

Investor-Operator Relationship

Operators typically have control and superior information control about activities on a rig

*Viscusi & Zeckhauser,
Vanderbilt Law Review,
Trex-280042*

It is therefore more effective and efficient to incentivize the operator

*Viscusi & Zeckhauser,
Vanderbilt Law Review,
Trex-280042*

Penalizing investors can reduce safety

*Pitchford,
The American Economic Review,
Trex-280033*

**Deterring and Compensating Oil-Spill
Catastrophes: The Need for Strict and
Two-Tier Liability**

“Making the oil-drilling operator responsible . . . is the best way to place incentives in the hands of the party that knows the most and that has the greatest ability to control the outcome.”

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**How Liable Should a Lender Be? The Case of Judgment-Proof
Firms and Environmental Risk: Reply**

By **ROMAN PITCHFORD***

Recent years have seen a trend in the United States toward creditor liability for environmental cleanup. The prerequisites for such an allocation of liability are that the creditor has some management involvement in the business that caused the damage, and that the firm is unable to pay. Different liability allocations affect the creditor-firm relationship and the care the firm takes to avoid environmental damage. The purpose of Pitchford (1995) was to examine the effect on the creditor-firm relationship of changes in the burden of liability. One key result is that an increase in creditor liability can lead to a perverse effect. When a firm is potentially judgment-proof, that is, when it can cause a bankruptcy accident, creditor liability can lead to an increase in the frequency of accidents, and reduced social welfare. A related result is that the deep pockets of creditors are not useful in reducing environmental problems. These findings are controversial because they suggest the need for closer examination of recent trends in U.S. environmental policy. Dieter Balkenborg (2001) and Tracy R. Lewis and David E. M. Sappington (2001) have made important contributions to our understanding of the effect of liability changes on the creditor-firm relationship. These articles explore what happens when some of the assumptions of Pitchford (1995) are relaxed. Balkenborg assumes that creditors operate in an imperfectly competitive environment, whereas I assumed perfect competition. He

finds that there is a cutoff level of creditor bargaining power, below which increased creditor liability increases the frequency of accidents, and above which it does not. In other words, Balkenborg confirms that the perverse effect of increased lender liability generalizes to the world of imperfectly competitive credit markets up to a point. He shows that the effect in Pitchford (1995) is not a knife-edge result that occurs only with strictly competitive creditors. Balkenborg's Comment also makes an insightful contribution to the literature by reconciling opposing results. One group of papers, for example Lewis, A. Kerschbamer (1982), has creditor liability leading to increased care. Pitchford (1995) has the opposite effect. Balkenborg's results are not at all unusual to raise, and I discuss them briefly in Section II.

Lewis and Sappington ask whether the implications of my model generalize when there are many levels of damages, not just two. While not completely at odds with my results, Lewis and Sappington's Comment makes a pointed criticism of my Paper (1995). When there are many states of nature, the creditor has many more instruments with which to control the care taken by the firm, including the possibility of subsidizing the firm for low or zero accident realizations. Their two conclusions are:

(I) A lender's deep pockets will help increase firm incentives for care provided the firm's assets are sufficiently large (the deep pockets argument), and

(II) If a lender's deep pockets are sufficiently high, then the firm's incentives for care can be

* Related to Balkenborg's paper is Pitchford (1995), where I derive a principal-agent model with limited liability, and examine the effect of varying bargaining power on the agent effort.

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