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Margaret Blair

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SPEECH

CORPORATE DISCLOSURE

*Margaret Blair**

One of the traditional ways of thinking about the social responsibilities of corporations starts from the premise that corporations are citizens of our society and, like other citizens, they have an obligation to act morally. I want to talk about a different way of thinking about corporations that I think, offers an alternative vision. I think it gets us to the same place but I think it gets us there in a way that may be a little easier to assign accountability. In using the kind of language that talks about corporations as moral actors, we tap into an old debate about the nature of corporations and we come down squarely on the side of the entity view which conceives of a corporation as a real person and not simply a legal fictional construct. I am not going to get into that debate because I don't think we can resolve it. It does make me uncomfortable to talk this way, however, because corporations don't weep; they are not human actors. I think it makes it harder to understand or think about who are the ones, or who are the human persons, who are accountable in this enterprise. I am more of a contractarian myself, and I laugh when I hear myself say that because I am always arguing with the contractarians, but I am sympathetic to some of the ways they approach the problems.

I tend to think that the best way to understand corporations is that they are legal devices through which a group of people, a group of individual human beings, contract among themselves in order to undertake some kind of productive activity. In this process, the people involved are acting together as a team. That does not make the team a person—we cannot think of the team being some sort of entity, but the team metaphor should be contrasted with the standard contractarian way of thinking about corporations. The standard contractarian way says that corpo-

* Margaret Blair is a senior fellow in the Economics Studies program at the Brookings Institution, and a Visiting Professor at Georgetown University Law Center. She specializes in corporate governance, corporate finance, business ethics, and the social role of corporations, and is the author of *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century,* Brookings, 1995, as well as numerous other books, articles and monographs. She directs the project on Corporations and Human Capital, and the project on Understanding Intangible Sources of Value at Brookings.

rations are holding devices for property and that that property in some sense belongs to the shareholders, and that in this view, shareholders own the property collectively, and manage it by hiring or contracting with managers. The managers are authorized to make decisions for the group of "owners" as a whole, by acting through the central contracting entity–the corporation. Under this theory, managers and directors are viewed as agents of shareholders and they are required to act on their behalf. The central contracting problem of corporate law is an agency problem—between shareholders who are the owners of the property, and are officers and directors who are their agents. Under this view, which is the standard contractarian view of corporations, corporations have no other social purpose other than profits for shareholders. Although they must achieve that through lawful means, there is no point in even talking about any other purpose for these holding devices for property. That is the standard contractarian story and it is one that has really dominated legal thinking in the last fifteen years.

Some of you may not be familiar with my work, but in a number of different things I have written in the past four to five years, I reject this version and I reject it because it fails to take adequate account of the contributions that are made to the productive activity that is going on in the corporation by those who contribute human capital. A large and growing share of the wealth that is created by corporations in this country comes from things like intellectual capital, idea capital, organizational capital, and all kinds of intangible assets. We do not really understand very well what these assets are, but we have good reasons to believe that they consist of things that are embodied in the employees, their knowledge, their skills, and their relationships to each other. We can be pretty sure that this stuff gets on the elevator at night and goes down and walks out the door and gets in the car and goes home and it is not really appropriate to talk about shareholders owning these assets.

So let me give you an alternative contractarian story about what a corporation is and what corporation law achieves. This is based on some work that I have done jointly with Professor Lynn Stout at the Georgetown law school and that offers an alternative way that we can understand this thing we call a corporation. This alternative view is contractarian in spirit but that gets us to where we want to go, which is to talk about who are the human beings involved in this. Lynn and I argue that a corporation is a legal device by which all of the participants in the enterprise act collectively, especially those who contribute human capital, and those who contribute financial capital. These are the key players, although I can make an argument on a case by case basis for why we

should include some other players, some community interests or the interest of suppliers or customers and that sort of thing, but in general I think the key players are those who contribute financial capital and those who contribute human capital. They enter into a mutual contract or agreement, the essence of which is that they give up property rights over both the inputs that are used in production and over the outputs from production. They yield the property rights to a separate legal entity controlled by an independent board of directors which has a legal responsibility to act for the corporation and fiduciary duties running to the corporation and its members.

Now, the central contracting problem that is addressed by this device by which everybody gives up property rights is not a principle agent problem. This particular solution generates some principle-agent problems, and I don't want to suggest that the principle-agent problems are not important. But the principal-agent problems are not the problem that the corporation was set up to solve in the first place. Rather, the contracting problem that is addressed by the formation of a corporation is a team production problem. OK, what's a team production problem? This is where I put on my economist hat now and introduce a different body of theory. Team production arises in situations in which the output of some productive enterprise is a joint function of the combined inputs and coordinated efforts of a number of different individuals, and importantly, it is not possible to separate the output into the parts that are attributable to each of the inputs. You cannot say this person did this part of it and so they get this part of the output, and that person did that part of it and so they get that part of the output. Outputs are a joint function and you cannot specify who did what and who is responsible for what.

The other aspect of team production is that the inputs are complex and specialized and very difficult to specify in advance. They are difficult to monitor and difficult to evaluate. One way to think about these kinds of inputs is that they are a type of enterprise-specific investment made by the participants; they may be in time, energy, or ideas contributed by the input provider. They are enterprise-specific in the sense that they are custom designed for this particular enterprise. Possibly another sense in which they may be enterprise-specific is that their value depends on comparable investments being made by others in the joint enterprise, so it is a collective activity. Production processes of this type are pervasive in the economy, but they present at least three different difficulties in contracting. First, you cannot write an *ex ante* contract specifying what each input provider is to do and if you tried you would have a great deal of difficulty evaluating whether the input provider actually did what they

were suppose to do. So contracting *ex ante*, over inputs, is very difficult. You could write an *ex ante* contract specifying in advance that each input provider would get some pro rata share of the output. You could say everyone gets 1/n, if there are n participants everybody gets a 1/n share of the output, but if you do that your contract would then be frought with free rider problems because each input provider would have an incentive to shirk. Each one gets 1/n of the output no matter what they do, because it is in the contract. Since the inputs are by assumption difficult to monitor, there is not a good mechanism for trying to detect and punish such shirking. On the other hand, if you do not write an *ex ante* contract specifying what the payouts are going to be before you start the enterprise, you will probably find, when you get the output, when it is time to divide it up, that the economic surplus that you have generated by this team production process gets eaten up in *ex post* rent-seeking behavior, or, to use more ordinary language, in fighting over who gets what piece of the pie.

Now, interestingly, economists have not really studied team production problems in very much depth. There are a few scholars who have worked on it and have thought about what this means. I think it is a very understudied area, but those who have studied team production problems have proposed three possible solutions. One is letting one team member be the owner. Then, that team member hires all the others, pays them according to their external opportunity costs, and pockets the residual. This solution ensures that the owner has adequate incentives to exert effort in order to do what they can, at least in terms of monitoring. It also ensures that the owner has the necessary incentives to make enterprise specific investments and this is probably what we see in entrepreneurial firms. That is, individual owners hiring other people to work for them. But if one party is the owner, and that one party is capturing all the rents, the other participants may lose their incentives to make these firm-specific kinds of investments. The second solution that has been proposed in the economic literature is an elegant mathematical solution. But if you are not an economist, you read it and you just scratch your head because it is very clever mathematically, but it doesn't seem to explain anything that sounds real to me. The solution is to write a contingent contract that says everyone gets 1/n of the total output, but only if the total output reaches some specified hurdle level, and that can only be reached if everyone exerts effort. In effect, the solution works by punishing everyone if anyone shirks.

Now, a contract like that would be extremely difficult to write in practice because there is probably no way to know in most situations how

high the hurdle would have to be in order to make sure that nobody shirks. It also creates really perverse incentive problems because suppose that one person shirks and the output falls short of the hurdle level and you still have a surplus. What do you do with it? You have a surplus that has been created, but if you pay it out to any of the team members then you are back into the *ex ante* and *ex post* contracting problem and you do not have a believable contract that really punishes everybody if anybody shirks. The author of that solution proposes in his paper that you need an outsider to the enterprise who becomes the recipient of the less-than-hurdle-level surpluses, a sort of passive recipient. The paper proposed that this is what shareholders do. But this is an extremely perverse notion of the role shareholders play. One problem with this solution is that if this outsider can exercise any influence over the team members, they have an incentive to come in and bribe a team member to shirk so that the output will fall short of the hurdle level and then the external party gets the surplus. So this strikes me as one of those clever mathematical solutions that is completely ridiculous in practice.

Now, a third solution has appeared very recently in the economic literature and it is one that will sound very familiar to you when you hear it. It is one of these sort of common sense things that has been going on all along and we just never thought about it. This is in a paper written by a couple of University of Chicago economists. This is the idea of third party arbitration. The specific solution is for team members to give up property rights over the joint enterprise to an external party who is not a member of the team. They yield property rights to some person who does not provide any critical enterprise-specific input. Giving up property rights to this external party helps team members to solve their own collective action problem because by giving up property rights over the input and over the output each team member in effect is able to make a credible commitment not to use their property rights to try to expropriate rents from the other members of the team. They do not own it, they cannot exercise undue influence and take the rents away from anybody else. The external party to whom all of the team members give up property rights, Lynn Stout and I argued, is not the shareholders; it is the corporation itself. It is a truly brilliant solution! An inherently passive entity that cannot come in and start trying to influence people to get them to give up, to get them shirk so that there is a surplus leftover. The control rights over collective property is vested in an independent board of directors.

Is this a flawless solution to the contracting problem I am talking about? Of course not. It is a solution that leads to agency problems of

the type that have been studied endlessly by law and economics scholars in recent years. But what has been missing in the analysis of the agency problems in corporations is a credible explanation of why you would set this thing up in the first place if it creates so many agency problems. Why don't entrepreneurs and investors choose a different organizational form that would give investors much tighter control over managers? We think the answer is that the team production problem is actually extremely important and quite pervasive in the economy, and it is the giving up of property rights and control rights to a separate legal entity governed by an independent board of directors that provides a workable solution to that problem. The team production analysis provides a contractarian rationale for the view that corporations have a larger social purpose than just profits, but I do not have to anthropomorphize corporations to get there. I don't have to argue that the corporation itself has social responsibilities. Instead, I suggest that the social purpose of corporations is to provide a mechanism through which groups of individuals can pool their efforts and their resources in order to undertake some enterprise that they hope will be productive and will increase their collective welfare. But in this view, the board of directors plays an absolutely critical role. It is they who must ultimately act for the corporation–for the team. It is they who bear ultimate responsibility for decisions that determine the allocation of costs and risks and returns among all the team members. And as moral beings, individual board members have the same responsibility for personal moral behavior as any other human being. But they have an additional responsibility when they act for the team to make decisions that are fair and just. This is their job, this is what they are there for. To use two old fashioned words, fairness and justice, two old fashioned words that are not particularly popular in the jurisprudence of law and economics but nonetheless, when one understands this conception of the corporation, become quite important. These decisions must not only be fair and just, they must be well considered and not self-serving. In other words, directors have fiduciary responsibilities to the team as a whole as well as to individual members of the team. Our hypothesis about the social corporations suggest that an important economic function is served by arrangements that help keep boards of directors independent of all corporate constituencies, including shareholders. They have to be free to make decisions that balance the interest of the various constituencies. That independence, of course, can be abused, and therein lies the problem. Unfortunately it can be abused and it is often abused. As to what extent disclosure can serve as a mechanism for preventing boards of directors from abusing the authority that they have

and the power they have, that is a subject for securities lawyers, and I won't try to take it on in this forum at this time.