TOO BIG TO CARE?: FINANCIAL CONTRACTS AND THE PROBLEM OF TRANSACTIONAL ASYMMETRY

TT Arvind*

I
INTRODUCTION

The policy debate on enhancing financial inclusion for small and medium enterprises (SMEs) has focused primarily on SMEs' access to finance and the steps that can be taken to improve it.[1] This preoccupation is also visible in the literature on SME finance where, again, the primary focus has been on policy measures and frameworks that increase the availability of external finance for SMEs.[2] At one level, this focus is both understandable and logical. It has been clear for at least three decades that SMEs are more dependent on banks for finance than are larger firms, and that this reflects SMEs' greater need for that specific form of finance in comparison with larger firms.[3] Broader forms of finance such as supplier finance or leasing are insufficient to fully meet the requirements of SMEs for finance.[4]

In its fullest sense, however, financial inclusion raises issues that go well beyond the bare issue of SMEs' *access* to finance. As the World Bank's definition of financial inclusion emphasizes, financial inclusion as a concept and policy

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* Professor of Law, York Law School, University of York, U.K. Email: t.t.arvind@york.ac.uk. An earlier version of this paper was presented at a symposium at Durham University on 28 May 2019. I am grateful to participants in the symposium, the editors of this special issue, and the editors of *Law and Contemporary Problems* for their comments on various iterations of this paper.

1. The primary focus of the World Bank's Financial Inclusion Global Initiative, for example, has been on its "Universal Financial Access 2020" goal, even though, as discussed below, its own definition of inclusivity incorporates a much broader range of features (see *infra* note 5). *Financial Inclusion Global Initiative (FIGI)*, WORLD BANK (July 18, 2019), https://www.worldbank.org/en/topic/financialinclusion/brief/figi [https://perma.cc/C9NY-3QJE].

2. *See, e.g.*, Allen N. Berger & Gregory F. Udell, *A More Complete Conceptual Framework for SME Finance*, 30 J. BANK. & FIN. 2945, 2946 (2006) (emphasizing "a causal chain from government policies to a nation's financial institution structure and lending infrastructure" as "significantly affect[ing]" SMEs' access to credit).

3. *See* Mitchell A. Petersen & Raghuram G. Rajan, *The Benefits of Lending Relationships: Evidence from Small Business Data*, 49 J. FIN. 3, 5, 36 (1994) (noting that SMEs concentrate borrowing from few lenders, predominantly banks, and this may be a deliberate choice to "concentrate their borrowing so as to improve availability of financing").

4. Thorsten Beck, Asli Demirgüç-Kunt & Vojislav Maksimovic, *Financing Patterns Around the World: Are Small Firms Different?*, 89 J. FIN. ECON. 467, 485 (2008).

agenda brings together three distinct, and not necessarily correlated, issues: (1) that of ensuring access to useful and affordable finance, (2) that of ensuring that the available financial products and technologies meet the actual needs of financial users, and (3) that of ensuring that the delivery of finance is both responsible and sustainable.[5] Although the focus of much of the existing work has understandably been on the first of these, the second and third also matter. In particular, there is an obvious need to assess what it means for SME finance to be responsible and sustainable; whether current systems of SME finance meet that standard; and, if not, what might be preventing them from doing so and what sort of policy measures or frameworks might be necessary to deal with the underlying issues.

This Article seeks to contribute to that debate. Principally, it argues that the sustainability and resilience of SME finance depends to a far greater degree on the actual terms of the financial contracts under which banks lend to SMEs than is usually acknowledged, and that those terms affect SMEs particularly strongly in times of financial crises. Prior research has shown that bank finance acts as a constraint on SMEs in a way it does not for large firms,[6] that these constraints have a non-trivial impact on SME performance in a manner that is amplified during crises,[7] and that the nature and extent of this impact are strongly influenced by the actual lending behavior and practices of banks.[8] Prior research has also shown that SMEs have a limited ability to influence the terms on which they access finance, particularly when they are dealing with rule-based, rather than more discretionary relationship-based, lending.[9] This Article argues that these issues reflect a deeper underlying factor, namely, that SME lending is typically governed by terms which give banks the ability and a strong incentive to engage in conduct that is permitted by their contracts, but that nevertheless

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5. *Financial Inclusion Overview*, WORLD BANK, (Oct. 2, 2018) https://www.worldbank.org/en/topic/financialinclusion/overview [https://perma.cc/2NH2-7PRS] ("Financial inclusion means that individuals and businesses have access to useful and affordable financial products and services that meet their needs – transactions, payments, savings, credit and insurance – delivered in a responsible and sustainable way.").

6. *See* Thorsten Beck Asli Demirgüç-Kunt, Luc Laeven & Vojislav Maksimovic, *The Determinants of Financing Obstacles*, 25 J. INT'L MONEY & FIN. 932, 939 (2006) ("Small firms report significantly higher financing obstacles than medium firms, and both report higher financing obstacles than large firms."); Thorsten Beck, Asli Demirgüç-Kunt & Vojislav Maksimovic, *Financial and Legal Constraints to Firm Growth: Does Firm Size Matter?*, 60 J. FIN. 137, 170 (2005) ("[T]he extent to which financial and legal underdevelopment and corruption constrain a firm's growth depends very much on a firm's size . . . the smallest firms . . . are consistently the most adversely affected by all obstacles").

7. Murillo Campello, John Graham & Campbell R. Harvey, *The Real Effects of Financial Constraints: Evidence from a Financial Crisis*, 97 J. FIN. ECON. 470, 486 (2010).

8. Patrick Behr & Lars Norden, *Financial Constraints of Private Firms and Bank Lending Behavior*, 37 J. BANKING & FIN. 3472, 3484 (2013).

9. Jens Grunert & Lars Norden, *Bargaining Power and Information in SME Lending*, 39 SMALL BUS. ECON. 401, 415 (2012). On the distinction between rule-based and relationship-based lending, see Geraldo Cerqueiro, Hans Degryse & Steven Ongena, *Rules Versus Discretion in Loan Rate Setting*, 20 J. FIN. INTERMEDIATION 503, 510 (2011) (listing variables impacting rule- versus relationship-based lending).

constrains, disrupts, and potentially causes considerable financial distress to SMEs during economic downturns.

There is a strong parallel between the concerns of this Article and those of the literature on relationship lending. Since the 1990s, an important theme in the literature on SME finance has been the argument that the financial needs of SMEs and, thus, the broader goals of financial inclusion and sustainability for SMEs, are better served by relationship lending, where decisions on financing are based on soft, qualitative data and judgements formed through relationships and interaction, rather than hierarchical lending, where decisions are made at arms' length and are primarily based on hard, quantitative data.[10] This Article is in sympathy with that literature, which it seeks to extend by analyzing the impact of relationship-based lending not just on banks' decisions whether or not to lend to a borrower, but also on their broader approach to managing the lender-borrower relationship. In doing so, this Article does not seek to argue that the issues it discusses are more significant than the issue of access to finance. Rather, it seeks to argue that they are *also* problematic and need to be addressed in any policy agenda directed towards financial inclusion. In recent years, there have been several measures taken to protect SMEs from lender overreach, such as the US Small Business Reorganization Act of 2019,[11] and the idea of financial inclusion offers a promising basis on which to integrate them into a more complete policy agenda.

Part II of this Article outlines the basic factual underpinnings of the argument, namely, that banks' loan management practices have a negative effect on the overall resilience of SMEs in times of crises, and that these practices are enabled and facilitated by the terms and conditions of contracts. This Part focuses on two case studies, both exploring lender practices in relation to SMEs, and cumulatively demonstrating that these practices have a broader impact on financial inclusion affecting a wider range of persons beyond the SMEs themselves.

Part III argues that a proper understanding of the problem requires an engagement with contract theory and, in particular, relational contract theory. It identifies two theoretical models of SME lending, one of which treats the contracts that underpin them as simple, discrete, and wholly un-relational contracts, while the other treats them as relational contracts whose effect is to create frameworks of private governance that supplant and supersede the priorities, interests, and outcomes embedded in public governance frameworks. This Part argues that the relational model is superior in its ability to explain the nature of financial contracts and provide a diagnosis of their impact.

Part IV then argues that addressing the resulting problems requires the law to take an active role in governing governance, by explicitly favoring and seeking

10. *See* Jose M. Liberti & Atif R. Mian, *Estimating the Effect of Hierarchies on Information Use*, 22 REV. FIN. STUD. 4057, 4082 (2009) (noting "greater hierarchical distance makes it difficult to use subjective information and favors the use of objective information instead").

11. Small Business Reorganization Act of 2019, Pub. L. No. 116-54, 133 Stat. 1079.

to encourage relational lending. Drawing on the literature on corporate pluralism and negotiated economies, this Part outlines a policy framework and agenda that can successfully address the issues this Article identifies while also avoiding the dangers of overregulation. Part V summarizes and concludes the discussion.

II
FINANCIAL CONTRACTS AND FINANCIAL INCLUSION: THE IMPACT OF BANK–SME ASYMMETRY

There is now a considerable body of work examining different models of lending to SMEs. Much of this literature has focused on two types of finance, or two "lending technologies," as they have come to be called: relationship lending on the one hand, and hierarchical lending on the other.[12] Relationship lending is usually associated with smaller local or community banks, whose decision-making is informed by soft and less easily quantifiable information that has been gathered by individual loan officers[13] over the course of a sustained lending relationship with the borrower in question.[14] Hierarchical lending, in contrast, is usually associated with larger banks, or with foreign banks; who make lending decisions based on models informed by hard, quantified data, with soft information playing a much more limited role; and who have loan officers with a lower degree of discretion.[15]

Relationship lending and hierarchical lending are better regarded as ideal types, rather than strict empirical categories.[16] As such, they do not describe rigidly defined types of lending, but point instead to sets of characteristics or elements that are commonly seen in different lending techniques used by banks. More recent work has shown that banks can and do deploy them in complementary ways, and that there is considerable diversity within each category.[17] Nevertheless, research also suggests that the categories do in fact encapsulate important differences in the way banks approach SME lending, even

12. Berger & Udell, *supra* note 2, at 2946.

13. Hirofumi Uchida, Gregory F. Udell & Nobuyoshi Yamori, *Loan Officers and Relationship Lending to SMEs*, 21 J. FIN. INTERMEDIATION 97, 120 (2012).

14. Allen N. Berger & Gregory F. Udell, *Universal Banking and the Future of Small Business Lending*, *in* FINANCIAL SYSTEM DESIGN: THE CASE FOR UNIVERSAL BANKING 558, 621–24 (Anthony Saunders & Ingo Walter eds., 1996).

15. Atif Mian, *Distance Constraints: The Limits of Foreign Lending in Poor Economies* 61 J. FIN. 1465, 1465 (2006).

16. The concept of an "ideal type" was formulated by Max Weber, who posited them as idealized constructs that model certain aspects of social reality in a manner that enables us to draw broader inferences about the empirical phenomena to which they refer, even though in practice most objects treated as an instance of an ideal type will deviate from the ideal. MAX WEBER, THE METHODOLOGY OF THE SOCIAL SCIENCES 90–103 (Edward A. Shils & Henry A. Finch trans. & eds., 1949).

17. *See* Francesca Bartoli, Giovanni Ferri, Pierluigi Murro & Zeno Rotondi, *SME Financing and the Choice of Lending Technology in Italy: Complementarity or Substitutability?*, 37 J. BANKING & FIN. 5476, 5484 (2013) (exploring the possibility that alternative lending technologies can "be complementary, i.e. used in combination for the same firm"); Berger & Udell, *supra* note 2, at 2946 ("An important oversimplification in the current framework is the way that lending technologies are often categorized into two types . . . this characterization is fundamentally flawed.").

if the boundaries between them are somewhat less bright-line than they were initially thought to be. This body of work originates from efforts to understand the implications of transaction costs and information asymmetries on financial markets and, specifically, the impact of the informational opacity of SME finances to banks seeking to assess their creditworthiness.[18] A strong relationship between a borrower and a bank, and the concomitant ability to form judgments based on qualitative, rather than quantitative information, was seen as an obvious and efficient way to overcome these information asymmetries[19] and avoid the credit rationing to which prevailing theory predicted imperfect information would otherwise give rise.[20] Early scholars in this tradition therefore focused on assessing whether community banks ought to play a central role in SME lending because of their superior ability to engage in relationship lending.[21] More recent work has focused on whether newer advances in risk modelling have enabled hierarchical or transactional lending—and, thus, larger banks—to play a broader role in SME finance, notwithstanding the informational opacity of SMEs.[22]

Overwhelmingly, however, the focus of the literature has been on evaluating the two as *lending* technologies, approached from the perspective of their effectiveness at providing access to finance. Research carried out after the financial crisis has, in contrast, indicated that relationship lending and hierarchical lending also produce different outcomes in relation to the *subsequent* course of the banker-borrower relationship. For example, it has been shown that hierarchical lending is likelier than relationship lending, which is based on soft data, to result in credit rationing to SMEs in times of crisis.[23] Studies have also identified a strong "flight home" effect across borders, and even a "flight to headquarters" effect within a single country, in which lending patterns associated with hierarchical lending are more likely to result in banks cutting or eliminating

18. Gregory F. Udell, *What's in a Relationship? The Case of Commercial Lending*, 51 BUS. HORIZON 93, 95 (2008); Petersen & Rajan, *supra* note 3, at 28.

19. *See* Jeremy C. Stein, *Information Production and Capital Allocation: Decentralized Versus Hierarchical Firms*, 57 J. FIN. 1891, 1892–93 (2002) (discussing the advantages of lending models based on soft information exchange in the lender-borrower relationship).

20. Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 409 (1981).

21. Jonathan A. Scott, *Small Business and the Value of Community Financial Institutions*, 25 J. FIN. SERV. RES. 207, 222 (2004).

22. Thorsten Beck, Asli Demirgüç-Kunt & María Soledad Martínez Pería, *Bank Financing for SMEs: Evidence Across Countries and Bank Ownership Types*, 39 J. FIN. SERV. RES. 35, 47 (2011); Berger & Udell, *supra* note 2, at 2946–47.

23. Bartoli et al., *supra* note 17, at 5480.

facilities for SMEs during a crisis.[24] Relationship lending, in contrast, appears to reduce SME credit rationing or, at least, to mitigate its effects.[25]

Crucially, and as discussed in more detail below, reports commissioned by lawmakers and legislators in the United Kingdom suggest that this difference also applies to other dimensions of the lender-borrower relationship, and in particular to the way in which banks engage with covenants in loan agreements with SMEs. Loan agreements incorporate a range of financial covenants, which typically serve a dual purpose. Firstly, they enable the lender to monitor the performance of the borrower during the period of the borrowing.[26] Secondly, because the breach of a financial covenant constitutes a technical default giving the lender significant powers of control, financial covenants also enable lenders to limit credit loss either directly by assuming control, or through renegotiation by wielding the threat of assuming control as a bargaining tool.[27]

There are sound reasons for loan agreements to have such provisions. Financial contracts are typically incomplete contracts in that they can neither foresee nor provide for even a reasonable proportion of the eventualities that might arise during the contract's term. The use of flexible terms, including unilateral powers, is an established way of dealing with this issue.[28] In the context of financial lending, covenants providing for a combination of monitoring and control are a particularly efficient way of dealing not just with incompleteness,[29] but also with the broader issue of uncertainty.[30] Nevertheless, the nature and extent of the control given to lenders by these provisions also creates serious risks for SMEs. SMEs have limited negotiating power in hierarchical lending and face a significantly higher degree of switching costs due to their informational

24. *Compare* Mariassunta Giannetti & Luc Laeven, *The Flight Home Effect: Evidence from the Syndicated Loan Market During Financial Crises*, 104 J. FIN. ECON. 23, 42 (2012) (discussing the "flight home effect" as part of the reason international financial markets collapsed in the 2008 financial crisis) *with* Hans Degryse, Kent Matthews & Tianshu Zhao, *SMEs and Access to Bank Credit: Evidence on the Regional Proposition of the Financial Crisis in the UK*, 38 J. FIN. STABILITY 53, 62 (2018) (discussing the "flight to headquarters" effect on SME financing in the post-crisis period).

25. Matteo Cotugno, Stefano Monferrà & Gabriele Sampagnaro, *Relationship Lending, Hierarchical Distance and Credit Tightening: Evidence from the Financial Crisis*, 37 J. BANKING & FIN. 1372, 1385 (2013).

26. Mitchell Berlin & Jan Loeys, *Bond Covenants and Delegated Monitoring*, 43 J. FIN. 397, 398 (1988).

27. Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 151 (1979).

28. Avery W. Katz, *Contractual Incompleteness: A Transactional Perspective*, 56 CASE W. RES. L. REV. 169, 180 (2005).

29. Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 490–92 (1992).

30. Peter R. Demerjian, *Uncertainty and Debt Covenants*, 22 REV. ACCT. STUD., 1156, 1193 (2017).

opacity[31] and the sunk costs of providing information to lenders.[32] These characteristics raise a significant risk that lenders may opportunistically use the powers they acquire under financial contracts to extract a financial windfall in situations where the risk that the SME will fail or be unable to meet its debts is not high. The powers conferred on lenders by financial covenants in effect act as a "hostage," in the sense identified by economist Oliver E. Williamson in his classic article,[33] but with the risk of opportunistic behavior by the hostage-taker—the bank—remaining wholly unmitigated.

Two sets of cases from the United Kingdom involving lender behavior vis-à-vis SMEs demonstrate that this risk is real and that it can have significant adverse consequences not only for borrowers, but also for a broader community of stakeholders. The first set of these cases arose following the post-2007 financial crisis out of the actions of the Royal Bank of Scotland (RBS) in connection to loans it had made to SMEs.[34] Prior to the crisis, the RBS had made itself the largest lender to SMEs in the United Kingdom.[35] Part of its approach to SME-lending involved referring SMEs to one of its internal turnaround units if they exhibited signs of financial difficulty. The task of these units was to assess whether the business was viable and, if it was, to restore it to financial health drawing on expertise within the turnaround unit.[36] If, however, the borrower's business was judged not to be viable, the RBS would move to taking recovery action against the borrower, a process that usually led to the business being liquidated.[37]

The process of turnaround, however, was not necessarily run in the borrower's interest. The RBS's internal documentation emphasized the need to

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31. *See* Carole Howorth, Michael J. Peel & Nicholas Wilson, *An Examination of the Factors Associated with Bank Switching in the U.K. Small Firm Sector*, 20 SMALL BUS. ECON. 305, 306 (2003) (explaining that credit rationing is likelier where there are informational asymmetries, from which SMEs are likelier to suffer). Subsequent developments are likely to have increased switching costs, in that hierarchical lending to SMEs now typically involves a suite of loan and non-loan products, thus increasing the cost of switching. Augusto de la Torre, María Soledad Martínez Pería & Sergio L. Schmukler, *Bank Involvement with SMEs: Beyond Relationship Lending*, 34 J. BANKING & FIN. 2280, 2292 (2010).

32. *See* Cotugno et al., *supra* note 25, 1376–77 (discussing how credit crises encourage banks to lend to better known borrowers, but incentives also exist for banks to apply worse loan prices to long-term borrowers who have higher switching costs and thus will not abandon the bank).

33. *See generally* Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983).

34. Three reports were commissioned to examine this crisis: LAWRENCE TOMLINSON, BANKS' LENDING PRACTICES: TREATMENT OF BUSINESS IN DISTRESS (2013) [hereinafter, TOMLINSON REPORT]; ANDREW LARGE, RBS INDEPENDENT LENDING REVIEW (2013) [hereinafter LARGE REVIEW], and PROMONTORY FINANCIAL GROUP, RBS GROUP'S TREATMENT OF SME CUSTOMERS REFERRED TO THE GLOBAL RESTRUCTURING GROUP: A REPORT UNDER SECTION 166 OF THE FINANCIAL SERVICES AND MARKETS ACT 2000 (2016) [hereinafter PROMONTORY REPORT]. The account in this article draws on the material set out in these reports.

35. LARGE REVIEW, *supra* note 34, at 24–25.

36. PROMONTORY REPORT, *supra* note 34, ¶ 4.2.2.

37. LARGE REVIEW, *supra* note 34, at 47.

treat customers "fairly and sensitively,"[38] but the primary purpose of turnaround was to assist the RBS in securing its own financial position. Turnaround was a largely unregulated activity, and there were in consequence few external constraints on how the RBS treated borrowers.[39] Although there was a potential congruence of interests between the RBS and its borrowers in situations where the RBS's own interests were best served by assisting the borrower to return to a sustainable financial position (internally called "return to satisfactory" or RTS), it cannot be assumed that the RBS would invariably perceive its interests as lying in RTS, even in situations where RTS was factually possible.[40] As a result, SMEs sent into the turnaround process always faced the risk that the RBS's turnaround units would prioritize other commercial considerations over returning the borrower to health and would, in consequence, act in a way that exacerbated the SME's financial distress sending a potentially viable business into insolvency. It was precisely this risk that eventuated in the aftermath of the crisis.

One of the RBS's turnaround units was the Global Restructuring Group (GRG). This was originally a small, specialized unit,[41] but after the post-2007 financial crisis it came to play a central part in the process by which RBS managed its debt. The number of SMEs referred to the GRG—or its local U.K.-based unit, the British Restructuring Group—rose from 738 in 2008 to 1,497 in 2009, and a total of 5,900 SME cases were referred to it between 2008 and 2013.[42] There were two reasons for the increase. Firstly, the crisis had led to many SME customers breaching financial covenants.[43] Secondly, it led to a change in the RBS's appetite for risk. After the crisis, the RBS sought to reduce its exposure to certain sectors and certain types of customers, including SMEs.[44] The GRG became one of the instruments deployed to achieve this end, with referrals to it being used to address poor lending or pricing decisions.[45] As a result, the process of turnaround came to be used not just to rehabilitate and restore distressed customers to financial health, but also to be a source of revenue for the RBS through the GRG's margin fees and other revenue-generating mechanisms, as well as to protect the RBS's capital, reduce its exposure, and help it meet relevant metrics.[46] Accordingly, the GRG's performance was measured not in terms of SMEs saved, but in terms of its performance in helping the RBS achieve its goal of reducing facility levels, and its contribution to the RBS's overall income.[47]

38. PROMONTORY REPORT, *supra* note 34, ¶ 1.38 (quoting GRG PROCEDURES AND GUIDANCE MANUAL (2010)).

39. *Id.* ¶ 2.1.56.

40. LARGE REVIEW, *supra* note 34, at 47, 51–52.

41. PROMONTORY REPORT, *supra* note 34, ¶ 2.1.46.

42. *Id.* ¶ 2.1.47.

43. *Id.* ¶ 2.1.40.

44. LARGE REVIEW, *supra* note 34, at 29.

45. PROMONTORY REPORT, *supra* note 34, ¶ 2.1.42.

46. *Id.* ¶ 3.1.3.

47. *Id.* ¶ ¶ 3.1.29–3.1.40.

The result was that SMEs were repeatedly and frequently treated in ways that exacerbated their financial difficulties. In practice, the GRG placed little emphasis on turnaround, or on returning customers to financial health and mainstream banking through genuine business restructuring.[48] Relationship managers within the GRG were often not provided with the tools that would be necessary to support an analysis of turnaround options.[49] Instead, the GRG strove to reduce facility levels without regard to the impact on borrowers, and to increase profits by increasing prices and exploiting leverage opportunities in non-transparent ways.[50] SMEs referred to the GRG were hit with management fees, arrangement fees, exit fees, risk fees, and waiver fees, among others.[51] The GRG also invented new instruments which adversely affected the position of the shareholders of SMEs. One example was the "upside instrument." In form, this instrument was designed to obtain an appropriate return for the increased risk the RBS incurred in continuing to support businesses showing signs of financial distress or falling outside current lending criteria,[52] and it was in theory linked to the growth in the value of the borrower's shares.[53] In practice, however, it was treated as simply another stream of income[54] delinked from the borrower's actual needs, and was often used opportunistically to create a windfall profit rather than to determine an appropriate price or an appropriate return based on any analysis for the actual risk the RBS had incurred.[55]

This conduct would have been less problematic had it related primarily to distressed businesses that were likely to have to close. However, subsequent reviews showed that approximately 66% of the SMEs referred to the GRG were viable and could have been turned around.[56] Despite this, 92% of these viable SMEs were treated inappropriately,[57] and in 16% of cases the SME borrower suffered material financial distress as a result of its treatment.[58] Viable SMEs were pushed on a journey towards administration, receivership, and liquidation. Adverse outcomes were particularly likely in trading-based businesses, with 22% of viable trading-based businesses sent into turnaround experiencing material financial distress as a result of the RBS's actions.[59] From the perspective of financial inclusion, this trend is a cause for concern. Although the issues raised by the RBS's practices do not touch on the issue of access to finance, it is hard to

48. *Id.* ¶ ¶ 4.2.63–4.2.65.
49. *Id*. ¶ 4.2.46.
50. *Id.* ¶ 4.2.61.
51. *Id.* ¶ 4.2.78.
52. *Id.* ¶ 5.2.7.
53. *Id.* ¶ 5.2.24.
54. *Id*. ¶ 5.2.30.
55. *Id.* ¶ 5.2.47.
56. *Id.* ¶ 6.2.53.
57. *Id.* ¶ 6.2.85.
58. *Id.* ¶ 6.2.53.
59. *Id.* ¶ 6.2.57.

see how the practices in question could be said to be either responsible or sustainable.

The second set of cases from the United Kingdom demonstrate that the impact of these practices reached beyond the borrower itself, to also encompass a broader category of stakeholders. The failure of Farepak serves as a good illustration.[60] Farepak was a Christmas savings company. Christmas savings companies in the United Kingdom appeal primarily to poorer and unbanked families and operate by convincing these families to make periodic payments into the savings scheme over the course of a year, which is put towards the cost of a Christmas hamper and Christmas shopping vouchers provided by the company. Farepak had a long history as a Christmas saving scheme, but it ran into financial trouble in 2006. Its directors made what a court would later describe as "genuine strenuous efforts" to save the group and, in particular, protect the interests of its depositors.[61] A number of proposals were put forward which offered a material prospect of preserving the business, some of which involved significant sacrifices by shareholders.[62] However, the company's bankers, HBOS, refused to permit any of these to be put into effect, which they were entitled to do under the actual terms of the loan agreement. The view HBOS took was that insolvency was not only inevitable, but it was—from HBOS's perspective—the preferred outcome, as their charge over Farepak's assets would enable them to "maximise their return as quickly as possible" in an insolvency.[63] As a result, and following what the judge described as "a policy of playing hardball, of which it appeared to be proud, and conceding nothing,"[64] HBOS used its contractual powers to compel Farepak to continue to collect deposits from savers until such time as there was enough money in Farepak's bank account to fully satisfy its debt to HBOS, at which time HBOS took Farepak into insolvency.[65] While HBOS fully recovered its money, Farepak's depositors recovered next to nothing.

III
CONTRACTUAL POWER AND TRANSACTIONAL ASYMMETRY: MOVING TOWARDS A DIAGNOSIS

Three broad themes emerge from the literature and case materials discussed in Part II. First, hierarchical lending, a category into which both the RBS loans

60. The account presented here is taken from a Judge's Statement made by Justice Peter Smith in the case of *Secretary of State v. Fowler*. *Secretary of State v Fowler and others: Day 15 – Judge's Statement*, COURTS & TRIBUNALS JUDICIARY (JUNE 21, 2012), https://www.judiciary.uk/wp-content/uploads/JCO/Documents/Judgments/farepak-judges-statement.pdf [https://perma.cc/5MTB-67ZD] [hereinafter *Farepak Judge's Statement*].

61. *Id.* ¶ 20.

62. *Id.* ¶ 119.

63. *Id.* ¶ 112.

64. *Id.* ¶ 20.

65. *See id.* ¶ 118 (explaining that HBOS was entitled to continue requiring collection of deposits, knowing that, if insolvency occurred, the depositors would not be repaid and they would instead benefit the bank).

to SMEs and HBOS's loan to Farepak fall, has effects on financial inclusion that stretch well beyond the narrow issue of access to finance, which has been the main focus of the literature. The manner in which banks approach hierarchical lending, however, also has non-trivial effects on the sustainability and resilience of borrowers and other stakeholders.

Second, ordinary approaches to financial regulation are not in and of themselves well-equipped to deal with the challenges that hierarchical lending creates for SMEs over the lifetime of the loan. In both sets of U.K. cases discussed above, the regulator had a somewhat limited power to take action against the bank, because the case related to commercial lending,[66] but they also appeared reluctant to use the powers they did have.[67] In the RBS cases, for example, the regulator initially refused to publish a report it had commissioned on the RBS's practices, and the report did not ultimately become public until it was obtained by a Parliamentary committee which proceeded to publish it.[68] In the Farepak case, the response of regulators was not to proceed against the bank, but instead to prosecute and seek to disqualify the directors of Farepak. The full nature of the bank's conduct only became public when the judge presiding over the trial took the unusual decision while acquitting the directors to make a judicial statement setting out how it was in fact the bank's conduct that had brought about the company's collapse and the directors' inability to protect the depositors' money.[69]

The third, and arguably most significant, theme that emerges from the discussion in this Part relates to the role of contracts and contract law. The lender's ability to exercise a high degree of control over the borrower, especially in ways that were both opportunistic and to the detriment of the borrower, had an entirely contractual basis. This was emphasized by the judge hearing the Farepak action,[70] as well as by the reviews commissioned by the U.K. government

66. In evidence to the Treasury Committee of the House of Commons, Andrew Bailey—then the Chief Executive of the Financial Conduct Authority (the United Kingdom's main financial regulatory body)—repeatedly argued that the RBS's conduct lay beyond the perimeter of its regulatory powers at the time. Although he also accepted that the powers had since been amended to bring commercial lending within the scope of the FCA's authority, he took the view that it would be improper to apply that expanded power retrospectively. *See* TREASURY COMMITTEE, ORAL EVIDENCE: THE WORK OF THE FINANCIAL CONDUCT AUTHORITY, HC 475, Q11 (31 October 2017), data.parliament.uk/Written Evidence/CommitteeEvidence.svc/EvidenceDocument/Treasury/The work of the Financial Conduct Authority/Oral/72428.html [https://perma.cc/9M8F-XN9Q].

67. A report by the Treasury Committee in 2019 pointed out that the FCA did in fact have the power to take action even beyond the perimeter of regulation, albeit in a more limited way; and these limitations led it to prioritize its resources to focus on activities in the perimeter. *See* TREASURY COMMITTEE, THE WORK OF THE FINANCIAL CONDUCT AUTHORITY: THE PERIMETER OF REGULATION, 2017-19, HC 2594, ¶¶ 19–22, (2019) https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/2594/2594.pdf [https://perma.cc/5ZSN-KDW8] (discussing that the FCA's powers to act beyond the perimeter are limited and, consequently, FCA tends to focus on activities falling within its perimeter).

68. TIM EDMONDS, HOUSE OF COMMONS LIBRARY, DEBATE PACK NO. CDP-2018-093: DEBATE ON REDRESS FOR VICTIMS OF BANKING MISCONDUCT AND THE FCA, 2018, at 9 (U.K) https://commonslibrary.parliament.uk/research-briefings/cdp-2018-0093/ [https://perma.cc/EF9H-VURS].

69. *Farepak Judge's Statement*, *supra* note 60, ¶ 77.

70. *Id.* ¶ 120.

and the Financial Conduct Authority—the main financial regulator in the United Kingdom—into the RBS's lending practices. A key finding of these reviews was that the RBS's right to exercise a high degree of control over companies was wholly contractual. The lending contracts between the RBS and SMEs gave the RBS a wide discretion which let it use a technical breach as leverage over SMEs.[71] The reviews also found that a major factor underlying this level of control was that the nature of the interaction between SMEs and banks meant that the balance of power had tipped too far in favor of banks. There was no longer a level playing field for banking agreements, and the market did not let borrowers make informed decisions on risk and reward.[72] Contracts were imbalanced, and although there was a broad expectation that banks would exercise their contractual powers in good faith and in a fair, transparent, and reasonable manner,[73] this expectation had no basis in law and in practice things were often otherwise.[74] For example, there was evidence the RBS had used its contractual discretion to send businesses which were not in financial difficulties, but were simply in legal disputes with the RBS, into turnaround.[75] There was accordingly a need to give SMEs legal protection against "heavy handed, profiteering and abhorrent behaviour"[76] by banks, and to "rebalance the relationship between business and bank."[77] The reports also stressed the need to protect SMEs against unfair contract terms,[78] and to develop an industry code on how banks can best support customers in need of business support, especially in relation to protecting SMEs referred to turnaround divisions.[79]

The findings of the reviews point to a deeper issue with the role of contracts in SME lending, addressing which would require reconceptualizing the role and function of financial contracts in asymmetric lending transactions. Relationship and hierarchical lending represent not just different models of *lending*, but also different models of *contracting*. As proponents of relational contract theory have pointed out, legal understandings of contract can be classified as falling within one of two archetypes: the discrete contract and the relational contract. These map closely onto the ideal types of hierarchical and relationship lending, respectively, in that hierarchical lending treats the loan relationship as a discrete contract, whereas relationship lending treats it as a relational contract. In discrete models of contract, the terms of the transaction set out in the parties' formal agreement exhaustively describe the parties' relationship. A financial transaction in this view is simply an instance of market exchange, indistinguishable from a classic instance of market exchange such as a transaction for the sale of a natural

71. PROMONTORY REPORT, *supra* note 34, ¶¶ 2.2.6, 4.4.73.
72. TOMLINSON REPORT, *supra* note 34, at 19.
73. PROMONTORY REPORT, *supra* note 34, ¶ 2.2.7.
74. *Id.* ¶¶ 1.4–1.5.
75. *Id.* ¶ 4.1.15.
76. TOMLINSON REPORT, *supra* note 34, at 19.
77. *Id.* at 20.
78. PROMONTORY REPORT, *supra* note 34, ¶¶ 7.19–20.
79. *Id.* ¶¶ 7.19, 7.26, 7.28.

commodity.[80] A borrower seeks purchasing power, and acquires it from a willing lender in exchange for the payment of a price—in the form of interest—for the acquired purchasing power and the provision of security to the seller in the event that the price is not paid on time.[81] Because the relationship is simply one of exchange, everything that one needs to know about the relationship can be discovered in the terms of the contract.[82] In contrast, relational models of contracting treat the formal contract as being simply one manifestation of a broader relationship, which is fundamentally and inextricably bound up with broader social expectations and understandings.[83] Much like formal processes in relationship lending, formal terms in a financial transaction are treated as merely one dimension of a broader relationship, which are embedded in wider social expectations in relation to how the powers and claim-rights conferred by the contract on the borrower and lender will be exercised.

Crucially, relational contract theory can and does draw a distinction between the *exchange* element of a contract and the *relation* element of the transaction, and recognizes that they can have very different characteristics.[84] This has particular relevance to financial lending. There is a real sense in which a loan *is* about exchange and, to that extent the discrete model of the transaction is not incorrect as much as it is incomplete. As relational contract theory points out, in addition to the exchange element, the transaction also has a relation element whose character, in this case, is better described as creating a framework of private governance. In its broadest sense, governance can be understood as "the setting of rules, the application of rules, and the enforcement of rules."[85] It encompasses not just the rules of the game, but also the ability to steer the rules of the game.[86] It is precisely this setting, application, and enforcement of rules that the control provisions of loan agreements have in the lender-borrower relationship, and it is precisely the manner in which these powers were used that have been at issue in the cases discussed in this Part. In doing so, these contractual control provisions not only supplement but also seek to supplant and displace public frameworks of governance, such as those contained in bankruptcy law,

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80. *See* TT Arvind, *Law, Creditors and Crises: The Untold Story of Debt*, *in* LAW AND FINANCE AFTER THE FINANCIAL CRISIS: THE UNTOLD STORIES OF THE UK FINANCIAL MARKET 8, 25 (Abdul K. Aldohni ed., 2017) (explaining that the demand for debt can be met through a market purchase, in the same way that the demand for any other commodity can be met).

81. *Id.* at 25–26.

82. For a recent restatement of this position, see JONATHAN MORGAN, CONTRACT LAW MINIMALISM: A FORMALIST RESTATEMENT OF COMMERCIAL CONTRACT LAW 128–29 (2013) (describing how, in certain instances, a detailed contract can be used as a "coordinating tool" to overlay a trusting relationship which allows the relationship and the contract to be mutually reinforcing).

83. Ian R. Macneil, *The Many Futures of Contract*, 47 S. CAL. L. REV. 691, 713, 732–33 (1974).

84. *See* IAN R. MACNEIL, THE NEW SOCIAL CONTRACT 130 n.18 (1980) (reasoning that ignoring benefits of an exchange because the relation is perceived as unjust can lead to suboptimal results that could have been avoided if the benefit of the exchange was fully accounted for).

85. ANNE METTE KJÆR, GOVERNANCE 10 (2004) (emphasis omitted).

86. *Id.* at 7.

including in relation to the specific interests that those frameworks prioritize and the level of protection they grant the borrower.[87]

The distinction that relational models of transactions draw between the exchange-oriented and governance-oriented dimensions of financial transactions therefore helps provide a deeper diagnosis of the impact that lender control has on financial inclusivity in SME lending. The role played by contracts in facilitating the sourcing of lending through market exchange may be desirable, but that does not mean their role in facilitating the creation of private governance systems is desirable. Relational models of contracting are often described as if their goals are primarily normative, and as if they do no more than argue for courts to take a very different approach in dealing with cases that come before them. This court- and litigation-focused approach to discussing and evaluating competing models of contract reflects a broader trend in the way in which academic legal scholars approach contract law.[88] This approach, however, also places somewhat less emphasis on the way in which contracts are actually used in practice and, in consequence, on the regulatory and policy issues that arise out of such use.[89] Yet relational contract theory is also, and has always been intended to be, an analytical approach to studying the practices of contracting. The theory of relationality, when reduced to its most essential elements, does no more than assert that the study of legal and economic relations must be informed by the study of social relations and the expectations arising out of them.[90] It does not suggest that parties, when left to govern their own contractual relations, will necessarily behave in relationship-enhancing or relationship-preserving ways. As legal scholar Ian R. Macneil pointed out, contractual powers and terms have the potential to cause what he terms "disproportionate harm."[91] Macneil argued that contracting depends on an expectation of, and common belief in, continued future interdependence. This interdependence ensures that participants can only access a share of the surplus generated by exchange through bargaining, and that no participant in a contractual system has the power to unilaterally appropriate

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87. *See infra* Part IV.

88. *See, e.g.*, Avery Katz, *Taking Private Ordering Seriously*, 144 U. PA. L. REV. 1745 (1996) (discussing Cooter's and Posner's economic legal theories which debate private and centralized decision-making).

89. Stewart Macaulay describes this as being one of the key issues separating 'old' and 'new' legal realism. *See* Stewart Macaulay, *Contracts, New Legal Realism, and Improving the Navigation of the Yellow Submarine*, 80 TUL. L. REV. 1161, 1164–65 (2005) (stating the need for empirical studies of how the law is "working on the ground" to assess whether it is accomplishing its intended objectives); Stewart Macaulay, *The New Versus the Old Legal Realism: "Things Ain't What They Used To Be"*, 2005 WIS. L. REV. 365, 391–92 (2005) (stressing that a "bottom-up" approach fixes the traditional issue in legal academics that unless or until legal issues arise to the top tribunals, they tend to be overlooked by legal scholars).

90. Ian R. Macneil, *Reflections on Relational Contract Theory After a Neo-classical Seminar*, *in* IMPLICIT DIMENSIONS OF CONTRACT: DISCRETE, RELATIONAL AND NETWORK CONTRACTS 207, 208, 213 (David Campbell, Hugh Collins & John Wightman eds., 2003).

91. MACNEIL, *supra* note 84, 102–04.

an undue share of that surplus.[92] This belief, which he termed the "solidary belief," is foundational to the sustainability of any system of private ordering supported by contract. The solidary belief cannot survive if there is a widespread view among one set of participants that other participants in that system of private ordering are willing to cause disproportionate harm to achieve gains for themselves.[93]

The RBS and Farepak cases discussed above, and the strong public reaction to them, represent precisely such a situation. In those cases, the banks used their powers under financial contracts to achieve gains for themselves and were perceived as causing disproportionate harm to SME borrowers and the broader public. The rise of hierarchical lending as a source of SME finance[94] is likely to have exacerbated this trend, in as much as hierarchical lenders are likelier to take a less relational approach to SME borrowers,[95] whereas relationship lenders are likelier to take a relationship-preserving approach.[96] While discrete models of financial contract can avoid grappling with the implications of this disjunction by taking a commodified and exclusively exchange-based view of lending, relational models draw attention to the disjunction, and to its potential impact on financial inclusion vis-à-vis SMEs and on the integrity of financial lending more broadly.

This makes relational models of contracting superior to discrete models of contracting when it comes to understanding the challenges posed to financial inclusion by the transactional asymmetry between banks and SME borrowers and the manner in which that asymmetry is reflected in the governance of the relationship. In particular, if the analysis moves away from a court-centric analytical approach to a more practical transaction-based approach, a focus on the relational dimensions of financial contracts provides an analytical tool for studying both the "relational sanctions and private government" that underpin lender behavior vis-à-vis SME borrowers,[97] and the systemic issues raised by the patterns of social relations underpinning contractual relations for the sustainability and integrity of the systems of private ordering that these contracts support.[98]

Loan transactions between banks and SMEs not only embed an exchange in the form of the actual loan, but also a complex framework of governance that

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92. Ian R. Macneil, *Exchange Revisited: Individual Utility and Social Solidarity*, 96 ETHICS 567, 585-8 (1986).

93. *See* MACNEIL, *supra* note 84, 90–93, 102–04 (discussing the importance of trust and a belief in the "mutuality" of contract norms to support a stable, interdependent relationship among contracting parties).

94. *See* Berger & Udell, *supra* note 2, at 2946–47, 2952–53 (explaining differential lending opportunities and practices from small and large institutions); Beck et al., *supra* note 22, at 36–37, 40–41 (finding empirical support for the "new paradigm" of banks deploying arms-length lending technologies for SME finance and tending to disfavor soft data when evaluating loans).

95. Bartoli et al., *supra* note 17, at 5484–85.

96. Cotugno et al., *supra* note 25, at 1372–73, 1385.

97. Stewart Macaulay, *Relational Contracts Floating on a Sea of Custom? Thoughts About the Ideas of Ian Macneil and Lisa Bernstein*, 94 NW. U. L. REV 775, 804 (2000).

98. MACNEIL, *supra* note 84, at 64–70.

gives the lender considerable regulatory power over the SME. Where the lender behaves in a way that deemphasizes the lender-borrower relationship, the implications of its conduct not only affect individual borrowers, but also have the potential to cause disproportionate harm and, through doing so, undermine the basis of the system of private ordering on which the debt system depends. That, ultimately, is the challenge with which the law must grapple if it is to support financial inclusion for SMEs.

IV

GOVERNING GOVERNANCE: TOWARDS A NEW FRAMEWORK FOR FINANCIALLY INCLUSIVE SME LENDING

How, then, can the challenges identified in Parts II and III be addressed? One option is to focus on the regulatory potential of private law in general.[99] Yet, although such an approach can play some part in the overall legal approach to SME lending, it is unlikely to be sufficient in and of itself, as the example of the law of lender liability illustrates. The laws of a number of states in the United States grant a remedy against lenders to borrowers who have been harmed by opportunistic lender conduct by drawing on a number of different theories of liability, including breach of contract, course of conduct, implied duties of good faith, fraud, negligence, and fiduciary duty.[100] In practice, however, lender liability has been limited in a number of ways. A number of leading cases have involved lenders with heavy involvement in the day to day running of the business, playing an active part in boardroom battles, or in a relationship of trust and confidence with the borrower.[101] The most expansive readings based on

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99. On the argument that private law does have regulatory potential, see generally TT Arvind & Joanna Gray, *The Limits of Technocracy: Private Law's Future in the Regulatory State*, *in* PRIVATE LAW IN THE 21ST CENTURY 237 (Kit Barker, Karen Fairweather & Ross Grantham eds., 2017) (exploring the role of private law in an increasingly regulatory state).

100. *See, e.g.*, Alaska Statebank v. Fairco, 674 P.2d 288, 293 (Alaska 1983) (finding that Statebank's failure to release a deed of trust because the borrower had difficulties repaying unrelated obligations constituted a breach of the agreement); Pipken v. Thomas & Hill, Inc., 258 S.E.2d 778, 781, 787 (N.C. 1979) (finding that the lender did not have authority to make a loan that was promised a year prior to repudiation but did have authority to enter a binding contract which promised permanent lender placement); Wells Fargo Realty Advisors Funding, Inc. v. Uioli, Inc., 872 P.2d 1359, 1363–64 (Colo. App. 1994) (finding that the lender owed a contractual duty of good faith to the borrowers and breached that duty); Crystal Springs Trout Co. v. First State Bank, 732 P.2d 819, 827 (Mont. 1987) (discussing that investors in a borrower can expect truthful representations from lenders and punitive damages are appropriate "where there is a sufficient showing of fraud"); MSA Tubular Prods., Inc. v. First Bank & Tr. Co., 869 F.2d 1422, 1424–25 (10th Cir. 1989) (discussing MSA's claims of negligent misrepresentation of creditworthiness where the bank misrepresented information to the borrower); Cowan Bros. v. American State Bank, 743 N.W.2d 411, 420, 422 (S.D. 2007) (recognizing that a lender may owe fiduciary duties to a borrower if they have a relationship of trust and confidence, but that substantial control over the business is not sufficient to impose fiduciary duties).

101. *See, e.g.*, A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 290–91 (Minn. 1981) (finding that the lender had a right of first refusal to purchase the borrower's grain); Connor v. Great W. Sav. & Loan Ass'n., 447 P.2d 609, 617 (Cal. 1968) (finding that the lender played an active role in home construction and had the right of first refusal to make loans to purchasers of homes); State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661, 672, 688, 690 (Tex. App. 1984) (finding that the lender sought to prevent

broad theories of unreasonable conduct, such as *K.M.C. v. Irving Trust Co.*,[102] have come in for considerable criticism and in general have not been followed or are read very narrowly in other states.[103] Courts have also been reluctant to hold liable a lender whose actions have stayed within the scope of actions authorized by the provisions of the loan agreement.[104]

The somewhat limited impact of lender liability reflects the distinction Macneil drew between the exchange element of a contract and the relation element of the transaction. Macneil pointed out that the two were conceptually distinct, and that participants could benefit from the exchange even if the actual working of the relation was unjust. Ignoring this distinction, he argued, could lead to bad results in which victims of unjust relations could end up losing whatever benefits they may have gained from the exchange.[105] Many of the problems with what has come to be called the "regulatory trilemma"[106] and with attempts to regulate transactions through contract law doctrines[107] arise out of the precise danger against which Macneil warned: where the law, in attempting to deal with an unjust relationship, fails to distinguish adequately between the exchange and relation elements of transactions.

This point is of particular importance to financial inclusion when it comes to SME financing, where the exchange element of lending does in fact play a productive role in SME finances. As Karl Polanyi pointed out, exchange is not just a feature of individual transactions, but also a key mode and process through which individual transactions are integrated into a broader economic system.[108]

the election of directors, select the chief executive, and pack the board with their own nominees); Barnett Bank v. Hooper, 498 So. 2d 923, 925–26 (Fla. 1986) (finding that where a bank and borrower established a relationship of trust and confidence, the bank had a duty to disclose material facts).

102. 757 F.2d 752, 759–761 (6th Cir. 1985) (explaining good faith doctrine as applied to financing documents and finding that the lender breached their duty of good faith).

103. *See, e.g.*, Shawmut Bank, N.A. v. Miller, 614 N.E.2d 668, 670–72 (Mass. 1993) (rejecting the principle that a bank has a duty of good faith when requesting repayment on a demand note loan, especially absent any specific agreement in the terms of the note); Check Reporting Servs., Inc. v. Mich. Nat'l Bank, 478 N.W.2d 893, 899 (Mich. Ct. App. 1991) (explaining that the Plaintiff's reliance on *K.M.C.* is "misplaced" and refused to follow its holding); Pavco Indus., Inc. v. First Nat'l Bank, 534 So. 2d 572, 577 (Ala. 1988) (refusing to follow the construction of the demand provision as set forth in *K.M.C.*).

104. Continental Bank, N.A. v. Everett, 964 F.2d 701, 703–05 (7th Cir. 1992) (finding that the lender is not liable where all actions were authorized by the loan agreement).

105. MACNEIL, *supra* note 84, at 130 n.18.

106. The regulatory trilemma suggests that regulatory law tends to fall into one of three traps: of irrelevance (in which it is ignored by the regulated community); of producing "disintegrating effects on the social area of life" (by damaging the regulated community); or of producing "disintegrating effects on regulatory law itself" (by damaging the integrity of the legal system). Gunther Teubner, *Juridification: Concepts, Aspects, Limits, Solutions*, *in* JURIDIFICATION OF SOCIAL SPHERES: A COMPARATIVE ANALYSIS OF THE AREAS OF LABOR, CORPORATE, ANTITRUST AND SOCIAL WELFARE LAW 3, 21 (Gunther Teubner & De Gruyter, Inc. eds., 1987).

107. For an argument in favor of a far-reaching acceptance of contract law as a regulatory system, see generally HUGH COLLINS, REGULATING CONTRACTS (2002). For a counterargument on the limits to contract law's regulatory capacity, see MORGAN, *supra* note 82, at ch. 7–8.

108. Karl Polanyi, *The Economy as Instituted Process*, *in* TRADE AND MARKET IN THE EARLY EMPIRES: ECONOMIES IN HISTORY AND THEORY 243, 257 (Karl Polanyi, Conrad M. Arsenberg & Harry W. Pearson eds., 1957).

Although other modes of integrating transactions into economic systems do exist,[109] as far as SMEs are concerned, exchange is likely to remain the key integrative mechanism for the foreseeable future. The challenge, therefore, is to separate the exchange element of lending from the governance element, and regulate the latter without adversely affecting the former, and do so in a manner that is sensitive to their broader systemic dimensions.[110]

Jenny Steele and I have recently suggested a framework for considering regulatory goals and techniques in governing systems of private ordering underpinned by contract.[111] We argue that there are four broad families of approaches to these sectors, based on four views, or categorical types, of markets, which we term market-individualism, relationalism, market-managerialism, and welfarist interventionism. In market-individualism, the market plays a necessary and benign role of setting prices and matching participants who are, for the most part, capable of self-protection. Contracts here have a propensity to be balanced, and law's primary role is to provide adaptive support for the market. In relationalism, the market plays an initial role, but is not of continuing importance, because participants are cooperative despite being motivated by self-interest. Contracts, again, tend to be balanced, and law's role is once again supportive, but with a focus on relations that endure in the medium- and long-term. Market managerialism presents a very different picture, in which markets play an essential role, but are nevertheless prone to disintegration without external support because participants have a propensity to adopt flawed courses of action which serve immediate interests but, in the long run, have a propensity to destabilize the market by adversely affecting participant trust in its mechanisms. Law, here, has to play a more active role in stabilizing, restructuring, and managing the market, and diverting it away from its internally destructive tendencies. Finally, welfarist intervention sees markets as necessary, but having a tendency to be oppressive, due to their participants' propensity to create one-sided, onerous transactions. Here, law plays an active role in enforcing public policy against a potentially fickle and unreliable body of market participants.[112]

The task for the law in relation to SME lending is primarily one of market managerialism. Although the market mechanism is adequate for the element of exchange in lending transactions, it is neither obvious nor necessarily effective as a way of designing governance systems. And although official neutrality between relationship lending and hierarchical lending is therefore defensible in relation to the actual allocation of finance, it is neither defensible nor sustainable in relation

109. *See id.* at 253–54 (naming two other modes of integrating transactions into economic systems: reciprocity and redistribution).

110. *Cf.* Steven L. Schwarcz, *Beyond Bankruptcy: Resolution as a Macroprudential Regulatory Tool*, 94 NOTRE DAME L. REV. 709, 728–34 (2018) (discussing the balance in bankruptcy between resolving the problems of individual firms and those of the system as a whole).

111. TT Arvind & Jenny Steele, *Remapping Contract Law: Four Perceptions of Markets, in* CONTRACT LAW AND THE LEGISLATURE: AUTONOMY, EXPECTATIONS, AND THE MAKING OF LEGAL DOCTRINE 435, 439–45 (2020).

112. *Id.*

to the actual governance framework for the subsequent lender-borrower relationship. As the discussion in Parts II and III has shown, a relational framework is superior when it comes to matters of governance.

What sort of mechanisms, then, might the law adopt to stabilize and restructure the market in the direction of a more relationally informed framework, which diverts it away from its tendency to cause disproportionate harm to SMEs in times of crisis? One possible answer may lie in the system that is referred to as "the negotiated economy" in the literature.[113] The negotiated economy was devised, along with the closely related idea of "corporate pluralism," to analyze and explain features of governance in Scandinavia.[114] In contrast to the "supermarket" model of governance which emphasizes economic rationality and consumer choice,[115] the negotiated economy emphasizes economic cooperation through the use of systems of corporate pluralism that enable all key interest groups to be represented in governance processes.[116] The classic example of such a system is the Scandinavian approach to making labor market policy, which has historically been formulated through collaborative governance arrangements between labor and employer interest groups.[117]

The negotiated economy has obvious relevance to situations such as those presented by SME lending, where the law's task is to support the continuance of contract's exchange function while regulating its governance functions. It is easy to see how the system could be adapted to SME lending, with model contracts, protocols, and procedures emerging through similar processes between interest groups representing SMEs and lenders. Such a system will necessarily require a legal scaffold and backstop in at least three forms: firstly, in the form of rules facilitating and incentivizing the production of new forms of contracting;[118] secondly, in the form of a more responsive, flexible, and relational approach to

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113. The negotiated economy is also called the "negotiation-based economy" or "economy via persuasion." Klaus Nielsen & Ove K. Pedersen, *The Negotiated Economy: Ideal and History*, 11 SCANDINAVIAN POL. STUD. 79, 81 (1988).

114. The idea of corporate pluralism comes from the work of Stein Rokkan. *See generally*, Stein Rokkan, *Norway: Numerical Democracy and Corporate Pluralism*, *in* POLITICAL OPPOSITIONS IN WESTERN DEMOCRACIES 70 (Robert A. Dahl ed., 1966). For a review of the subsequent literature, see generally Martin O. Heisler, *Corporate Pluralism Revisited: Where is the Theory?*, 2 SCANDINAVIAN POL. STUD. 277 (1979).

115. Tom Christensen, *Narratives of Norwegian Governance: Elaborating the Strong State Tradition*, 81 PUB. ADMIN. 163, 180–84 (2003).

116. Klaus Nielsen, *The Mixed Economy, the Neoliberal Challenge, and the Negotiated Economy*, 21 J. SOCIO-ECON. 325, 326, 334 (1992).

117. *See* Nielsen & Pedersen, *supra* note 113, at 85-91 (discussing different coordination responses to socio-economic problems by key interest groups).

118. An example of a very similar framework in a commercial, common law context is provided by the United Kingdom's Housing Grants, Construction and Regeneration Act 1996, which was motivated by common practices in the construction industry which, cumulatively, were seriously destabilizing the finances of SME contractors and which expressly sought to incentivize the construction industry to create new contract forms which would reform these practices. *See, e.g.*, Charlotte Ellis, *Regulating Commercial Contracts: What can we Learn from Part II of the Housing Grants, Construction and Regeneration Act 1996?*, *in* CONTRACT LAW AND THE LEGISLATURE: AUTONOMY, EXPECTATIONS, AND THE MAKING OF LEGAL DOCTRINE 329, 339–51 (TT Arvind & Jenny Steele eds., 2020).

defining the scope of the regulator's powers;[119] and thirdly, in the form of SME-friendly bankruptcy laws along the lines of the reforms recently introduced in the United States through the U.S. Small Business Reorganization Act of 2019.[120] Such a system will, however, be superior both to the current state of deregulated private governance and to more intrusive and coercive forms of regulation, in supporting broader dimensions of SME financial inclusion.

V
CONCLUSION

Although financial inclusion as a policy objective has multiple dimensions, the focus of the debate on financial inclusion for SMEs has largely been on the issue of enhancing SME access to finance. This Article has shown that more attention needs to be paid to the issue of reshaping lender practices to make the delivery of finance to SMEs more responsible and sustainable. The terms of SME financing agreements offer considerable scope for lenders to engage in opportunistic or predatory behavior. As this Article also has shown, there is evidence to suggest both that this is a problem, and that it causes material financial distress to SMEs and beyond. Against that background, this Article has argued that the law needs to take a less neutral approach that is more favorable to relational lending practices. It has also suggested a range of techniques, grounded in the established models of negotiated economies and corporate pluralism, which can help achieve this end. Although the challenge of fostering responsible and sustainable lending practices is not a simple one, it is one that can be met with the right combination of approaches.

119. The 2019 report of the Treasury Committee of the U.K. House of Commons on the perimeter of regulation forms a useful starting point for charting the shape of these reforms. The Committee recommended that more clarity be provided to customers of banks when the banks were engaged in unregulated activities and that the FCA be given a formal statutory power to review and formally recommend changes to its perimeter of regulation. *See* TREASURY COMMITTEE, *supra* note 67, ¶¶ 13–18, 23–31). These changes, if embedded in a broader turn to a negotiated economy, would have helped redress many of the problems that SMEs encountered in their dealings with the GRG.

120. Despite the SME-friendly intentions of the US Small Business Reorganization Act of 2019, scholarship has already begun to emerge examining how lenders can circumvent its provisions and maintain their superior position over small business borrowers under the new regulatory regime created by the Act. *See generally* Christopher G. Bradley, *The New Small Business Bankruptcy Game: Strategies for Creditors Under the Small Business Reorganization Act*, 28 AM. BANKR. INST. L. REV. 251 (2020).