

## Frank H. Knight on the “Entrepreneur Function” in Modern Enterprise

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The true uncertainty in organized life is the uncertainty in an estimate of human capacity, which is always a capacity to meet uncertainty.

-Frank H. Knight

### I. INTRODUCTION

In *The Modern Corporation and Private Property*, Adolf Berle and Gardiner Means argued that modern times required the rejection of the classic economics conception of business enterprise. For Berle and Means, the modern economy was dominated by corporations, whose legal structure allowed the separation of operational control from the enterprise’s ownership. In consequence, one could no longer assume that free markets would lead to socially preferable outcomes. Competition among Adam Smith’s numerous artisan shops and merchant owned-and-operated businesses had been replaced by industries dominated by a few large corporations, whose concentrated management operated independently of its ownership, which was diffused across hundreds, if not thousands, of isolated individuals. Diffused ownership with concentrated managerial control in oligopolistic industries could then lead to outcomes that were less than socially optimal.

The separation of ownership and control in the modern corporation raised two related questions for Berle and Means. First, if stockholders were no longer responsible for operational decisions, should they be en-

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titled to be the residual claimants on profits?<sup>1</sup> Second, given that managers, rather than owners, had control, could “social and legal pressure . . . be applied” to management to ensure that corporations operated “in the interests of some . . . wider group,” or “all society”?<sup>2</sup>

Berle and Means’s claim that the separation of ownership and control mattered for industrial society and policy set their theory of the corporation on a collision course with neoclassical economic theory. Just eleven years before their book appeared, neoclassical theory was given a coherent theory of business profit in Frank H. Knight’s *Risk, Uncertainty, and Profit* (RUP).<sup>3</sup> In a perfectly competitive world, Knight argued, economic profit was eliminated because no economic agent experienced uncertainty. Not only were all opportunity costs and benefits known to the agents in perfect competition, but individuals were certain of both their own and others’ desires and knew without doubt that parties would fulfill their contractual obligations. Decision-making in an environment of perfect competition was almost mechanical: as Knight later said, “[t]he Economic Man neither competes nor higgles . . . ; he treats other human beings as if they were slot machines.”<sup>4</sup>

The presence of economic profit, therefore, signaled the presence of uncertainty. Yet Knight did not draw the same conclusion from the presence of uncertainty as Berle and Means. For Knight, at the core of the modern enterprise operating in the midst of uncertainty was a small group of owners and managers who together performed the *entrepreneurial function* of providing “*responsible direction* of economic life,” the neglected feature of which was the inseparability of two elements: “*responsibility and control*.”<sup>5</sup>

While Knightian uncertainty is often characterized as an expression of the limitations of human knowledge, Knight argued it posed both problems of morals and knowledge. Responsible control required wise judgment not only about courses of action the outcomes of which could only be estimated, but also about the capacity of others to make wise judgments in the face of uncertain outcomes. The profit and loss of the enterprise was thus a return on entrepreneurs’ business judgments regarding both the outcomes of decisions and others’ capacities to make decisions in the midst of uncertainty. The implication of Knight’s focus

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1. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 333 (1932).

2. *Id.* at 333, 356.

3. FRANK H. KNIGHT, *RISK, UNCERTAINTY, AND PROFIT* (1921).

4. Frank H. Knight, *Ethics and Economic Reform* (1939), in 2 *SELECTED ESSAYS BY FRANK H. KNIGHT: LAISSEZ FAIRE: PRO AND CON* 1, 18 (R.B. Emmett ed., 1999) [hereinafter 2 *SELECTED ESSAYS*].

5. KNIGHT, *supra* note 3, at 271 (emphasis in original).

on inseparability is clear: those who fulfill the entrepreneurial role are not merely "passive property owners"<sup>6</sup> whose claims on business profits can be ignored in pursuit of the wider community's interests.

This Article explores Knight's theory of the entrepreneurial function in the modern enterprise in two contexts. The first is Berle and Means's arguments, in which I offer a reconstruction of Knight that responds to the argument in *The Modern Corporation* regarding both the corporate separation of ownership and control, and the potential for industrial policy to promote the social interest. The second context I use to explore Knight's understanding of entrepreneurship is his later arguments regarding the problem of intelligent control in a democratic society. From the 1930s to the end of his life in the early 1970s, Knight increasingly focused on the nature of a free, democratic society and the attendant problems for a social science that wishes to inform democratic action. While it is convenient to divide his life's work into two parts—the first focused on economic theory (ending in the early 1940s) and the second on social philosophy—the two are connected by a conception of human and social action in the midst of uncertainty that runs from RUP to Knight's last book, *Intelligence and Democratic Action*.<sup>7</sup>

Part II lays out the basic structure of Knight's theory of human and social action. Two features of uncertainty in modern political economy—namely, the principal-agent and moral hazard problems—are emphasized in Part III, and their implications for Knight's theory of entrepreneurship and his understanding of the potential for social control are developed. Finally, Part IV summarizes the essential features of a Knightian response to Berle and Means.

## II. KNIGHT ON HUMAN ACTION

### *A. Individual Action*

The primary problem of human action, in Frank Knight's view, is not the instrumental choice of an action that satisfies desires or wants. Rather, the first problem of action is discovering what one truly desires. That is, at the heart of every choice humans make is not the problem of want-satisfaction, but of want-*valuation*. The chief thing that the common-sense individual actually wants is not satisfactions for the wants which he has, but more, and better wants. The things that he strives to get in the most immediate sense are far more what he thinks he ought to want than what his untutored preferences prompt.

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6. BERLE & MEANS, *supra* note 1, at 356.

7. FRANK H. KNIGHT, *INTELLIGENCE AND DEMOCRATIC ACTION* (1960).

Life is not fundamentally a striving for ends, for satisfactions, but rather for bases for further striving; desire is more fundamental to conduct than is achievement, or perhaps better, the true achievement is the refinement and elevation of the plane of desire, the cultivation of taste. And let us reiterate that all this is true *to the person acting*, not simply to the outsider, philosophizing after the event.<sup>8</sup>

Actual human actions are therefore *moral judgments* rather than mere felicitous calculations, mechanical and chemical reactions, or instinctual responses. Such judgment is difficult, even in the context of a single person's decision-making. It not only requires rationality, to be sure, but also a degree of self-knowledge plus the virtues of courage, temperance, and prudence to carry out. Moreover, choices are perpetually prone to error, and not simply because we make mistakes emerging from our lack of knowledge about resources and tools. Error also occurs because we are exploring our values; even when we know the desire we seek to satisfy, we may later realize that it was not what we truly desired. And of course, there is always the problem classical philosophers called *akrasia*—weakness of will, or acting in ways we know to be against our better judgment.

In a world with many humans, individual action becomes vastly more complex because it requires estimation of others' judgments.<sup>9</sup> Knight argues the complexity is not only due to the lack of knowledge of other humans, but also fundamental *uncertainty* because others are often unsure how they will behave. If life is an exploration of values,<sup>10</sup> then human action is perpetually done in the midst of uncertainty, not only because of individual exploration, but also because of the exploration of all those similarly engaged.

In some cases, including the entrepreneurial context, uncertainty includes not only uncertainty about others' actions, but also uncertainty regarding the courage and willingness of others to act. Thus, human ac-

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8. Frank H. Knight, *Ethics and Economic Interpretation* (1922), in 1 SELECTED ESSAYS BY FRANK H. KNIGHT: "WHAT IS TRUTH" IN ECONOMICS? 40, 42–43 (R.B. Emmett ed., 1999) [hereinafter 1 SELECTED ESSAYS].

9. Although I adopt the artifice of moving from the individual to the social in analyzing Knight's theory of human action, he always thought of "valuation [as] inherently a social activity," and saw the "priority between individual and society" as mutual: "Each presupposes the other and this fact accentuates the complexity of the problems." Frank H. Knight, *Fact and Value in Social Science*, in FREEDOM AND REFORM: ESSAYS IN ECONOMICS AND SOCIAL PHILOSOPHY, 268, 276–80 (1982). Unlike Adam Smith, with whom he shared the notion of valuation as a social phenomenon mediated by language and who often spoke of the way the desire to be praiseworthy shaped our values and tastes, Knight spoke first of our use of concealment and deception in our communication with others. ADAM SMITH, *THE THEORY OF MORAL SENTIMENTS*, (D.D. Raphael & A.L. Macfie eds., 1982); KNIGHT, *supra* note 3, at 273.

10. Frank H. Knight, *The Limits of the Scientific Method in Economics*, in 1 SELECTED ESSAYS, *supra* note 8, at 1.

tion becomes a moral, as well as a knowledge, problem. All of these factors thus make human action a moral, as well as an intellectual, problem.

For most, certain areas of action are less explorative than others. Relationships are built over time, surprise us while they are developing, and provide stability once built. Rules and social conventions emerge as ways to structure common interactions that remove our need to make constant judgments about mundane (and sometimes not so mundane) actions. Contracts provide stability by reducing the range of uncertainties in our dealings with other parties. Institutions and organizations emerge to monitor, organize, and enforce rules and contracts, providing further stability and reducing the need for judgment in every aspect of our action.<sup>11</sup>

But judgment is still required, and some of us (or perhaps all of us at various times in some aspect of our life) are looking for challenges. As Knight said, “It is because human beings do not completely ‘know what they are doing’—particularly the consequences very far ahead—that life presents problems; and one result is that the entrepreneur function in economics exists and comes to be in all degrees specialized in a limited number of individuals.”<sup>12</sup>

Entrepreneurs are those persons who take challenges and are confident enough to back up their business engagement with financial resources they may lose.<sup>13</sup> In *The Ethics of Competition*, written a year after the publication of RUP, Knight argued that entrepreneurs deliberately constrain their consumption (i.e., want-satisfaction) in order to free resources and release their attention for the pursuit of challenges offered by the business “game.” Like all good games, the business game has known rules but an unpredictable outcome. Winners cannot be predicted in advance, but depend upon some combination of innate ability, learning from prior experience, exerted effort, and luck. (If it was not so, the Yankees would win every year.) “Where ‘records’ are made, the interest centers in the unpredictable fluctuations in the powers of men (or horses, etc.) from one trial to another.”<sup>14</sup> And if you are not willing to have any “skin in the game,” then you are not an entrepreneur.

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11. Later in life, Knight discussed the constant interplay of stability and novelty in the making, and breaking, of law. See, e.g., Frank H. Knight, *Science, Society, and the Modes of Law*, in 2 SELECTED ESSAYS, *supra* note 4, at 392.

12. Frank H. Knight, *Economics and Ethics of the Wage Problem* (1951), in 2 SELECTED ESSAYS, *supra* note 4, at 346.

13. The ones who take on the entrepreneurial function are “those with confidence in their judgment and disposition to ‘back it up’ in action.” KNIGHT, *supra* note 3, at 270. In a later essay, he pointed out that “[i]nsofar as the wage-workers are not actually made secure, they share in the entrepreneur function, regardless of how far they know what they are doing.” Frank H. Knight, *Economics and Ethics of the Wage Problem* (1951), in 2 SELECTED ESSAYS, *supra* note 4, at 336, 346.

14. Frank H. Knight, *The Ethics of Competition* (1923), in 1 SELECTED ESSAYS, *supra* note 8, at 80. For Knight’s general discussion of games and the ethics of sport in business, see *id.* at 75–82.

And what if you are certain that you are not going to be an entrepreneur? What happens as you interact with others in a complex, uncertain world? Having emerged from a religious background, which made him sensitive to moral criticisms of capitalism that emerged from Victorian England,<sup>15</sup> Knight considered this question. Near the end of RUP, Knight argued that society's central problem was the creation of a means for individuals to feel responsibility for their actions. Knight wrote that "[t]he insuperable difficulty of cooperative production has been to make the individual *feel* that the results depend upon his own activity."<sup>16</sup> Echoing Karl Marx, Ruskin, and many others, Knight continued that, "[t]he individual feels lost in the mass, helpless and insignificant."<sup>17</sup>

The usual modern answer to alienation—a democratic society that allows the individual to participate in social action—was problematic to Knight. For Knight, the fundamental question underlying social action was whether intelligent democratic action could provide us with what we seek—a life that is challenging and interesting, and not merely one of consuming things and acquiring wealth.<sup>18</sup> That, for Knight, was the fundamental problem underlying social action.

### B. Social Action

Neoclassical welfare economics has long argued that the chief problem of social action is the aggregation of individual wants regarding collectively provided goods. Yet Knight rejected this tradition from the outset.<sup>19</sup> Under Knight's theory, the primary problem of social action is not

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To recognize that his comments are relevant to entrepreneurs, one must note his occasional references to games in RUP, which closely parallel his discussion in *The Ethics of Competition*. KNIGHT, *supra* note 3, at 53, 88–89, 360–61.

15. The late Victorian critic of capitalism that Knight cites most frequently in his early work is John Ruskin, especially his collection of essays, *Unto This Last*. JOHN RUSKIN, *UNTO THIS LAST: FOUR ESSAYS ON THE FIRST PRINCIPLES OF POLITICAL ECONOMY* (1872). On Knight's early religious life, see Donald Dewey, *Frank Knight Before Cornell: Some Light on the Dark Years*, in 8 *RESEARCH IN THE HISTORY OF ECONOMIC THOUGHT AND METHODOLOGY* 1 (1990); Ross B. Emmett, *The Religion of a Skeptic: Frank H. Knight on Ethics, Religion, and Spirituality During his Iowa Years*, 40 *HIST. POL. ECON.* 315 (2008).

16. KNIGHT, *supra* note 3, at 359 (emphasis in original).

17. *Id.*

18. *Id.* at 369.

19. While the problem of aggregation lay in the background of early neoclassical welfare economics, Lionel Robbins kicked off the twentieth-century debate with his denial of interpersonal welfare comparisons. LIONEL ROBBINS, *AN ESSAY ON THE NATURE AND SIGNIFICANCE OF SCIENCE* (1932). Knight wrote a letter to Robbins shortly thereafter in which he argued: "The more I think about it the more I am inclined to say that the fundamental principle stressed so much in your book, of an absolute contrast between judgments of facts and judgments of value, is actually the basic error . . . . Stating it another way, I am inclined squarely to reverse the maxim, *De gustibus non [est] disputandum*, in this regard, and hold that only judgments of value can be discussed, facts as such not at all. That is, when we disagree about a fact it seems to me we disagree about the *validity* of observation or evidence, and that every disagreement is essentially a difference in evaluation." Ross B. Emmett, *De gustibus est disputandum: Frank H. Knight's Response to George Stigler and Gary*

the mechanical aggregation of preferences, for human language provides us with the means (i.e., discussion) to reach agreement on what we collectively want. Rather, the primary problem is social agreement on the standards by which wants will be socially valued. That is, just as individual action is a judgment regarding want-valuation more than an act of want-satisfaction, so too is social action more a judgment regarding the choice of standards by which wants will be socially valued than an act of satisfying preferences regarding public goods. Instead of affirming the standard economic assumption that *de gustibus non disputandum est*,<sup>20</sup> Knight not only claimed that *de gustibus* is all humans argue about, but also that it is the primary form of social valuation.<sup>21</sup>

Knight’s initial step from individual human action to social action is apparent in two writings produced shortly after RUP. The first was a series of lecture notes for his students at the University of Iowa, written in the mid-1920s, and used a decade later at the University of Chicago for a general social science undergraduate course. The notes were eventually published under the title *The Economic Organization*.<sup>22</sup> In the first chapter, he identified the primary function of any form of economic organization as being that of “fixing standards”: “when the production of wealth is socialized, there has to be a *social* decision as to the relative importance of different uses of productive power, as to which wants are to be satisfied and which left unsatisfied or to what extent any one is to be satisfied at the expense of any other.”<sup>23</sup>

The same problem emerges as central to social action in an essay on value theory from the same time period. Knight says:

Acceptance of some kind and degree of validity in canons and standards of taste involves recognition of values which are *more* than factual desire and desire-satisfaction. As in the previous steps, valuation involves desire, unquestionably; values *are* desired; much confusion arises from the human disposition to over-simplification, tending to assume that the two must be either identical or wholly different. . . . What is essential is the recognition that intelligent dis-

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Becker’s ‘*De gustibus non est disputandum*,’ 13 J. ECON. METHODOLOGY 97, 108 (2006) (emphasis in original).

20. George J. Stigler & Gary S. Becker, *De gustibus non est disputandum*, 67 AM. ECON. REV. 76 (1977).

21. Emmett, *supra* note 19.

22. For the history of *The Economic Organization*, see generally Ross B. Emmett, FRANK KNIGHT AND THE ECONOMIC ORGANIZATION (2008).

23. FRANK H. KNIGHT, THE ECONOMIC ORGANIZATION, WITH AN ARTICLE ‘NOTES ON COST AND UTILITY,’ (1951). In economics, most treatments of Knight’s first function have adopted Paul Samuelson’s claim that it is equivalent to the question “what should we produce”—the first function of an economy in Samuelson’s famous list. PAUL SAMUELSON, ECONOMICS: AN INTRODUCTORY ANALYSIS (2d ed. 1951). Clearly, however, Knight means more by “fixing standards” than most economists do.

cussion of conduct includes and requires acceptance of valuation or taste as *more* than motivation, as motivation is *more* than vegetable appetite plus awareness, and this *more* than force, and force *more* than laws of motion. This recognition of valuation introduces a new *kind* of possibility of error, error in regard to *ends* as well as error in regard to *means*.<sup>24</sup>

The second essay also reminds us that the social decision to fix the standards by which values are judged emerges because of the fundamental uncertainty in our lives about what we value. But in both essays, Knight quickly raises the question: Who decides the standards? Most social scientists resort to the generic term “society” as an answer to that question; Berle and Means, for example, argued that it is up to “society” or “the community” to decide how to control the modern corporation, without concern for the problem of social agreement in the community. For Knight, however, social action is peculiar to democratic capitalism. In an authoritarian regime, the action of the dictator is the action of society (*L'état, c'est moi*), and hence the result of individual judgment. In a democracy, social action requires *discussion* about what we want to do, and discussion of what to do is for Knight, as we have seen already, a discussion of what we value. What wants will be satisfied? Which will not? How will we know the relative value of different uses of production? For Knight, a free society chooses to answer those questions through a price system in the economic realm, and democracy in the political realm. And the decision regarding the economic and political institutions that will shape social action is itself a moral judgment. Social action, then, “in the essential and proper sense, is group self-determination.”<sup>25</sup> In fact, Knight argued that one should only speak of social action in the context of a free, democratic society.

### III. MORAL HAZARD AND PRINCIPAL–AGENT PROBLEMS

#### *A. In the Context of Democratic Governance*

Echoing Viscount Bryce,<sup>26</sup> Knight often said that democracy is “government by discussion.”<sup>27</sup> Discussion is a form of human conduct, and hence Knight argued that our participation in it is susceptible to the entire range of our interests and motives. Despite our best intentions to

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24. Frank H. Knight, *The Problem of Value in Economic Theory*, (unpublished papers) (on file in University of Chicago Special Collections Research Center).

25. Frank H. Knight, *Social Science* (1941), in *ON THE HISTORY AND METHOD OF ECONOMICS: SELECTED ESSAYS* 121, 133 (1956).

26. JAMES BRYCE: *THE AMERICAN COMMONWEALTH* (1888).

27. Frank H. Knight, *The Sickness of Liberal Society* (1946), in *2 SELECTED ESSAYS*, *supra* note 4, at 302.



be rational participants, our participation in social discussion still involves “an unanalyzable mixture of mechanical interaction, free exchange of [ideas], and also both giving and taking, by coercion or deception, on both sides.”<sup>28</sup> Knight focused on two related features of our participation in social action that emerge from the complex, “unanalyzable mixture”: they are what we now call the moral hazard and principal-agent problems.

Democratic discussion that leads to good judgments is costly to participants, and hence, some members of a free society may seek to obtain the benefits of social action without incurring the cost. Those committed to democratic participation could find that others shirk their social responsibilities while benefiting from social action. In particular, Knight argued that free society was constantly in danger of its participants replacing discussion-based democratic judgment with some close substitute. For example, from the late 1940s on, he characterized the appeal to moral authorities (moralism) and the appeal to scientific expertise (scientism) as the chief threats to free society. When the moral authority of tradition or religion or the expert knowledge of a scientific community became the basis for policy, the action ceased to be a social action according to Knight’s standard. At that point, members of society turned over their own judgment to another group. Knight never explicitly identified this democratic dilemma as a social version of the problem of moral hazard. But late in his career, his perpetual quest to shore up the institutional structure of free markets and liberal democracy with an ethical defense of our devotion to participation in free discussion can be seen as a response to the moral hazard implicit in democratic governance of human social action.<sup>29</sup>

The principal-agent problem is closely related to the moral hazard problem, but Knight seldom mentioned it in his later work on social action. Yet the concept is discussed at length in the concluding chapter of RUP, “Social Aspects of Uncertainty and Profit.” The chapter is seldom mentioned in studies of Knightian uncertainty and is perhaps rightly ignored as a meandering set of final thoughts, some rehearsing what was already said, and others more explorative than declarative. Among the latter is a discussion of the principal-agent problem in the modern enterprise and in modern democracies. Despite their brief and explorative nature, Knight’s comments are remarkably prescient to Berle and Means’s argument in *The Modern Corporation*.

Knight questioned whether managers in a modern enterprise would *feel* more responsibility for their decisions under a system of private

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28. *Id.* at 300.

29. *See, e.g., id.*

ownership or one of public ownership. Advocates of public ownership (socialism) argue, in a manner similar to what Berle and Means claimed eleven years later, that diffused private ownership of modern corporations leaves active managers disconnected from passive owners. Greater efficiency could be gained, the public ownership advocates claim, by substituting the public—"society"—for this dispersed body of private owners. We will return to Knight's response to this claim in regard to its effect on the modern enterprise in a moment, but now look only at his response regarding how the manager would respond to society as his owner.<sup>30</sup>

Earlier, we saw that Knight agreed with the critics of capitalism that the system alienates individuals, leaving them lost in the masses. But unlike the critics of capitalism,<sup>31</sup> Knight argued that the feeling of insignificance applies to the capitalist entrepreneur as well as laborers, for in modern society, even the capitalist is "*really a social functionary*."<sup>32</sup> Yet the problem with the critics' position is that substitution of public control would only make that alienation worse, both for the capitalist-entrepreneur and for society as a whole:

If we get more effective management through the system of concentrated private ownership than we would through some democratic machinery, it is because men plan better when they do not *feel* like government officials doing things for other people, when they feel their work as their own and identify their personalities with it.

And this even though the same men know "in their hearts," subconsciously if not consciously, that they *are* the agents of the democracy and ultimately responsible to it for their trust. For it is clear that the "personal" interests which our rich and powerful business men work so hard to promote are not personal interests at all in the conventional economic sense of a desire to consume commodities. . . . The real motive is the desire to excel, to win at a game, the biggest and most fascinating game yet invented, not excepting even statecraft and war.<sup>33</sup>

For Knight, turning capitalist-entrepreneurs into public servants in a government bureaucracy would separate their interests from those of the society or community that charges them with the task of working on their

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30. Knight offers no empirical evidence for his claims in this section, depending, as in his later work, on the introspective method. Frank H. Knight, *What is Truth in Economics* (1940), in 1 SELECTED ESSAYS, *supra* note 8.

31. Marx is probably the critic who comes closest to Knight's position. KARL MARX, CAPITAL: A CRITICAL ANALYSIS OF CAPITALIST PRODUCTION (1887).

32. KNIGHT, *supra* note 3, at 359 (emphasis in original).

33. *Id.* at 360 (emphasis in original).

behalf. The principal–agent problem, therefore, is a significant issue in social action and undermines the effort of society to direct socially controlled resources to productive ends.

Even more importantly, the principal–agent relation between society and public officials would lead to cautiousness on the part of public bureaucrats thrust into business management. They would make decisions that maintain the status quo and act in favor of efficiency and manageable risks, rather than undertake entrepreneurial actions with the potential to move society forward. The claim that entrepreneurs will be too cautious in the face of uncertainty is false, Knight reminded his readers as he closed the book, precisely because the challenges of contributing new value to people in an uncertain world is what entrepreneurs live for.<sup>34</sup>

To Knight, both the problems of moral hazard and the coordination of incompatible principal–agent interests make *social* control of productive resources unlikely to produce the best possible outcomes. Achieving efficiency in resource utilization will be problematic, and social progress will be stymied by bureaucratic cautiousness. Unfortunately, even increased social oversight of government—whether by scientific experts, blue-ribbon committees, congressional audits, or even citizen panels—will not solve this central failure of social action. When Knight returned to this problem later in life, the only protection he could offer was the cultivation of a commitment to intelligent, free discussion among a liberal society’s citizenry:

If free society is to persist, or improve, the people must learn that problems are to be solved only by intelligent agreement through genuine free discussion. . . . The possibilities of freedom in effectively organized society [have] sweeping limitations; but accepting these and working intelligently within their bounds, and not too discontentedly, is the price of the residual freedom that is possible.<sup>35</sup>

Despite clinging to the faint hope that liberal society might uphold the limited promise of “intelligent agreement through genuine free discussion,”<sup>36</sup> Knight’s recognition of the sweeping limitations moral hazard and principal–agent problems posed for intelligent social action (not to mention the romantic urge to appeal to moral solutions) made him frequently despair that freedom could be retained.

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34. *Id.* at 369–73.

35. KNIGHT, *supra* note 7.

36. *Id.*

*B. In the Context of Entrepreneurial Action*

The four sentiments of the previous section regarding the prospects for intelligent social action do not apply equally to Knight's assessment of the prospects for entrepreneurial action. Of course, given his generally dyspeptic approach, you will not be surprised if Knight is only slightly less skeptical of the potential success of market outcomes than of government action.<sup>37</sup> After all, if the description of Knight's theory of human action in Part II was correct, then his fundamental insight is that all human action (which is always action in the midst of uncertainty) is plagued by the problem of moral hazard. Private control of productive resources, then, faces the same moral hazard problem as social control.

Yet in RUP, Knight argued that the principal-agent problem could be solved, and the moral hazard problem faced, if not overcome, in the context of entrepreneurial action. The entrepreneurial solution to the principal-agent problem includes two parts. First, despite the fact that dispersed ownership of the modern enterprise opens the possibility for owners and managers to have incongruent interests and expectations, Knight argues that in every successful modern enterprise there is a "small group of 'insiders' who are the real owners of the business."<sup>38</sup> The majority of the dispersed owners "do not regard themselves and are not regarded as owners," a fact that the "insiders count upon"<sup>39</sup>—here Knight agrees with Berle and Means regarding the passivity of most corporate owners. But the insiders, as well as senior corporate managers, "know each other's personalities, motives, and policies tolerably well." Their common knowledge of, and accountability to, each other, as well as their mutual accountability, creates a cadre of company leadership that functions like a single entrepreneur.<sup>40</sup> Because the "entrepreneur function"<sup>41</sup> of making responsible judgments for the enterprise is carried out by a small group of owner-managers, there is no separation of ownership and control; "responsible direction" is carried out *as if* by a single person.

The second aspect of Knight's solution to the principal-agent problem harkens back to a central feature of his argument about why the problem is so difficult for social action: the manager's *feeling* of responsibility and accountability for his actions. We saw earlier that when the manager serves "society," he loses any feeling of direct responsibility and accountability for his actions. Because he does not feel a connection

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37. In an earlier essay, I argued that RUP also reaches a similar conclusion regarding the prospect for the Economist as "knower." Ross B. Emmett, *The Economist and the Entrepreneur: Modern Impulses in Frank H. Knight's Risk, Uncertainty and Profit*, 31 HIST. POL. ECON. 29 (1999).

38. KNIGHT, *supra* note 3, at 359.

39. *Id.*

40. *Id.*

41. *Id.* at 289.

to “society” at large, his actions serve his own interests. But in the enterprise, insiders who perform the entrepreneurial function do *feel* responsible and accountable. The sense of responsibility and accountability that owners and managers share in the modern enterprise allows them to fulfill the function played by the entrepreneur in the classic sole proprietorship.

Let me pause for a moment to suggest that Knight’s solution to the principal–agent problem highlights a problem with most interpretations of Knightian uncertainty. Most interpreters of Knight consider his contribution to be the introduction of the notion that we do not entirely know what the future holds. Those who want to make a finer point note the distinction between risk and uncertainty is either between outcomes where probabilities can be assigned or not,<sup>42</sup> or between insurable and uninsurable situations.<sup>43</sup> For Knight, however, uncertainty is not simply a knowledge or insurability problem; it is what makes uncertainty uninsurable that matters. What we do not know—and what makes our own future actions uncertain and hence uninsurable—is what we really want to accomplish by our own actions, and what drives other people to act. For Knight, then, uncertainty is fundamentally a *moral problem*.<sup>44</sup>

The moral component of Knight’s conception of uncertainty is important as we turn to the moral hazard problem in the context of entrepreneurial action. In the first Part, we saw that for Knight, those who accept the moral challenge of exercising *responsible judgment* regarding the use of resources in the midst of uncertainty are entrepreneurs. The entrepreneur accepts the challenge of acting even when there is a potential for moral hazard to exist, and backs it up by hazarding his own resources.<sup>45</sup> But the entrepreneur exercises responsible judgment in doing so. The key judgment the entrepreneur makes, Knight argued, regards his opinion of those with whom he contracts, including suppliers, workers, and clients. In an uncertain world, “attention and interest shift from the errors in men’s opinions of things to the errors in their opinions of men.”<sup>46</sup> Frequently we speak of moral hazard and other problems of uncertainty as unsolvable. Knight agrees, yet he says: “Like a large portion

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42. MILTON FRIEDMAN, *PRICE THEORY: A PROVISIONAL TEXT* 282 (1976).

43. Stephen F. LeRoy & Larry D. Singell, Jr., *Frank H. Knight on Risk and Uncertainty*, 95 J. POL. ECON. 394 (1987).

44. In a 1951 essay that touches on entrepreneurship, Knight lends some credibility to the insurability account of uncertainty when he says: “Analytically, it is desirable to restrict entrepreneurial ‘risk’ to that which cannot be insured against or eliminated by grouping cases; it is commonly thought better to call it by the different term ‘uncertainty.’” Frank H. Knight, *Economics and Ethics of the Wage Problem* (1951), in 2 *SELECTED ESSAYS*, *supra* note 4, at 345. But he goes on to discuss why such risks are uncertain in the same terms he did in RUP: the necessity of responsible direction and, in particular, the need to choose wisely in hiring one’s agents.

45. KNIGHT, *supra* note 3, at 299.

46. *Id.* at 292.

of the practical problems of business life, as of all life, this one of selecting human capacities for dealing with unforeseeable situations involves paradox and apparent theoretical impossibility of solution. But like a host of impossible things in life, it is constantly being done.”<sup>47</sup> The difference between the managerial function and the entrepreneurial function boils down to this: “the *crucial* decision is the selection of men to make decisions, that any other sort of decision-making or exercise of judgment is automatically reduced to routine function.”<sup>48</sup> For Knight, entrepreneurs earn their profit because they alone judge who they trust to make decisions.

#### IV. A KNIGHTIAN RESPONSE TO *THE MODERN CORPORATION*

We are now ready to construct a Knightian response to Berle and Means’s claims regarding the modern enterprise and social control in *The Modern Corporation*.<sup>49</sup> We proceed in three stages.<sup>50</sup>

The first stage of construction concerns the claim that the modern corporation is characterized by the separation of ownership and control. Berle and Means are correct that diffused ownership causes some, if not most, shareholders to lose interest in operational control of the firm; these passive owners, Knight said, are similar to creditors and are regarded by the firm as such.<sup>51</sup> But there is a subset of shareholders who, together with the core managerial leadership, take responsibility for direction of the firm and also put their own resources at risk. To quote Knight, they are the ones who “venture”<sup>52</sup> and fulfill the entrepreneur function. Thus, the initial stage of a Knightian response argues that Berle and Means are incorrect to claim that all shareholders are passive and can therefore be entirely separated from operational control of the firm.

The second stage follows Berle and Means’s claim that, in absence of owner control of the firm, modern corporations can be directed by society toward more beneficial societal goals. The Knightian response builds on the assumption, true enough in most democratic societies, that

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47. *Id.* at 298.

48. *Id.* at 297 (emphasis in original).

49. An interpretation of Berle and Means that is consistent with the claims this Knightian response is aimed at can be found in Erika George, *See No Evil? Revisiting Early Visions of the Social Responsibility of Business: Adolf A. Berle’s Contribution to Contemporary Conversations*, 33 SEATTLE U. L. REV. 965 (2010).

50. I hasten to remind you of two things: First, Knight never reviewed or directly responded to Berle and Means; and second, I do not speak for Knight, but merely construct a response consistent with the argument made in the previous sections about his understanding of uncertainty, entrepreneurial function, the modern enterprise, and the prospects for social control. Rather, what is sketched here is a possible avenue of criticism of the Berle and Means argument, constructed on the basis of Knight’s understanding of uncertainty and the entrepreneurial function in modern enterprise.

51. KNIGHT, *supra* note 3, at 358–59.

52. *Id.* at 269.

representatives of “society”—elected officials perhaps, as well as bureaucrats and regulators—would act on behalf of society to provide direction of the corporations. In the final chapter of RUP, Knight argued that these representatives—“agents” of the people, if you will—are placed in the same position in relation to “society” that Berle and Means argued managers hold in relation to the stockholders of the modern corporation. Thus, substituting “society” for a corporation’s “ownership” does not solve the principal–agent problem, and probably intensifies it, because “society” is far more diffuse than the ownership of any modern corporation.

Before moving to the third stage, we should pause to acknowledge a possible problem with the second stage of the Knightian response. Knight does not abandon methodological individualism as he moves from considerations of individual action to social action. Rather than adopt an organic conception of society (i.e., methodological collectivism), he saw social action as the actions individuals take as a result of laws constructed through intercommunication (through formal and informal discussion) among individuals in society.<sup>53</sup> If Berle and Means based their argument regarding social control of the modern corporation on organicism, one could defend their position on the grounds of their methodological starting point. At many points, they do indeed appear to operate with an organic conception of society; for example, when they claim that the modern corporation places “the community in a position to demand” that the corporation serve “all society,”<sup>54</sup> or speak of the “economic organism” as superseding the state “as the dominant form of social organization.”<sup>55</sup> But at other points they sound more like Knight:

It remains [after the creation of the modern corporation] only for the claims of the community to be put forward with clarity and force. Rigid enforcement of property rights as a temporary protection against plundering by control would not stand in the way of modification of these rights in the interests of other groups. When a *convincing system of community obligations is worked out and is generally accepted*, in that moment the passive property right of today must yield before the larger interests of society.<sup>56</sup>

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53. Knight’s adoption of functionalist language (“entrepreneur function” and “social functionaries”) can be confusing in this regard, because functionalism is generally associated with social organicism. But Knight does not assume that once individuals step into social functions they substitute a social interest for their own. Thus, he is always attuned to the problems, like agency and moral hazard, which occur because of the tension between individual and social interest among those performing social functions.

54. BERLE & MEANS, *supra* note 1, at 356.

55. *Id.* at 357.

56. *Id.* at 356 (emphasis added).

While one could reconcile their talk of groups with organicism, a “convincing system of community obligations” would be “worked out” and “generally accepted” by individuals engaged in deliberative discussion, that is, by Knightian social action. Their lack of clarity regarding the nature of “community” and “social interest” lends force to the Knightian critique.

Assuming the methodological individualist position Knight adopts, the third stage of a Knightian response addresses the moral hazard problem. In Knight’s view, moral hazard creates more problems for social control than the principal–agent problem. Participation in social discussion is distributed widely, but control by what Knight called social functionaries is concentrated in individuals that could actively use their position to better their own welfare rather than the common interest. And there is little in Berle and Means’s argument about society and the social control of the modern corporation to stop them. Assuming politicians and bureaucrats are socially benevolent, and giving them control over vast economic power in the name of social good is hazardous, as we knew long before Knight.

In the modern enterprise, Knight argues, the moral hazard problem also exists, but the “entrepreneur” accepts that hazard because he trusts his judgment regarding the capacity of people to face uncertainty. He may be wrong, but he then bears the financial and operational responsibility for that failure. In society, no such entrepreneur exists. Social control faces the prospect of failure from both principal–agent and moral hazard problems. The modern enterprise, under the leadership of an entrepreneurial group, eliminates the principal–agent problem, and accepts the challenge of responsible direction knowing moral hazard problems may appear. To expect more would be a denial of the basic uncertainty of the world in which humans act.