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Learning Topic

Governance and Accountability

Who Owns the Corporation? The Legal Debate

Do shareholders own the company? To most people, this idea is so axiomatic that the question hardly seems worth asking. However, the long-simmering debate about the age-old argument over the board's responsibilities to shareholders versus the rights of all company stakeholders flared up again recently, drawing attention once again to that central question (Bernstein, 2008).

In the latest round of this debate, two leading corporate governance experts—Lucian Bebchuk, Harvard Law School professor and ardent shareholder-rights proponent, and Martin Lipton, founding partner of Wachtell, Lipton, Rosen & Katz and a stalwart defender of the view that management's prerogative is to act in the best interest of the corporation—squared off in the pages of the *Virginia Law Review* (see Bebchuk, 2007, p. 675; Lipton & Savitt, 2007, p. 733). The central issue in this debate is whether directors of a public company owe their primary fiduciary duty to its shareholders, as Bebchuk insists, or if they have to consider the prerogatives of all the stakeholders, as Lipton maintains.

Bebchuk (2007) cites a widely quoted 1988 ruling by the Delaware courts that "the shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests" and points out that corporate law gives boards the authority to hire and fire management and set the company's overall direction. Next, he argues that since directors are expected to serve as the shareholders' guardians, shareholders must have the power to replace them. Thus, the fear of being replaced is supposed to make directors accountable and provide them with incentives to serve shareholder interests.

He continues by noting just how infrequently US directors are actually challenged, much less removed, and concludes that shareholder power to replace directors in the United States is largely a myth. To make shareholder power real, he supports the proposal that directors be elected by a secret ballot open to rival candidates nominated by shareholders. To put them on an equal footing with the slate proposed by the board's nominating committee (usually with management input), he suggests that challengers be reimbursed by the corporation if they receive a threshold number of votes.

Taking the opposing view and challenging the widely accepted argument that a company's primary goal is to maximize shareholder value, Lipton challenges the very notion that corporations are the private property of stockholders. "Shareholders do not own corporations," he says. "They own securities—shares of stock—which entitle them to very limited electoral rights and the right to share in the financial returns produced by the corporation's business operations" (Lipton & Savitt, 2007, p. 733). Directors, he argues, are not merely representatives of shareholders who have a legal responsibility to put investor interests first. Instead, the role of the board is simply and dutifully to seek what is best for the company itself, which means balancing the interests of shareholders as well as other stakeholders, such as management and employees, creditors, regulators, suppliers, and consumers. He concludes that Bebchuk's notion that a board's primary fiduciary obligation is to shareholders is a myth of corporate law.

Focus of US Governance Law: Conduct or Accountability?

Governance in the United States has evolved as a medley of federal law—including not only corporation law but also tax and labor law—state law, and a series of codes of various self-regulating authorities ranging from the NYSE to the accounting industry. State law has traditionally been the ultimate arbiter of governance issues. In contrast, in the United Kingdom, corporate reform can be affected simply through an act of Parliament.

This unusual history of governance law in the United States has created an opening to support different interpretations of a variety of its provisions. For example, the law not only identifies shareholders as the owners of the corporation but also defines them as investors who receive ownership in the corporation in return for money or assets they invest. It stipulates that shareholders are responsible for electing a board of directors, the operators of the corporation who have overall responsibility for the business of the corporation, but it does not meaningfully address the implementation of this statute. It also specifies that the board of directors, rather than its shareholders, directs a company's business and affairs.

Additional guidance about a board's fiduciary role is contained in statutes governing the role and conduct of individual board members. Specifically those defining a director's obligation in terms of such principles as the duty of care, duty of loyalty, and the business judgment rule. The duty of care requires directors to be informed, prior to making a business decision, of all material information reasonably available to them in the exercise of their management of the affairs of a corporation. The duty of loyalty protects the corporation and its shareholders. It requires directors to act in good faith and in the best interests of the corporation and its shareholders. The prevalent legal standard is that the duty of loyalty requires that the director be "disinterested," such that he or she "neither appears on both sides of a transaction nor expects to derive any personal financial benefit from it," and his or her decision must be "based on the corporate merits of the subject before the board rather than extraneous considerations or influences" (*The American Law Institute*, 1994, p. 61). The business judgment rule protects directors from liability for action taken by them if they act on an informed basis in good faith and in a manner they reasonably believe to be in the best interests of the corporation's shareholders. The business judgment rule does not apply in cases of fraud, bad faith, or self-dealing.

As long as these principles are adhered to and as long as directors are careful and loyal to corporate and shareholder interests, they have wide discretion to exercise their business judgment as they see fit. None of these principles provide clear guidance to the central question of who owns the corporation.

Corporate Purpose: A Societal Perspective

One reason that US governance law is sometimes indeterminate is that the enormous differences between the two legal views described above reflect a broader, philosophical debate on the role and purpose of corporations in society. Indeed, opposing views on the purpose and accountability of the corporation—shareholders versus stakeholders, or private (property) versus public (social and political entity) conceptions of the corporation—have been part of the governance debate for well over 100 years.

Shareholder capitalism, until recently prevalent mainly in the United States and the United Kingdom, holds that a company is the private property of its owners. From a legal perspective, the Anglo-American corporation is essentially a capital market institution, primarily accountable to shareholders, charged with creating wealth by exploiting market opportunities. Stakeholder capitalism, on the other hand, embodies a more organic view of the corporation in which companies have broader obligations that balance the interests of shareholders with those of other stakeholders, notably employees but also including suppliers, distributors, customers, and the community at large. Under this set of beliefs, the corporation is seen as an institution with a continuing purpose, and therefore, with a life of its own. Shareholders and wealth creation for owners do not dictate its priorities. Rather, a deep concern for employees, suppliers, and customers, and implicitly for its own continued existence, defines the corporate mission.

Stakeholder capitalism can take different forms, reflecting the degree of commitment to different stakeholders. Germany's legal system, for example, makes it clear that firms do not have a sole duty to pursue the interests of shareholders. Under Germany's system of codetermination, employees and shareholders in large companies hold an equal number of seats on the companies' supervisory boards, and the interests of both parties must be taken into account in decision making. In Denmark, employees in firms with more than 35 workers elect one-third of the firm's board members, with a minimum of two. In Sweden, companies with more than 25 employees must have two labor representatives appointed to the board. These employee board members have all the rights and duties of other board members.

The situation differs somewhat in France. French firms with more than 50 workers have employee representatives at board meetings, but they do not have the right to vote. More conventional codetermination systems exist for former public-sector French firms that have been privatized. These systems can be introduced voluntarily by companies. In Finland, companies can also voluntarily adopt employee representatives on the board. Across the European Union (EU) as a whole, another type of worker participation in decision making is the works council, a group that has a say in such issues as layoffs and plant closures. A corporation with at least 1,000 employees, of which there are 150 or more in at least two EU countries, must have a European Works Council.

Japanese firms also differ from those in the United States and the United Kingdom. Japanese executives do not have a fiduciary responsibility to stockholders, but they can be liable for gross negligence in performing their duties. At the same time, it is accepted practice in Japan that managers align their priorities with the interests of a variety of stakeholders. For example, a recent survey revealed that if Japanese executives feel that the company is going through a tough period financially, keeping their employees on the job is much more important than maintaining dividends to shareholders. Specifically, only 3 percent of Japanese managers said companies should maintain dividend payments to stockholders under such circumstances. This compares with 41 percent in Germany, 40 percent in France, and 89 percent in both the United States and the United Kingdom.

In the United States, these issues also continue to be debated. Some time ago *Reason* (2005) magazine featured a spirited debate featuring the late Milton Friedman, former senior research fellow at the Hoover Institution and Paul Snowden Russell Distinguished Service Professor of Economics at the University of Chicago; John Mackey, founder and CEO of Whole Foods Market; and others, on the purpose of the corporation. Friedman, a Nobel laureate in economics and the author of a famous 1970 *New York Times Magazine* article titled "The Social Responsibility of Business Is to Increase Its Profits," had no patience with capitalists who claimed that "business is not concerned 'merely' with profit but also with promoting desirable 'social' ends; that business has a 'social conscience' and takes seriously its responsibilities for providing employment, eliminating discrimination, avoiding pollution, and whatever else may be the catchwords of the contemporary crop of reformers" (Friedman, 1970).

He wrote that such people are "preaching pure and unadulterated socialism. Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades."

Mackey disagreed vehemently with Friedman. A self-described ardent libertarian who likes to quote Ludwig von Mises on Austrian economics and Abraham Maslow on humanistic psychology, and is a student of astrology, Mackey believes Friedman's view of business is too narrow and underestimates the humanitarian potential of capitalism. Selected portions of this debate are reprinted below, beginning with Mackey's passionate, personal vision of the social responsibility of business.

> In 1970 Milton Friedman wrote that "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud." That's the orthodox view among free market economists—that the only social responsibility a law-abiding business has is to maximize profits for the shareholders.

> I strongly disagree. I'm a businessman and a free market libertarian, but I believe that the enlightened corporation should try to create value for all of its constituencies. From an investor's perspective, the purpose of the business is to maximize profits. But that's not the purpose for other stakeholders—for customers, employees, suppliers, and the community. Each of those groups will define the purpose of the business in terms of its own needs and desires, and each perspective is valid and legitimate. (Friedman, Mackey, & Rodgers, 2005)

Mackey continues, "We have not achieved our tremendous increase in shareholder value by making shareholder value the primary purpose of our business...the most successful businesses put the customer first, ahead of the investors. In the profit-centered business, customer happiness is merely a means to an end: maximizing profits. In the customer-centered business, customer happiness is an end in itself, and will be pursued with greater interest, passion, and empathy than the profit-centered business is capable of."

Not surprisingly, Friedman respected Whole Foods' success but took issue with its business philosophy.

"Maximizing profits is an end from the private point of view," he wrote. "It is a means from the social point of view. A system based on private property and free markets is a sophisticated means of enabling people to cooperate in their economic activities without compulsion; it enables separated knowledge to assure that each resource is used for its most valued use, and is combined with other resources in the most efficient way."

Mackey replied, "While Friedman believes that taking care of customers, employees, and business philanthropy are means to the end of increasing investor profits, I take the exact opposite view: Making high profits is the means to the end of fulfilling Whole Foods' core business mission. We want to improve the health and well-being of everyone on the planet through higher-quality foods and better nutrition, and we can't fulfill this mission unless we are highly profitable. High profits are necessary to fuel our growth across the United States and the world. Just as people cannot live without eating, so a business cannot live without profits. But most people don't live to eat, and neither must a business live just to make profits" (Friedman, Mackey, & Rodgers, 2005).

Mackey's logic was perhaps most effectively first articulated by Peter Drucker in 1974 in his famous book *Management: Tasks, Responsibilities and Practices*. "The purpose of a business is not to make a profit," Drucker wrote. "Profit is a necessity and a social responsibility. A business, regardless of the economic and legal arrangements of society, must produce enough profit to cover the risks of committing today's economic resources to the uncertainties of the future; to produce the capital for the jobs of tomorrow; and to pay for all the non-economic needs and satisfactions of society from defense and the administration of justice to the schools and the hospitals, and from the museums to the boy scouts. But profit is not the purpose of business. Rather a business exists and gets paid for its economic contribution. Its purpose is to create a customer" (Drucker, 1974, p. 67).

This discussion raises questions that transcend the legal debate on fiduciary obligations. It asks us to consider questions, such as, What does society want from corporations? What are the moral obligations and responsibilities of business? Who has the right to make such decisions in a public company? Is shareholder wealth maximization the right objective? What obligations does a company have to other stakeholders, such as employees or suppliers, and the community at large? Are these objectives necessarily in conflict with each other? If so, how should trade-offs be made? Furthermore, the discussion suggests that to be consistent and effective, directors and boards should have ready answers to many, if not all, of the questions and know where they agree or disagree. As we shall see, regrettably, this is not true. Not only has the United States, as a society, changed its perspective on this issue several times, but also, today, the majority of directors remain confused, sometimes intimidated, by the law and often are unwilling or unable to debate these issues openly.

The Primacy of Shareholder Interests: A Historical Perspective

During the first part of the nineteenth century, the corporation was viewed as a social instrument for the state to carry out its public policy goals, and each instance of incorporation required a special act of the state legislature. The function of the law was to protect stakeholders by making sure corporations would not pursue activities beyond their original charter or state of incorporation. By the end of the nineteenth century, states began to allow general incorporation, which fueled an explosive growth in the creation of companies for private business purposes. In its aftermath, concern for stakeholder welfare gave way to the concept of managing the corporation for shareholders' profits. This section draws on Sundaram and Inkpen (2004).

In 1919 the primacy of shareholder value maximization was affirmed in a ruling by the Michigan State Supreme Court in *Dodge vs. Ford Motor Company*. Henry Ford wanted to invest Ford Motor Company's considerable retained earnings in the company rather than distribute it to shareholders. The Dodge brothers, minority shareholders in Ford Motor Company, brought suit against Ford, alleging that his intention to benefit employees and consumers was at the expense of shareholders. In their ruling, the Michigan court agreed with the Dodge brothers:

A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes (*Dodge v. Ford Motor Co.*, 1919).

In *The Modern Corporation and Private Property,* published in 1932, Adolph Berle and Gardiner Means provided important intellectual support for the shareholder value norm. In this now classic book, the authors called attention to a new phenomenon affecting corporations in the United States at the time. They noted that ownership of capital had become widely dispersed among many small shareholders, yet control was concentrated in the hands of just a few managers. Berle and Means warned that the separation of ownership and control would destroy the very foundation of the existing economic order and argued that managing on behalf of the shareholders was the sine qua non of managerial decision making because shareholders were property owners.

Following the 1929 stock market crash and the Great Depression, stakeholder concerns were being voiced once again. If the corporation is an entity separate from its shareholders, it was argued, it has citizenship responsibilities (Dodd, 1932, p. 1145–1163). According to this point of view, rather than being an agent for shareholders, the role of management is that of a trustee with citizenship responsibilities on behalf of all constituencies, even if it means a reduction in shareholder value. In the following years, states adopted a number of stakeholder statutes reflecting this new sense of corporate responsibility toward nonshareholding constituencies, such as labor, consumers, and the natural environment.

By the end of the twentieth century, however, despite state-level legislative efforts to the contrary, American-style market-driven capitalism had prevailed and the pendulum swung back to the shareholder. Friedman's (1970) view that the "sole social responsibility of business is to increase profits" energized a push back on corporate social responsibility. In the meantime, agency theory emerged. Agency theory is directed at the dilemma in which one party (the shareholder as the principal) delegates work to another (management as the agent) who performs that work. Agency theory is concerned with resolving two problems that can occur in such a relationship. The first is the agency problem that arises when (1) the desires or goals of the principal and agent conflict and (2) it is difficult or expensive for the principal to verify what the agent is actually doing. The issue here is that the principal cannot verify that the agent has behaved appropriately. The second is the problem of risk sharing that arises when the principal and agent have different attitudes toward risk. In this situation, the principle and the agent may prefer different actions because of the different risk preferences and the concept of the corporation as a nexus of contracts (Easterbrook & Fischel, 1991). The nexus of contracts theory views the firm not as an entity but as an aggregate of various inputs brought together to produce goods or services. Employees provide labor. Creditors provide debt capital. Shareholders initially provide equity capital and subsequently bear the risk of losses and monitor the performance of management. Management monitors the performance of employees and coordinates the activities of all the firm's inputs. The firm is seen as simply a web of explicit and implicit contracts establishing rights and obligations among the various inputs making up the firm.

To protect the interests of other stakeholders, 30 states in the United States enacted stakeholder statutes that allowed directors to consider the interests of nonshareholder constituencies in corporate decisions. Thus, the law gave boards latitude in determining what is in the best long-term interests of the corporation and how to take the interests of other stakeholders into account. Nevertheless, the mainstream US corporate law remains committed to the principle of shareholder wealth maximization.

Governance Without a Shared Purpose?

The lack of a clear, shared consensus about why a company exists, to whom directors are accountable, and what criteria they should use to make decisions—in the law as well as in society at large—is a significant obstacle to increasing the effectiveness of the corporate governance function. When boards operate with tacit assumptions about their objectives and loyalties, they may hide potential disagreements among their members and sacrifice effectiveness. Such hidden disagreements make it difficult to get consensus on complex issues, such as what qualifications a CEO should have, whether or not to outsource parts of the value chain, or how to evaluate and compensate top management.

Lorsch (1989) first identified the confusion among directors about their accountabilities. Based on their beliefs, he categorized directors as belonging to one of three groups: traditionalists, rationalizers, or broad constructionists. Each has a different vision of what the modern corporation's fundamental purpose is and, therefore, to whom and for what a board should be held accountable.

Traditionalists see themselves as accountable to shareholders only. For them, there is no need to debate the fundamental purpose of the modern corporation—it is and always has been the maximization of shareholder value. They do not believe there is a conflict between putting the shareholder first and responding to the needs of other constituencies, and therefore experience little role ambiguity or conflict. Members of this group find support for their position in a narrow interpretation of current state and federal law. They also tend to view the highly publicized abuses at Enron, WorldCom, Vivendi, and other companies as anomalies made possible by imperfections in the current system, rather than as indicators of more systemic problems.

A second, larger group—the rationalizers—experiences more anxiety about their role as directors. They recognize that, in today's complex, global economy, real tensions can occur between the interests of different constituencies and that not all decisions can be reduced to the simple formula that assumes what is good for the shareholder is good for everyone else. Examples include whether or not to close a domestic plant in favor of manufacturing in a low-cost, foreign location; whether or not to outsource production to lower cost suppliers; or how to respond to pressures for greener operations.

The final group, which Lorsch labels the broad constructionists, recognizes specific responsibilities to constituencies other than shareholders and is willing to act on its convictions. Directors belonging to this group constantly struggle to balance their views with the more traditional view of a director's accountabilities and—to stay within the boundaries of the law—frame their decisions in terms of what is in the best long-term interest of the corporation as a whole.

Lorsch summarized his findings stating, "Thus we found the majority of directors felt trapped in a dilemma between their traditional legal responsibility to shareholders, whom they consider too interested in short-term payout, and their beliefs about what is best, in the long run, for the health of the company." He further observed that in many boards a group norm had evolved, prohibiting open discussion of a board's true purpose and that a lot of directors were unaware of recent rulings in the evolving legal context that grant them the latitude to consider constituencies other than shareholders.

In recent years the issue of a board's primary role and accountability has, if anything, become even more confusing. Despite strong rhetoric from many quarters advocating maximization of shareholder value as a company's primary goal, there is a growing recognition that a company and the board have broader responsibilities. This trend reflects the fact that real—that is, economic and psychological rather than legal—ownership of the corporation is moving from shareholders to employees, customers, and other stakeholders that make up the human capital of the firm.

This trend has created problems for directors. As Carter & Lorsch (2004) note, "Boards have a real challenge in deciding to whom they are really responsible and where their commitments ultimately lie. Directors must think about and discuss among themselves the constituencies and the time horizons they have in mind as they think about the board's responsibilities. Many boards have skirted discussion of these complex issues. They seem too abstract, and reaching a consensus among board members about them can take more of that most precious commodity—time—than directors want to devote."

Is Shareholder Value Maximization the Right Objective?

In their widely cited book *The Value Imperative—Managing for Superior Shareholder Returns*, McTaggart, Kontes, and Mankins (1994) write, "Maximizing shareholder value is not an abstract, shortsighted, impractical, or even, some might think, sinister objective. On the contrary, it is a concrete, future-oriented, pragmatic, and worthy objective, the pursuit of which motivates and enables managers to make substantially better strategic and organizational decisions than they would in pursuit of any other goal. And its accomplishment is essential to the welfare of all the company's stakeholders, for it is only when wealth is created that customers will continue to enjoy a flow of new, better, and cheaper products and the world's economies will see new jobs created and old ones improved."

Implicit in this statement are three important assumptions, all of which can be challenged:

- Shareholder value is the best measure of wealth creation for the firm.
- Shareholder value maximization produces the greatest competitiveness.
- Shareholder value maximization fairly serves the interests of the company's other stakeholders.

With respect to the first assumption, it can be argued that firm value, which also includes the values to all other financial claimants, such as creditors, debt holders, and preferred shareholders, is a better indicator of wealth. The importance of distinguishing between firm value and shareholder value lies in the fact that managers and boards can make decisions that transfer value from debt holders to shareholders and decrease total firm and social value while increasing shareholder value.

The second assumption—that shareholder value maximization produces the greatest long-term competitiveness—can also be challenged. An increasingly influential group of critics, which also includes a substantial number of CEOs, thinks product-market rather than capital-market objectives should guide corporate decision making. They worry that companies that adopt shareholder value maximization as their primary purpose lose sight of producing or delivering a product or service as their central mission, and that shareholder value maximization creates a gap between the mission of the corporation and the motivations, desires, and capabilities of the company's employees who only have direct control over real, current, corporate performance. They note that shareholder value maximization is simply not inspiring for employees, even though they often share in some of the gains through benefit, bonus, or option plans. To many of them, shareholders are nameless and faceless, under no obligation to hold their shares for any length of time, never satisfied, and always asking, "What will you do for me next?" Worse, they say, not only does shareholder-value appreciation fail to inspire employees, it may encourage them to view maximizing one's financial well-being as a legitimate or even the only goal. Instead, they want companies to create a moral purpose that not only provides a clear focus on creating competitive advantage for the company but also unites its purpose, strategy, goals, and shared values into one overall, coherent management framework that has the power to motivate constituents and the legitimacy of the corporation's actions in society (Ellsworth, 2002, p. 6).

The third assumption—that shareholder maximization is congruent with fairly serving the interests is the firm's other stakeholders—is perhaps most controversial. Proponents of shareholder value maximization—including many economists and finance theorists—are adamant that maximizing shareholder value is not only superior as a fiduciary standard or management objective but also as a societal norm. Jensen (2001), for example, writes, "Two-hundred years of research in economics and finance have produced the result that if our objective is to maximize the efficiency with which society utilizes its resources (that is to avoid waste and to maximize the size of the pie), then the proper and unique objective for each company in the society is to maximize the long-run total value of the firm. Firm value will not be maximized, of course, with unhappy customers and employees or with poor products. Therefore, consistent with stakeholder theory value-maximizing firms will be concerned about relations with all their constituencies. A firm cannot maximize value if it ignores the interest of its stakeholders."

McTaggart et al. (1994) also believe shareholder value maximization allows managers and boards to resolve any conflicts to everyone's long-term benefit. Consider, for example, their prescription for resolving trade-offs between customer- and shareholder-focused investments. "As long as management invests in higher levels of customer satisfaction that will enable shareholders to earn an adequate return on their investment, there is no conflict between maximizing shareholder value and maximizing customer satisfaction. If, however, there is insufficient financial benefit to shareholders from attempts to increase customer satisfaction, the conflict should be resolved for the benefit of shareholders to avoid diminishing both the financial health and long-term competitiveness of the business."

Not surprisingly, stakeholder theorists take a different point of view. They argue that shareholders are but one of a number of important stakeholder groups and that, like customers, suppliers, employees, and local communities, have a stake in and are affected by the firm's success or failure. To stakeholder theory advocates, an exclusive focus on maximizing stockholder wealth is both unwise and ethically wrong. Instead, the firm and its managers have special obligations to ensure that the shareholders receive a fair return on their investment. But the firm also has special obligations to other stakeholders, which go above and beyond those required by law (Freeman, 1984, p. 17).

More recently, Ian Davis, managing director of McKinsey, criticized the shareholder value maximization doctrine on altogether different grounds. He observed that, in today's global business environment, the concept of shareholder value is rapidly losing relevance in the face of the larger role played by government and society in shaping business and industry elsewhere in the world. "In much of the world," he wrote, "government, labor and other social forces have a greater impact on business than in the U.S. or other more free-market Western societies. In China, for example, government is often an owner. If you're talking in China about shareholder value, you will get blank looks. Maximization of shareholder value is in danger of becoming irrelevant (Davis, 2006).

Finally, a growing number of parties, including CEOs, while not questioning that shareholder value maximization is the right objective, are concerned about its implementation. They worry that the stock market has a bias toward short-term results and that stock price, the most common gauge of shareholder wealth, does not reflect the true long-term value of a company. Lucent Technologies CEO Henry Schacht, for example, has stated, "What has happened to us is that our execution and processes have broken down under the white-hot heat of driving for quarterly revenue growth" (Loomis, 2003).

Stakeholder Theory: A Viable Alternative?

Although the recognition of stakeholder obligations has been with us since the birth of the modern corporate form, the development of a coherent stakeholder theory awaited a shift in legal thinking from a perspective on shareholders as owners to one of investors, more on a par with providers of other inputs that a company needs to produce goods or services. Whereas the ownership perspective, rooted in property law, provides a natural basis for the primacy of shareholder rights, the view of the corporation as a bundle of contracts permits a different view of the fiduciary obligations of corporate managers. According to Freeman and McVea (2001), "The stakeholder framework does not rely on a single overriding management objective for all decisions. As such it provides no rival to the traditional aim of 'maximizing shareholder wealth.' To the contrary, a stakeholder approach rejects the very idea of maximizing a single-objective function as a useful way of thinking about management strategy. Rather, stakeholder management is a never ending task of balancing and integrating multiple relationships and multiple objectives.

To pragmatists, the rejection of a single criterion for making corporate decisions is problematic. Directors occasionally face situations in which it is impossible to advance the interests of one set of stakeholders and simultaneously protect those of others. Whose interests should they pursue when there is an irreconcilable conflict? Consider the decision whether or not to close down an obsolete plant. The closing will harm the plant's workers and the local community but will benefit shareholders, creditors, employees working at a more modern plant to which the work previously performed at the old plant is transferred, and communities around the modern plant. Without a single guiding decision criterion, how should the board decide?

The problem is not just one of uncertainty or unpredictability. Ultimately, the stakeholder model is flawed because of its failure to account adequately for what Bainbridge (1993) calls "managerial sin." The absence of a single decision-making criterion allows management to freely pursue its own self-interest by playing shareholders off against nonshareholders. When management's interests coincide with those of shareholders, management can justify its decision by saying that shareholder interests prevailed in this instance, and vice versa. The plant closing decision described above provides a useful example: Shareholders and some nonshareholder constituents benefit if the plant is closed, but other nonshareholder constituents lose. If management's compensation is tied to firm size, we can expect it to resist any downsizing of the firm. The plant likely will stay open, with the decision being justified by the impact of a closing on the plant's workers and the local community. In contrast, if management's compensation is linked to firm profitability, the plant will likely close, with the decision being justified by management's concern for the firm's shareholders, creditors, and other constituencies that benefit from the closure decision.

It has been argued that shareholders, in fact, are more vulnerable to management misconduct than nonshareholder constituencies. Legally, shareholders have essentially no power to initiate corporate action and, moreover, are entitled to vote on only very few corporate actions. Under the Delaware code, shareholder voting rights are essentially limited to the election of directors and the approval of charter or bylaw amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolutions. As a formal matter, only the election of directors and the amendment of the bylaws do not require board approval before shareholder action is possible.

In practice, of course, even the election of directors, absent a proxy contest, is predetermined by the existing board nominating the following year's board. Rather, formal decision-making power resides mainly with the board of directors. As a practical matter, of course, the sheer mechanics of undertaking collective action by thousands of shareholders preclude them from meaningfully affecting management decisions. In effect, shareholders, just like nonshareholder constituencies, have but a single mechanism by which they can negotiate with management—withholding their inputs (capital). But withholding inputs may be a more effective tool for nonshareholders than it is for shareholders. Some firms go for years without seeking equity investments. If the management groups in these firms disregard shareholder interests, the shareholders have no option other than to sell out at prices that will reflect management's lack of concern for shareholder wealth. In contrast, few firms can survive for long without regular infusions of new employees and new debt financing. As a result, few management groups can prosper while ignoring nonshareholder interests. Nonshareholder constituencies often also are more effective in protecting themselves through the political process. Shareholders—especially individuals—typically have no meaningful political voice. In contrast, many nonshareholder constituencies are represented by cohesive, politically powerful interest groups. Unions, for example, played a major role in passing state antitakeover laws. Environmental concerns are increasingly a factor in regulatory actions. From this point of view, it can be argued that an explicit focus on balancing stakeholder interests is not only impractical but also unnecessary because nonshareholder constituencies already have adequate mechanisms to protect themselves from management misconduct.

Resolving the Conflict: Toward Enlightened Value Maximization?

Jensen (2001) believes the inherent conflict between the doctrine of shareholder value maximization and the objectives of stakeholder theory can be resolved by melding together "enlightened" versions of these two philosophies:

> Enlightened value maximization recognizes that communication with and motivation of an organization's managers, employees, and partners is extremely difficult. What this means in practice is that if we simply tell all participants in an organization that its sole purpose is to maximize value, we will not get maximum value for the organization. Value maximization is not a vision or a strategy or even a purpose; it is the scorecard for the organization. We must give people enough structure to understand what maximizing value means so that they can be guided by it and therefore have a chance to actually achieve it. They must be turned on by the vision or the strategy in the sense that it taps into some human desire or passion of their own—for example, a desire to build the world's best automobile or to create a film or play that will move people for centuries. All this can be not only consistent with value seeking, but a major contributor to it.

> Indeed, it is a basic principle of enlightened value maximization that we cannot maximize the long-term market value of an organization if we ignore or mistreat any important constituency. We cannot create value without good relations with customers, employees, financial backers, suppliers, regulators, and communities. But having said that, we can now use the value criterion for choosing among those competing interests. I say "competing" interests because no constituency can be given full satisfaction if the firm is to flourish and survive. Moreover, we can be sure—again, apart from the possibility of externalities and monopoly power—that using this value criterion will result in making society as well off as it can be. (Jensen, 2001, p. 16)

Thus, Jensen defines "enlightened" stakeholder theory simply as stakeholder theory with the specification that maximizing the firm's total long-term market value is the right objective function. The words "long-term" are key here. As Jensen notes, "In this way, enlightened stakeholder theorists can see that although stockholders are not some special constituency that ranks above all others, long-term stock value is an important determinant (along with the value of debt and other instruments) of total long-term firm value. They would recognize that value creation gives management a way to assess the tradeoffs that must be made among competing constituencies, and that it allows for principled decision making independent of the personal preferences of managers and directors (Jensen, 2001, p. 17).

Even though shareholder value maximization is increasingly being challenged on pragmatic as well as moral grounds, its roots in private property law, however—a profound element in the American ethos—guarantee that it will continue to dominate the US approach to corporate law for the foreseeable future. As a practical matter, the courts have given boards increasing latitude in determining what is in the best long-term interests of the corporation and how to take the interests of other stakeholders into account. This latitude makes it imperative that directors openly and fully discuss these issues and agree on a clear, unambiguous statement of purpose for the corporation.

Glossary

agency theory a theory that attempts to reconcile the relationship between shareholders and the agent of the shareholders (for example, the corporation's managers)

board of directors an elected group of business individuals who have overall responsibility for the business of the corporation

broad constructionists directors who recognize and are willing to act on responsibilities to constituencies other than shareholders

business judgment rule a rule that protects directors from liability if they act on an informed basis in good faith and in a manner they reasonably believe to be in the best interests of the corporation's shareholders. This does not apply in cases of fraud, bad faith, or self-dealing

duty of care a statute that requires directors, before making a business decision, to be informed of all material information reasonably available to them in exercising their management of the corporation's affairs

duty of loyalty a statute that protects a corporation and its shareholders by requiring directors to act in good faith and in the corporation's and shareholders' best interests

enlightened stakeholder theory a theory that corporate value cannot be maximized unless the corporation concerns itself with all its constituent stakeholders, with the specification that maximizing the corporation's long-term market value is the right goal

enlightened value maximization a theory that recognizes that corporate decision-makers need to be more sensitive to nonshareholder constituencies, that maximizing shareholder value does not produce the most value for the organization

management	executives who act in a trustee manner toward a corporation's nonshareholders, including labor, consumers, and the environment
rationalizers	directors who recognize the tensions that occur in the interests among different constituencies but who nevertheless act primarily for the sake of shareholders
shareholder capitalism	an economic system of capitalism that holds that a company is the private property of its owners
shareholder value	the value of profit that a corporation earns for employees, suppliers, and other creditors
shareholder value maximization	a doctrine that holds that a company's ultimate success can be measured by the extent to which shareholders' wealth and stock value are increased
stakeholder capitalism	an economic system of capitalism that holds that companies balance the interests of shareholders with those of other stakeholders, primarily employees but also suppliers, distributors, customers, and the community at large; holds the view that companies have a broader obligation than shareholder capitalism
stakeholder theory	a theory that corporate value cannot be maximized unless the corporation concerns itself with all its constituent stakeholders
strategy	a method for guiding management's choices about where to compete--which customers to serve, with what products and services, and how to deliver those products to customers effectively and profitably
traditionalists	directors who see themselves as being accountable only to shareholders
	the maximization of a corporation's common stock by increasing the wealth

value maximization of that corporation's shareholders

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Resources

- Corporate Governance (http://link.galegroup.com.ezproxy.umuc.edu/apps/doc/CX3273100058/GVRL?u=umd_umuc&sid=GVRL&xid=2b6c3a24)

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