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The Cost of Capital – the Normative Foundation of Corporate Law: A Reply

by

Sarah Paterson*

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This essay is a reply to Dr Steffek's ambitious work, 'The Cost of Capital – the Normative Foundation of Corporate Law?' Dr Steffek's paper identifies that reducing, or minimising, the cost of capital occurs as normative in the Capital Markets Union ('CMU') project, but that it appears alongside many other normative concerns. The paper makes a contribution to the CMU literature by promoting minimising the cost of capital to 'the' normative concern of CMU. It also makes a contribution to wider corporate law theory by extending its claim beyond CMU.

Methodologically the paper supports its claim by a series of careful steps. Three of these are particularly important for the plausibility of the thesis. First, the concept of 'cost of capital' is broadly drawn, including costs of production, costs of finance and governance costs. Each of these costs is, in its turn, broadly drawn so that, for example, the costs of mistakes of managers are included as costs of governance and the costs of finance include all 'associated' costs of finance such as return on default. Secondly, the paper carefully reconstructs the corporate law rules with which it is primarily concerned, and assesses them against the objective of minimising cost of capital (in its broad sense). Finally, the paper does not dispute that other normative concerns exist, such as protec-

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tion of consumers, employee protection etc. but it attributes these normative concerns to other areas of the law such as consumer protection law or labour law, or affords them a subsidiary role.

The paper is rich, detailed and careful and it is tempting to enter into a meta-analysis of its detailed claims. But instead I have chosen to focus on the central claim of the paper, that 'the' normative concern of the CMU project in particular, and of corporate law more generally, is to minimise the cost of capital. I should say at the outset that I have assumed the purpose of identifying a dominant normative concern is to inform policy choices. This essay then proceeds in four stages. First, it considers the case for what a Western ethicist might call a 'transcendental' normative concern of corporate law.[1] Secondly, it considers the analytical force of Dr Steffek's conception of 'cost of capital' and the challenge with incorporating a number of important externalities within it which would be need to be taken into account in order to determine whether the costs of capital have, in fact, been minimised. Thirdly, it touches briefly on the vexed question of the relationship between law and the cost of finance. Finally, it considers the extent to which minimising the cost of capital should be a dominant normative concern after the financial crisis. The essay then concludes.

A Transcendental Normative Concern for Corporate Law

The first way in which Dr Steffek's paper makes a contribution is by identifying what I have termed (adopting the language of those in the Western ethical tradition such as Amartya Sen) a 'transcendental' normative concern for all corporate law. Sen uses this term in his lively critique of the work of John Rawls' on political justice, and in his famous conundrum of three children and a flute. He sees the problem of striving for a 'unique impartial resolution' to the question of a perfectly just society in the following terms, '... the possible sustainability of plural and competing reasons for justice, all of which have claims to impartiality and which nevertheless differ from – and rival – each other.'[2] Benjamin Friedman makes a similar point in different terms, 'There is no contradiction in the fact that most citizens care about many different aspects of their society, including different questions of public policy, and that any one individual's preferences on different issues are often in tension with one another.'[3] Deirdre McCloskey is similarly critical of attempts in ethics to

1 See, for example, A. Sen *The Idea of Justice* (London: Penguin Books 2010).

2 Ibid., at p. 12.

3 B. Friedman, *The Moral Consequences of Economic Growth* (New York; Vintage 2005) at p. 100.

find the 'ultimate norm',[4] and makes a similar point about the reality of conflicting interests (drawing on Jane Addams), 'The collision of interests, each of which has a real moral basis and a right to its own place in life.'[5] A similar question mark arises as to whether it is possible to promote the normative concern of minimising the cost of capital over all other normative concerns for corporate law, or whether we can, for example, readily agree on different normative concerns for corporate law, some of which we would like to see fulfilled at the same time, some of which we would like to apply in different weights in different circumstances, and all of which may appear to conflict with each other.

Dr Steffek is not the first person to undertake the exercise of seeking to uncover a single, or at least dominant, normative concern for corporate law. In Easterbrook and Fischel's pioneering work, the normative concern of corporate law is that it 'should contain the terms people would have negotiated, were the costs of negotiating at arm's length for every contingency sufficiently low.'[6] Although Easterbrook and Fischel do not expressly extend their analysis to corporate restructuring and insolvency law, others have sought to do so. Most famously, Thomas Jackson conceived of the stakeholders in the company negotiating behind a veil of ignorance (borrowing from Rawls again). In this state a creditor would not know how she would fare in the race to enforce against the assets of an insolvent company. As a result, she would prefer a system in which creditors were prevented from enforcing against the assets of the company, and the proceeds were shared rateably amongst them. Thus corporate restructuring and insolvency law should reflect this hypothetical bargain, so that modern insolvency law should offer a moratorium against enforcement and should respect rateable division of the assets.[7] This provides a coherent 'contractarian' normative theory for all of corporate law, including corporate restructuring and insolvency law (notwithstanding that part of it rests on a hypothetical bargain).

Yet often this 'economic' analysis of the law seems to us curiously detached from the reality of the situations with which we are concerned. McCloskey tells us how the distinguished US judge Richard Posner (and the father of the law and economics movement) stretches the thesis to slavery and rape but

4 D.N. McCloskey, *The Bourgeois Virtues: Ethics for an Age of Commerce* (Chicago and London: The University of Chicago Press 2006), at p. 264.

5 From J.B. Elshtain 'Addams, Jane' in Fox and Kloppenberg (eds) *A Companion to American Thought* cited in McCloskey, n 4 above, at p. 285.

6 F.H. Easterbrook and D.R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Massachusetts and London, England: Harvard University Press 1996) at p. 15.

7 T.H. Jackson, *The Logic and Limits of Bankruptcy Law* (Cambridge, Massachusetts and London England: Harvard University Press 1986).

admits, 'That any sort of rape license is even thinkable within the framework of the wealth-maximization theory that guides so much of the analysis of this book will strike many readers as a limitation on the usefulness of that theory.'[8] But one does not need to go so far as slavery or rape to run into trouble. Much more straightforward, real world scenarios present themselves where other normative concerns for corporate law are implicated besides reduction of transaction costs. For example, suppose we take the example of a small supplier who is routinely paid late by a larger, powerful customer, so that she struggles to pay for her own supplies. Of course, she can simply take her business elsewhere, or launch proceedings in the courts, but we all know that the realities of the 'free' market do not match up to this theory. So the normative theory sounds clever (brilliant even) in abstraction but we are suspicious if we have lived and done business in the real world. We cannot neatly box up all of these concerns and parcel them out to other branches of the law – consumer law, perhaps, or employment law. We must face the fact that the longer we live with markets the more we understand their imperfections, and reducing transaction costs is *a* concern, but it can scarcely be said to be *the* concern, for corporate law.

In a recent working paper, Jackson and Skeel describe the primary concern of corporate insolvency law 'to help reduce the frictions that otherwise would impede assets from moving to their highest and best use.'[9] It is not the purpose of their paper to extend the analysis beyond corporate insolvency law, but adopting Dr Steffek's framework one can see that they might have done so. Essentially, the reallocation of capital, from a firm which cannot make use of it to a firm which can, minimises the cost of capital for sustainable businesses in the economy. Indeed, in a famous article, Douglas Baird frames the point in this way,[10] and goes on to focus on the *ex ante* effects of corporate bankruptcy law on the costs of capital for healthy firms.[11] But crucially Jackson and Skeel acknowledge, 'even those who think this [reducing the frictions that otherwise would impede assets from moving to their highest and best use] is too narrow a description of the purposes of bankruptcy law would almost certainly agree that it is a, if not the, primary purpose'. And their normative concern is itself framed in a different way from Easterbrook and Fischel's theory (as extended

8 R. Posner, *The Economic Analysis of Law* (Boston: Little Brown 4th ed 1992), p. 218 cited in McCloskey, n. 4 above, at p. 404.

9 See TH Jackson and DA Skeel Jr, 'Bankruptcy and Economic Recovery' University of Pennsylvania Law School Institute for Law and Economics Research Paper No 3–27, 29–34 (available at SSRN: http://ssrn.com/abstract=2306138).

10 D. Baird, 'Bankruptcy's Uncontested Axioms' (1988) 108(3) Yale Law Journal 573 at p. 580

11 Ibid., at p. 589.

by contractarian bankruptcy theorists). Let us suppose that you disagree with me in my analysis, or that you prefer Easterbrook and Fischel's framing to that of Jackson and Skeel. Given that right-thinking, consenting adults can validly disagree on the ranking of different normative concerns, is the search for a single, primary normative concern for all of corporate law a search we should undertake?

To this somewhat sententious question, we might also ask whether, even if a transcendental normative concern can be found, it will remain constant over time and geography. In a recent paper I challenged the ongoing relevance of Chapter 11's normative concern for distributional fairness in large corporate debt restructurings.[12] I did not dispute the appropriateness of elevating distributional fairness above Chapter 11's other normative concerns when it was first developed in the 1970s (although others have sought to do so, and there is an extensive, associated literature),[13] and I agreed that it continued to be a dominant concern in corporate insolvency and small and medium sized enterprise restructuring. Rather, I sought to show how changes in the finance market have solved some of the distributional problems which informed the original policy choices in some scenarios. In the introduction to their wonderful work on the neoliberal project, Bondi and Laurie analyse the problem of developing what they call 'neoliberal best practice', so that policies are transferred, 'from one context to others, wrestling the specific socio-political contexts and relationships through which they had been forged, and imposing them elsewhere with minimal regard for distinctive features of policy-making and policy-receiving environments.'[14] This is consistent with an evolutionary theory of law, where 'law is regarded as a social subsystem

12 S. Paterson, 'Rethinking Corporate Bankruptcy Theory in the Twenty-first Century' (2015) 36(4) Oxford J Legal Studies 697.

13 See, for example, LM LoPucki 'The Debtor in Full Control – Systems Failure under Chapter 11 of the Bankruptcy Code?' (1983) 57 American Bankruptcy Law Journal 247, 249; M Bradley and M Rosenzweig, 'The Untenable Case for Chapter 11' (1992) 101 The Yale Law Journal 1043; L Bebchuk and H Chang, 'Bargaining and the Division of Value in Corporate Reorganization' (1992) 8 Journal of Law, Economics and Organization 179; B Adler, 'Financial and Political Theories of American Corporate Bankruptcy' (1993) 45 Stanford Law Review 311; LM LoPucki, 'The Trouble with Chapter 11' (1993) Wisconsin Law Review 729; DA Skeel Jr, 'Rethinking the Line Between Corporate Law and Corporate Bankruptcy' (1994) Texas Law Review 471, 535; A Schwartz, 'A Contract Theory Approach to Business Bankruptcy' (1998) 107 The Yale Law Journal 1807; DA Skeel Jr, 'Creditors' Ball: The New New Corporate Governance in Chapter 11' (2003-2004) 152 University of Pensylvania Law Review 917, 920–21.

14 L. Bondi and N. Laurie, 'Introduction' in N. Laurie and L. Bondi (eds) *Working the Spaces of Neoliberalism* (Massachusetts, Oxford and Victoria: Blackwell Publishing 2005), at p. 2.

evolving together with, but distinct from, other aspects of society such as the economy'.[15] Thus the normative concerns of one era may not be those of a subsequent era, nor may those concerns necessarily be constant between jurisdictions. Normative concerns are local in time and space.

Arguably this does not matter. We must simply continually revisit the normative concerns which have informed policy decisions as we adapt corporate law. The problem with this is that law's development is path dependent: as Cronk and Leech put it in the context of organic evolution 'what it is like now is a function of what it was like in the past, and what it is like now constrains what it can become in the future.'[16] In my own work I have suggested that US scholars have found it hard to reconsider the debate between the economic objectives of Chapter 11 and the concern for distributional fairness in the context of the very different finance market of the twenty-first century, but that a reimagining is required. Saul Bellow puts it this way 'Like everyone who invests in doctrines at a young age, I couldn't give them up.'[17] Thus I argue that we should be cautious about raising one normative concern above the others at one point in time.

One reason why the search for the absolute ideal continues to attract us, I suggest, is that it seems more systematic, more orderly, than the alternative. As Dr Steffek points out, this is all the more the case when we consider the work of scholars who have railed against the projects of Easterbrook and Fischel or Jackson or Baird to provide us with a 'pocket sized card'[18] to tell us what we should expect of corporate law (generally) or corporate insolvency law (specifically). Thus, as Dr Steffek hints, Elizabeth Warren appears to throw in the towel with her 'dirty, complex, elastic, inter-connected .....' view of corporate insolvency law.[19] Elizabeth Warren denies us the hope of a coherent formula which we can apply to the dilemma of the corporate law project, but does not seem to offer us anything concrete in its place. Yet just as McCloskey has argued in the field of ethics, the absence of a single, normative concern which dominates all others does not need to leave us with 'merely a fungible list of good things you might want to get hold of,'[20] and we can still strive for 'a

15 R.C. Nolan, 'Property in a Fund' (2004) 120(Jan) L.Q.R. 108–136.

16 L. Cronk and B.L. Leech, *Meeting at Grand Central: Understanding the Social and Evolutionary Roots of Cooperation* (Princeton and Oxford: Princeton University Press, 2013), at p. 24.

17 S. Bellow, *It All Adds Up: From the Dim Past to an Uncertain Future* (New York: Penguin 1994), at p. 308 cited in McCloskey (n 4 above), at p. 59.

18 Borrowed from McCloskey (n 4 above), at p. 322.

19 E. Warren, 'Bankrupcty Policy' (1987) 54 U. Chic. L. Rev. 775, at p. 811.

20 McCloskey (n 4 above), at p. 316.

useful middle ground – a golden mean, you might say.'[21] It is possible to systemise our normative concerns, and we certainly should not avoid organising for fear that it will necessarily lead to ordering (with all of the attendant dangers of privileging one normative concern over another). We can accept that we have a number of values for corporate law which cannot be combined and which may perhaps be accorded different weights in different situations. Dilemmas will emerge, but the system is all the more useful for acknowledging the dilemmas and the need to make choices. Vanessa Finch has had a go at such a system, identifying (somewhat after the virtue ethicists) four values to act as guiding principles in evaluating corporate insolvency law.[22] I have begun to make my own contribution, by taking one normative concern for 'fairness' (both substantive and procedural) and applying it to the reality of three different types of corporate debt restructuring. The project aims to illustrate the necessity of considering the normative concern and the reality of the situation together (the 'ought' and the 'is' as essential bedfellows) and to show that the normative concern cannot be applied unthinkingly from one situation to another. So we might, for example, divide our normative concerns into how we treat the individual participants in the system (both procedural and distributional fairness between equally situated stakeholders, and between one group of stakeholders and another), how we influence the economy as a whole (the availability and cost of capital for healthy companies and the ability to facilitate the (re)allocation of scarce resource to highest and best use) and the implications for society at large (whether the system creates negative externalities) and apply them carefully in designing CMU. It is not the purpose of this paper to expand on that scheme, but it is suggested merely to show that rejecting a unifying normative concern does not necessarily lead us to chaos.

Defining 'costs of capital'

Dr Steffek's construction of 'costs of capital' begins uncontroversially enough. On the one side, he places the costs of production and, on the other, the cost of finance for those costs of production. The classic objection to this formulation is that by focusing only on the costs of capital, a number of unfair effects are ignored which, even if they are not considered from a moral or ethical standpoint, obscure the overall economic result. So, for example, if corporate insolvency law focuses only on making sure that companies in the economy have the right capital structure, we might be concerned that it will ignore other conse-

21 McCloskey (n 4 above), at p. 337.

22 V Finch, *Corporate Insolvency Law: Principles and Perspectives* (Cambridge: Cambridge University Press 2nd ed 2009).

quences such as the loss of jobs which ought properly to be taken into account in determining the final economic result.[23] For the moment, I have deliberately framed this as an economic issue (adding in the cost of lost jobs) rather than as a moral or ethical one (fairness to weaker creditors or stakeholders in the insolvency bargain). But even framed as an economic question, it is not clear how it can be quantified and included within the firm specific model.

First, there is the purely practical question of quantification. The politically motivated rescue of the US car industry provides a useful illustration. Scholars have plausibly argued that a central concern of corporate insolvency law is to separate viable from unviable businesses. Accordingly, they are critical of the rescue of Chrysler which was, by all accounts, struggling in the competition to produce cars which consumers wanted to buy.[24] These scholars argue that if Chrysler had been allowed to fail other, better manufacturers would have captured its share of the market and would have thrived, a process which Joseph Schumpeter called "creative destruction." This is, of course, how a market economy is supposed to work. If demand for Chrysler's products falls, then Chrysler's income should fall relative to the incomes of owners of 'better' producers in the sector. If Chrysler is allowed to fail, this will motivate those employed by Chrysler to move to jobs with more efficient producers. In the context of Dr Steffek's thesis, the failure of Chrysler would have minimised the costs of capital for other, better manufacturers and over the long run this would produce more jobs rather than fewer and would make a greater contribution to economic growth. Thus it is that in the command economy of East Germany before 1988, 'the design of the Trabant, the boxy, pollution-belching East German sedan hadn't changed in thirty years,'[25] whilst in the market economy of the West state-of-the-art-of-production Mercedes rolled off the line. There may be a political motivation to compensate those who lose their jobs with Chrysler for moving to new employment, but that is not for corporate law.

The difficulty with this argument is whether it stands up to scrutiny in the real world. First, there is the question of the scale of the loss which may require compensation. This includes not only direct economic costs, such as state welfare benefits paid to unemployed workers whilst they seek new jobs, but also indirect costs such as mental health care costs caused by long-term unemployment, the costs of severely fractured families as a result of the strain of the situation etc. These costs may be too large to be compensated at a time

23 LM Lopucki and WC Whitford, 'Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1993) 14 U Pa L Rev 669.

24 Jackson and Skeel n 9 above, at p. 33.

25 A. Greenspan, *The Age of Turbulence: Adventures in a New World* (London and New York: Penguin 2007), at p. 132.

of scarce resources and it may simply be more cost-effective to bail out the firm. As Alan Blinder puts it, 'Short spells of unemployment may not be terribly problematic; some are even welcome as people move or change jobs. But long spells of joblessness are devastating.'[26] So a straightforward cost-benefit analysis may militate against failure.

Secondly, whilst in theory the failure of Chrysler should enable other firms to make better use of its resources leading to new jobs, the real-world effects in competitive markets may be quite different and it may be that the loss of jobs at Chrysler is not replaced by an equal number of permanent jobs elsewhere, or at least not in the United States. In a world of competitive, global markets, there is a chance that non-American car brands would have picked up the market share. This is a particular issue at a time when globalization and technology, cumulatively, are reducing the number of skilled, industrial jobs, and the US endures growing income inequality and risks to social cohesion. Once again, proponents of the economic view argue that the answer to this dilemma is better and more targeted education and training dedicated to the new economy. Yet once again this is unlikely to provide immediate relief for the newly-redundant Chrysler workforce. Those who shrug at the inevitable hardship visited on the losers by the process are rarely losers themselves.

Moreover, even if the sector does rebalance itself over time, and more efficient US producers pick up the slack, we have no way of knowing how long that will take and, therefore, how long the 'short run' will be (or, to reflect a more famous saying, the long run could take a very long time). In order for the residents of the geographically affected area (and much of wider society) to accept the devastating effects of the closure or serious downscaling of a principal employer, they must believe that things are going to get better. Yet the reality of a collapse may not be able to secure transitions to other employers fast enough to convince those affected that this will be the case. In the meantime, the slowness and difficulty of delivering improvements may simply be interpreted as the comfortable imposing devastation on the deprived in their own, selfish interests.

At the same time, Dr Steffek's model is understandably a firm specific one. But factors such as the 'ripple effect' as other businesses fail, or wholesale dislocation in a particular state as unemployed individuals come to terms with their situation, ultimately require us to model the economy as a whole. As Greenspan has admitted, the financial crisis revealed that, 'macromodeling unequivocally failed when it was need most.'[27] The challenges with macroeconomic modelling lead to the risk that we retreat behind straightforward assumptions

26 A.S. Blinder *After the Music Stopped: the Financial Crisis, the Response and the Work Ahead* (New York: the Penguin Press 2013), at p. 12.

and ignore difficult ones. All that can be built are broad, conceptual models with abstract mathematical beauty waiting to be 'slayed' (as Thomas Huxley put it), by 'ugly fact'.[28] This concern has been at the heart of a great deal of post-crisis criticism of neo-classical economic thinking on a more general level.[29] It is one of the reasons why modern risk management forecasting failed to predict the scale of so-called 'fat tail' events such as the financial crisis: the effects of rare but significant events on the scale of probabilities. On a more parochial level the financial crisis provides a neat illustration of this risk. Famously, financial institutions modeled their 'value at risk' or VAR. Those who designed these models were probably well-aware of their limitations, particularly that they were not intended as a model for running the business. But somewhere along the line many in positions of authority appear to have lost sight of the seriously limiting assumptions which bounded the usefulness of 'VAR' and to have come to see it instead as a prescription to live by. The crisis revealed to us all the dangers of relying on simplistic models. Overall, then, although the costs and benefits can be framed as economic issues rather than, say, communitarian concerns,[30] and would seem capable of being included in Dr Steffek's model, they are in reality somewhat imponderable in many complex situations, and it is not at all clear how we can practically quantify them. Put shortly there is a risk that we 'sacrifice realism to mathematics,'[31] or to put it another way that we arrive at 'grossly fallacious, if superficially plausible, assessments.'[32]

Not only is Dr Steffek's model a firm specific one, but it also does not really engage with the question of capital flows across borders. CMU focuses not only on reducing the cost of capital but also on increasing the availability of capital by encouraging the free flow of capital among Member States, and from investors based outside the European Union. However, a significant challenge here is the natural home bias of the investor. This was obvious even to Adam Smith, who (in the only place in *Wealth of Nations* where the phrase 'invisible hand' actually appears) counselled against protectionist measures on the basis that the investor's home bias rendered them unnecessary:

27 A. Greenspan, *The Map and the Territory: Risk, Human Nature, and the Future of Forecasting* (New York: The Penguin Press, 2013) at p. 7.

28 Thomas Huxley, 'Biogenesis and Abiogenesis' (presidential address at the British Association 1870) cited in Greenspan *The Map and the Territory* ibid., at p. 151.

29 Ibid., at p. 188–190.

30 For an excellent overview of communitarian theory see M. Sandel, *Justice: What's the Right Thing to Do?* (Penguin Books 2010), at pp. 220–221.

31 R. Skidelsky, *Keynes: The Return of the Master* (London: Penguin, 2009), at p. 82.

32 D.M. Winch, *Analytical Welfare Economics* (Middlesex, England: Penguin 1971), at p. 156.

He generally, indeed, neither intends to promote the public interest, nor know how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.[33]

In the CMU project, divergent laws are seen as contributing to this challenge, as they encourage investors' home bias by raising the costs of due diligence and the risks of legal uncertainty. In a relatively recent article, Franken broadly divides states into dominant states (which export capital) and dependent states (which import it).[34] In Franken's thesis, a dependent state has an incentive to transplant laws from the dominant state not so much because the normative concerns of corporate law identify that those laws are superior to the current laws of the dependent state, but rather simply because they are already understood by the financiers from the dominant state, so that those financiers will not be required to due diligence and understand a new regime before investing. Against this backdrop, many aspects of the CMU project appear increasingly influenced by the laws of the United States, given the depth of the finance market in that jurisdiction and the promise of inward investment. This leads to new questions about the reality of universalising corporate law, given the complex interactions between different aspects of corporate law, between corporate law and other law such as labour law and consumer law, between corporate law and the local social and political context and between corporate law and the overall institutional environment, all of which fall outside the scope of this essay. For our purposes the crucial point is that CMU is not only concerned with reducing the cost of capital but also with the availability of capital, and that implicates different concerns for the process of law making and law reform.

Things become even more complicated if we engage seriously with the political motivation for the rescue of Chrysler. It is easy to discount this as political expediency: if Chrysler fails then the mid-West will suffer and voters will defect from the party in power. Framed in this way, the policy is driven by an overtly political, short term view, with no conceptualizing of the best option to be preferred in the long-run. But in casting the objective in this way, we are making one sort of value judgement. If we reframe the issue such that in twenty-first century US society it is no longer seen as acceptable for one part of the country to suffer short-term, terrible losses in order to increase the

33 A. Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* R.H. Campbell and A.S. Skinner (Oxford: The Glasgow Edition of the Works of Adam Smith 1976) at IV ii 4, p. 456 cited in J.Z. Muller, *The Mind and the Market: Captialism in Western Thought* (New York: Anchor Books) at pp. 65–66.

34 S. Franken, 'Cross-border Insolvency Law: A Comparative Institutional Analysis' (2014) 34 Oxford Journal of Legal Studies 97.

welfare of US society at large over the long run, and the government is responding to this value judgment in US society, then we have an entirely different view of the objective of the policy. It is a twenty-first century equivalent of Victorian society's outcry against utilitarianism as a guiding principle in urban industrialization,[35] and the demand to temper the 'blind operation of the market economy.'[36] It can readily be accepted that by rescuing Chrysler some of the efficiency of the competitive markets in which Chrysler operates are undermined. But it is perfectly possible to make a particular distributional value judgment, which determines that it is more important to protect the workers of Chrysler and the communities in which it is embedded from the consequences of failure than to ensure that the competitive equilibrium is not jeopardized, without a wholesale rejection of the principles of free markets. Indeed, it may be part of the process by which a general commitment to free market values is legitimated. It is the function of the political process to make these sorts of value judgments,[37] and to decide how different imperatives interact, although once the value judgment has been made, other disciplines such as corporate law can assist in determining how it can best be fulfilled.

A further note on this can be added, once again, from the financial crisis. In his excellent work on the financial crisis, Alan Blinder has highlighted what he calls 'the strangest legacy' of the period: 'The stunning combination of *policy success* and *political failure*.'[38] By this he means that the extraordinary intervention by the authorities does broadly seem to have worked (it does seem that things could have been much worse) but that the electorate is not prepared to accept it. Professor Blinder attributes this to two things. The first is a total failure to understand that if the bailout terms were seen to be too generous they would simply outrage the public, so that the bailouts involved shares with low dividend rates, no outright ban of dividend payments to shareholders, no explicit requirements to maintain or increase lending volumes, no commitment to address housing foreclosures and only minimal restrictions on executive compensation.[39] Secondly, there was a complete failure to explain clearly to the public what had happened and why the authorities were acting in the way that they were. The result has been a public awakened 'in a foul mood.'[40] Professor

35 See, for example, D. Winch, 'Mr Gradgrind and Jerusalem' in S. Collini, R. Whatmore and B. Young (eds) *Economy, Polity and Society: British Intellectual History 1750–1950* (Cambridge and New York: CUP 2000).

36 P. Thompson, *The Making of the English Working Class* (Narmondsworth 1968) pp. 64, 376 cited in Winch ibid., at p. 252.

37 See, for example, D,M, Winch, *Analytical Welfare Economics* (Middlesex, England: Penguin Books 1971), at pp. 25–30.

38 Blinder (n 26), at p. 438.

39 Ibid. This list is taken from p. 202.

40 Ibid., at p. 291.

Blinder then shows how this has given rise to a serious backlash, leaving 'many observers wondering whether the U.S. government would be able to mount such an extensive and complex rescue should the music stop again.'[41] This is relevant to our account because it shows that politics matter. In the end, in a democracy, political leaders must carry the electorate with them, or the wider consequences for public policy will be more damaging than the short run concessions.

The 'inter alia'

Dr Steffek's paper also includes a small, but crucial, qualification: that the cost of capital is, *inter alia*, determined by the costs of company law and corporate insolvency law. Here the devil is in the '*inter alia*' detail. Notwithstanding an extensive literature, the precise influence of company law and corporate insolvency law on the cost of capital remains highly contentious. For example, scholars have justified the insolvency priority of secured credit on the grounds that it increases the availability and reduces the price of financing – in other words, that it reduces the cost of finance in Dr Steffek's model.[42] But in his path finding work Alan Schwarz has challenged this analysis, arguing that either lower pricing for secured credit should be compensated by higher pricing elsewhere, or that it involves a transfer of risk from secured (powerful) creditors to unsecured (weaker) ones.[43] In the empirical finance literature, the relationship between interest rates and the presence of collateral is somewhat murky. At first sight, the intuition would be that the presence of security should make the loan safer, and thus reduce the cost of capital. However, Rodano et al, drawing on Berger and Udall, note that banks may require collateral from borrowers they consider riskier, so that in practice collateral can be associated with both higher and lower rates.[44] Choi and Triantis propose an even more complex relationship between price and collateral, in some ways reversing the relationship, in seeking to explain the relatively well documented observation that amounts of collateral pledged increase when interest rates are higher. They argue that an increase in the interest rate attracts a riskier pool of

41 Ibid., at p. 344.

42 T. Jackson and A. Kronman, 'Secured Financing and Priorities Affecting Creditors' (1979) 88 Yale L.J. 1143.

43 A. Schwarz, 'Security Interests and Bankruptcy Policies: A Review of Current Theories' (1981) 10 J. Legal Stud. 1

44 G. Rodano, N. Serrano-Velarde and E. Taratino, 'The Causal Effect of Bankruptcy Law on the Cost of Finance' available at http://ssrn.com/abstract=1967485, at pp. 9–10, citing A.N. Berger, G.F. Udell, 'Collateral, Loan Quality and Bank Risk' 25(1) Journal of Monetary Economics 21–42.

borrowers, and that lenders may respond to this by flexing what they call the nonprice terms of the loan such as strengthening the collateral in order to differentiate less risky borrowers from risker ones (because riskier borrowers are less willing to pledge assets as collateral).[45]

Choi and Triantis's inquiry seeks to propose a more nuanced answer to the relationship between prevailing market interest rates and prevailing levels of collateral than the practitioner intuition that the relationship is dictated by swings in bargaining power between lenders and borrowers – it's the market stupid! In my own work, I have touched on the extent to which different approaches to valuation in financial distress *ex post* influence capital structure *ex ante*, finding important differences in the capital structures of leveraged bond deals in the UK and the US during the course of work on the high yield bond market.[46] Happily, this was an incidental discovery and, although I wondered in passing whether the comparatively less favourable conditions for junior bondholders in the UK legal regime than in Chapter 11 in the US had had a causal effect, I did not make much of it. This was all to the good because the prevailing view since then seems to be that the availability of (cheaper) all senior deals in the UK at the time was a function of market conditions and not the detail of insolvency or restructuring law.[47] Put shortly, the point is that it is difficult to unpick the legal effects from other effects, such as selecting between borrowers, types of financing (a refinancing of an existing debt structure or an M&A structure), or the liquidity cycle. More recently AFME produced a report considering the potential gains from reform of insolvency law.[48] A detailed economic annex prepared by Frontier Economics does seek to demonstrate a relationship between bond pricing and the robustness of insolvency law. But it also notes that:

The focus of the estimation is on 'vanilla' bonds, i.e. non-callable, zero-coupon bonds issued in home currency. Other types of bond are not analysed, as it is difficult to model these specific features within a general model, and unless these features are captured properly, their inclusion could bias the results.

45 A. Choi and G. Triantis, 'Market Conditions and Contract Design: Variations in Debt Contracting' 88 New York Law Review at pp. 105–106.

46 S. Paterson, 'The Adaptive Capacity of Markets and Convergence in Law: UK High Yield Issuers, US Investors and Insolvency Law' (2015) 78(3) Modern Law Review 431–460.

47 See *European Leveraged Loan Chart Book – 2Q2016* FitchRatings July 2016, at pp. 19–20 and *Leveraged Finance: Borrower-Friendly Credit Conditions Endure as the European Leveraged Finance Market Shrugs off Brexit Uncertainty* 8 August 2016 S&P Global Ratings.

48 AFME *Potential Gains from Reforming Insolvency Law in Europe* February 2016.

Thus we see once again the challenges with building a general model which is also comprehensive. Indeed, admittedly largely anecdotal evidence has suggested that, given the widely diverging approaches to corporate insolvency law's normative concerns which we see across Europe, we might expect to see greater divergence in the bond spreads of some countries from others than is actually the case.

The normative concern

There has been lively debate about the extent to which British economic growth has been held back by the lack of long-term financing at appropriate rates ever since the turn of the twentieth century.[49] The authorities have pointed to an apparent lack of regard by British banks for the needs of British industry, whilst British banks have repeatedly argued that lending to many businesses is simply not profitable.[50] After the so-called 'Big Bang' opened up competition in the City of London, and lenders began to compete on price across each other's spheres of influence, a new model of lending opened up (popularly known as 'distribution banking'). Instead of focusing on returns from lending, banks and other alternative lenders began to focus on transactions and transaction fees. This necessitated the reduction of transaction costs by restricting monitoring, improving tradability, encouraging diversification and developing hedging techniques to reduce risk on default. Above all, lenders began to focus on the role of leverage in improving returns.

For a good while it appeared as if this period of intense financial innovation had solved the uncompetitive problems of the past and would provide seemingly limitless liquidity for British business without risking financial stability. However, the real day of reckoning came when, notwithstanding their apparent depth, global reach and diversification, the short term funding markets (notably the interbank market and the commercial paper market) seized up completely once serious concerns about the quality of the assets which had been financed took hold.[51] Once this happened one of the principal things which provided investors with confidence, market liquidity, disappeared increasing concerns about default.[52] This was particularly acute because some

49 R.C. Michie, *The City of London: Continuity and Change, 1850–1990* (Hampshire: Macmillan 1992), particularly the summary, at pp. 3–11.

50 D. Kynaston, *The City of London: Volume III Illusions of Gold* (Chatto & Windus, London 1999), at p. 7.

51 H. Davies *Can Financial Markets Be Controlled?* (Cambridge, England and Malden, USA: Polity Press, 2015), at pp. 1–2.

52 A. McNally *Debtonator* (London: Elliot and Thompson, 2015), at p. 48.

investors invested in the first place not on the basis of a proper investment appraisal, but rather because they were confident that a liquid market would always exist which would enable them to sell their investment.[53] As Greenspan reflects, 'The institutions were led astray by the mistaken belief that the tight bid-ask spreads in financial markets at the top of the boom were an indication of the persistent availability of liquidity.'[54] Some came to believe that there had been a structural shift in financial markets which assured them of permanently liquid markets. But even when most had been disabused of this market view, there was still the difficulty of 'calling' the moment of retrenchment. It is notoriously difficult to identify what will trigger loss of confidence in markets, and financial firms who call a downturn too early, and do not continue to invest in markets which (perhaps against the odds) continue to rise, are as vilified as those who call the downturn too late. This led to Chuck Prince's now infamous comment', "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." The comment seemed cavalier when the music stopped, and it cost Prince his job. But it reflected the reality of a highly competitive market in which a financial institution could no more be outdone by a braver competitor than by a more prescient one. Thus many felt they had no choice, even when the lie had been given to the myth of permanent liquidity, than to continue to invest aware that they may not be able to "anticipate the crisis in time to retrench,"[55] but in the hope that a diversified portfolio would enable them to manage the downturn when it came.

Yet when it came a familiar pattern arose: banks and other financial institutions unable to fund themselves in the short term market were forced to liquidate assets which rapidly achieved fire sale prices (or were not saleable at any price) and to call in loans from other institutions, depositors became concerned about the safety of institutions and runs on deposits follow.[56] Major investment banks had sailed "into the financial storm with financing that depended on a level of liquidity that was about to vanish."[57] A classic liquidity and capital crisis rapidly developed. Whilst the derivatives markets should have gone some way to maintaining confidence that protection was in place if the underlying

53 What Keynes called a "liquidity fetish"; see A. McNally (n 52), at pp. 47–48. For a general discussion of the role of influences on behaviour other than credit assessment see J Black, 'Reconceiving Financial Markets – From the Economic to the Social' 13(2) (2013) JCLS 406–407.

54 Greenspan, *The Map and the Territory* (n 27) at p. 39.

55 Ibid., at p. 71.

56 CM Reinhart and KS Rogoff, *This Time is Different: Eight Centuries of Financial Folly* Princeton and Oxford: Princeton University Press, 2011), at p. 144.

57 Greenspan, *The Map and the Territory* (n 27), at p. 103.

assets defaulted, derivatives turned out to be far from a panacea and actually exacerbated some aspects of the liquidity crisis as collateral securing open positions fell in value, and as it transpired that banks had funded many players through the derivatives market without requiring the posting of sufficient margin, in each case leading to swinging margin calls.[58] In short, the hedging which the derivatives provided for a defaulting book was more limited than it had appeared in stable markets, and it became clear that this had led many financial institutions to miscalculate the overall risk of their book.[59]

In another recent paper,[60] I have pointed to a growing body of literature which explores the role which our reliance on debt played in contributing to the crisis.[61] The changing political landscape in Britain (notably the decline of a clearly identified working class loyal to a labour government in all states of the world) reduced the credibility of redistributive policies. Thus successive governments sought to build London as a financial centre for the world as a solution for the long-run decline of productivity in the British commercial sector, and facilitated borrowing as a method of equalising standards amongst the population. Yet as a result the only visible benefit of the boom years for that part of the population which is seriously economically and culturally left behind has been a mountain of debt, and it is these people who have borne the brunt of the downturn. The trickle-down theory does not seem to have come to pass, but instead the rich have simply got richer. In a pre-crisis world, McClosky took issue with the idea of 'necessary excess'; that what 'a rich woman cannot consume, such as the diamond bauble that sits unworn at the back of her jewelry box' is not socially wasted because it put people to work.[62] Not so she says; it is not economic prudence to keep us all at work by 'spending on luxuries and working, working, working.'[63] So the financial crisis has left us with big questions. How can we ensure that the benefits of economic growth are shared more widely, in an age where straightforward redistributive

58 Davies (n 51), at p. 40; Katharina Pistor, 'Toward a Legal Theory of Finance: Retheorizing Law & Finance' (2012) Available at: http://works.bepress.com/katharina_pistor/17, at pp. 14–15 and 29.

59 D Awrey, 'Toward a Supply-Side Theory of Financial Innovation' (2013) 41(2) Journal of Comparative Economics.

60 S. Paterson, 'Collaborating in a Meritocracy and Post-crisis Reform' available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2801024.

61 See, for example, T. Piketty *Capital in the Twenty-first Century* (Cambridge, Massachusetts and London, England: The Belknap Press of Harvard University Press 2014); J Kay, *Other People's Money* (Profile Books 2015); A Mian and A Sufi, *House of Debt: How They (and You) Caused the Great Recession, and How We Can Stop It Happening Again* (Chicago und London: University of Chicago Press, 2015).

62 McClosky (n 4), at pp. 457–458.

63 Ibid., at p. 460.

policies attract little consensus and without dampening the entrepreneurial spirit? How do we fund the education necessary for a greater proportion of society to find meaningful work in our new economy? How do we provide the returns necessary to fund an ageing population in a low growth environment?[64] Is our economy too dependent on the financial sector? How do we address the productivity puzzle, if we are to try to drive economic growth as a solution? What sorts of employment opportunities are there for those left behind by the knowledge economy? How do we embed non-market norms as a disciplining force in modern markets?[65]

I would argue that one of the most profound lessons of the financial crisis was that leverage throughout the system is not the answer to these big questions. Or to put it the other way around, debt matters. Here lies the rub. I fear that if we promote minimising cost of capital to the first normative concern of capital markets union (and corporate law more generally), we will come inevitably to focus on lowering the cost of finance, and cheap debt is a significant factor which got us here in the first place. It is of course crucial that the commercial sector has access to keenly priced capital in order to flourish. But not everyone will flourish, and we know that capital structure choices are intrinsically related to the risk of failure.[66] So it is essential that we promote the right sorts of capital structure decisions. Thus, at the moment, we puzzle over whether to regulate the rise of so-called covenant lite loans (which do not have the usual package of financial ratios such as EBITDA: Net Debt which allow the lenders to monitor the borrower's financial health and to bring it to the negotiating table if its financial health worsens), or the reemergence of collateralised loan obligations after the crisis, notwithstanding the significant role which they played within it, or the growing 'shadow banking system' (largely unregulated alternative lenders who are filling the gap left by the retreating traditional banks after Basel III but whose links to the traditional banking sector are obscure).

64 F. Fukyama, *Political Order and Political Decay* (Produce Books 2015), at p.443 'But many biomedical technologies have succeeded in extending life spans at the expense of quality of life and sharply increased dependency on caregivers. In all developed countries, the costs of end-of-life care have accelerated faster than the overall rate of economic growth, and they are on their way to becoming the single largest component of government spending.'

65 M. Sandel, *What Money Can't Buy: the Moral Limits of Markets* (London: Penguin 2013).

66 J.R. Graham and M.T. Leary, 'A Review of Empirical Capital Structure Research and Directions for the Future', (2011) Vol 3 Annual Review of Financial Economics, particularly at p. 9.

If we wanted an example of how law can influence decision-making on financing choices, the financial crisis also provides specific examples. A growing volume of literature in the US has pointed to the way in which the so-called bankruptcy safe harbours contributed to the growth of the derivatives market and repo market.[67] Whether that is a good thing or a bad thing is highly contested,[68] and may depend on whether derivatives and repos are used to reduce risk in the system or may actually contribute to it. But the important thing for the present debate is that the decision to derogate from ordinary bankruptcy rules definitely facilitated their growth. So law does matter, and we must be clear about all of the consequences of our normative concerns.

At the same time, serious debate is emerging over the role of monetary policy in containing credit growth precisely because of the depth and length of the slump after the economic crisis, and the indisputable evidence of the problems with simply "mopping up" after the credit bubble has burst. Whilst many continue to subscribe to the view that monetary policy is not effective to deflate bubbles,[69] there is a growing view that the effects of financial crises caused by credit booms are so severe and damaging in the long term that we should consider using monetary policy to "lean against the wind" and counteract excessive credit growth.[70] These are highly complex and contested questions and they require detailed and specific policy review and responses. But they show a much greater appreciation after the financial crisis of the implications of excessive credit growth before it, and suggest that we should pause before we promote minimising the cost of capital as the primary objective of corporate law in general and capital markets union in particular without at least coupling that concern with the implications of policy choices for choice of capital structure. Thus ultimately my concern with minimising the cost of capital as the crown prince of normative concerns is that it is a rather blunt instrument if used as a tool of policy. In these interesting times I would suggest that we need to be alive to all the competing visions of corporate law and to weave our way through them, however challenging and messy that might sound.

67 See, for example, M.J. Roe and F. Tang, 'Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain' (2013) 99 Va. L. Rev. 1235.

68 For the English literature see P. Paech, 'The Value of Financial Market Insolvency Safe Harbours' (2016) 36(4) Oxford J of Legal Studies 855 and R. Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2016) 10 Brooklyn Journal of Corporate, Financial and Commercial Law.

69 Greenspan, *The Map and the Territory* (n 27), at p. 66.

70 F. Gourio, A.K. Kashyap and J. Sim, 'The Tradeoffs in Leaning Against the Wind' available at: faculty.chicagobooth.edu/anil.kashyap/research/papers/Tradeoffs_in_Learning_Aganot_one_wind_2016.pdf.

Conclusion

Ultimately, there is both a great deal and nothing at all between Dr Steffek's analysis and mine. I am all too ready to agree that reducing the cost of capital is *a* normative concern for corporate law generally, and CMU specifically. But I am not prepared to elevate it to *the* central organising normative concern. I base this conclusion on four things. First, in a manner somewhat after the ethicists in the Western tradition, given that right thinking adults can readily imagine different normative concerns for corporate law, some of which they may wish to see fulfilled at the same time, some of which they may wish to see accorded different weights in different circumstances, and all of which conflict, I am sceptical about the project of identifying a dominant normative concern for the whole of corporate law. I am bolstered in my scepticism by a strongly held belief that normative concerns are local both in geography (jurisdiction) and time (different ages of corporate law).

Secondly, I have a number of reservations about the possibilty of calculating the cost of capital and bringing it into account in some sort of cost/benefit analysis. My reservations stem in part from the breadth of Dr Steffek's concept of cost of capital which is at once necessary (so that everything which should be brought into account is included in the calculation) and at the same time undermines his thesis (because it makes the task of calculation impossible). It also stems in part from doubt as to the validity of the neoliberal economic idea of facilitating the (re)allocation of resources to highest and best use as a panacea; in part by the need to (yet relative impossibility of) extend the calculation beyond the specific firm; in part by the implications of focusing on the flow of capital across borders as well as within borders; and in part by the political need, on occasion, to mediate the effects of the free market without entirely abandoning a free market ideology.

Third, Dr Steffek's qualification that the cost of capital is *inter alia* determined by the costs of company law and corporate insolvency law is a linguistically minor but practically highly significant caveat, and I am more doubtful about the depth of the relationship between cost of capital and law than he is. And finally, I wonder whether a superior normative concern for the cost of capital seems rather out-of-date in light of the lessons of the financial crisis. Thus Dr Steffek and I can readily agree on 'a'; we remain divided only by 'the'.