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CORPORATE STAKEHOLDERS, CHOICE PROCEDURES and COMMITTEES

Bruce Chapman*

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In a recent speech entitled “What's Right About Corporate Governance?,” the Chairman of the Ontario Securities Commission, Edward Waitzer, paraphrasing an old aphorism, once advised that “people who live in glass houses should always answer the doorbell”. It seems clear that Waitzer was offering some free advice to the leaders of our corporations: they should be more responsive to the public demand for increased social responsibility by corporations. Specifically, Waitzer's point was that corporate leaders need to think more proactively and less defensively about criticisms directed at the corporate sector. If they do not, then government will rush into the vacuum and respond to the social demands that something be done about apparent corporate misbehaviour. However, these politically motivated responses, while possibly satisfying all the high profile requirements which are so much cherished by elected politicians or publicly appointed officials, could well be totally misguided from a more purely economic point of view.

In some respects I worry that Ronald Daniels' article, recently published in this Journal, is insufficiently responsive to the call at the door in just the way that Waitzer suggests. However, before developing this point, it must be conceded at the outset that the article is an effective reply to any claim that a statutorily increased level of personal directors' liability is an obvious solution to those difficulties which are generated by limited shareholder liability. In

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the first place, Daniels argues convincingly that these difficulties may not be so very great to begin with. Specifically, the impetus that limited shareholder liability provides for the adoption of excessively risky projects is undercut by the fact that managers, not shareholders, make corporate decisions. Managers have invested their human capital very specifically in the corporation and, unlike shareholders who have a diversified portfolio of investments across corporations, are often more worried about the effects that excessive risk-taking will have on the continued viability of the one corporation which has provided them with a job.  

Second, even if it can be shown that a problem of excessive risk-taking truly exists, Daniels argues convincingly that directors' liability has its own set of difficulties, not least of which is the mirror image problem that corporations, now under the control of outside directors who are uncertainly insured for liability, might be too timid in the face of possible social risks. As economic analysis constantly reminds us, the proper goal is not to encourage the corporation to increase or decrease its risk-taking activity, but rather to seek some optimal or efficient level of unavoidable risk.  

However, having shown that increased directors' liability is not the obvious solution to an apparent problem, Daniels leaves us with no answer to the call at the door for more corporate social responsibility. Of course, it is somewhat unfair to critique an author for failing to set out the complete details of his own corporate social responsibility regime. It is perfectly legitimate to set the record straight on someone else's proposed solution. Yet, having said this, there is still something dismissive of the call for corporate social responsibility in Daniels' article. He says, for example, that the stakeholder debate has largely been won by those who argue that directors owe duties exclusively to shareholders. That seems to be an overstatement. The recent stakeholder statutes passed in so many U.S. jurisdictions suggest otherwise and, while it must be admitted that these statutes focus mostly on the effects of takeovers, that is just what one would expect for stakeholder protection legislation arising out of the events of the 1980s.  

I also think that Daniels' claim that corporate directors should only attend to the interests of shareholders, and not other corporate stakeholders, needs more argument. He advances the view, for example, that a manager or director who is personally responsible to a broad range of different constituencies is in fact answerable to none of them since there will always be the opportunity of rationalizing an inadequate performance for one constituency by pointing out how well that performance serves another. While this is certainly something to worry about, it is not at all clear that the same problem will not appear within the regime of enterprise liability which Daniels favours. Even if managers or directors owe their corporate duties exclusively to shareholders, a system of enterprise liability can impose, for example, a set of competing environmental obligations on the corporation. In such circumstances the manager or director can point to the external environmental obligation as the reason he or she did not maximize shareholder wealth. That will do just as well as any internal set of obligations owed to a broad range of corporate stakeholders. It is only if the externally imposed environmental laws are written so specifically that all discretion for meeting them is removed from managers or directors (for example, if the environmental laws regulate very particular choices of inputs and technology and not just the output levels of pollution), that this problem of opportunism will be controlled. But I suspect that Daniels, for all the usual good reasons, would be reluctant to support such an intrusive form of input regulation.

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3 This argument needs to be qualified. Managers of subsidiaries may not be worried about losing their jobs if the subsidiary is sued into bankruptcy for excessive risk-taking; they may be able to get other jobs in the parent. Indeed, the need to control for this may be a reason for piercing the subsidiary's corporate veil and holding the parent liable for any of the subsidiary's unpaid debts. On this, see Frank Easterbrook and Daniel Fischel, The Economic Structure of Corporate Law (Cambridge, Massachusetts, Harvard University Press, 1991), p. 57.

4 For a survey of these recent stakeholder statutes, see M. O'Connor, "Restructuring the Corporation's Nexus of Contracts: Recognizing a Duty to Protect Displaced Workers" (1991), 69 N. Carolina L. Rev. 1189, at pp. 1229-35.

5 For some discussion of the literature showing the economic effects of stakeholder legislation in the context of takeovers, see R. Romano, "A Guide to Takeovers: Theory, Evidence, and Regulation" (1992), 9 Yale J. on Reg. 119 at pp. 171-73.
Daniels' second argument in favour of making shareholders the exclusive target of directors' corporate governance obligations really turns on the first. His worry is that self-indulgent managers and directors, now pretty much unconstrained by any specifically defined obligations to shareholders, will simply use corporate resources to vindicate their own personal visions of the good. That, I take it, is only a problem because the resources belong to someone else—in particular, I suppose, shareholders.

However, it still may be possible to meet this second argument directly, and in a way which does not so plainly beg the question against other corporate stakeholders who have an interest in how the corporation is run. Surely, another way to answer Waitzer's call at the door for more corporate social responsibility, a way that does not depend as much on a regime of ex post enterprise liability as the one recommended by Daniels, is to introduce a socially responsive ex ante governance regime into the corporate boardroom, one which allows different corporate stakeholders a right to participate in corporate decision-making up front. This is what Stanley Beck and others have recommended in their work, and it is to an assessment of the feasibility of that broader form of corporate governance that this comment now turns.

II

As Beck has recognized, the idea that the different constituencies which are affected by corporate decision-making should all have direct representation on the board of directors is hardly a new one, and has also been long criticized. While these criticisms vary in their detail, they essentially boil down to two different kinds of worries. The first is that there is a problem of political legitimacy when corporations, rather than choosing to maximize profits, use shareholder investments to serve the interests of a broader range of corporate constituencies, including, for example, employees, consumers, environmentalists, and local community groups. However, it cannot merely be assumed without argument that a corporation which is responsive to some nonshareholder interest, such as a cleaner local environment, is funding its own pet project "with other people's money" in the way that this sort of criticism suggests. Again, that simply begs the question at issue: to whom does the corporation properly owe its obligations?

The second sort of criticism is that more broadly representative corporate boards are recipes for corporate inefficiency and, ironically, more, not less, discretion for management to serve their own particular interests. Beck has dealt effectively with this criticism in his own work, but in this comment I want to structure the original criticism somewhat differently and to provide a slightly different response to it. Leading corporate law theorists, such as Frank Easterbrook, Dan Fischel, Jeffrey Gordon, and Henry Hansmann, have all argued in different ways that enhanced representation of different constituencies on corporate boards carries with it the danger that there will be much instability and arbitrariness in corporate decision-making as a result. The public choice literature upon which these arguments are based is now huge, but the essential point can effectively be illustrated by the following example.8

Suppose that a corporation is considering whether or not to build an additional plant. The new plant can be located at either site A, its current home site, or site B, with the first site being slightly more profitable than the second. A third option, of course, is not to build the new plant at all. Call this option N. Thus, the corporation's shareholders, who are interested most in maximizing profits, rank the three options in the order: A preferred to B preferred to N. However, locating an additional plant at either site produces negative externalities which concern some environment-

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talists. They would prefer most that no plant be built at all, but if one had to be built they agree that expansion at the current home site A is the better decision. Thus, the environmentalists rank the three options as follows: N preferred to A preferred to B.

However, there is also a third group of interested individuals. These are the local community members who live near site A and who are employees of (or otherwise economically dependent on) the corporation. While concerned about the effects of plant expansion at site A on the environment around their home (a concern they share with the environmentalists), they are also reasonably interested in enhancing the profitability of the corporation upon which they depend for their livelihood (a concern that unites them with the shareholders). Thus, they most favour the building of a new plant at B (i.e., elsewhere), but failing that, they would rather see no plant built at all to seeing it built at A. This strategy increases corporate profitability without damaging their local environment. Hence, their ranking of the three options is: B preferred to N preferred to A.

Now suppose that each of these three groups had some representation on the corporate board or, more specifically, some input into the decision to be made about building the plant. Then it is possible that a decisive coalition could form between the shareholders and the environmentalists favouring option A over option B, that an equally decisive coalition could form between the environmentalists and the local community for option N over option A, and that a third coalition between the local community and the shareholders could decisively favour option B over option N. Thus, every one of the possible options has another option preferred to it by some decisive coalition. This makes it very difficult for a corporation, when subject to these decisionmaking influences, either indirectly through the board or more directly through management, to settle on any one of these options as a final decision. In this way, therefore, we can see how a broad representation of different stakeholder interests on the board could lead to corporate indecisiveness and inefficiency.

The example can also show why it might be true that a broader representation of corporate stakeholders on the board could mean more, not less, discretion for the corporation's inside management to serve its own interests. Suppose it were true that the corporation was reluctant to reconsider options which had already been rejected in a comparison with other available alternatives. Then, in the example given above the option not considered first is most likely to be the final choice. For instance, if the corporation deemed it important to settle the locational aspects of the plant decision first (i.e., should the plant be at site A or site B?), then while site A might be decisively favoured by the environmentalists and shareholders over site B, the no plant option N might well defeat that locational choice once the corporation goes on to consider whether the plant should be built at all. After all, the environmentalists and the local community members all prefer N to A. On the other hand, if the decisionmaking sequence were structured slightly differently — for example, if the corporation first compared site A with option N, the no plant alternative — then while option N would defeat site A in this first round, site B considered next as an alternative location for the plant would defeat option N.

This dependence of the final choice on the sequence in which the various options are considered gives tremendous power to that individual, or group of individuals, who sets the agenda for decisionmaking. By structuring the sequence of decisionmaking in a particular way, such an agenda setter can manipulate the different coalitions of interest groups on the board in such a way as to produce almost any final result that might be desired. Thus, the example shows how a broader representation of different stakeholders on the corporate board can, somewhat paradoxically, enhance rather than diminish the powers of insiders (the agenda setters), within the corporation.

If this were the end of the matter, then it would sound a dismal note for more broadly based stakeholder representation within corporate governance. However, more can be said about the relevance of agenda influence for corporate decisionmaking than this, and some of it directly affects a suggestion which Stanley Beck has also made in his work on the subject that more use should be made of a mandated corporate committee system. For want of space, only the merest suggestion of what might be involved can be made here. More complete development of the argument will have to await some other occasion.

Beck's interest in the committee system arises out of its potential for improving the flow of information both within and outside the corporation to appropriate public authorities. However, in these last few remarks I want to suggest that the committee system may have a role in giving structure to and,
therefore, controlling the worst possible cases of agenda influence referred to above, even in the presence of broad-based stakeholder representation on the corporate board. Suppose there was, consistent with Beck’s suggestions, an environmental audit committee in our corporation considering the decision to build the plant. And suppose further that it was the specific mandate of this committee to consider the environmental impact of the different possible decisions and to reject that option for which the environmental impact was deemed to be so severe as to be unacceptable. Then an environmental audit committee, focused on and restricted to that environmental decision, would (at most) reject site B as the least desirable alternative. The only remaining acceptable alternative, site A, would then be compared in the next round with option N. Whether option N would be chosen over A would depend a great deal upon whether at this round of the decisionmaking process the environmentalists were permitted to make further submissions on the environmental costs of site A, or whether decisions at this second stage were to focus exclusively on profitability.

Clearly, if the latter method of decisionmaking is chosen, then it is very likely that site A would prevail as the final corporate choice. While under this method the environmentalists would have been given, by way of the environmental audit committee, the power to render certain alternatives absolutely unchoosable—that is, they would have a kind of veto power in the first round—they would not be in a position to exercise any further decisionmaking power. The alternative decisionmaking process, which allows the environmentalists the initial veto plus the right to influence subsequent decisionmaking, is obviously more likely to help environmental interests. One can imagine an exactly analogous two-staged decisionmaking process which would give an exclusive veto first to a shareholder audit committee focused exclusively on profit, and then either allow or not allow that committee some further decisionmaking power in the second round of the process when environmental considerations were brought into play. In this respect there is a kind of symmetry in the range of committee possibilities which are available to the corporation.

The important point to note is that these decisionmaking processes, however they might be structured in detail, are processes that force the corporation to choose along the “environment versus profit” choice continuum which in some sense both divides and unites the shareholder and environmental stakeholder groups. These two groups are divided on the issue of whether the corporation should give up profit to preserve the environment, but they are agreed, nevertheless, that this is the key issue between them. What is not permitted by these processes is the sort of decisionmaking influence provided by members of the third stakeholder group, the local community group in our example, which sees the overall choice issue quite differently. Unlike the shareholder and environmental groups, this third stakeholder group is not prepared to rank the least profitable and most environmentally friendly alternative, option N, as either better or worse than both of the new plant alternatives, A or B. Rather, this third group puts N between the other two alternatives, indicating thereby only a very ambiguous commitment to the “environment versus profit” choice continuum which divides and unites the other two groups. It is this ambiguity which allows the third group to form a series of opportunistic coalitions with each of the other two groups given the right choice sequence. This is something which, as we saw above, can be either destabilizing for the corporation, or conducive to an agenda setter’s own self-interested manipulation of these coalitions so as to effect a particular final choice.

However, if the corporate committee system were operating as described above, then the third local community stakeholder group cannot be part of a decisive coalition both for site B over option N on profit grounds and for option N over site A on environmental grounds (as that group’s ranking of the alternatives would suggest). This is because the environmental (or shareholder) committee would already, at the first stage of the choice sequence, have vetoed B (or N) as a possible choice before going on to consider issues of profit (or the environment) in a second stage choice between the remaining alternatives A and N (or A and B). In this way, therefore, the corporate committee system can structure the choice sequence so as to avoid some of the pitfalls which are often said to confront the introduction of stakeholder representation.

9 For a general proof that a sufficient condition for avoiding a majority voting cycle is that there is consensus amongst all voters that in every triple of alternatives one of the three alternatives is not ranked “between” the other two, see A. K. Sen and P. Pattanaik, “Necessary and Sufficient Conditions for Rational Choice under Majority Decision” (1980), J. of Econ. Theory 178.
holder representation onto the corporate board. The committee system, therefore, is not so much an attractive alternative to the overall design of more representative corporate boards, as Beck sometimes suggests in his work, as it is an essential complement to any such structural change.