation, usually assigned to a chief financial officer (CFO) and his or her staff, which is concerned with raising and deploying capital. In a sense, a CFO makes investment decisions and manages a portfolio, but these decisions are not about which securities to hold but about what business opportunities to pursue and especially how they are to be financed. Every corporation must have a financial structure in which capital is divided between equity, debt, and other types of obligations. All of these decisions are usually guided by the objective of maximizing shareholder wealth. In the United States, the Sarbanes–Oxley Act assigns the CFO a responsibility to personally attest to the accuracy of financial statements, and the act also requires that corporations have a code of ethics for its top financial managers.

The ethical issues in financial management fall into two broad categories: the ethical obligations or duties of financial managers of a corporation and the ethical justification for organizing a corporation with a certain assignment of control (usually to shareholders) and the designation of an objective (usually shareholder wealth maximization). The former category of issues bears on the decisions made by financial managers in fulfilling the finance functions of a corporation, and involves the fiduciary duties of financial managers to a corporation and its shareholders. The latter category is a matter largely for government in establishing the laws of corporate governance and those governing other aspects of corporate financial conduct, such as managing bankruptcy.

One function that falls to a CFO, as well as other top officials, is managing the risk of a corporation. Indeed, some corporations now have the position of chief risk officer. How risk is managed in a corporation can have immense

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impacts on many different constituencies, including the public. CFOs are typically involved in decisions about bankruptcy and especially about the possible abuse of the Bankruptcy Code for strategic ends. Sections on corporate governance and the objective of shareholder wealth maximization complete the chapter.

The Corporate Objective

A fundamental tenet of financial management is that the objective of the corporation is shareholder wealth maximization (SWM). Pursuing this objective means that all major decisions in a for-profit business firm ought to be made with the sole aim of increasing the return from its activities to the putative owners, the shareholders. Since this return is commonly in the form of profits, SWM may also be expressed as maximizing profits—which, in turn, go to shareholders. Further, the stock markets' estimates of future profits are reflected in the share price of a firm, and so SWM can also be expressed, in practice, as the imperative for maximizing the price of a company's stock.

The objective of shareholder wealth maximization is seldom justified in financial management textbooks and is presented, instead, as a basic axiom, like those of geometry. However, a justification for SWM can be easily constructed from the argument for shareholder control of a firm—also called the doctrine of *shareholder primacy*. This argument is based on the financial theory of the firm and the resulting system of corporate governance, which are discussed in another section of this chapter. To anticipate, if shareholders ought to have control (shareholder primacy), then this right of control includes the power to decide whose interests should be paramount in corporate decision making. Assuming that shareholders invest in a firm in order to benefit themselves by obtaining a maximum return on their investment, then they have the right to make this the objective of the firm. The justification for shareholder primacy and, with it, for SWM is not without controversy, but for present purposes it may be accepted as a fundamental tenet of financial management.

Accepting this objective raises further questions about what constitutes SWM. The objective of SWM is not as clear as may first appear, and clarifying it requires some ethical considerations. First, even if SWM is the *ultimate* objective of a corporation, it begs many questions about how this objective is to be achieved. Completing 18 holes with the fewest number of strokes is the objective in golf, but a golfer's attention must be focused on each swing. Reaching the ultimate objective is how we judge the success of a golfer or a manager, but achieving success depends on setting and reaching more immediate goals or aims. Indeed, focusing exclusively on any ultimate end may be counterproductive by neglecting the means necessary for achieving it. Thus, management advice books often counsel a focus on customers and employees as the means to success—in order to better serve shareholders in the end.

Furthermore, corporations, in their ordinary course of business, are bound by many commitments, contracts, and legal restrictions that constrain the pursuit of SWM. These obligations must be met even if they do not constitute an objective. It may be argued that an objective that takes priority over profit making is remaining solvent, which enables a corporation to meet its obligations to a wide range of other constituencies. Thus, meeting the payroll for employees and paying suppliers must be an objective that takes precedence over making a profit for shareholders. This point is often overlooked because the objective of remaining solvent is already achieved when any profit is made, since profit is the net revenues of a firm that remain after all fixed expenses are paid. In addition, it is often argued that managers can serve the shareholders only by fulfilling a wide-ranging set of responsibilities to all corporate constituencies, that is, by exercising corporate social responsibility.

Second, the objective of a corporation is not necessarily the same as the *purpose* of a business firm.[1] Why should corporations exist at all, and what are we trying to achieve by doing business in the corporate form? Some would answer, to make a profit! In this case, the objective and the purpose of a corporation are the same. However, people engage in business for many reasons, including to provide a product or a service, as well as to earn a living through labor. Corporations are the means we have devised to organize our productive activity and meet our basic needs. Indeed, corporations would probably not have arisen, and certainly would not continue to exist, if they were not effective ways of providing for our economic well-being.[2] Part of the argument for shareholder primacy—and hence SWM—is that control by shareholders best ensures that everyone will benefit from corporate activity. A corollary of this point is that managers, by pursuing SWM, end up operating a corporation for maximum social benefit. If managers effectively seek shareholder wealth maximization, the argument goes, then the welfare of society will be the ultimate outcome.

In sum, the objective of shareholder wealth maximization may be held in a weak and a strong form.[3] In its weak form, this objective is merely a guide for managers in the operation of a corporation and a means for setting incentives and measuring success. Its scope is limited to managerial decision making, corporate planning, and performance assessment. The strong form of SWM expands this objective to the purpose of a corporation and affects not only how managers should view their task but also how corporations should be understood by everyone in society. The strong form, because of its greater implications, is more controversial and difficult to justify than the weak form.[4]

What is shareholder wealth?

Before SWM can be accepted as the objective of the firm in either form, we need to clarify the concept. First, even determining what is a share and who is consequently a shareholder is complicated by the existence of ordinary and preferred stock, convertible stock, restricted stock, stock options, and other financial instruments that may resemble stock. Thus, shareholders are not a single, undifferentiated group, and so speaking of *their* interest may not be entirely clear.

Second, even ordinary shareholders are diverse with different risk preferences and time horizons, and so decisions that raise the value of the firm for one set of shareholders might lower it for another. Further, the interests of shareholders are assumed to be identical with that of the firm, and so perhaps the interest of the firm could be substituted for shareholder interests. However, the correlation is not perfect and the two interests may diverge. Thus, well-diversified shareholders might prefer a firm to take risks that threaten its survival, whereas managers, as well as employees and other constituencies who have a greater stake in the firm as an ongoing entity, are generally more risk-averse. No one group's interest is necessarily identical to the interest of the firm itself, and identifying a firm's interest may be as challenging as determining the shareholders' interests.

It has also been observed that institutional shareholders, such as pension funds and endowments, are "universal shareholders," whose interests are affected less by the performance of individual companies than by the condition of the whole economy.[5] Such "universal shareholders" may be concerned more than individuals with social and political issues that affect the broader economy. For example, a decision to pollute or downsize, which may benefit individual shareholders, may be opposed by institutional investors, whose total portfolio may be adversely affected by the social cost of such corporate actions. Institutional shareholders may also hold bonds as well, and sometimes decisions that benefit shareholders harm bondholders, which may leave "universal shareholders" worse off on balance.

Given that the interests of shareholders are often diverse and may not be identical with that of the firm, what precisely does it mean to pursue SWM? One answer, provided by finance theory, is that this does not matter. Differences between shareholders with regard to their risk preferences and time horizons ought to be ignored by management. The irrelevance theorem, advanced by Franco Modigliani and Merton Miller, holds that decisions about financial policy, such as capital structure and dividends, do not affect firm valuation because investors can make changes in their own portfolios to achieve any desired outcome.[6] Thus, an investor who would prefer that a corporation have a different debt-to-equity ratio or a different level of dividends can make other investments that offset the financial policies of the corporation in question. Therefore, managers should concentrate on other nonfinancial decisions that affect share price.

However, this conclusion overlooks the fact that shareholders are not always able to invest on the same terms as corporations, and hence they may incur greater costs in satisfying their own risk and return preferences. Moreover, a corporation may change its financial policies suddenly before investors have the opportunity to make changes in their portfolios. If these considerations are relevant, then the problem of the meaning of SWM remains in the choice of financial policies.

Possible measures of shareholder wealth are accounting profits (earnings per share), cash flows, and share price. Accounting profits, which are the net revenues of a corporation after all costs of doing business are subtracted from gross revenues, is an unsatisfactory measure since it is based on the accounting for revenue and expenses, which may be manipulated to some extent within generally accepted accounting principles (GAAP). Reported profits may also be inflated by outright fraud in violation of GAAP, as occurred at Enron and WorldCom, among other notable failures. Profits also do not take account of the risk that is taken. A smaller return with less risk may represent greater wealth for an investor on a risk-adjusted basis if a higher return is not commensurate with the greater risk.

Further, profits do not take account of the cost of capital, and so a company could make profits and still be losing money if the cost of capital is not covered. A remedy for this problem is use of the concept of *economic value added* (EVA), which measures only profit in excess of capital costs. Free cash flow, which is the actual cash generated minus capital expenditures, is not only a good measure of the return on investment so far but also a fair predictor of the future earnings that free cash flows make possible. In addition, this measure is less subject to manipulation than is net revenue or profit.

The most common measure of shareholder wealth is share price, the price of a company's stock. In practice, SWM often means, simply, the focus on raising the price of the company's stock. However, share price is influenced by many nonfundamental factors, including investor psychology, economic trends, and market irrationality, all of which are beyond management's control. Furthermore, share price may be affected by the strategies of short-term investors who have little stake in the long-term prospects of a firm. Thus, a costly investment in research and development may not be valued by investors in the current market. In such a case, how can it be determined what is in the shareholders' interest and whose judgment of shareholder interests should prevail. Is the current share price really accurate and should the measure be the current price or one expected in the future? For all these reasons, managing to maximize stock price may not be an adequate guide for pursuing SWM.

To meet these problems, Henry Hu proposes the "blissful-shareholder" model.[7] In this model, the managers of large publicly held companies with actively traded stock and well-diversified shareholders should seek to maximize "what the share price would be in a stock market that is completely omniscient and fully efficient."[8] Management would thus have a fiduciary duty to pursue what in their judgment are worthwhile projects, even if doing so results in a reduction in the price of a company's stock because of market mispricing. The hazard in this model is that it elevates the judgment of management over that of shareholders and the investment community, which creates the potential for self-serving management entrenchment. In such cases, the board of directors must play a critical role in evaluating the judgment of management and providing a voice for shareholders.

Bradford Cornell and Alan C. Shapiro propose that the objective of the firm be measured by an "extended balance sheet," which includes, in addition to the usual assets and liabilities, the value to the firm of implicit claims to various constituencies and the costs to the firm of honoring these claims.[9] These constitute "organizational capital" and "organizational liabilities" respectively, and the difference between them is "net organizational capital," which represents a form of wealth that is not recorded by traditional financial accounting practices. This proposal reflects the view that the value of a firm consists not merely in its financial state but also in its organizational abilities (and the failure of some financially restructured firms to perform lends credence to this view).

The "blissful shareholder" model and the "extended balance sheet" model each addresses the fact that maximizing wealth for shareholders is not a clear objective for managers. Deciding which shareholders to favor and resolving differences between shareholders and the firm both involve some value judgment about the worth of the respective claims. Short-term profits benefit well-diversified shareholders with a strong preference for risk and a short time horizon. By contrast, a decision to promote the long-term prospects of the firm considers the interests of risk-averse shareholders as well as the various constituencies with a stake in the survival of the firm.

For example, Hu considers other constituency statutes to embody a "blissful shareholder" view because they permit directors to choose long-term value over short-term shareholder gain in responding to a takeover bid. The long-term value of a firm has been understood by the courts in some cases to include its value to employees, consumers, and society in general.[10] Moreover, SWM is subject to differing interpretations, and the choice between these interpretations requires the use of value judgments. If the value of a firm is taken to be its value as an ongoing entity that is capable of creating wealth for society indefinitely into the future, then managers cannot consider the interests of individual shareholders or current stock price, but must take into account the interests of all of the groups that make up the corporation.

Do firms seek to maximize?

It is no secret that most business firms do not seek to maximize shareholder wealth. If all corporations did, there would be no extravagant headquarters or fleets of corporate jets; prices would be the highest possible and costs the lowest, so that neither could be changed if the need arose to improve profitability, and every legal stratagem would be employed, no matter how unconscionable, in order to extract the full return from every dollar invested. Some regard this failure to maximize shareholder wealth as a regrettable shortcoming of a system in which managers are able to consume perquisites, collude with employees and customers against the interests of investors, and salve their consciences and gain public approval with good works. Others hold that SWM is a theoretical ideal that cannot and should not be realized in practice.

In a 1960 article in the *Harvard Business Review*, Robert N. Anthony contended that most large, publicly held corporations do not attempt to maximize profits but seek only a *satisfactory* level of profit—and that this is a good thing![11] First, profit maximization is an impractical goal that, if pursued single-mindedly, would have counterproductive consequences. Pricing, for example, is not done by comparing demand and costs at all volumes—which is a formidable task that is seldom attempted outside economics classrooms; rather pricing is done by developing a "normal" price based on a conventional cost-accounting system.

Similarly, capital budgeting does not commonly consist of comparing every investment opportunity in order to select the one with the greatest return over the marginal cost of capital. Typically, promising projects are selected if they exceed a minimum expected return. Although decisions are often made by inexact means that still aim at profits, ethics also plays a role in these decisions. Business people have learned, for example, that pricing is only one aspect of marketing and that higher prices can be charged if there is a high degree of consumer trust. Some opportunities are pursued and others rejected for reasons of a corporation's social responsibility.

The main implication for ethics if firms deliberately seek only a satisfactory return is that a surplus remains to be distributed. Whether managers divert the surplus to themselves, as many maintain they do, or confer it upon employees, customers, suppliers, or other groups is immaterial to the point that a distribution is being made by some criteria other than SWM. These distributions are often justified on the grounds that they ultimately benefit shareholders, but such claims are partially true at best. (It is unfortunate that corporate managers feel compelled to justify decent treatment of employees—offering generous severance packages to those laid off, for example—as indirectly benefiting shareholders when, in truth, they believe that this is the compassionate thing to do.) These criteria for distribution are varied, but some include ethical standards that are considered a part of responsible business conduct.[12]

SWM and social responsibility

A major concern about SWM as the objective of a corporations is its possible implications for practicing corporate social responsibility (CSR). Although the responsibility of a business firm to serve social ends is much debated, corporations typically devote some resources to philanthropy and other worthwhile social initiatives.[13] However, the objective of shareholder wealth maximization might seem to be incompatible with the pursuit of corporate social responsibility. CSR also includes addressing the social costs of production, also known as externalities. Social costs or externalities are costs of production, such as pollution, that are not *internalized* (factored into the price of a product) but *externalized* (passed on to society). Given the SWM objective, what should firms do with regard to CSR, including social costs or externalities?

Friedman's argument

The economist Milton Friedman, who holds a strong version of the SWM objective, has argued against the idea of corporate social responsibility by saying:

> This view shows a fundamental misconception of the character and nature of a free economy. In such an economy, there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.[14]

Friedman's argument proceeds mainly from the premise that when managers make decisions in their capacity as agents of the corporation and not as private citizens, they have an obligation to serve the interests of the corporation alone. Otherwise, they are taking on the role of public officials with the power to tax, and as such they ought to be elected through the political process and not by the shareholders of private business firms.

He writes further:

> What does it mean to say that the corporate executive has a "social responsibility" in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers. For example, that he is to refrain from increasing the price of the product in order to contribute to the social objective of preventing inflation, even though a price increase would be in the best interests of the corporation. Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment. . . . In each of these cases, the corporate executive would be spending someone else's money for a general social interest. Insofar as his actions in accord with his "social responsibility" reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money.[15]

In presenting this argument, Friedman acknowledges that there are "rules of the game," and these rules may impose more obligations on corporations than he realizes. The operation of a free market requires an extensive set of rules that we often overlook. These include common understandings, background institutions, the legal system, and government regulations. In addition, corporations, like government and other institutions in society, gain the legitimacy needed for survival by meeting people's legitimate expectations. This point has been expressed as the Iron Law of Responsibility: "In the long run, those who do not use power in a manner which society considers responsible will tend to lose it."[16] Friedman accepts the need to consider matters of social responsibility in order to serve the ultimate interests of the corporation, but he appears to underestimate the attention to such matters that this long-term perspective requires.

Friedman charges that acts of social responsibility, such as spending money to prevent pollution beyond the amount that is in the corporation's best interest, takes money away from shareholders, employees, and other groups. To be sure, acting in a socially responsible manner involves trade-offs between the interests of different constituencies, and managers must be careful not to exceed their authority and assume the powers of elected officials. However, managing trade-offs is a task that is inherent in management decision making. Thus, spending money on pollution might be described not as spending other people's money without authority but as bargaining with environmentalists who have the power to affect the corporation as consumers (who can boycott the company's products), as citizens (who can lobby for government regulation), and even as employees and shareholders, who favor environmental protection and are willing to accept less in wages or dividends in order to achieve this goal.

Friedman would not object to spending money to prevent pollution as long as the expenditure is in the best interest of the corporation. However, the best interest of the corporation is not merely what the shareholders of the moment prefer, because managers deal with all constituencies on whose cooperation the corporation depends. Corporations organize production involving many input providers, and a major task of management is securing commitments from these diverse constituencies.[17] Short-term shareholders might complain that managers are spending *their* money in preventing pollution, and they might respond by driving the price of the stock down. However, we have already noted that stock price is not always a reliable indicator of shareholder value. Acting in the best interest of the corporation may require a long-term perspective, such as the "blissful shareholder" model, and taking such a perspective leads to more socially responsible behavior than Friedman's argument suggests.

Problem of social costs

Social costs or externalities pose a particular challenge to shareholder wealth maximization since the pursuit of this objective would seem to counsel, even demand, that managers externalize costs at every opportunity. Every cost passed on to society is one that shareholders do not have to bear. In some instances, internalizing costs is a matter of being a socially responsible corporation and so the problem of social costs or externalities may be addressed, in part, as a matter of CSR. That is, to the extent that SWM is compatible with CSR, it may not entail the externalization of all costs. One way of ensuring this compatibility is government regulation to require internalization, for example, by laws limiting pollution. In this way, internalizing costs become part of the "rules of the game" that Friedman cites as a constraint on the pursuit of SWM.

Another response to the challenge posed by social costs or externalities is the argument that pursuing the objective of SWM indirectly solves this problem. Managing a corporation so as to maximize shareholder wealth, the argument goes, results, in the end, in greater wealth for society that enables it to pay the social costs generated by business. In particular, managing for SWM leads to more efficient production, which in turn has social benefits. Frank Easterbrook and Daniel Fischel make the point in the following way:

> A successful firm provides jobs for workers and goods and services for consumers. The more appealing the goods to consumers, the more profit (and jobs). Prosperity for stockholders, workers, and communities goes hand in glove with

> better products for consumers. Other objectives, too, come with profit. Wealthy firms provide better working conditions and clean up their outfalls; high profits produce social wealth that strengthens the demand for cleanliness. . . . [W]ealthy societies purchase much cleaner and healthier environments than do poorer nations—in part because well-to-do citizens want cleaner air and water, and in part because they can afford to pay for it.[18]

Thus, a wealthier society is better able to afford the cost of pollution, for example, because it has both the desire and the resources to clean up the environment.

However, this response does not address the question of who pays. The wealth created by pursuing the objective of SWM would seem to be the same regardless of whether corporations internalize or externalize costs. (One relevant factor is which party can clean up pollution, for example, at the lowest cost?) So the problem remains: Should corporations bear the costs of production by internalizing them? Or is it permissible for corporations to externalize these costs by passing them on to society? Easterbrook and Fischel propose a market solution that is compatible with SWM. They write:

> The task is to establish property rights so that the firm treats the social costs as private ones, and so that its reactions, as managers try to maximize profits given these new costs, duplicate what all of the parties (downstream users and customers alike) would have agreed to were bargaining among all possible without cost.[19]

The crucial point in this argument is that a clear assignment of property rights would force firms to internalize what would otherwise be external costs. For example, if third-party victims of pollution could demand compensation for damage to their property caused by the pollution in the stream, then firms would be forced to include this compensation in their cost calculations, thereby internalizing the cost of pollution. This cost could be paid by a company either by cleaning up the discharge into the stream or by paying compensation, whichever is cheaper.

This argument exemplifies the Coase Theorem, which holds that externalities do not cause a misallocation of resources provided that there are defined and enforceable property rights and no transaction costs—that is, that the affected parties could form contracts at no cost.[20] A flaw in the argument, however, is the absence, in many cases of externalities, of both property rights and zero transaction costs.[21] Although steps can be taken to remedy both of these factors, they are likely to remain insurmountable obstacles to the solution that Easterbrook and Fischel propose.

The conclusion to be drawn, then, is that SWM is likely to remain an obstacle to addressing the problem of social costs or externalities. If corporations are to be socially responsible in addressing this problem, then there must be either some relaxation of the SWM objective to admit socially responsible conduct or else more extensive government regulation.

Risk Management

Managing risk is a large part of finance. Risk is of great concern to individual investors and the managers of investment funds, and, indeed, any firm involved in financial markets or financial services deals with risk in some way. This task also belongs to the financial managers of any business enterprise, whether in finance or some other area, since all financial decisions in business involve some attention to risk. However, risk has many sources and can be addressed by different means, and so risk management must be the responsibility of people throughout any organization. Viewed broadly, the category of risk encompasses all the bad things that could happen, and managing for their potential occurrence is obviously a large part of engaging in business activity.

The management of risk has a long history. In his book *Against the Gods: The Remarkable Story of Risk*, Peter L. Bernstein locates the dividing line between modern times and the centuries of human existence preceding it in the mastery of risk, which occurred, during the Renaissance, with the discovery of the mathematics of probability.[22] This development showed that the misfortune that occurs in life could be subject to active human control rather than being endured passively as the whims of the gods. For centuries following, managing risk for the benefit of society was the main function of the insurance and banking industries, which employed actuaries and statisticians to calculate the probabilities of untoward events. Governments have also long played a role in managing risk for its citizens.[23]

Modern risk management developed in the 1970s in financial institutions as they took greater risks in making business loans, trading securities for their own account, and creating new financial instruments. Theoretical discoveries during this period, such as modern portfolio theory, the capital asset pricing model, and option pricing theory, led to a vast expansion in the use of derivatives of various kinds. This very profitable activity required highly accurate calculations of the downside risk as well as the upside return. Finance theory stresses the ideas that risk represents an opportunity as well as a hazard and that the aim of business should not be merely to avoid or reduce risk but to seek the optimal return at an acceptable level of risk.

What is risk management?

Risk is central to finance. First, risk and return are inextricably linked since without risk there would ordinarily be no return on an investment. Any return is compensation for the risk taken and, typically, the greater the return sought, the greater the risk that will have to be taken. An investor must seek to ensure that the expected return is commensurate with the risk and that the level of risk is acceptable. Second, risk is not always a readily known quantity, and much financial activity is devoted to determining the amount of risk being taken—along with the return, of course. In making a loan, for example, a bank must calculate the risk of default in order to determine the appropriate interest rate. Similarly, the price of a security or the premium for an insurance policy depends on complex calculations of risk. Means must be found to calculate risk, and in recent years this has been done using highly sophisticated mathematical measures and models.

Risk in investment is confined mainly to individual financial instruments and whole portfolios of such instruments. However, a business firm, whether it be in finance or some other area, must consider a wider range of risks. The main types of risk have been commonly classified as *credit risk* and *market risk*. Thus, creditors to whom debts are owed run the credit risk that these debts may not be paid, and decreasing market demand for a company's products is an example of market risk. The holder of a bond, for example, needs to be concerned, first, with the possibility of default by the issuer (credit risk) and, second, with potential changes in interest rates (market risk); both kinds of risk can significantly impact the value of a bond. More recently, the field of risk management has come to include the category of *operational risk*, which results from events that affect a company's operations, such as a storm that prevents delivery by a supplier.[24] Reputational risk, which involves damage to a company's brand or franchise, has also become widely recognized.[25]

In the past few decades, risk management has extended beyond finance to virtually all businesses to become what is called *enterprise risk management* (ERM). This large and important function is described by one writer as involving "the identification and assessment of the collective risks that affect firm value and the implementation of a firm-wide strategy to manage those risks."[26] For financial and nonfinancial firms alike, the goal of ERM is to maximize the value of the enterprise by shaping the firm's risk profile. This consists of identifying all of the risks faced by the firm, including their likelihood and potential costs, targeting an acceptable level of risk, developing a plan to keep risks within the preferred limits, and carefully monitoring the implementation of this plan.

One feature of ERM is its *comprehensive* nature: virtually all adverse conditions that could affect a company's performance have come to be labeled risks and made into a subject for risk management. Second, ERM recognizes that risks do not occur in silos but interact with each other in a complex dynamic process. Therefore, the management of all risk cannot be undertaken in isolation or in a piecemeal manner but must be considered together in an *integrated* fashion. Third, ERM is no longer a specialized function of low-level risk managers but a task for the C-level officers and the directors of a corporation. Indeed, many companies have created the office of chief risk officer to aid the CEO, CFO, and the board in placing risk management at the center of corporate decision making. Thus, ERM is different from traditional risk management in that it treats risk in a comprehensive and integrated manner at the highest levels of decision making.

There are five main responses to risks: a firm may *avoid* a risk entirely, for example, by not entering a certain line of business; it may seek to *reduce* a risk by taking appropriate action; the risk may be *hedged* so that a loss-inducing event is offset by some gain; the risk may be *transferred* so that it is assumed by another party, often with compensation as in the case of insurance policies; or it may be *borne*. This latter response may be taken either because the risk cannot be avoided, reduced, hedged, or transferred or else because it represents a business opportunity in which the firm can profitably employ its core competencies and investment resources. Indeed, the competitive advantage of any firm lies in its ability to exploit the opportunities created by the right, carefully selected risks.

The main tools for implementing ERM are financial instruments to hedge or transfer risks, operational changes that avoid or reduce risks, and capital reserves to prevent insolvency in cases of loss due to risks. Changes in interest rates or currency values can be hedged, for example, by swaps or options; insurance policies transfer risk from a company to the insurer; the risk of loss from fire can not only be transferred by the purchase of insurance but can be reduced by investment in prevention; and setting aside reserves to cover losses can avoid disruption of business from losses. One function of equity capital in a corporation and bank capital reserves is to enable the business to absorb losses and continue operation. Since there are usually several tools available for managing any particular risk, the choice typically depends on the comparative costs.

Risk management played a role in the recent financial crisis, first, by facilitating the construction of collateralized debt obligations (CDOs), which are securities that bundle together large numbers of loans and divide them into tranches with different risks and rates of return. More mathematical models were needed for the construction of other exotic financial instruments, such as synthetic CDOs and credit default swaps (CDSs). A second use of risk management occurred when banks assessed the risk of their portfolios, which included large volumes of CDOs and similar securities. Although they assumed very substantial risks by leveraging their capital—in some instances more than thirty to one—the banks were able to do so with great confidence because they had measured their risks very precisely by newly developed model-based techniques. In particular, value at risk (VaR) became a widely adopted tool for determining the risks posed by a bank's portfolio. VaR gave users a great sense of confidence that their firm's risks were being managed prudently—mistakenly, as it turned out.

Ethical issues in risk management

It seems only prudent to manage risk. This is certainly true if the only alternative is a return to the superstition and blind acceptance of fate that Bernstein describes in *Against the Gods*. The development of sophisticated risk management techniques based on a mathematical treatment of probability has been a decided boon for mankind. However, important questions can be raised about the general enterprise of risk management. Bernstein cautions that risk management could become "a new kind of religion, a creed that is just as implacable, confining, and arbitrary as the old."[27] An overreliance on numbers may lead, he says, to errors as serious as those committed by ancient priests who placed faith in omens and offerings. Risk management may also create an overconfidence that leads to disaster. As Niall Ferguson has quipped, "those whom the gods want to destroy they first teach math."[28]

There is no question that risk ought to be managed, but it matters immensely which risks are managed, by whom, with what means, and for whose benefit. Modern risk management is a distinctive recent development in which certain kinds of risks are treated in a certain manner by certain actors for certain ends. As Lisa Meulbroek has written:

> Risk management is not only a decision about how much risk the firm should bear, it is also a decision about much risk the firm's customers or suppliers are prepared to bear. As a more general matter, suppliers, customers, community members, firm shareholders, and employees are all risk bearers for a firm. Managers must determine the optimal level of risk for all parties and consider not only how each individual risk affects the firm's total risk exposure, but also evaluate the optimal way of managing and distributing those risks.[29]

What specific impacts can a firm's practice of risk management have on parties other than the firm? First is the obvious point that a firm generally identifies only those risks that create a potential loss for the firm itself and ignores any impacts that are borne by others. The category of risks is indefinitely elastic as firms succeed in their relentless quest to externalize costs and to exploit situations of moral hazard. This category also includes systemic risk, which is not only beyond the power of any one firm to manage but is also a risk that affects all groups in an economy. Thus, ethics is involved in the *identification* of risks to be managed.

In the recent financial crisis, the risks of loans, including subprime mortgages and the CDOs that were securitized from them, were of little concern to banks once these risks were transferred to other parties. The main risks that were managed were confined to the banks' own portfolios; the losses that might result from these "toxic assets" were someone else's problem. Similarly, the moral hazard that the implicit government guarantee provided to "too-big-to-fail" institutions and the systemic risk that their activities posed were opportunities to be exploited, without regard for the consequences to others.

Second, other groups are affected by the *means* that firms select to manage risk. Any given means chosen will have impacts on different groups, and the choices made will distribute these impacts differently. For example, a firm that avoids certain risks might deny benefits that people would otherwise enjoy, as when the uncertainties of flood damage lead insurance companies to cease issuing such policies, thereby forcing homeowners to assume that risk themselves, or else to rely on government. A company that reduces the risk of workplace injury by making safety improvements does so in a way that benefits workers, but if it chooses instead to transfer that risk by purchasing an insurance policy, then the benefit to workers is changed. The company has traded *ex ante* safety on the job for *ex post* compensation in the event of an accident, which may not be the workers' preference.

However, the transactions in question may occur without full understanding, so that risks are assumed unknowingly and without consent. Thus, in the financial crisis, much of the risk of subprime mortgages was transferred to unwitting borrowers, who in some cases lost their life savings, and these risks were also borne by savers who were unaware that their mutual funds and pension funds contained securities backed by these same subprime mortgages. Although banks thought that they had transferred the risk of securities in their own portfolios by means of credit default swaps, the risk returned to them—and to taxpayers!—when the issuers of these swaps were unable to pay claims.

The transfer of risk, which often occurs without much awareness or consideration, is a major development in recent history. In *The Great Risk Shift*, Jacob Hacker documents how corporations and governments are shedding many of their traditional responsibilities and putting a greater burden on ordinary people in such areas as employment, healthcare, education, and retirement, with a resulting erosion of economy security.[30] Much of this shedding of traditional responsibilities is due to the pursuit of profit, as banks cease to bear the risk of loans by securitizing them and collecting fees instead, and many corporations have changed the forms of their pension plans so as to shift the risk in retirement portfolios to employees. This massive transfer of risk, whether good or bad, is certainly a matter of ethics.

A third area in which risk management has ethical implications lies in the choice of an acceptable *level* of risk. In managing risk, a firm identifies its own appetite or tolerance for risk and acts accordingly. Because shareholders generally prefer a higher level of risk than other groups, risk management systems, which generally lessen risks, serve to reduce conflicts between shareholders and other groups over risk preferences. However, conflicts may remain not only over the level of risk but also over the types of risk. Individuals can respond to any chosen level of firm risk and seek to secure their own risk preferences. For example, workers may change jobs to secure safer working conditions or may bargain in a union for greater safety. However, the opportunities for such steps are limited, so that workers may still bear some risks they would prefer to avoid.

Aside from the identification of the risks to be managed, the means for managing them, and an acceptable level of risk, there is a fourth ethical concern. Risk management may create a *false sense of confidence* that leads firms to assume too much risk. This false sense of confidence may also extend to the public, leading ordinary people to accept too high a level of risk as well. The existence of apparently sophisticated risk management systems may create an illusion that all risks are understood and under control so that even a high level of risk is deemed acceptable. As Nassim Taleb has observed, the greater danger comes not from a high level of known risks but from the unknown risk of low-probability but high-impact events, which are by their nature unpredictable—and hence unmanageable.[31] Therefore risk management systems may themselves be a source of risk by creating a false sense of confidence that blinds managers and the public to the hazards that they actually face.

This false sense of confidence may extend from risk management tools to the legitimacy of the whole corporate system. The public demands that risk be managed, and so the key institutions in society must at least give the impression that this task is being addressed competently, whether it is or not. Risk from low-probability, high-impact events is especially difficult, if not impossible, to manage, but the legitimacy of business may depend on maintaining a convenient fiction of competent control. Risk management meets this need by inspiring public confidence in corporations, countering fear and suspicion of their activity, and defusing or deflecting blame when things go wrong.

When such legitimacy is earned, then everyone benefits, but there is also the danger that risk management serves to deceive the public by erecting a "managerial smokescreen" to maintain "myths of control and manageability."[32]

The failure of risk management

Given the role of risk management in the financial crisis, ethical questions may be raised about the use of risk management measures and models. However, the prominent role of risk management in the crisis does not necessarily mean that it was at fault in some way. Some risks are worth taking, and even great risks may be rationally chosen if the returns are sufficiently high. The task of risk management is to ensure that top management knows and understands the risks and the potential gains and makes prudent trade-offs. Moreover, mistaken judgment is not necessarily ethical failure, and so a question for ethics is how to determine when incompetence becomes immorality.

Critics identify four theoretical problems with the techniques of risk management. First, in developing measures and models, risk management attempts to quantify the probability of extremely rare events that occur far out on the tails of normal distribution curves. Some experts question whether such assignments of probabilities are even meaningful,[33] while others note the inherent unreliability of decisions based on any such probability measurements.[34] This is the problem of "fat tails" or "black swans," which have either no known distributions or else distributions too scant to be successfully modeled. Peter Bernstein asks, "How can we instruct a computer to model events that have never occurred, that exist beyond the realm of human imagination?"[35] Risk management also assumes that the past is a reliable guide to the future, so that predictions can be made with models that use historical data. In the case of extremely rare events, however, historical data may be unavailable or of little predictive value, and data for even more common events may become unreliable when circumstances change.

Second, models assume a deterministic world that operates according to physical laws that can be expressed mathematically. Calculations of probabilities are reliable only when events are the result of an underlying causal system that may be imperfectly understood but is still orderly. Thus, weather predictions may be difficult, but they are still possible since rain occurs according to fixed laws of physics. However, economic behavior is an extremely complex phenomenon, with far too many variables to be accommodated in any model, and, further, human behavior, which is being modeled, does not follow fixed laws of physics, like those for rain.

In addition, models assume that a knowledge of probabilities does not affect the causal system or its outcomes. When people carry an umbrella after a forecast of rain, their behavior can have no impact on whether it actually rains. This is not true in risk management models: people following models can affect the outcome, especially in times of crisis.[36] Models assume randomness, but they can lead traders to take similar positions based on the same information and to take identical actions in crises, so that the market ceases to be random. (The October 1987 stock market crash is often used as an example of this phenomenon.) Because of such model-inspired herd behavior, Daníelsson argues, "The basic statistical properties of market data are not the same in crisis as they are during stable periods; therefore, most risk models provide very little guidance during crisis periods."

Third, in using models, it is difficult to anticipate the interactions among variables, which can often result in the compounding of consequences from small changes. This problem, which is known as procyclicality, may result when small changes in such factors as prices, volatility, and liquidity, which often occur in crises, lead to vicious feedback loops that produce large, unexpected effects. The nonlinear dependence involved in such large magnitudes of change may be more of a problem than fat tails or black swans, because it is harder to detect and model.[37]

Fourth, a great deal of criticism has been directed toward value at risk as a measure. VaR utilizes sophisticated mathematical formulas to circumvent the need to perform an immense number of calculations about each asset in a portfolio. Its widespread adoption is due to the convenience of a single dollar figure that represents the maximum amount that a portfolio might lose in a certain period of time with a specified degree of probability. For example, a manager might be informed that there is a 99 percent probability that the maximum amount that a $100 million portfolio could lose in the next seven days is $10 million, or 10 percent. With a sufficient gain, this risk may be considered worth taking since the loss is acceptable and has a very small probability of being any worse.

VaR proved to be of limited value in the recent crisis in part because it leaves the possible losses in extremely rare conditions unspecified. Measures of VaR with a 95 percent or a 99 percent degree of probability do not even attempt to estimate the losses that could occur in the realm of the 5 percent or the 1 percent range, which could be enormous. Moreover, this lack of attention to possible losses from very low-probability events may encourage traders to seek investments with an overall low level of risk but the potential for enormous losses in extremely unlikely cases. Such trades may not come to the attention of a manager using VaR as the only measure of risk.

Furthermore, VaR assumes normal distributions of even very rare tail events, but, as critics argue, this underestimates the probability of some adverse event or other occurring. Although *any* given low probability may be unlikely (by definition), it is quite likely at any given time that *some* improbable event or other will occur. Critics also note that VaR takes little account of correlation, when events, such as housing foreclosures, are related, as occurred in the financial crisis. In addition, VaR does not work well in crises because it assumes that positions can be sold or hedged costlessly, whereas in times of stress, when liquidity or confidence is lacking, assets may have no buyers or may be sold only at a deep discount. For this reason, VaR has been compared to an airbag that always works except in crashes.[38]

A final criticism is that VaR calculates only the specific risk of a firm's own portfolios and not the systemic risk for the whole economy. As Richard Posner observes:

> The essential point is the difference between a 1 percent probability that a firm will go broke, because of risky lending, and a 1 percent chance of a depression because the lending financial firms have a correlated 1 percent risk of going broke. The toleration of the risk is rational for each firm, irrational for society.[39]

Posner's observation cites not only the risk of correlation—for example, the failure of one broker-dealer such as Bear Stearns or Lehman Brothers would have posed little risk to the economy if every other financial firm had not also been in perilous condition and thus unable to absorb the loss—but also the fact that VaR is calculated only by firms with regard to their own specific risk, not to the systemic risk for the whole economy.

On a more practical level, managers have been criticized for using risk management tools, including VaR, as justifications for taking even greater risks in a search for maximum returns without fully understanding the extent of these risks. Although risk management may provide a plausible cover for taking extreme risks, prudent managers may use it to draw different conclusions. Measures and models are only as good as their interpretation and application. As one writer observes, "Not taking risks one doesn't understand is often the best form of risk management."[40] The story is told about how Goldman Sachs bankers decided to rein in their risks after they sought to discover the cause of declining results from their profit and loss models, which were still satisfactory but worrisome.[41] By drawing a different conclusion than their competitors might have, Goldman Sachs avoided significant losses. Furthermore, recent indicators before a crisis are generally benign, even promising, and, as John Cassidy observes, that may be the time to get worried.[42]

The development of risk management, especially by means of sophisticated mathematical measures and models, is not only a remarkable intellectual achievement but also a decided practical benefit. However, like all important innovations, risk management comes with significant ethical challenges that must be addressed, by both practitioners and regulators. Some failures must be expected but not ignored.

Ethics of Bankruptcy

Bankruptcy occurs when individuals and corporations that have insufficient assets to pay their debt obligations are subject to laws that provide some protection from creditors. Personal bankruptcy absolves individuals of many debts and enables them to secure a "fresh start." For businesses, bankruptcy provides temporary relief from the obligation to pay debts while they seek to reorganize, or else it produces an orderly liquidation of assets in which, ideally, all creditors are treated fairly, if not made whole.

Bankruptcy of an individual or a firm is commonly thought to constitute a failure. The only ethical issues, in the minds of many people, are the broken promises to pay debts and the faulty character involved in accumulating upayable debts. Prior to 1893—the year in which the United States enacted the first federal bankruptcy code—individual debtors could lose all their worldly goods and even be sent to prison, and insolvent firms were quickly liquidated by creditors in a mad scramble for salvageable assets. This harsh treatment was generally regarded as just punishment for the bankrupt's profligacy, and an injustice was thought to occur only when creditors were not made whole.

In finance, by contrast, bankruptcy is typically regarded as a natural event in an impersonal and unforgiving marketplace. Firms that cannot compete are eventually forced out of existence. Nothing of value in the economy is lost as long as the assets of the bankrupt firm are redeployed by others. Individual creditors may lose money, but that is part of the risk of doing business, for which there is some offsetting reward. No moral opprobrium is attached to bankruptcy. In fact, bankruptcies should be welcomed, because this ruthless Darwinian struggle for survival strengthens the economy. The only moral consideration in this financial view of bankruptcy is the rightful settling of claims, which is largely a matter of enforcing, to whatever extent is possible, the commitments made by a firm before it became insolvent. This rightful setting of claims should also be accomplished with a view to efficiency. Thus, the reorganization or liquidation of firms should be done not only fairly but also at the lowest cost and in a way that puts assets to their most productive use.

In contrast to both the common view of bankruptcy as a moral failing and the nonjudgmental view in finance, bankruptcy raises many difficult and important ethical issues. These issues arise primarily from the use—or some would say, the *abuse*—of bankruptcy protection.[43] In recent years, solvent firms have filed for bankruptcy for many reasons: to defer or avoid payments, renege on contracts, stop litigation, evade legal liability, break unions, and get rid of pension plans. Instead of being a last resort in a fight for survival, bankruptcy has become, in the view of its critics, just another management strategy for maximizing profits.[44] In the book *Strategic Bankruptcy: How Corporations and Creditors Use Chapter 11 to Their Advantage*, Kevin L. Delaney coins the term "strategic bankruptcy" and argues that bankruptcy is often a choice that companies make to achieve strategic ends.[45]

The discussion of bankruptcy that follows is concerned with the ethical justification of the bankruptcy system and, in particular, with what might constitute an ethically objectionable *abuse* of the bankruptcy process in cases of strategic bankruptcy. The ethical questions are concerned, at bottom, with the legal framework of the bankruptcy system, and as such they must be answered primarily by the drafting of bankruptcy legislation. However, the decisions of managers to engage in strategic bankruptcy can be criticized from a moral point of view. Indeed, moral concern about these abuses and other unfair treatments in bankruptcy proceedings has prompted heated debate and calls for reform.

Ethical basis of bankruptcy

The use of bankruptcy as a management strategy has been facilitated by a system that enables, indeed encourages, distressed or insolvent firms to reorganize instead of liquidating. The 1893 US Bankruptcy Act required firms filing for bankruptcy to liquidate, and it was not until 1938, during the Great Depression, that a law was enacted to protect insolvent firms from their creditors and permit reorganization. A major overhaul of the Federal Bankruptcy Code in 1978 (with further revisions in 1994) restructured the 1893 Act and created Chapter 11, under which corporate bankruptcy petitions are now filed. The 1978 Act eased the conditions for declaring bankruptcy (a company need not be insolvent, but must demonstrate merely that it faces insolvency without protection from creditors), and the Code removed the stigma from bankruptcy by eliminating pejorative terms (bankrupts are now called debtors, for example).

Once a firm files for bankruptcy under Chapter 11, creditors are prevented from enforcing their claims. The managers of the firm are left in control (unless a court finds dishonesty, mismanagement, or incompetence), and they are allowed a period of time (initially 120 days, with extensions possible) to develop a reorganization plan. A plan generally reduces the claims of creditors and specifies how these reduced claims will be met. The plan offered by management must be accepted by most of the creditors whose claims are reduced. The plan must be approved by the shareholders as well.[46] In the event that no management plan is accepted within the time allowed, creditors are permitted to submit their own plans, subject to the same rules for acceptance.

The financial argument for this system of bankruptcy is that it maximizes a firm's assets.[47] The underlying assumption is that insolvency often results from uncontrollable outside forces or from innocent management mistakes. If insolvent but financially viable firms are given the opportunity to reorganize, then they can return to profitability and repay their creditors. Such an outcome is preferable, from a financial point of view, if reorganization instead of liquidation leads to more productive deployment of a firm's assets. This is often the case, because assets generally have greater value when they continue to be held by an ongoing entity than when they are broken up and sold off piecemeal. However, a bankrupt firm cannot be operated as an ongoing entity if diverse creditors are allowed to press their conflicting claims. The solution, which is provided by bankruptcy law, is to force creditors to act collectively and to create incentives for them to make wealth-maximizing decisions.[48] In short, bankruptcy law forces creditors, who have control during the bankruptcy process, to act like a group of shareholders with responsibility for enhancing the total value of a firm instead of acting as individual claimants who are concerned only with getting their due.

The ethical argument follows directly from the financial argument. Called the "creditors' bargain," this argument employs a hypothetical contract approach and asks what bankruptcy system would all creditors agree to in advance of any bankruptcy proceedings.[49] That is, suppose that creditors, both secured and unsecured, could write the Bankruptcy Code. What provisions would the law contain? The answer, it is assumed, is that creditors would favor a system that maximizes a firm's assets and hence its ability to repay all creditors, either through liquidation or reorganization. Although individual creditors, especially those with secured claims, might collect more of what they are owed in particular cases by liquidation, the cost and uncertainty of these alternatives make them less attractive as a universal system, when, in other cases, the same creditor may have unsecured claims. In addition, liquidation eliminates jobs and has an impact on customers, suppliers, communities, and other stakeholder groups. Thus, easy access to bankruptcy protection not only deploys assets more productively—which benefits creditors—but also enhances the welfare of society.

Use and abuse of bankruptcy

Easy access to bankruptcy protection has resulted in a number of controversial uses of the law that were not envisioned by Congress in creating the modern bankruptcy system. Consider the following.

Product liability suits

In August 1982, Manville Corporation, a Fortune 500 company with annual earnings of $60 million and a net worth in excess of $1 billion, declared bankruptcy. Manville's business was healthy, but many users of its main product, asbestos, were not, and the sick and dying were threatening to bury Manville in a flurry of lawsuits. Manville had already settled 3500 suits at a cost of $50 million, 16 500 were still pending, and new suits were being filed as the rate of 500 per month. In the bankruptcy petition, the company claimed that future suits against the company would eventually total between $2 billion and $5 billion dollars. In 1985, A.H. Robins filed for bankruptcy protection after agreeing to settle the claims of women who suffered injuries from the Dalkon Shield intrauterine birth-control device, and Dow Corning Corporation sought bankruptcy protection in 1995 in the face of heavy liability from suits over silicone breast implants that women blamed for a variety of disorders.

Collective bargaining agreements

In 1983, two solvent companies, Wilson Foods and Continental Airlines, filed for bankruptcy protection on the grounds that generous labor contracts placed the companies at a competitive disadvantage that might eventually make them insolvent. Bankruptcy enabled each company to void collective bargaining agreements currently in force and to slash wages virtually in half. Continental also laid off about 65 percent of its workforce and resumed operation as a low-fare, nonunion carrier. Wilson Foods and Continental were following in the footsteps of Bildisco, a New Jersey building supply firm, which successfully broke a labor contract with the Teamsters Union by filing for bankruptcy. In the 1984 *Bildisco* decision, the US Supreme Court held that collective-bargaining agreements are no different from any other contracts and can be unilaterally rewritten or terminated if the long-term solvency of the firm is at stake.[50] Congress has since revised the Bankruptcy Code to limit the ability of companies to act in this manner.[51]

Liabilities and obligations

Bankruptcy has enabled many companies to reduce or avoid substantial liabilities and contractual obligations. LTV Steel used Chapter 11 in an attempt to dump $2.3 billion in underfunded pension liabilities onto the federal

Pension Benefit Guaranty Corporation, and in the ensuing court fight, thousands of retirees found their pension benefits jeopardized. Texaco was ordered by a court to pay Pennzoil damages of $10.5 billion for "stealing" Getty Oil during merger negotiations between Pennzoil and Getty. Despite $35 billion in assets, Texaco declared bankruptcy and managed to reduce the payment for damages to $3 billion. The 1983 bankruptcy of HRT Industries, the operator of a chain of discount stores, achieved several ends.[52] Despite holding net assets of $50 million, the company declared bankruptcy because of a "very recent" cash-flow problem after receiving the bulk of its merchandise for the Christmas season. Afterwards, HRT closed more than thirty unprofitable stores. The company's short sojourn in Chapter 11 thus enabled HRT to get an interest-free loan on all of its debt and to terminate a number of onerous long-term leases.

What is wrong with strategic bankruptcy?

The charge that companies such as Manville, Dow Corning, Continental, LTV, and Texaco are *abusing* the bankruptcy system suggests some moral wrong, but it is difficult to identify that wrong precisely. One charge is that these companies are using the bankruptcy law for purposes other than that for which it was enacted. However, to use a law for an unintended end is not itself morally objectionable. Once a law is on the books, its use is limited solely by the wording of the law, not by the intent of the legislature in passing it. (For example, the use of SEC Rule 10b-5 to prosecute insider trading represents a novel application of law beyond its original scope.)

A second charge is that bankruptcy is being used in these instances to avoid ethical and legal obligations that result from contractual agreements or court judgments. However, bankruptcy law is designed, in part, to enable a firm to fulfill its obligations to the maximum extent possible, consistent with fairness and efficiency, when the firm is unable to fulfill these obligations fully. That is, Congress, in creating the bankruptcy system, has already taken into account the fact that a firm seeking bankruptcy protection will be avoiding some ethical and legal obligations, and Congress has determined that, all things considered, it is better to permit a firm to fulfill its obligations only in part and to continue as an ongoing entity than to require an immediate liquidation in which creditors will still not be made whole.

Furthermore, by seeking bankruptcy protection, firms do not avoid their obligations entirely but negotiate the terms under which they will be filled, and in the end, the claimants are often well served. When Manville emerged from bankruptcy in 1986, the majority of stock was transferred to two trusts, one to pay claims for health-related injuries and the second to pay for property damages. The victims of Manville thus became the owners, and the ability of these new owners to be compensated depends on the continued profitability of the company. Similarly, LTV emerged from bankruptcy after seven years of protracted negotiations with the Pension Benefit Guaranty Corporation and other creditors by agreeing to contribute $1.6 billion to the company's underfunded pension plans. The success of asbestos victims and pensioners in securing their claims did not come easily. They had to fight for their rights, but in the end, these claimants gained more than they might have done without the opportunity for the company to seek bankruptcy protection.

A third and more promising objection to the conduct of Manville, Dow Corning, Continental, LTV, Texaco, and other companies that seek bankruptcy protection is not that claimants do not receive what they are owed but that claimants who receive their claims under one set of rules are forced to fight for them again under another set of rules. Victims of defective products who succeed in court suits for tort damages must now win their case all over again in bankruptcy proceedings. Workers who negotiate a labor contract in good faith can find themselves back at the bargaining table, this time before a bankruptcy judge. Texaco, which was ordered by a judge in a jury trial to pay Pennzoil $10.5 billion, gained another opportunity to dispute the case in an entirely different setting. Thus, bankruptcy provides a company with onerous obligations the opportunity to renegotiate or relitigate them under a different set of rules.

However, this charge—that bankruptcy provides a second chance under different rules—carries no weight if companies are genuinely insolvent. No claimant can seize assets that are not there, and every claim includes provisions for default. Thus, a creditor must expect to go to court if a debtor cannot or will not pay and commercial law provides the means for resolving such disputes. The critical question is whether a company that seeks bankruptcy protection, and thereby changes the rules on claimants, is actually insolvent or would face insolvency without the protection of bankruptcy law. If an otherwise healthy company with heavy liabilities is able to use bankruptcy law to force creditors to renegotiate or relitigate their claims under different conditions, then arguably the system has been abused.

Critics of the bankruptcy system argue that bankruptcy is not always a condition that afflicts companies but is sometimes a deliberate *choice* that companies make for strategic ends.[53] Virtually any company could make itself "bankrupt" by amassing unpayable debts, but, short of that step, a company with massive liabilities can easily arrange the balance sheets, shift assets, or even induce a crisis event so as to become insolvent. A company is held to be insolvent when its liabilities exceed its assets, as though liabilities and assets were objective, precisely measurable quantities. Not only do assets and liabilities reflect decisions made by a company, but the valuation of assets and liabilities is subject to manipulation. As a result, the bottom line is not a hard fact that everyone can observe in the same way but an artificial construct that is created by a firm's managers—within accepted accounting principles, of course.

For example, one critic contends that Manville chose not to include its liabilities for asbestos-related injuries on the company books prior to filing for bankruptcy.[54] Before 1982 the company claimed that it was not legally required to do so because the liabilities could not be accurately estimated. When Manville decided to "go bankrupt" in 1982, $2 billion in liabilities suddenly appeared on the company's balance sheet. Both Continental and Texaco carefully defined the part of the company that was declared to be the "bankrupt unit," and Continental, according to some observers, provoked a union strike rather than negotiate, in order to qualify for bankruptcy. Bankrupt Dow Corning is owned 50–50 by (solvent) Dow Chemical and (solvent) Corning Incorporated. Complex ownership structures permit movement of assets from one unit to another prior to filing a bankruptcy petition.[55]

Such strategic use of bankruptcy strikes us as unfair because the accepted rules for conducting business are suddenly changed. Strategic bankruptcy might be compared to a game of poker in which a dealer with bad cards is allowed to stop the game, rearrange some of the hands, perhaps take some money off the table, and resume play with different rules. However, the poker game just described is not unfair if the dealer's options are understood at the beginning of play. Under such conditions, the game is merely one of many possible forms of poker, albeit with rather complicated rules, and players can play their hands with the possibility of a rule change in mind. Similarly, a bankruptcy system that permits companies to seek bankruptcy protection for strategic reasons is not unfair merely because of the possibility of a change in the rules. The first few strategic bankruptcies might be considered unfair because the affected parties, such as the asbestos victims of Manville and the employees of Continental, had not anticipated this use of the Bankruptcy Code. After these well-publicized events, however, creditors and other groups should be aware of this possibility and play their hands accordingly.

Fairness and efficiency of Chapter 11

In order to understand what is really wrong with a bankruptcy system that permits bankruptcy as a strategic choice, we need to look at the impact of this system on the functioning of a business system in which considerations of both fairness and efficiency play a role.

One argument for the current Chapter 11 is that it is the bankruptcy system that would be selected by creditors themselves if they were to choose a system in advance of any bankruptcy filing. According to this argument, which is called the *creditors' bargain*, a bankruptcy system that permits reorganization rather than forced liquidation is preferable because it will maximize a firm's assets through an orderly adjudication of creditors' claims. However, the creditors' bargain argument does not provide clear answers to more specific questions. In particular, strategic bankruptcy is greatly facilitated by the 1978 revision of the Bankruptcy Code that gives distressed companies easier access to bankruptcy protection. If creditors could write the law on bankruptcy, what conditions would they include for filing for bankruptcy protection? In particular, how easy would they allow the filing for bankruptcy to be?

The answers to these questions are disputable, but some evidence suggests that creditors, as well as shareholders, have suffered losses from the 1978 revision of the Bankruptcy Code and that the winners are the managers of firms and the legion of lawyers, accountants, and financial advisers who assist them. Two researchers who studied 326 firms that filed bankruptcy petitions between 1964 and 1989 found that losses suffered by bondholders after 1978 were 67 percent greater than the losses suffered before the 1978 revision.[56] Shareholders have fared even worse. Before 1978, shareholders of bankrupt firms lost on average slightly more than one-half of the value of their investments, and after 1978, the losses were almost 100 percent. The researchers concluded: "Chapter 11, in other words, may be seen as a kind of management defensive tactic against corporate debtholders, which, like certain antitakeover defensive measures, enhances management's wealth at the expense of corporate security holders."[57] If this result is correct, the current system of bankruptcy law would not be much of a bargain for creditors and would not be justified, therefore, by the creditors' bargain argument.

If the purpose of the Bankruptcy Code is debt collection—that is, enforcing the rights of creditors before a firm becomes insolvent—then there is no justification for creating any new rights unless doing so enforces creditors' preexisting rights.[58] Chapter 11 creates some new rights for managers. They are permitted under current law to control the process of filing the bankruptcy petition, to remain in their positions during the bankruptcy process, and to develop the first reorganization plan. The rationale for these rights is the assumption that creditors will be better served, but this assumption is not always well founded.

For example, bankruptcy protection allows managers to "play games" at the creditors' expense. Both shareholders and managers have little to lose from continued operation of a troubled firm and might prefer a long-shot, "bet-the-farm" strategy, which would leave creditors with little should the strategy fail.

(This is an instance of the well-known problem of moral hazard.) Furthermore, if bankruptcy is an acceptable risk, firms may be encouraged to court bankruptcy, even when they are not in distress, by pursuing exceptionally risky strategies. This is especially true when shareholders stand to gain the benefit while bondholders and other creditors assume the risk (again, the moral hazard problem). Thus, bankruptcy law, which is intended to protect creditors of distressed firms, may have the unintended effect of generating greater risk-taking that further endangers creditors.[59]

Easy access to bankruptcy protection has far-reaching and unpredictable implications for rights in market transactions and some areas of law. The effect is to complicate ordinary commercial relations and alter such diverse matters as labor relations and product safety.

One principle of market ethics is that investors and those who extend credit should have sufficient information to make reasonable decisions about risk and return. Thus, suppliers should have some information about the credit-worthiness of a retailer who is seeking merchandise on credit in order to negotiate terms. If the risk of extending credit to a retailer like HRT Industries includes the possibility of a bankruptcy filing for strategic reasons, then reasonable estimates of risk become more difficult to make. Further, the sources of risk are expanded from ordinary market conditions (such as the fact the HRT had a number of unprofitable stores) to include a firm's strategy (for example, to seek bankruptcy protection in order to close unprofitable stores). In addition, if HRT was planning to file a bankruptcy petition at the same time that it was seeking credit, then, arguably, this is material information that ought to be disclosed to creditors, since concealment might constitute fraud.[60] In any event, easy access to bankruptcy protection complicates such a fundamental matter as the extending of credit in ways that might be better avoided.

Both labor law and product liability law are premised on certain rights: namely, the right of workers to organize and bargain collectively and the right of people who are injured by defective products to be compensated. The law in these areas is carefully constructed to balance the various competing rights and interests. Insofar as strategic bankruptcy enables firms to renege on labor contracts or avoid product-liability awards, then important rights may be denied, and the carefully constructed balance may be upset. At a minimum, union members and victims of defective products have lost ground as a result of bankruptcy reform because of the greater risk in collective-bargaining agreements and product-liability judgments.

In addition, liberal access to bankruptcy protection might encourage business firms and labor unions to bargain differently if they believe that worker contracts could be easily broken, or it might encourage manufacturers to design and produce less safe products if it were the case that liability suits could be easily evaded. Easy access to bankruptcy also has an impact on strategic planning. Some companies, such as airlines, may operate for years with bankruptcy protection. As a result, their nonbankrupt competitors, which must meet all of their current obligations, complain that they are placed at an unfair competitive disadvantage.[61] Even the knowledge that a major competitor could engage in strategic bankruptcy at any time is an unsettling factor in a company's own strategic planning.

In conclusion, the American bankruptcy system is ethically justified, in its broad outlines, on the grounds of both efficiency and fairness. The creditors' bargain assumes that because the system serves to maximize the assets of an insolvent firm—which is a consideration of efficiency—creditors would prefer such a system. Hence, the current bankruptcy system is also fair since it is based theoretically on the consent of all affected parties. At bottom, the charge that strategic bankruptcies are morally wrong rests on the view that one or another corporate constituency is being treated unfairly, and it may be argued that easy access to bankruptcy protection encourages forms of strategic bankruptcy that certainly complicate business decision making and may impact the rights of some constituencies, most notably employees and consumers. However, an evaluation of this argument depends on a complex analysis of the actual consequences of strategic bankruptcies, which are not clearly known.

Personal bankruptcy

The standard justification for personal bankruptcy, which allows individuals to discharge many of their debts and have a "fresh start," is based on the twin considerations of *welfare* and *justice*.

At one time, when individuals were unable to pay their debts, they were cast into prison. Even without the threat of imprisonment, people with heavy debts might spend a lifetime of economic struggle, with consequences not only for themselves and their families but also for the whole of society. The loss of productivity from heavy debt loads alone would make an unforgiving system inefficient. Moreover, the greater caution that people would exercise—for example, in starting a business—would further impede productivity. Indeed, many successful entrepreneurs have endured personal bankruptcy from prior failures and would not have been able to continue without lenient legal protection.

Everyone, debtors and creditors alike, are better off in a society that allows personal bankruptcy, because even creditors might find themselves with debts they cannot pay. Although there is an obligation to pay one's debts, the benefit of fulfilling this obligation may be outweighed by the loss that results for both individuals and society when people are unable to live full, productive lives. Thus, everyone in society is better off and would choose to live under a more forgiving system that allows some erasure of debt obligations. In addition, it is unfair for people to suffer crushing debt loads that are caused, in many cases, by adversities beyond their control. The idea of bankruptcy as a personal failing is not always correct.

However, a lenient system of personal bankruptcy creates opportunities for abuse. Easy access to bankruptcy protection with little stigma or inconvenience might lead individuals to be less restrained in incurring debts. When facing bankruptcy, individuals might incur all the debt they can, knowing that it will soon be discharged, and seek to shield other assets from creditors by improper means. (For example, prior to personal bankruptcy, a person might transfer property to a relative, although such a move can be challenged as a form of *fraudulent conveyance.*) In the United States, creditors, most notably bank lenders and credit card issuers, whom critics accuse of enticing customers into unmanageable debt loads, have protested these abuses and sought changes in the law to prevent them. The prevention of abuse is of concern not only to creditors, such as bank lenders and credit card issuers, but also to consumers, for whom access to credit and the cost of credit is affected by the personal bankruptcy system.

The main issues in the debate over personal bankruptcy are: (1) Should individuals above a certain income level be required to repay a certain portion of their debts instead of having them discharged completely? (2) Should some critical assets (such as a home or pension savings) be shielded from creditors during bankruptcy proceedings? (3) Should certain debts be nondischargable, such as those incurred from luxury goods or large cash advances obtained just prior to seeking bankruptcy protection?

In 2005, the US Congress passed and the president signed a sweeping overhaul of the Bankruptcy Code for individuals. The new law, long sought by the banking industry, utilizes a means test to limit access to a complete discharge of debts under Chapter 7 and forces more applicants to develop a five-year partial repayment plan under Chapter 13. In most cases, a debtor with income above the state median income may not file under Chapter 7. Other provisions of the new law include mandatory credit counseling and debtor education and limits on the amount of debt that can be discharged for purchases of luxury goods (over $500 within 90 days of filing) and cash advances ($750 within 70 days). In general, pension funds are exempt, as are assets in a home within limits set by state laws.

Opponents of the more stringent 2005 personal bankruptcy law argue that abuse is committed by only a small portion of those seeking protection and that the vast majority of personal bankruptcies are caused by job loss, disability, divorce, medical bills, and business failure.[62] For such people, a "fresh start" will often enable them to resume successful lives, whereas requirements to pay off a portion of their debts will mire them in a cycle of indebtedness. Opponents also claim that bankruptcy due to the failure of a business is more common than is generally recognized and that more stringent laws will strongly deter individuals from starting new businesses, thus damaging a vital engine of economic growth.

Supporters of the 2005 law argue, by contrast, that there is a genuine personal bankruptcy "crisis" that needs to be addressed.[63] The standard view that personal bankruptcy is caused mainly by financial distress cannot account for the rapid rise since 1978 (the date of the previous change in the Bankruptcy Code) in the number of personal bankruptcies. In addition to financial distress, American consumers have shown an increasing propensity to avail themselves of personal bankruptcy protection due to decreases in the social stigma and the economic costs of bankruptcy. As a result, personal bankruptcy may be merely a rational consumer choice that should be restricted.

Corporate Governance

In its broadest sense, corporate governance includes all the factors that determine how decisions are made in business organizations that are organized as corporations. The shareholders of publicly held corporations and the directors whom they elect are commonly recognized as having *de jure* control, but these shareholders and directors, as well as the managers, who typically exercise *de facto* control, are subject to the power of many groups which, acting within their legal rights, strongly influence, and often determine, corporate decisions.

Most notable among these groups that affect corporate decisions are governments at all levels, which have the legal power to regulate and tax; auditors and accounting standard setters; securities exchanges, which set rules for the listing of stocks and other instruments; rating agencies, which rate a company's securities; banks, which provide funding and exercise close monitoring; the media, which inform the public of a company's activities; and all the markets in which corporations operate—capital markets, labor markets, commodity markets, and consumer markets. In addition, many decisions in business firms are made by employees at all levels as part of their role responsibilities. These diverse groups provide a multitude of forces that bear on corporate decision making.

Viewed in this broad sense, corporate decision making is very highly dispersed among many groups, and the ordinarily recognized corporate governance actors, namely shareholders, directors, and senior executives or officers, make comparatively few decisions. However, these decisions are among the most important ones, and it is these major decisions which are identified with the ultimate control of business organizations that is the subject of what is generally considered corporate governance. Corporate governance in this more common, narrower sense of the term is the set of legal rules which specify the parties having the right to make the most important decisions that constitute corporate control, as well as the legal rules which specify the processes and procedures by which these parties exercise this decision-making power or control.

However, the assignment of control rights, as well as the processes and procedures for exercising these rights, is of little importance in a corporation that is owned and managed by a single individual or a small group—which is to say a corporation without a separation of ownership and control. The legal rules which comprise corporate governance become critical mainly when there are a large number of diverse shareholders and a separation of ownership and control. Under such conditions, conflicts over control arise among the different parties, and legal rules become necessary to protect the rights and interests of each group and ensure that decisions serve the proper corporate objective.

Case for shareholder primacy

In a capitalist economy, large business organizations or firms are legally structured most often as publicly held for-profit corporations. Businesses may also be organized as sole proprietorships, partnerships, closed corporations, and the like, and many organizations are not-for-profit. Although these other forms of organization are subject to governance rules, they do not commonly involve the significant conflicts over control that characterize publicly held corporations, and, consequently, they raise few concerns about their governance.

In a publicly held corporation, the group with control is the shareholders, which, because this group has control, leads to the maximization of shareholder wealth as the objective of the firm. The main moral question about corporate governance, then, is why shareholders, morally, ought to have control and why, morally, their interests ought to be the objective of the firm. This right of control with its corresponding role for shareholders in a firm's objective is often expressed as the doctrine of *shareholder primacy*. So the main moral question about corporate governance is the justification of shareholder primacy. The answers to further questions about the processes and procedures of corporate governance—for example, the specific rights of shareholders in exercising control and the fiduciary duty of officers and directors—follow largely from the justification of the shareholder primacy doctrine.

In addition to the right to control, shareholders possess another defining right, namely a claim on the residual revenues or profits of a corporation. Many groups have a claim on a corporation's revenues. These include bondholders, who have claims for interest and principal payments; employees, who have claims on revenues for payment of wages; suppliers, who have claims for the payment of materials; government, which has a claim for payment of taxes; and so on. Most of the income that a corporation generates from customers and other sources is paid out to a variety of groups that have fixed claims on a firm's revenue. *Fixed claims* are debts that a corporation is legally obligated to satisfy as long as the firm is solvent. A firm that cannot satisfy all fixed claims or debts is, by definition, insolvent. Whatever income remains after all fixed claims are satisfied—that is, all bills are paid—constitutes residual revenue, and the shareholders' right to residual revenue constitutes *residual claims*.

Every claim on a corporation's revenues is a return for some resource that is contributed for production. Employees contribute labor, suppliers contribute materials, and bondholders contribute debt capital. (Customers do not contribute to production, but they provide the necessary element of revenue when they purchase a product.) Therefore shareholders, who typically finance a corporation with equity capital—as opposed to the debt capital provided by bondholders—contribute a necessary and distinctive resource and accept, in return, the residual revenues or profits of the firm. Shareholders may be defined, then, as *the group that has both the right of control and a claim on profits*.

The justification of shareholder primacy has two sources, which reach the same conclusion by different routes. One source is *public policy*, which asks, in this case, what form of governance best serves the good of society, and the other source is the *market*, which reveals the form of governance that would result from voluntary market transactions. More specifically, corporations must contract with shareholders for the provision of equity capital. Given that there is a market for raising such capital, what terms would corporations and investors find mutually agreeable, consistent with all the other contracts that a corporation must form? Markets serve as a means for the exercise and protection of property rights, and so any system of corporate governance that emerges from markets is a reflection of this important moral concern.

The first of these two sources, namely public policy, reflects the fact that corporate governance is established in law by government through legislation, regulation, and adjudication, and that public policy is a major factor guiding these processes. Public policy is also reflected in public attitudes toward business generally and in each company's reputation. In creating the body of law for corporate governance, one of government's main concerns is to ensure that business organizations serve the public good, although government action may also aim to protect property rights, thus leading to the market as the second source of justification.

Insofar as corporations result from private contracting among individuals in the exercise of their property rights, then the contracting that forms a corporation may include the assignment of decision-making rights. In this way, the rules of corporate governance result from individual's market transactions. Corporate law, especially in Anglo-American countries, permits business firms great latitude in choosing the terms of their legal incorporation. In the United States, where corporate law is a function of individual states, firms may choose to incorporate in the state with the most advantageous system. Consequently, in Anglo-American countries, the market is a major factor in determining the forms of corporate governance. The law in Europe and Asia allows less discretion in choosing the terms of corporate governance and is based more on considerations of public policy.

Public policy

Traditionally, the law on corporate governance has been guided by two conceptions of the corporation: one conception as the private property of the owners of the enterprise and the other as a right granted or conceded by the state. (These two conceptions are discussed in Chapter 2.) However, the idea that shareholders are the owners of the modern publicly held corporations whose claims are based on property rights ended with the separation of ownership and control that was observed by Adolf A. Berle Jr and Gardiner C. Means in their famous 1932 book *The Modern Corporation and Private Property*.[64] There they argued that with the separation of ownership and control, shareholders, who have ceased to exercise the responsibility associated with property rights, had forfeited their claim to control based traditionally on ownership.

Without property rights as a basis for shareholder primacy, what else could justify the claim that shareholders ought to have control of a corporation? Berle argued that without strong shareholder control, corporate management would be effectively unconstrained and that such power would be dangerous to the economic order.[65] It would be unwise, in Berle's judgment, for the law to release managers from a strict accountability to shareholders, not out of respect for their property rights (for they have none) but as a matter of sound public policy. In short, shareholder primacy is justified, in Berle's view, as a matter of public policy, to constrain and guide management. However, the contractual theory of the firm offers a more powerful public policy justification, for the shareholders' role in corporate governance can be constructed by determining which group can operate a firm most efficiently for maximum value or wealth creation.

Efficiency is both an economic and a moral value because operating a business organization efficiently—which means producing the greatest amount of output for the least input—creates greater prosperity or material well-being than operating inefficiently. Other things being equal, we should prefer more rather than fewer material goods from any given resources, and corporations ought to be governed so as to achieve this end. Therefore, if one group can exercise ultimate decision-making power with greater efficiency and wealth creation than any other group, then, on the basis of public policy, that group ought to have control. Although this group receives some benefit from having control, its members provide a service that makes everyone in society better off.

This public policy justification of shareholder primacy is completed by arguing that, under most conditions, the financiers of a corporation—which is to say the investors of equity capital—can exercise control in such a way as to achieve the greatest efficiency and hence create the greatest value or wealth creation. Under some conditions this can be done best by employees or by customers or suppliers, and, as a result, some firms are employee-owned, customer-owned, or supplier-owned. (These latter are called cooperatives, and Henry Hansmann has suggested that the shareholder-owned firm can be viewed as a "capital cooperative."[66]) However, corporations are more commonly controlled by financiers or investors, and justifiably so.

The main reason for this greater efficiency and wealth-creating power stems from the shareholders' role as residual risk bearers. Given that the shareholders' return on their contribution to production, namely equity capital, is a claim on residual revenues, only they have an incentive that a firm be maximally profitable as opposed to merely solvent. Any group with fixed claims, such as employees, customers, or suppliers, has an interest only in a firm being solvent and thus able to satisfy this group's fixed claims.

If employees, for instance, had control with only fixed claims for wages, they would tend to operate the firm with a low level of risk so as to assure their wages, even though greater risk might lead to greater wealth creation. Because the greater wealth creation would accrue disproportionately to other groups, especially shareholders in the form of profits, employees would be disinclined to take the risks that may be socially desirable. Similarly, bondholders would prefer that a firm be operated at a low level of risk to avoid jeopardizing their fixed claims for principal and interest payments, since they, like employees, would derive little benefit from maximal wealth creation.

Executives, too, would be suboptimally risk averse unless they were given incentives tied to profits, which is the rationale for compensating executives with performance-based bonuses and stock options.

From the point of view of public policy, decisions in a business organization ought to be made by the party or group with two features: the greatest amount of relevant knowledge and the strongest incentives to operate the firm for maximum efficiency or wealth creation. Although shareholders lack much of the knowledge necessary to operate a firm and, consequently, must rely on more knowledgeable directors to exercise general oversight and competent managers to exercise day-to-day control, they alone have the right incentives to operate a firm for maximum profitability.

Moreover, the decisions that shareholders make about selecting a board of directors and approving major structural changes, such as mergers and acquisitions, are matters about which shareholders are or can become knowledgeable. Perhaps the most important decisions that shareholders make are to buy and sell stock, thereby setting a price for a company's shares that constitute an up-to-the-minute evaluation of a company's performance and prospects. In practice, shareholders make very few decisions, but their central role in corporate governance derives from the knowledge and, more importantly, the incentives they have in making some of the most critical decisions in the operation of a corporation.

The market

In their role as financiers or investors, shareholders provide one resource needed by a business organization, namely capital. In return, they receive a payment or claim on revenues, specifically the residual revenues or profits of the firm. In this respect, shareholders are little different from other input providers, which include bondholders, employees, suppliers, and so on. They provide some resource and receive a payment in return. All these groups contract with a firm, so that the firm itself may be viewed as a nexus of all the contracts so formed. Insofar as the return for the provision of any input is insecure, a contract is necessary to safeguard the return. On this nexus-of-contracts view, a firm "buys" capital in the same way it buys labor or materials, and such a purchase is an economic transaction that takes place in a market, namely a capital market, in the same way that a firm buys labor in a labor market and materials in a commodities market.

The shareholder contract

Corporate governance may be understood as the contract that a firm forms with its shareholders, who finance the firm by providing equity capital. The terms of this contract are determined, in large part, in a market through a process of negotiation by firms seeking capital and investors seeking to deploy their savings, with each party bargaining to obtain the best deal for itself.

From a moral point of view, any agreement or contract that is formed by mutual consent between firms and investors is justified in the same way that the outcome of any market exchange is justified. The crucial task in justifying the role of shareholders in corporate governance is to understand why shareholder primacy would result from contracting between a firm and its financiers or investors. In particular, why would investors providing equity capital not only do so in return for residual revenues or profits but also insist on obtaining control? Or, alternatively, why would a firm seeking capital offer control rights in addition to a claim on residual revenues?

The answer lies in the role of shareholders as residual risk bearers. Equity capital is different from debt capital, which is obtained in loans from banks or in bonds sold to bondholders. First, equity capital is provided for the life of a firm with no provision for its return, unlike the fixed term of a loan or a bond. Second, equity capital has no fixed return, such as the specified interest on a loan or bond; the return is, rather, the profits of a firm, which are variable and may even be negative. By accepting a return in the form of a claim on residual revenues, shareholders become residual risk bearers.

Being a residual risk bearer is not only a benefit—the return is the profits of a firm—but it is also a service that protects the fixed claims of other groups. Because shareholders do not need to be paid if there are no residual revenues, a firm can suffer a loss without becoming insolvent and incurring the risk of being forced into bankruptcy and possibly liquidated. By serving as residual risk bearers, shareholders thus make the fixed claims of other groups more secure. Shareholders are compensated for this service by the prospect of higher returns when a firm is profitable.

Solving a contracting problem

The role of residual risk bearer creates special contracting problems for shareholders. The fixed claims of other groups—of employees for wages, for example, or suppliers for payments—are relatively easy to express in legally enforceable contracts. By contrast, the profitability of a firm, upon which the payment to shareholders depends, cannot be mandated in a contract. In a firm without a separation of ownership and control—that is, in a firm in which shareholders operate the business—there is no problem protecting the shareholders' return. However, once shareholders leave the task of operating a firm to professional managers, a problem arises as to how shareholders can be assured that these managers will operate the firm for maximum profitability.

The solution to this problem is for shareholders to accept the role of residual risk bearer only on the condition that they also have control. The roles of residual risk bearer and holder of control rights are conceptually distinct. In theory, these roles could be held by different groups, and sometimes they are. In practice, however, few investors would be willing to become residual risk bearers without having control. Without control rights, an investor would generally insist on significantly higher returns to compensate for the greater risk, with the result that the cost of capital for firms would greatly increase. Alternatively, firms can lower their capital costs by offering control rights as well as claims on profits when they seek capital from investors. Thus, control rights can be viewed not only as a demand of investors to secure the return on their contribution of capital but also as an offer from firms to obtain capital on favorable terms.

Combining risk bearing and control in the shareholders' role is not a complete solution to the contracting problem, however. Shareholders cannot merely order managers to operate a firm for maximum profit, because what managers need to do to make a firm maximally profitable is complex and uncertain. The best shareholders can do is ask managers to exert their best effort to be profitable. This is commonly done not only by aligning managers' interests with those of shareholders by means of bonuses and stock options but also by imposing a fiduciary duty on managers to act in all matters in the shareholders' interests.

A fiduciary duty generally is a strong, open-ended obligation to exercise loyalty, candor, and care in the service of another party whose interests the fiduciary is pledged to serve. The fiduciary duty of directors and officers is a major feature of the law of corporate governance that is designed to overcome the fact that shareholders cannot bind persons by explicit contracts that fully specify the conduct to be performed. That the fiduciary duty of management flows mainly to shareholders is often thought to privilege shareholders in some way, but it should be understood that only shareholders benefit from being the beneficiary of managers' fiduciary duty as a solution to their distinctive contracting problem with a firm. All other groups are better protected by, and thus prefer, other contractual means.

Efficiency of the solution

This provides a partial explanation of why residual risk bearers would seek control, as well as the benefit of managers' fiduciary duty, namely to protect their at-risk return for providing equity capital. Although assuming residual risk and the right of control has a cost, the benefit to shareholders for incurring this cost is greater than the benefit for any other group with only fixed claims, which can protect its claims more effectively and economically by other contracting means. In short, control is worth more to residual risk bearers than any other group, and so they are willing to pay more for it.

A more complete explanation, however, is that shareholders are able to bear the costs of residual risk bearing more economically than other groups, which reduces the cost overall. First, shareholders as equity capital providers are better able than employees, customers, suppliers, or other groups to diversify their investments in a firm. One reason why employee-owned firms, for example, are relatively rare is that an employee's whole wealth becomes tied up in the company, thus increasing that person's overall level of risk. Second, an active market for corporate control assures that if any group can operate a firm at lower cost or with greater efficiency or wealth creation than the current shareholders, they will do so. As in any good in a market, corporate control will be obtained through Pareto-superior transactions by the party to whom it is worth the most, which will be the party that can operate a corporation for maximal wealth creation.

In sum, then, corporate governance is the contract between shareholders and a firm that confers control rights on the shareholders, along with the benefit of managers' fiduciary duty, in order to protect the claim to residual revenues that they receive as a return for providing equity capital to a firm. Unlike the contract that other input providers form, this contract is unusually complex due to the special contracting problems in the relationship between shareholders and the firm. Although the terms of this contract are, to some extent, specified by law, corporations still have great flexibility to negotiate with investors in a market, and the law itself reflects the terms that would result from market negotiations. Thus, the law of corporate governance is determined both by public policy and the market and is justified on both grounds—that it best serves society and is the result of voluntary, efficiency-promoting market transactions.

Directors and CEO

Although shareholders may have ultimate control of corporations in accord with the shareholder model, the main locus of decision making in corporations is in director boardrooms and executive suites. Accordingly, the law of corporate governance must focus not solely on the role of shareholders but also on the roles and functions of directors and the chief officers, especially the chief executive officer (CEO).

Given the scope and complexity of decision making by all the parties involved and the potential for conflicts among them, corporate governance must be defined more broadly than merely the contract between shareholders and the firm to include the relationships among shareholders, directors, and officers or senior executives, as well as with various stakeholders. It is also in these aspects of corporate governance that differences among national systems are most pronounced. Although the shareholder model of corporate governance may be characteristic of all capitalist firms, they differ from country to country mainly in the relative authority and power of the many groups involved in corporate decision making.

Role of boards

In a typical publicly held corporation, the shareholders elect a board of directors to effectively exercise control with a fiduciary duty on the part of directors to act in all matters in the interests of shareholders and the corporation. (In theory, the interests of shareholders and the corporation are identical, but they may diverge in some instances, which create difficult dilemmas for board members.) In a small company with only a few shareholders, the board may include all shareholders, but in a large corporation with a large number of shareholders, each with small holdings, this is impractical. Consequently, shareholders delegate the task of operating a business enterprise to professional directors and managers, who can do the job much better than they are able to.

The task of professional directors and managers is to operate the firm in the way the shareholders would themselves, with only a few decisions reserved for a shareholder vote. Since these three groups possess different information and have different incentives, a critical question of corporate governance is what decisions should be allotted to each one. Since the incentives of directors and managers are never perfectly aligned with those of shareholders or with each other, a further question is how to ensure that the decisions they make are in the shareholders' interest—which is to say, are maximally efficient and hence wealth maximizing. Although the CEO and some other top officers or insiders are commonly directors, often with the CEO as the chair (known as CEO duality), boards also include outside or independent directors who have no relationship with the corporation other than membership on the board.

Boards of directors and, in particular, the independent members serve five main functions. First, they exercise control by selecting, monitoring, compensating, and, if necessary, replacing the CEO and the top management team. Second, they approve the overall strategy and the major policies and procedures of the corporation. Third, they determine how the corporation's activities are financed. Fourth, they evaluate major restructurings, such as mergers, acquisitions, and divestitures. Fifth, they make recommendations on these and other matters that are submitted for a shareholder vote.

In addition, boards of directors provide a service as decision makers with considerable knowledge and experience who can advise the CEO and make independent decisions. Board members, who are often CEOs of other firms and usually have extended networks, expand the resources available to a corporation. Among these resources may be finance (access to institutions and markets that can provide funding), technology (access to research that may be a source of innovation), and regulation (access to legislatures, industry organizations, and regulatory bodies). Also, boards of directors, which include many distinguished and trusted individuals, provide the level of confidence that is necessary to assure all the parties that deal with a corporation. This confidence-creating or assurance function is especially important insofar as other groups beside shareholders make firm-specific investments that could be exploited in the pursuit of the shareholders' interests.

In most countries, there is a single or unitary corporate board with both inside and outside directors. Several continental European countries, including Germany, France, Austria, and the Netherlands, have a dual board structure. This structure involves a supervisory board, comprised mostly of outsiders, which exercises general oversight, and a managerial board of insiders, which oversees day-to-day operations. In Germany, the supervisory board includes directors selected by shareholders and employee representatives, whose role is part of the German system of co-determination or *Mitbestimmung*, in which employees have decision-making power at the shop level and the board level. Japanese corporations have a unitary board of mostly insiders, including representatives of other firms in a company's circle of partners or *keiretsu*.

Role of the CEO

Much of corporate governance is intended to ensure that those who effectively exercise control do so in the shareholders' interest. Generally, it is the CEO who makes the most important decisions in a corporation and thus effectively governs it. CEOs also have considerable influence in the selection and retention of board members so that, to some extent, they are responsible only to themselves. Also, CEOs typically have the greatest amount of knowledge of any participant in corporate governance and so properly should make the most important decisions.

The main problem with CEOs that is addressed by corporate governance is how to ensure that they and other top executives have the right incentives. This is achieved by four main means. First, like directors, officers of a corporation have a legally imposed fiduciary duty to act in all matters in the shareholders' interest. Although this duty is legally enforceable in that officers and directors can be sued for breaches, both are protected by the business judgment rule that exempts them from lawsuits for good faith business decisions. Moreover, successful suits for breach of fiduciary duty are generally limited to egregious acts of incompetence or self-dealing, so that fiduciary duty provides a relatively weak incentive for strong performance.

Second, executives' interests can be effectively aligned with those of shareholders by a substantial ownership interest or performance-based compensation through bonuses and/or stock options. In this way, CEOs act more like shareholders because they, in fact, become significant shareholders themselves and not merely hired professional managers. Indeed, managers with an ownership stake may have a greater incentive than shareholders to operate a firm profitably since their investment is less diversified than that of shareholders.

Third, a competitive labor market for CEOs and other executive positions places a premium on a manager's success in his or her current job. Even if it is relatively rare for an executive to hold multiple CEO positions, a CEO has a strong incentive to avoid dismissal, and new CEOs are drawn from the ranks of aspiring executives who have incentives to excel. Thus, the market for CEO talent perhaps works best at lower levels among potential CEOs, who help support the current one.

Fourth, an active market for corporate control serves to discipline underperforming or self-serving management by the threat of a takeover. Although hostile takeovers are relatively rare in Europe and Japan and increasingly more difficult to wage in the US, greater pressure by institutional investors has been successful, in many instances, in producing the same kind of change that a hostile takeover would achieve.

Problems with shareholder primacy

The justification of shareholder primacy and, along with it, the justification of the roles of shareholders, directors, and executives or officers encounter a number of critical problems. On the practical level, many corporate scandals, such as the collapse of Enron, WorldCom, and other companies in the early 2000s, and the financial crisis beginning in 2007 have been blamed on failures in corporate governance. These events have led to many proposals for reform, including the passage of the US Sarbanes–Oxley Act in 2002, which mandates, among other things, some changes in the composition and operation of boards of directors. Other concerns, such as high executive compensation, have prompted proposals to increase shareholder voice in the nomination and election procedures for directors.

On the theoretical level, some of the fundamental assumptions of the shareholder model have been challenged by a transformation in corporations worldwide. Traditional corporate governance is focused almost exclusively on the role of the financiers of a corporation. The interests of other groups are neglected in corporate governance, not because they are not important and deserving of protection, but because they are addressed by other means. This narrow focus of corporate governance is commonly justified by two related assumptions that have held true until now. However, changes in the strategy and structure of corporations bring these assumptions into question.

The first of these assumptions is that only shareholders bear residual risk. All other groups that contract with a firm do so for fixed claims—that is, for claims of fixed amounts that can be secured by complete, legally enforceable contracts. Thus, their claims are properly handled by contract law, not the law of corporate governance, which is uniquely designed to protect residual risk bearers, who have been, until recently, only shareholders. The second assumption, which is related to the first, is that only shareholders are affected by corporate decision making. The returns of all other groups that contract with a corporation are determined by the market prices for their inputs in the appropriate market for labor, commodities, products, and so on. These prices depend on market forces, such as supply and demand, and are unaffected by corporate decisions. As long as a firm remains solvent, these claims will be honored, whereas the returns to shareholders, who have residual claims, are directly affected by corporate decisions, thus justifying their control of the corporate decision-making process.

Significant changes have occurred in recent years that bring these assumptions into question. The traditional corporation, for which the prevailing systems of corporate governance have been devised, has sought to employ large fixed capital assets and realize economies of scale in order to reduce prices and capture market share. In such a firm, obtaining large amounts of capital at low cost is critical, and the control over other inputs, including labor, is secured by vertical integration and hierarchical command structures. Because of the high demand for capital and the high level of risk involved, it is necessary for the traditional corporation to seek outside investors and offer them control in return for their investment.

Since the early 1970s, though, corporations have been forced to change from such an asset-intensive strategy that exploits economies of scale to strategies that focus on gaining the benefits of innovation, quality improvements, and globalization. New and better products, made and marketed globally, are now the keys to success instead of cheaper, more abundant, domestically made products. As a consequence, the structures of many corporations have changed from large conglomerates to small, more nimble firms; from rigid hierarchical companies to looser, flattened ones; and from vertically integrated firms to more flexible, open forms of collaborative networks.

Corporations have changed their strategies and structures in recent years, so that fixed tangible assets have become less important than people's skills and knowledge. As human capital has become more important than financial capital, corporations must focus less on their financiers and more on their truly productive assets—which are not only their own employees on the inside but individuals and organizations outside a firm. In the process, relationships rather than transactions have become the ultimate source of organizational wealth. Under these conditions, employees and other groups become residual risk bearers because they must be induced to make firm-specific investments in order to engage in innovation and make quality improvements, and because these firm-specific investments could be expropriated by shareholders, these providers of human capital have a need for more protection from this possibility. These nonshareholder constituencies are also more affected by corporate decisions since their return is dependent on firm performance and not merely on the price of their input in the market.

These changes in strategy and structure challenge the three critical assumptions underlying the justification of the shareholder model and, with it, the current systems of corporate governance. This challenge suggests not only that the traditional allocation of decision-making rights in corporations needs to be altered but also that corporate governance itself must expand its focus from the financiers of corporations to all groups that make investments in a firm and are responsible for creating wealth. In particular, it should be the task of corporate governance to provide the conditions in which all groups can make firm-specific investments with the assurance that they will share equitably in the wealth created. Although the problems with the shareholder model are evident, it is not clear what reforms are needed for corporate governance to fulfill this task. Thus, the systems of corporate governance are still evolving in ways yet to be realized.

Conclusion

The financial management of corporations is but one area of finance that needs to be guided by ethics. The field of finance ethics is broad, encompassing as it does the financial services industry and activity in financial markets, as well as financial management. The same few basic ethical principles apply in all areas of finance, but the specific ethical problems and issues are many and varied and require thoughtful analysis. A study of ethics in finance must recognize the immense changes that have occurred in financial services and financial markets in the past few decades. These changes have resulted from advances in finance theory, new technology, globalization, increased regulation, heightened public expectations, and a vastly more competitive environment. The pressures on people in finance today are immense, and the difficulty of succeeding, combined with the high rewards that are still possible, create great temptations for unethical, as well as illegal, behavior.

Ultimately, securing a financial system that embodies the highest level of ethics is a joint effort. The first step requires that the people who work in finance have the necessary understanding of ethical conduct and a commitment to act accordingly, but good people are not sufficient. Attention must also be paid to the organizations and market structures within which people act and especially to the pressures and incentives that operate on them. Ethics is also inseparable from financial regulation, which is a main means by which ethical conduct is, first, identified and then made subject to enforceable rules. Ethics guides much regulation, but regulation, in turn, gives expression to ethics and provides a means for approaching it. Indeed, anyone committed to good ethics in finance must also work for good regulation. Just as necessary as good regulation, however, is wise, effective leadership in financial services and financial markets worldwide, which can balance the competing demands of business success and social responsibility.

Notes

1. For this distinction, see Charles Handy, "What's a Business For?" *Harvard Business Review*, 80 (December 2002), 49–55.
2. See, for example, John Micklethwait and Adrian Woolridge, *The Company: A Short History of a Revolutionary Idea* (New York: Modern Library, 2003).
3. See Duane Windsor, "Shareholder Wealth Maximization," in John R. Boatright (ed.), *Finance Ethics: Critical Issues in Theory and Practice* (New York: John Wiley & Sons, Inc., 2010).
4. For criticism, see Lynn A. Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (San Francisco, CA: Berrett-Koehler Publishers, 2012).
5. James Hawley and Andrew Williams, *The Rise of Fiduciary Capitalism: How Institutional Investors Are Making Corporate America More Democratic* (Philadelphia, PA: University of Pennsylvania Press, 2000).
6. Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance, and the Theory of Investment," *American Economic Review*, 48 (1958), 261–297; and Merton H. Miller and Franco Modigliani, "Dividend Policy, Growth, and the Valuation of Shares," *Journal of Business*, 34 (1961), 411–433.
7. Henry T. C. Hu, "Risk, Time, and Fiduciary Principles in Corporate Investment," *UCLA Law Review*, 38 (1990–1992), 277–389.
8. Hu, "Risk, Time, and Fiduciary Principles in Corporate Investment," p. 282.
9. Bradford Cornell and Alan C. Shapiro, "Corporate Stakeholders and Corporate Finance," *Financial Management*, 16 (1987), 5–14.
10. This point is made explicitly in *Unocal Corporation v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (1985), and in *Paramount Communications v. Time, Inc.*, 571 A.2d 1140, 1152 (1990).

11. Robert N. Anthony, "The Trouble with Profit Maximization," *Harvard Business Review*, 38 (1960), 126–134.
12. That such standards should be part of the objective of business corporations is recommended in the *Principles of Corporate Governance* drafted by The American Law Institute. Section 2.01 states that in addition to "enhancing corporate profit and shareholder gain," a business corporation "may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business."
13. See David Vogel, *The Market for Virtue: The Potential and Limits of Corporate Social Responsibility* (Washington, DC: Brookings, 2005); Craig C. Smith, "Corporate Social Responsibility: Whether or How?" *California Management Review*, 45 (2003), 52–76; and David Hess, Nikolai Rogovsky, and Thomas W. Dunfee, "The Next Wave of Corporate Community Involvement: Corporate Social Initiatives," *California Management Review*, 44 (2002), 110–125.
14. Milton Friedman, *Capitalism and Freedom* (Chicago, IL: University of Chicago Press, 1962), p. 133.
15. Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits," *New York Times Magazine*, September 13, 1970, p. 33.
16. Keith Davis and Robert L. Blomstrom, *Business and Society: Environment and Responsibility*, 3rd edition (New York: McGraw-Hill, 1975), p. 50.
17. See James Post, Lee Preston, and Sybille Sachs, *Redefining the Corporation: Stakeholder Management and Organizational Wealth* (Palo Alto, CA: Stanford Business Books, 2002).
18. Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press, 1991), p. 38.
19. Easterbrook and Fischel, *The Economic Structure of Corporate Law*, p. 39.
20. Ronald H. Coase, "The Problem of Social Cost," *Journal of Law and Economics*, 3 (1960), 1–44.
21. Indeed, Ronald Coase, the creator of the Coase Theorem, later claimed that his main message had been misunderstood, because a full assignment of property rights and no transaction costs are seldom present. Ronald H. Coase, *The Firm, the Market, and the Law* (Chicago, IL: University of Chicago Press, 1988), p. 15.
22. Peter L. Bernstein, *Against the Gods: The Remarkable Story of Risk* (New York: John Wiley & Sons, Inc., 1996).
23. For the role of government in managing risk, see David A. Moss, *When All Else Fails: Government as the Ultimate Risk Manager* (Cambridge, MA: Harvard University Press, 2002). Bernstein points out that the word "statistics" developed from the use of quantitative facts in the administration of state affairs. Bernstein, *Against the Gods*, p. 77.
24. Operational risk has received great attention as a result of the requirement of the Basel II bank regulations that banks include it in their risk management systems. The Basel II Accord defines operational risk as "The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events."

25. See Ingo Walter, "Reputational Risk," in John R. Boatright (ed.), *Finance Ethics: Critical Issues in Theory and Practice* (New York: John Wiley & Sons, Inc., 2010). Other types of risk include liquidity risk, which is the risk that assets cannot be sold, and sovereign risk, which is the risk that a sovereign state may default on its national debt.
26. Lisa K. Meulbroek, "A Senior Manager's Guide to Integrated Risk Management," *Journal of Applied Corporate Finance*, 14 (2002), 56–70, 56.
27. Peter L. Bernstein, "The New Religion of Risk Management," *Harvard Business Review*, 74 (1996), 47–51, 47.
28. Niall Ferguson, "Wall Street Lays Another Egg," *Vanity Fair* (December 2008).
29. Meulbroek, "A Senior Manager's Guide to Integrated Risk Management," p. 65.
30. Jacob S. Hacker, *The Great Risk Shift: The Assault on American Jobs, Families, Health Care, and Retirement and How You Can Fight Back* (New York: Oxford University Press, 2006).
31. Nassim Taleb, *The Black Swan: The Impact of the Highly Improbable* (New York: Random House, 2007).
32. Michael Power, *The Risk Management of Everything: Rethinking the Politics of Uncertainty* (London: Demos, 2004), p. 10.
33. See Ricardo Rebonato, *The Plight of the Fortune Tellers: Why We Need to Manage Finance Risk Differently* (Princeton, NJ: Princeton University Press, 2007).
34. Taleb, *The Black Swan*.
35. Bernstein, "The New Religion of Risk Management," p. 50.
36. Jón Daníelsson, "The Emperor Has No Clothes: Limits to Risk Modelling," *Journal of Banking and Finance*, 26 (2002), 1273–1296.
37. Jón Daníelsson, "On the Feasibility of Risk Based Regulation," *Economic Studies*, 49 (2003), 157–179.
38. David Einhorn and Aaron Brown, "Private Profits and Socialized Risk," *Global Association of Risk Professionals*, June–July 2008, pp. 10–26.
39. Richard A. Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (Cambridge, MA: Harvard University Press, 2009).
40. Raghuram G. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy* (Princeton, NJ: Princeton University Press, 2010), p. 144.
41. Joe Nocera, "Risk Management: What Led to the Financial Meltdown," *New York Times*, January 4, 2009.
42. John Cassidy, "What's Wrong with Risk Models?" *New Yorker*, Blog, April 27, 2010.
43. "The Uses and Abuses of Chapter 11," *The Economist*, March 18, 1989, 72; and Paul G. Engel, "Bankruptcy: A Refuge for All Reasons," *Industry Week*, March 5, 1984, pp. 63–68.
44. Anna Cifelli, "Management by Bankruptcy," *Fortune*, October 31, 1983; and Harold L. Kaplan, "Bankruptcy as a Corporate Management Tool," *ABA Journal*, January 1, 1987, pp. 64–67.
45. Kevin J. Delaney, *Strategic Bankruptcy: How Corporations and Creditors Use Chapter 11 to their Advantage* (Berkeley and Los Angeles: University of California Press, 1992).

46. One exception is that a plan may be imposed over the objections of one or more classes of creditors as long it is approved by at least one class of creditors whose claims are reduced and a court finds the plan to be "fair and equitable" for all creditors. The imposition of a nonunanimous plan is called a "cramdown."
47. See Douglas G. Baird and Thomas H. Jackson, *Cases, Problems, and Materials on Bankruptcy*, 2nd edition (Boston, MA: Little, Brown, 1990); and Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* (Cambridge, MA: Harvard University Press, 1986).
48. The need to force creditors to act collectively and enhance the total value of a firm's assets is called the problem of the common pool. See Baird and Jackson, *Cases, Problems, and Materials on Bankruptcy*, pp. 39–42.
49. Thomas H. Jackson, "Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain," *Yale Law Journal*, 91 (1982), 857–907.
50. *NLRB v. Bildisco*, 465 U.S. 513 (1984).
51. Section 1113 of the Bankruptcy Code requires companies to attempt to negotiate with unions in good faith and, if an agreement cannot be reached, to demonstrate that any changes are "necessary to permit the reorganization" or that rejection is justified by a "balancing of equities." The courts enforced these more stringent standards in *Wheeling–Pittsburgh Steel Corporation v. United Steelworkers of America*, 791 F.2d 1074 (3d. Cir. 1986).
52. "A Retailer's Chapter 11 Has Creditors Enraged," *BusinessWeek*, May 9, 1983, pp. 71, 74.
53. See Delaney, *Strategic Bankruptcy*, pp. 162–168.
54. Paul Brodeur, *Outrageous Misconduct: The Asbestos Industry on Trial* (New York: Pantheon Books, 1985), pp. 257–258, 268, 270–271.
55. Some asset shifts can be challenged by creditors on the grounds that they constitute "fraudulent conveyance," which is the transferring of assets in an effort to defraud creditors.
56. Michael Bradley and Michael Rosenzweig, "The Untenable Case for Chapter 11," *Yale Law Journal*, 101 (1992), 1043–1095.
57. Bradley and Rosenzweig, "The Untenable Case for Chapter 11," pp. 1049–1050. This conclusion is controversial and has been challenged. See Elizabeth Warren, "The Untenable Case for Repeal of Chapter 11," *Yale Law Journal*, 102 (1992), 437–479.
58. Jackson, *The Logic and Limits of Bankruptcy Law*, pp. 21–27.
59. Chapter 11 contains some mechanisms to counter these management rights and limit possible abuses. Thus, at any time during bankruptcy proceedings, creditors can file a petition for immediate liquidation, which permits a bankruptcy court to judge whether managers are "playing games" with the creditors. Because creditors can always hold out for liquidation or the opportunity to submit their own plan, and because management's plan must be approved by each creditor group, managers are forced to propose a plan that is reasonably fair and equitable. In the event of a "cramdown," a court must determine that the reorganization plan is fair and equitable for all parties.

60. In such cases, abuse of bankruptcy could be addressed by fraud statutes rather than by provisions of the Bankruptcy Code.
61. Joseph McCafferty, "Is Bankruptcy an Unfair Advantage?" *CFO*, June 1995, p. 28; and Stephen Neish, "Is the Revised Chapter 11 Any Improvement?" *Corporate Finance*, March 1995, pp. 37–40.
62. See Teresa Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, *The Fragile Middle Class: Americans in Debt* (New Haven, CT: Yale University Press, 2000); and Elizabeth Warren, "The Bankruptcy Crisis," *Indiana Law Journal*, 73 (1997–1998), 1079–1110.
63. Todd J. Zywicki, "An Economic Analysis of the Consumer Banking Crisis," *Northwestern University Law Review*, 99 (2005), 1463–1541.
64. Adolf A. Berle Jr and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).
65. Adolf A. Berle Jr, "For Whom Corporate Managers Are Trustees: A Note," *Harvard Law Review*, 45 (1931–1932), 1365–1372.
66. Henry Hansmann, *The Ownership of Enterprise* (Cambridge, MA: Harvard University Press, 1996), pp. 13–14.