Lenders as Monitors of Risk Devolution

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In March 2020, during the first wave of the COVID-19 pandemic in the United States, my fiancée worked as a trainee doctor in New York's public hospital system. When the severity of the pandemic became clear and the city began to lock down around us, we decided to isolate in our separate apartments. Our only meetings during that first month were my weekly walks across Manhattan to bring her groceries.

One grey evening in mid-April, torrential rain forced me to break from this ritual and hail a ride through an app. As I climbed into the van, the driver thanked me – although he had been driving since 6:00 a.m., I was one of the few passengers he had found. Eager, I am ashamed to say, to change the subject, I complimented him on the plastic barrier between the front and back seats that he had clearly installed himself. "Oh, I'm being very careful," he told me. "I can't afford to be sick!"

The rest of the ride passed in silence. I exited the car on 1st Avenue, next to Bellevue Hospital. Across the street, travelling nurses brought into New York City on temporary contracts to bolster the overwhelmed medical staff assembled refrigerated morgue tents in the gardens.

This essay is written in the context of the ongoing COVID-19 pandemic which has killed millions worldwide and seen the kind of widespread emergence of risk that would have been barely imaginable a few years ago. Entire industries have been suspended on a global scale, and millions of businesses have been closed by government order.

My driver, the travelling nurses and tens of millions of other workers across the world are forced to navigate the pandemic through a web of short-term contracting that presents serious ethical issues. These contingent contracts range from highly detailed and highly compensated month-long contracts for the travelling nurses to my point-and-click 10-minute contract with my driver. However, both the nurses and the driver fall outside the context of traditional employment and bear significant individual risks.

As the Observatoire de la Finance research group noted after the 2008 financial crisis, liquidity in markets can conceal the erosion of crucial but intangible social and economic infrastructure — trust, loyalty, and patience. (Observatoire de la Finance, 2008). Similarly, unfair allocations of risk can be invisible during times of prosperity. When risks materialise in a crisis, however, the ultimate bearers of those risks become apparent. This presents unique ethical issues when risk is devolved to "smallholders"; poorly-diversified individuals whose primary source of income involves leasing their labour or property either directly or through thinly-capitalised companies. The ethical issue is simple: during good times the distribution of risk can be invisible to ordinary people, and sophisticated companies can get away with shifting quite a lot of risk to smallholders. When a crisis emerges, these smallholders go bankrupt or go hungry.

This risk devolution is not inevitable, however, and finance practitioners are well-positioned to rein in some of the worst abuses. In the first part of this essay, I describe the risk-pooling function of a traditional firm and outline how this is eroded by the growing trend of smallholder risk devolution. Next, I argue that finance structures play a key role in incentivising such risk-shifting, and that debtholders are well-suited to police smallholder risk devolution because it presents structural risks to the interests of debt. Finally, I suggest mechanisms for debtholder monitoring of risk devolution.

Risk devolution in the contingent economy

The modern economy is dominated by "firms" — organisations of individuals and assets under the direction of a specific legal entity that participates in market transactions externally but allocates resources internally through command-economy structures rather than market mechanisms. In an early and highly influential account of the origin and purpose of firms, Coase theorised that firms exist because pricing discrete assets or activities can be less efficient than pricing control rights over those assets. Creating a firm through asset acquisition and employment contracts avoids costs associated with discovering prices, negotiating "complete" contracts, and forecasting future needs in the face of uncertainty. An employer who buys an employee's labour rather than paying for discrete actions, or a company that buys a supplier's company rather than paying for discrete products, does so to avoid the cost of negotiating and pricing "complete" contracts. (Coase, 1937).

Grossman and Hart describe incomplete contracts in Coasian firms as creating two kinds of rights: "specific rights" that are allocated by the terms of the contract and "residual rights of control" — the power to fill in gaps. In an integrated firm (as opposed to a collection of contractors pricing each action), ownership of the firm is synonymous with control of the residual rights; everything that is not explicitly traded by contract. (Grossman & Hart,1986, p. 716). By buying residual control rights, firms act as employee risk-pooling mechanisms.

However, "gig economy" structures disaggregate these risk pools by leaving residual rights with gig economy contractors. This presents serious ethical issues because it erodes the coinsurance function of the firm and discretely devolves significant risk to contingent workers.

Firms as an employee risk-pooling mechanism

One often overlooked function of firms is that they provide a level of diversification to employees who sell their residual control rights to the firm. This "diversification" function is not limited to international firms or complex and internally diversified companies. At a basic level, any firm provides a hedge against uncertainty for employees. The most obvious forms of coinsurance between employees are often prescribed by law or explicitly included in employment contracts; sick leave, vacation and other flexible work structures rely on a firm's capacity to reassign employees to cover new tasks. However, even employees in jurisdictions with limited labour protections usually derive a level of immediate coinsurance through their sale of residual control rights to the firm, because collective employment can function as a macro- and microeconomic hedge. Employment at a global firm may reduce an employee's exposure to national-level economic volatility. Employment at a firm that produces multiple products can protect workers against volatility in product demand; a worker can simply be asked "to move from department Y to department X" (Coase, 1937, p.80). This hedge functions at every scale. If more grocery store customers decide to check out with Clerk A than Clerk B in a Coasian firm, Clerk B will not be paid less for that hour of work.

This hedge comes from the "incomplete" nature of traditional employment contracts, which imprecisely define a general range of duties and compensation terms. This flexibility provides a fundamental level of certainty for the employees entering into such contracts: show up to work, perform the work that you are assigned, and receive the specified compensation. At the same time, the owners of the firm hold not just residual control rights but the accompanying residual risk, and entrepreneurs are tasked with filling in these gaps productively.

Risk in the contingent economy

The gig economy inverts the relationship between entrepreneurs and workers. Workers in the gig economy do not resemble employees in a Coasian firm because they are not subject to regular employment contracts but instead paid for discrete tasks. In such circumstances, most of the terms left unspecified by the contract are open to being "filled in" by the contingent worker. This economic arrangement is not new or historically unusual, although the rise of the platform economy makes such contingent arrangements highly visible. Pay-for-performance, also called piecework or the "putting out system", was a staple of the early industrial revolution. It is also not unique to "contractors". The Brookings Institution recently highlighted the rise of "just-in-time" scheduling practices that schedule shifts on short notice based on expected demand and devolve similar risks to employees of otherwise Coasian firms (Guyot & Reeves, 2020).

With the retention of residual rights, however, comes erosion of coinsurance. A delivery worker or cab driver working under a gig economy contract is entirely subject to the risk of fluctuations in their work. A worker who is healthy or sick, quick or slow, lucky or unlucky, is fully exposed to the variability in their output. Browning notes that many contingent workers attempt to mimic the coinsurance function of the Coasian firm by diversifying their labour: working for multiple platforms, maintaining traditional employment in addition to "gig economy" employment, or pooling resources with a spouse. (Browning, 2021, p.28). This internal diversification is very similar to the strategies employed by poor workers faced with precarious economic circumstances and a high risk of variability across the globe. However, this diversification comes with attendant costs, including a strong disincentive to specialise in the absence of a concentrated demand for that specialisation. At the same time, the entrepreneur is protected by this risk devolution. When workers are fully contingent the entrepreneurs who hire them can benefit from the same insurance mechanism that protects slow or sick workers in a Coasian firm: a "portfolio" of available contingent workers.

Ethical issues raised by risk devolution

Specific ethical issues are raised when risk is devolved to smallholders. The defining features of a smallholder that raise ethical concerns are (1) thin capitalisation and (2) an individual reliance for daily sustenance on contracted assets (individual labour, a small plot of land, a personal car) that are difficult to employ in a diversified way. These features raise ethical concerns because they result in materialised risk either passing through to the community as an externality or being absorbed by the smallholder, who is forced to reduce his or her own consumption.

A fundamental principle of transactional ethics is that costs should not be imposed on actors who are not parties to the transaction. These externalities are both inefficient, because they incentivise transactions that are value-destroying to society as a whole but profitable for their participants, and unethical, because they unilaterally impose harm on unwilling third parties. Browning notes, however, that thinly-capitalised smallholders have few options other than to pass on harms as externalities, whether by seeking bankruptcy protection against their creditors or by relying on the social safety net. (Browning, 2021, pp. 32, 38). Entrepreneurs who devolve risk in turn derive some benefit from these externalities. An agrobusiness firm contracting with small farmers, for example, may indirectly benefit from the unpaid labour of a farmer's relatives or economic development incentives directed towards poor farmers. Sophisticated entrepreneurs drafting short-term contracts may also devolve or externalise risks that only appear over time, such as environmental risks from soil degradation or pollution.

In transactions with smallholders, even value-neutral risk-shifting presents serious ethical concerns. In the abstract, a transaction with a value of $120 (a day's work at New York City's minimum wage) has the same expected value as a transaction with an even chance of producing a return of $0 or $240. However, here finance elides the human cost of risk devolution. As Dembinski notes, "[n]umbers disguise the rough edges and gaps in reality by postulating an ideal world in which all things are perfectly divisible and perfectly interchangeable". (Dembinski, 2017, p.26). When a risk allocated to a smallholder materialies, it directly impacts their quality of life. United States Congressman Danny Davis, discussing deferred unemployment benefits, put the issue bluntly: "You can't eat retroactively." (Davis, 2020).

An observer might argue that smallholders can and do price these risks into the fees they charge for contingent employment. This explanation, however, assumes a level of sophistication and true choice between the parties. In reality, risk devolution often occurs in the context of effective monopsony or unequal access to legal systems and advice. Even if perfectly equal negotiation occurs, the "negotiated risk" theory does not explain why a truly unanticipated risk such as

COVID-19 should be allocated to smallholder contractors versus equity.

The role of debt in restraining risk devolution

Finance specialists reading this article may well ask why they should care (or more charitably, how they can help). Ultimately risk devolution is a product of a company's labour agreements and local regulation, and specific labour terms are rarely set in financing agreements. However, smallholder risk devolution has ethical implications for finance specialists because debt instruments place external pressure on managers during crises such as the COVID-19 pandemic in which devolved risks materialise. At the same time, covenants and terms of debt instruments may provide a decision-making framework that shapes even the unrelated behaviour of debtor companies in response to crises.

Equity representatives may have difficulty making credible commitments to protect the interests of smallholders when distributing risk in the face of an emerging crisis. Debtholders, however, are well-positioned to restrict risk devolution to smallholders because the interests of debtholders and contingent workers align in certain crisis situations, as debtholders have an interest in preserving the enterprise value of the distressed company (as opposed to the value of the company's equity).

Debt contracts as ethical instruments

The drafting of a debt contract represents what Dembinski describes as a key ethical "structuring moment" for the debtor (Dembinski, 2017, p.22). Debt contracts create transaction costs that limit the scope of future behaviour and reorder the existing incentives of management. At the same time, debt contracts create new rules and institutions to shape the ethical intuitions of decision-makers. As such, ethical considerations should be expressly considered during the negotiation of significant debt contracts.

Debt instruments influence the behaviour of the parties to such instruments by creating transaction-cost barriers around certain activities. Gilson famously described transactional lawyers as "transaction cost engineers" who add value to economic exchanges by reducing transaction costs through the creation of private codes of governance; that is to say, contracts (Gilson, 1984, p.253). However, contracts also *create* transaction costs as mechanisms for enforcement. The cost of breaching a condition of a debt instrument is often the acceleration of the underlying debt. Certain legal mechanisms increase this cost; for example, a collateralised lender may seize accounts, assets, or even third-party contracts to enforce its right to repayment.

These synthetic transaction costs not only limit prohibited actions but influence second-order decisions as well. Hart and Moore (1995) note that equity holders may structure debt precisely to discipline managers of firms by requiring them to generate and disgorge short-term free cash flows. The manager of a restaurant closed by COVID-19 who must choose between paying workers or paying debt will have to consider the costs associated with default. That decision will be influenced by the structure of the debt. A manager may prioritise payments differently if the lender can enforce its claims directly by seizing the restaurant's accounts.

Finally, contractual restraints in debt instruments provide an ethical lodestone that will steer future decision-making processes. Tung (2009) demonstrates that the terms of debt instruments have a significant impact on day-to-day corporate decision-making; arguably more so than the preferences of independent boards. This may be in part because the private legal ordering created by transactional lawyers provides clear guidelines for managerial activity. Mayer notes that managers often "exist in an artifactual context" where legal standards and institutions "are sometimes *created* by common practice" (Mayer, 2001, p.217). While financial actors may sometimes intentionally breach contracts, clearly established legal duties — even unenforceable ones — can have a significant impact on moral intuitions and may make otherwise abhorrent ethical decisions seem permissible (Huang, 2017). Our hypothetical manager, now choosing whether to default on his or her advertising bill (owed to a freelance artist) or plumbing bill (owed to a large corporation), may be guided by mortgage covenants that require the ongoing maintenance of the restaurant and say nothing about advertising.

Isn't this management's problem?

At first glance, the managers of firms seem like the obvious monitors of risk devolution to smallholders. Even accepting the significance of debt as an ethical structuring tool, managers are charged with structuring smallholder contracts *and* debt contracts. However, managers are limited by the extent to which they owe legal, contractual, and cultural obligations to other constituencies - most commonly equity.

Equity representatives may genuinely want to include risk-protection mechanisms in contracts out of concern for the orderly operation of the enterprise or the ethical treatment of their counterparties. However, the interests of equity and labour dramatically diverge in a crisis such as the COVID-19 pandemic, when cash flows dry up and a manager is forced to cut costs to preserve the equity value of the company. Faced with imminent bankruptcy, formal codes of ethics and internal norms may be insufficient to persuade managers to police their own compliance with debt covenants.

Greenfield described the challenge of integrating ethical standards into well-defined corporate managerial roles when he noted that "[t]he 'role morality' of executives, created by law and norm, creates for them the overarching and urgent goal of producing financial returns for shareholders, focused in the short term. That goal subordinates other matters" (Greenfield, 2008, p.429). Even well-meaning equity representatives will struggle to effectively advocate for smallholder protections in debt instruments if such protections conflict with what many perceive as the "primary purpose of corporate governance" — profit-maximisation for equity (Henderson, 2012, p. 1414). Without fundamental changes to the systems in which managers work, ethical duties that impose costs or lengthen decision-making time horizons beyond those prioritised by equity investors will often be overpowered by cultural and legal duties owed to equity. Ultimately, as Greenfield puts it, "[w]e cannot expect people to act as Saints in a devilish system" (Greenfield, 2008, p.435).

Debt as a monitor of risk devolution

In contrast to equity holders, debtholders are well-positioned to monitor risk devolution. Debtholders (and in particular, banks) are already adept at monitoring the activities of borrowers and using sophisticated covenant structures to curb excessive risk-taking by management. Additionally, structural risks to employees and smallholders present structural risks to the interests of debtholders as well. The reason for this alignment is simple: a company's contracts are significant operating assets, and lenders have an interest in preserving those assets in crises.

As previously discussed, private lenders often have more tools at their disposal than independent directors do to exercise control over the day-to-day operations of a borrower. Bank lenders are especially adept at monitoring borrower cash flows and net worth. Similarly, lenders regularly prevent borrowers from undertaking fundamental changes to their business and have the capacity to monitor the internal governance of borrowers by requiring disclosure, mandating periodic reporting and even sitting directly on the board of the borrower entity. Ultimately, sophisticated lenders have a large suite of tools available to enforce covenants once they are in place.

Debtholders are also incentivised to monitor risk devolution to smallholders because contracts, including employment contracts and contingent worker contracts, are key operating assets. While ordinarily debtholders might welcome structures that shift risk away from the core business of the borrower towards third parties, the dynamics and analysis of smallholder risk devolution are different precisely because of the thin capitalisation that characterises smallholders.

Well-capitalised counterparties may be able to absorb or insure against shifted risks, but smallholders by their nature will be harmed — maybe irreparably — by significant materialised risks. In the same way that covenant-heavy loans often prevent borrowers from skipping maintenance on valuable real estate to save short-term cash, lenders have every incentive to ensure that unexpected volatility or risk is not shifted to smallholders in a way that damages the value of the smallholder contracts. If a lender knew *ex ante* that our hypothetical borrower's restaurant would shut down for a month due to quarantine regulations and then reopen, the lender would have every incentive to make sure that equity, not smallholders, absorbed the cost of that crisis.

Limits to lender monitoring

Despite the alignment of interests between debtholders and smallholders, there are serious limitations on lender monitoring of smallholder risk devolution that should prevent finance ethicists from viewing it as a panacea. Fundamentally, the limits of lender monitoring are set by the simple fact that debtholders' interests will not always align with smallholder interests.

Debtholder interests may diverge from smallholder interests in crises where bankruptcy is imminent or where the cost of smallholder replacement is low. While smallholder contracts are assets of the borrowing company, they are not infinitely valuable. The lender's assessment of the "restaurant lockdown" scenario described above will depend in part on the replacement cost of the smallholder contracts, and in part on whether and when the lender expects to step into the equity role. If the cost of contract maintenance is less than the cost of contract replacement, debtholders may abandon smallholders.

Debtholders may also be overly-conservative in their monitoring and reduce risk that smallholders would prefer to bear. Some contingent workers prefer the flexibility and higher per-hour salaries that they can command outside of the typical firm structure. Given the diversity of smallholders we should not be surprised to find a diversity of risk preferences. Lender-influenced governance, on the other hand, may be risk-averse to a fault (see, for example, Tung, 2009).

Finally, third-party risk devolution controls offer only limited protections for smallholders because the terms of debt contracts are simply transaction costs, not insurmountable barriers. The normal outcome of a covenant being violated is renegotiation, not acceleration and foreclosure. Ultimately, covenants just give lenders an *option* to restrain borrower activity, which is often traded for better terms (Tung 2009, pp.26-27). While the terms of the debt agreement will set an ethical baseline for discretionary decision-making, a lender may still be "bought off" by a borrower who determines that renegotiation with the lender is cheaper than protecting smallholders.

Making lender monitoring work

Risk devolution to smallholders occurs globally, across a dazzling array of industries. The travelling nurses and the taxi driver mentioned in the introduction were each operating as contingent workers, but probably faced very different contractually devolved risks. This diversity of circumstance, and the accompanying diversity of contracts devolving such risk, means that there is no universally applicable tool that will allow lenders to appropriately restrain managers from devolving unacceptable risks to smallholders.

However, traditional covenant-heavy finance provides three clear models for monitoring risk devolution: (1) event triggers based on *force majeure* clauses; (2) volatility triggers; and (3) procedural protections against risk devolution.

Force majeure clauses

The COVID-19 pandemic, as an unanticipated catastrophe that falls outside any party's control, suggests an immediate model for lender monitoring: *force majeure*. Conceptually, *force majeure* clauses (also called "Act of God" clauses) are meant to capture large-scale "no-fault" risks such as floods, earthquakes, and wars, that prevent the terms of a specific contract from being performed. When a *force majeure* event materialises, it excuses the nonperformance of certain covenants and obligations made impossible by the event. Traditional *force majeure* clauses would need to be modified to match specific lender concerns regarding risk devolution; for example, to contain an assurance that the borrower will continue paying smallholders whose performance is barred or rendered unnecessary by a *force majeure* event. This mimics the logic described previously: that at a bare minimum the costs of truly unforeseeable risks should be borne by equity rather than undiversified smallholders.

However, the *force majeure* model has an inherent flaw: it is not very sensitive. Classic *force majeure* events are catastrophic disasters and tend to be interpreted quite strictly. Any *force majeure* trigger that limits risk devolution would have to be specifically tailored to the devolving contracts. For example, contingent workers may be equally harmed by a government-mandated business closure and a lack of customers caused by pandemic fears, but the second circumstance would not fall within most *force majeure* clauses. This lack of sensitivity would seriously limit the usefulness of *force majeure* clauses as smallholder protections, although at a minimum such clauses would protect smallholders (and their contracts) during extreme disasters.

Variance triggers

Debtholders can also use "variance triggers." Structured as contingent events of default and sometimes combined with concepts such as "material adverse effects", a variance trigger is treated as an event of default if a measured outcome changes within a certain time following a potentially material event. For example, a classic variance trigger may provide for an event of default if a borrower's credit rating drops following a significant sale of assets. This trigger would function to discourage such a borrower from making sales that could reduce its creditworthiness.

The success of a smallholder variance trigger would hinge on the specific variable tested. Too-specific variable tests may be subject to "gaming" without careful construction. For instance, if the lenders set a standard for weekly smallholder pay to protect against income variance, a borrower could maintain a high per-smallholder payment amount by changing the way it devolves risk, terminating select smallholder contracts rather than reducing overall pay. Variance triggers tied to pay would lean heavily on sophisticated lenders' ability to closely monitor and direct borrower cash flows.

Procedural protections against risk devolution

Finally, lenders may decide to take an active role in firm governance by establishing broad governance principles that restrain risk devolution. As previously discussed, the disadvantage of mandating specific terms is that it is expensive to negotiate and articulate *ex ante* rules that capture an uncertain future, and rigid yet incomplete rules are subject to manipulation. This is the underlying idea behind the Coasian firms: rather than negotiate "complete" contracts that capture all future contingencies, parties may choose to bargain for control rights over future uncertainty.

The downside of procedural risk frameworks is that hands-on approaches to governance can be expensive for lenders and may be resented by borrowers. If borrowers can find loans on the market with less-burdensome covenants, they may reject significant constraints on their managerial discretion (Tung 2009).

Conclusion

The importance of protections for contingent workers has been made evident by the COVID-19 pandemic, which has resulted in the widespread materialisation of delegated risks and caused economic catastrophe for contingent workers across the globe. Fortunately, lenders' interests align with those of smallholders in curbing the worst abuses of risk devolution: those in which unanticipated risk is allocated to smallholders rather than absorbed by equity. Lenders can offer smallholders access to a range of contractual tools from covenant-heavy financing that can be repurposed to limit risk devolution.

There are clear limits to debtholder monitoring, and it is crucial to recognise that debtholder monitoring of smallholder risk devolution is merely a proxy for universally-applied statutory protections. However, in a time "in which culture and community are eroded by rapid economic change," practical reforms that tie the interests of lenders and smallholders together can provide a clear and achievable goal for finance ethicists (Mayer, 2001, p.219). As COVID-19 recedes and economies reopen, it is incumbent on every participant in the post-pandemic economy to learn from the failures of pre-pandemic systems. Aligning debtholders with smallholders in the post-pandemic world to rein in managerial risk devolution will build structural resiliency and strengthen our financial system against future risks that have yet to be imagined. •

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