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## COMMENTARY: STAKEHOLDER VALUES, DISCLOSURE, AND MATERIALITY

*Donald C. Langevoort\**

To what extent should the SEC treat as material—and as such, at least presumptively, the subject for mandatory disclosure in an issuer’s 10-Ks or proxy statements—data relating to company actions affecting stakeholders such as labor, consumers, local communities, or the public at large? When it began in earnest in the 1970s, the debate over “qualitative” materiality was largely about whether unadjudicated violations of law had to be disclosed (particularly crimes like illegal campaign contributions and commercial bribery). Gradually, this category of potential disclosure responsibilities stretched to include labor policies and practices, charitable contributions, and various other indicia of a company’s supposed social character and integrity.<sup>1</sup> In this Commentary, I want to think through some of the issues associated with expanding disclosure obligations in this area, especially if done in the name of noninvestor stakeholders. In doing so, I will sound a mildly cautious note, notwithstanding my embrace of the idea that firm managers do have moral obligations to corporate stakeholders that go beyond the duty to maximize short or long-term profits.

We should note first that there are two different kinds of arguments at work in the “stakeholder” debate. The first, and more aggressive, is that to the extent that corporations are simply webs of stakeholder interests mediated by company managers, disclosure in the interests of other stakeholders is justifiable on the same protective grounds as disclosure for investors. The second argument retains investor primacy, but argues that other stakeholder-oriented disclosure is needed so that investor/shareholders can evaluate properly the governance and financial performance of the firm. Both arguments tend to end up at the same place,

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1. For good recountings of the history in this area, see generally Ralph C. Ferrara et al., *Disclosure of Information Bearing on Management Integrity and Competency*, 76 NW. U. L. REV. 555 (1981), reviewing disclosure requirements regarding corporate directors and officers, questionable and illegal corporate acts, and certain company policies, and Bevis Longstreth, *SEC Disclosure Policy Regarding Management Integrity*, 38 BUS. LAW. 1413 (1983), addressing the issue of disclosure of information regarding corporate officers. Of course, the management integrity question pre-dated the 1970s, especially in the classic administrative proceeding, *In re Franchard Corp.*, 42 S.E.C. 163, 169-78 (1964).

which can tempt those committed ideologically to the former to invoke the latter because of its more conventional rhetoric.

The core of orthodox securities regulation can be stated simply: we want to promote stock price “integrity.” That is to say, we want the price at which investors buy or sell securities to reflect fairly the truth about the issuer’s current situation and insight about its prospects.<sup>2</sup> We do this because history teaches us that promoters, managers, brokers, and others often have selfish reasons to manipulate prices, almost always by inflating them.<sup>3</sup> Reputation provides a check on the incentive to deceive, but hardly a complete one. So, we mandate disclosure and prohibit various forms of fraud and misrepresentation. In this setting, the natural focus is on pure economic value.

Even here, of course, there may be difficult administrative judgments. Investors may have different utility functions and differing perceptions about what constitutes a “fair” price. Are we safe to assume that investors seek only measurable financial return? What, for instance, are the conflicts faced by a union that is both a large shareholder via pension fund holdings and a labor representative?<sup>4</sup> Furthermore, disclosure policy occasionally sacrifices the affirmative disclosure norm in the name of corporate confidentiality—we allow issuers passively to conceal trade secrets and business strategies from the public, even if some investors will be financially worse off as a result.<sup>5</sup>

It should be clear, then, that mandatory disclosure questions necessar-

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2. Hence the classic rhetoric of “truth in securities.” See generally Milton H. Cohen, “Truth in Securities” Revisited, 79 HARV. L. REV. 1340 (1966) (covering the major securities acts and their effects on stock prices through freedom of information).

3. See Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 392-93 (1990) (referring to the power of the SEC under section 10(b) of the Securities Exchange Act to regulate manipulative practices that influence securities prices).

4. See generally Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018 (1998) (providing an interesting commentary on the conflicts that arise when a labor union is a shareholder and a labor representative).

5. See Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 848-57 (1995) (arguing how disclosure of commercial information and other corporate secrets can benefit competitors and hurt investment); see also Donald C. Langevoort, *Toward More Effective Risk Disclosure for Technology-Enhanced Investing*, 75 WASH. U. L.Q. 753, 772-74 (1997) (arguing that a company should be exempt from continuous disclosure of risk-related or adverse information that exposes business strategy, plans, or secrets that could cause significant competitive injury); see generally Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995) (taking the view that the mandatory disclosure system needs to be more focused and limited to ensure accuracy of corporate information).

ily demand cost-benefit trade-offs, even in the conventional framework. The commonplace analysis is to start by asking whether disclosure is likely to benefit some significant category of investors in making fair price assessments over and above what leaving it to the marketplace to produce such information would accomplish.<sup>6</sup> Then, three kinds of costs are considered. The first is the direct cost (often in the form of legal and accounting fees) of gathering, formatting, and disseminating the information. The second is the litigation cost associated with enforcing any given obligation, whether through SEC enforcement or private rights of action. Finally, as noted above, there is the concern with legitimate corporate confidentiality. This analytic process has led to a fairly aggressive set of requirements relating to historic financial performance and managerial conflicts of interest, reticence with respect to forward-looking information, and subjective evaluations of business judgment.

The question posed in this Symposium is why should investor interests, especially financial ones, be the *sine qua non* for disclosure regulation? If we are coming to see investors as simply one kind of corporate stakeholder, why not provide disclosure for the benefit of other stakeholders (including public interests)? This question becomes all the more interesting when we invoke, with attribution to Justice Louis Brandeis, the idea that the "sunlight" of disclosure has benefits in terms of primary business behavior, which presumably will be "better" in an environment of public accountability. Moreover, mandating disclosure about some societally important issue is a form of legitimization, with at least the potential for educating the public about its importance and hence shaping the public's collective preferences. We are quickly tempted to use securities disclosure for matters *whether or not* a significant number of investors would treat such matters as material. Environmental protection and community impact of plant closings are two standard examples of such information.

Why not? The most direct response to this question begins with the kinds of costs described above. Especially in the aggregate, such social disclosures can be very costly to prepare, especially if the disclosure is very detailed or particularly subjective or open-ended. In the latter case, especially, litigation over contested matters will be frequent, time con-

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6. Mandatory disclosure can be preferable to market "scouring" for information in two respects: first, it overcomes the natural inclination of managers to conceal some kinds of private data; and second, it avoids the wasteful duplication of effort that comes when too many analysts chase down the same data. Obviously, that duplication is not necessarily wasteful with respect to more subjective information. See generally John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 733-34 (1984) (arguing that a mandatory disclosure system would be more efficient).

suming, and expensive—and sometimes, at least, without substantial merit. Of course, that by itself is not dispositive if the aggregate of benefits exceeds these costs. Yet here I am somewhat of a skeptic. To be sure, a prima facie case of benefit is made to the extent that disclosure of these other stakeholder-interest matters would actually cause these stakeholders to behave differently.<sup>7</sup> But there are numerous situations where the emphasis is much more on Brandeisian sunlight—disclosure as a good thing simply because of the accountability it introduces.

Psychologists have shown that accountability affects judgment and decision making. However, we should be careful here before deciding that accountability is necessarily all to the good. Psychologists have also shown that people's reaction to being held accountable can be as much as anything to engage in window-dressing—anticipating the reaction of the audience and seeking plausible justifications for the otherwise desired course of action.<sup>8</sup> Where window-dressing can be found (or rationalized), the impact on primary behavior will be lessened. I agree that the SEC's recent fascination—prompted by politics as much as anything—with full disclosure relating to executive compensation is an example of sunlight having very little disinfectant power. A board's compensation report and a performance graph easily become the subject of rationalization and self-serving inference that blunt any sense of embarrassment.

Indeed, there may sometimes be perverse effects to mandatory disclosure. My intuition is that disclosure is most effective when it forces the identification of the laggard—the one whose behavior is in some recognizable way inferior to his peers in terms of a consensus about social respectability. In other words, it helps induce what sociologists call a “mimetic” process,<sup>9</sup> or in more pedestrian terms, organizational conformity.

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7. Of course disclosure is a commonly invoked mechanism by which workers, consumers, and other agencies can gain useful information. I am not doubting the efficacy of this in general, but simply saying that this is not a proper function of securities law. To this I would add some doubt as to whether issuer management always has an accurate sense of the nature and consequences of its policies on other stakeholders. I suspect that there is a good deal of corporate “myth-making” by which managers fail to perceive the harms they may be doing. See generally Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997).

8. See Donald C. Langevoort, *Ego, Human Behavior, and Law*, 81 VA. L. REV. 853, 865-72 (1995) (stating that a person may fail to recognize, or try to justify, the wrongfulness of his own actions in order to bolster his self-image); see also Langevoort, *supra* note 7, at 143-46 (concluding that management is susceptible to an approach wherein they “see what they want to see”).

9. See Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, 48 AM. SOC. REV. 147, 151-52 (1983) (arguing that mimetic isomorphism, one of three mechanisms by which insti-

In the compensation area, however, it may, if anything, have caused companies to raise compensation faster than it might have otherwise, as peer payments become more visible and companies want to be at least competitive and—if they believe their executives are “special”—supra-competitive. The idea that boards who choose the CEO are motivated to see him or her as “special” should come as no surprise.<sup>10</sup> This herding kind of behavior could also have some troublesome effects in other areas as well. For instance, would mandatory disclosure of a broad range of corporate charitable contributions inhibit companies from making contributions either in amounts substantially greater than their peers or (more importantly) to causes that might be deemed overly controversial?<sup>11</sup>

I have one other important concern. By most accounts, the SEC is a highly successful administrative agency, even though it remains a bureaucracy with predictable flaws.<sup>12</sup> My sense is that one dominating reason for the success of the SEC is the focus that comes from a clearly defined mission—the protection of investors against overreaching by promoters, managers, and the like. This mission is the focus of the Commission’s culture, sometimes transmitted with what seems almost a theological fervor,<sup>13</sup> and is largely (though not entirely) apolitical. One can be extremely conservative and yet agree that, under some circumstances, markets work better because of the intervention of public disclosure requirements and antifraud enforcement.<sup>14</sup> Securities regulation,

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tutional isomorphic changes occur, results from standard responses to uncertainty); see generally Donna M. Randall & Douglas D. Baker, *The Threat of Legal Liability and Managerial Decision Making: Regulation of Reproductive Health in the Workplace*, in *THE LEGALISTIC ORGANIZATION* 169 (Sim B. Sitkin & Robert J. Bies eds., 1994) (providing an illuminating study of the relationship between organizational conformity and moral decision making).

10. See Langevoort, *supra* note 8, at 876-78 (“Having chosen either to hire or retain the chief executive officer, and often having superficially endorsed his or her major policies, the board is primed to allow the wisdom of those collective decisions to emerge over time”).

11. See generally Faith Stevelman Kahn, *Pandora’s Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 *UCLA L. REV.* 579 (1997) (providing a study of the charitable contribution problems). See also Symposium, *Corporate Philanthropy Law, Culture, and Education and Politics*, 41 *N.Y.L. SCH. L. REV.* 753 (1997) (foreword by Faith Stevelman Kahn).

12. See Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation*, 47 *WASH. & LEE L. REV.* 527 (1990).

13. See *id.* at 531.

14. Of course, politics plays an important role in the day-to-day functioning of the Commission, even on disclosure matters, but political considerations tend to be at the margins rather than on the question of whether mandatory disclosure and aggressive en-

properly administered, can be seen not as paternalism, but rather as an effort to optimize the cost of capital, justifying regulation on efficiency grounds. The introduction of the protection of potentially conflicting noninvestor interests as a regulatory objective is contrary to this focus, and would threaten a coherence that has long existed at the agency.

This is particularly important when we recognize the breadth and complexity of potential stakeholder interests. Labor unions are a good example.<sup>15</sup> To what extent are incumbent employees privileged over those less identifiable who might gain if there were changes? How are labor interests versus consumer (or environmental) interests to be balanced? There is no consensus on such questions; the answers could only be intensely political and ideological. Although it is impossible to prove, I believe that the Commission would be much less effective through a loss of cultural continuity were its agenda broadened in such a way. Disclosure for the benefit of other stakeholders often may be appropriate, but it should be the responsibility of another agency.

Of course, investors are not homogeneous, and even if investor protection remains the sole focus of the Agency, it does not follow automatically that disclosure of issuer-related information regarding its treatment of other stakeholders is inappropriate. This brings us to the other kind of stakeholder disclosure argument noted at the outset. Some investors have less financially-oriented utility functions, and there can be linkages between the treatment of stakeholder interests and financial returns. But here again, I would resist any effort to redefine the Commission's objective away from the protection of the financial interests of investors, for exactly the same reason just identified. The financial interests of investors are still the dominating concern, perhaps overwhelmingly so. Any significant move away from that focus becomes intensely political and ideological, with a resulting loss of simplicity and, inevitably, a sense of organizational tradition.

That leads me to the belief that proposed stakeholder-related disclosure subjects should have to pass fairly rigorous tests for what has been termed "quantitative" materiality, that is, some relatively tight coupling between the required disclosure and investment risk or return. Although I would love to be proven wrong, I doubt that there will be, anytime soon, good empirical tests linking social performance and financial return in a useful predictive way. There are too many contingencies in the na-

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forcement are good things. Indeed, some Republican-led periods of the SEC have been notable for the aggressiveness of their enforcement efforts.

15. See generally Schwab & Thomas, *supra* note 4 (describing realignment challenges to corporate governance posed by union-shareholder activism).

ture of the business, company history, and the current dynamics of its capital, labor, and product markets. I suspect that identification of such relationships will be more obvious to those ideologically committed to the interests of the stakeholder group in question than to anyone else. Only when greedy investment analysts and money managers take an interest in social performance and begin to demand stakeholder-oriented disclosure will we know that we are really on to something.<sup>16</sup>

Having said this, I should make clear that certain kinds of questions that have been debated under the rubric of “qualitative materiality” have such a nexus to investor well-being. For instance, I tend to agree with the trend in the courts that treats undisclosed illegality (whether under investigation or not) as material if either: (a) after applying the probability/magnitude test, the illegality would upon discovery have a significant impact on the company’s business or financial condition; or, (b) the illegality suggests a propensity of one or more senior executives to act disloyally or recklessly.<sup>17</sup> It is of course nonsensical to expect disclosure of such information in a 10-K, except in those situations where the company has already taken remedial action. Yet if there is some breach of an independent duty to disclose, the concealment should be actionable if for no other reason than investors can be injured directly by the misrepresentation or nondisclosure.<sup>18</sup> Similarly, I am persuaded that additional disclosure relating to a company’s charitable contributions is warranted, based on my sense that we are often talking about either a managerial prerequisite or, in more extreme cases, a form of self-dealing.<sup>19</sup> That is not far from the core “agency cost” concern of securities disclosure. But this is based on a desire to control or restrain improper contributions, not as a means of encouraging some socially optimal level of corporate giving.

If I have any qualms about this public endorsement of investor primacy, it is the sense that by identifying financial risk and return as the

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16. Admittedly, there is the circular point that until this information is disclosed, we will have no way of testing its materiality. That, however, gives short shrift to the alternative ways that investors have of gaining insight into the stakeholder-related practices of companies. Indeed, one can make the argument that the stakeholders themselves are better sources of information on this issue than company managers.

17. *See* *Roeder v. Alpha Industries, Inc.* 814 F.2d 22, 25 (1st Cir. 1987) (providing grounds when information about bribery may be considered material).

18. For example, a company that misrepresents its compliance with FTC regulations would surely be causing compensable financial harm to purchasers of the company’s securities. *See* *Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d 628, 640 (3d Cir. 1990).

19. *See* *Kahn*, *supra* note 11, at 624-25 (arguing that federal and state law condone a manager’s ability to use corporate contributions for his or her own interest at the expense of shareholders).



exclusive agenda item for the Commission, there is something of a social signal about what is important and what is not. I do not believe that maximizing anyone's return on investment is the highest social or moral good, and I accept that public discourse and the framing of economic issues does have an effect on values and attitudes. How we think and talk about markets, publicly and privately, does have important moral consequences.<sup>20</sup> I suspect, however, that there are better means than SEC disclosure for promoting a more inclusive social discourse.

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20. See Samuel Bowles, *Endogenous Preferences: The Cultural Consequences of Markets and Other Economic Institutions*, 36 J. ECON. LITERATURE 75 (1998).