Article #5

The Social Responsibility of Management: A Reprise

[Response to Frederick Post's comments on *The Social Responsibility of Management: A Classical Critique* published in the *Mid-American Journal of Business*, Vol. 18, No. 1]

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It is amazing what complicated lies some people will believe, even when the truth is simple and obvious. Indeed, the truth is often rejected as "simplistic" by those who are dedicated to some complicated lie. —Thomas Sowell (2003)

Introduction

Frederick R. Post's response (2003) to our paper ("The Social Responsibility of Corporate Management: A Classical Critique," 2003) is factually mistaken, inconsistent, and confused over: 1) the contents of our paper, 2) how corporate capitalism works, and 3) the consequences of what he advocates. This reply discusses these points, and revisits both our critique of the stakeholder paradigm and defense of shareholder primacy.

Post's Primary Contentions

Post makes two basic arguments, the first is:

> *. . . 19th Century Shareholder Theory is based upon numerous factual and legal inaccuracies and fictions when evaluated in the context of the modern era (p. 25).*

Appealing to authority, Post (p. 26) states that "business ethicists" have found that shareholder theory is: 1) "factually inaccurate in its several legal bases;" and 2) "overly simplistic and morally untenable in the modern era." Post believes that fiduciary duty is not owed to shareholders alone, but to stakeholders who are affected by corporate actions. Post's second footnote (p. 35) summarizes his thinking; he suggests that the rule of law and imperfections in capitalistic competition may lead managers who believe in shareholder primacy into "moral relativism" and "ethical egoism." To avoid these, universities should teach ". . . deontological reasoning (the deontology of Immanuel Kant, the deontology of John Rawls and the deontology of Judeo-Christian belief systems)." Post writes:

> *. . . many of the problems in corporate America today stem from the fact that my generation was never exposed to such [deontological] reasoning processes and, therefore, out of ignorance fall into the traps of ethical egoism and moral relativism, both being discredited forms of ethical justification for management decisions that have effects on others* (p. 35).

Post's second contention is that:

> *Refinements and clarifications about who qualifies as a stakeholder make the Stakeholder Theory both workable and a very useful way to improve corporate governance (p. 25).*

Post (p. 32) argues that any deficiencies in stakeholder theory can be overcome by a "short list" of six stakeholders: ". . . employees, management, shareholders, suppliers, customers, and the local community." Management is superior to the other stakeholders because management's job is to decide any conflicts that arise between and among stakeholders: "If settlement [of conflicts between stakeholders] is not possible, management then assumes the role of arbitrator and makes the judgement call with the long-term survival of the corporation being the uppermost consideration." (Post, p. 32)

Replies to Post's Contentions

Shareholders and Corporations

The contention that shareholder theory is ". . .factually inaccurate in its several legal bases. . ." (p. 26) is based upon the speculations of Nesteruk (1989) and Boatright (1994). Post analogizes that because financial assets do not have the same physical characteristics of other assets such as automobiles they should be treated differently by the law. He agrees with Nesteruk and " . . . observes that *despite the corporate law definition of shareholders as 'owners,'* the observable experience of their status is that as a group they have transitioned from 'owners' to 'investors' to simple 'beneficiaries.'" (p. 28, emphasis added)[1] Post acknowledges that this is in conflict with the way the written law defines shareholders, but wants to disavow the legal definition because stock ownership is " . . . not at all like the ownership of tangible personal property (an automobile) where the owner actually possesses and uses the property." (p. 28) This is an extreme line of argument; if it were applied to intellectual property (software, textbooks, recorded music, and all material covered under the patent and copyright laws), then it would result in destruction of the industries involved in publishing, film making, pharmaceuticals and computer software, among others. Does Post really think that only assets that are tangible warrant the full protection of the law? If he is in disagreement with this extension of his argument where does he draw the line, or is he willing to let the line be drawn by all-knowing managers who have wisdom beyond the legislatures and courts? As a matter of law and fact, intangibles can and are owned; this is a great achievement of the law that has led to measurable improvements in human well-being. Private ownership of patents, copyrights, and shares of corporate stock creates incentives for their owners to use them in the most economical way; whether it be to produce by themselves (excluding others), or licensing others, or selling them to those who value them more highly. In these and other nontrivial ways, the ownership of an automobile corresponds exactly; one can use an automobile to drive to work in the pursuit of income, or can sell his automobile to someone who values it more highly.

A second legal basis that Post disputes is contract theory. Post is persuaded by Boatright's argument that shareholders are no longer the owners of corporations because of the absence of: 1) expressed contracts between shareholders and managers, and 2) face-to-face dealings between them. Does this imply that all stockholder suits against corporate wrongdoing should be dismissed? If we apply Boatright's reasoning, then these suits should be voided. This is precisely what the courts have refused to do; the case law is unambiguous, shareholders are the residual claimants of the corporation.[2] Boatright's reasoning has not been adopted by the legal system.

Again citing of Boatright, Post argues that agency is an invalid legal basis for shareholder primacy:

> *Directors and Officers cannot unilaterally change the corporation's legal status with third parties (mergers, acquisitions, etc.) without first obtaining the shareholder's approval. If management were truly the agents of the shareholders they would not have to first seek approval since the whole agency relation is predicated upon unilateral power to make decisions on the principal's behalf.* (p. 29)

Because the ranges of actions over which managers have unilateral power are constrained does not imply the absence of agency. All agents are constrained because there are no perfect agents.[3] Accepting Boatright's argument that the necessity for assent to certain actions implies that there is no agency means accepting as a corollary that agency cannot exist. There are always limitations, either contractually and/or legally, upon the decisions that agents can make on behalf of their principals. As a practical issue agency does exist and there are always limits on principal/agent relationships; either Boatright and Post are wrong, or the world is.[4]

Is Shareholder Theory "Simplistic" and "Morally Untenable?"

Post contends that the current era has outgrown the legal origins of the corporation:

> *It is my view that management decisions ought to be based upon three different dimensions: economic– Is this profitable?; legal – Is this legal?; and ethical– Is this right? While external constraints imposed by free market capitalism and the statutory and common law making up the legal system usually answer the first two questions, the third question is of a different dimension and is only answered by internal reflection. The Shareholder Theory never requires that the third question be asked and answered, because if it appears profitable and appears to be legal then, at that point, it also becomes a socially responsible action. . . . My point is that the correct answer to the economic question (Is it profitable?) does not always produce the correct answer to the ethics question (Is this the right decision?)"* (p. 27).

Post is arguing that managerial reflections about right and wrong should constrain the fiduciary duties of management to shareholders *because shareholder theory never requires that the question of whether an action is right should be considered.* This is sophistry. One size does not fit all; in democratic and pluralistic societies, the question of what is ethical can only be answered individually. Shareholder theory entails individually determined ethics:

> *If an enterprise is sanctioned as lawful in a democratic society, in good conscience an individual may choose to work, or not work, for the enterprise. The choice will depend upon the individual's conception of right and wrong. Restating the point, a firm has no ethics because it is not a human being. The question of whether it is ethical for a person to work for a firm that produces, sells, or provides services to businesses that traffic in such things as alcohol, tobacco, narcotics, pornography, explosives, anesthesia, abortions, beef, pork, shellfish or divorce services is either a trivially simple question, or a question so complex that it cannot be answered. Trivially simple if by ethical we mean those activities allowed in society. To define ethical as anything else is to believe that the individual's judgement should be substituted for those of the legally anointed authorities of the state. This is the road to rebellion, anarchy, and ruin. An ethical person's conduct should not lead to disastrous consequences unless the consequences of not acting would be even worse. . . .*
>
> *Alternatively we regard the question of what is ethical for an agent of business as too complex to answer because it depends upon how the individual*

in question regards this employment. Individual ethics cannot be taken out of their historical and social context. Even a cursory knowledge of human societies and histories reveals startlingly wide divergences of what is considered ethical behavior. To argue that behaviors that are legal and sanctioned by society [are unethical] because someone disagrees with them is moral absolutism. But in a democratic society, individual freedom to determine what is right and just within the strictures of society can be the only moral absolute. The employees of legally constituted firms have an ethical obligation to their shareholders and societies to follow that absolute. (Coelho, McClure, and Spry, pp. 16-17; footnote omitted)

A Short List?

Post argues that the stakeholder theory is workable and useful with management arbitrating conflicts among a "short list" of six stakeholders: employees, management, shareholders, suppliers, customers, and the local community.[5] Post's six-pack proposal raises some interesting issues. First, the proposed "short list" in practice is not short. How far does the local community extend; which customers should be approached, long-term, occasional, or potential; similarly which suppliers' interests should be considered, present suppliers, former suppliers or potential suppliers? A second difficulty is that Post previously appealed to Rawls' theories of social justice; Rawls argued that societies should be designed to aid the least advantaged. Are these stakeholders the least advantaged of society? An assertion that corporate management is disadvantaged is absurd on its face, so is Rawls irrelevant now? Inconsistent principles lead to incoherent policies.

A third difficulty with Post's six-pack proposal is the resolution of conflicts among stakeholders; his solution is to assign the ultimate authority to management (" . . . management makes the final decision . . . " [p. 34]). This is an odd position to take because management is: 1) one of Post's stakeholders, and 2) itself unreliable by Post's own admission.[6] Post's argument seems to be that the past two years of experience with management engaging in illegal activities shows that management cannot be trusted to follow the law, so we should give management even more discretion over the allocation of the assets that are controlled under the corporate facade; this is truly whimsical. If management cannot be trusted to follow laws and procedures duly established, then management should have less discretion and more independent oversight of its activities; the fiduciary rights of shareholders should be strengthened, not attenuated.

A pillar supporting Post's paradigm of stakeholder primacy is a publication by Donaldson and Preston (1995) who argue that long-term employees have non-contractual rights to employment. Similar non-contractual rights may exist for others who may be harmed by corporate decisions. Post (p. 30) lauds their work as:

. . . original . . . [for making the argument that] under a factually accurate definition of property ownership rights in the modern era, a theory of property rights supports the Stakeholder Theory, and not the Shareholder Theory of social responsibility. . . .
Applying this analysis to corporate governance, Donaldson and Preston argue that other groups who may be harmed by corporate decisions must also have their interests considered, concluding that the Shareholder theory is morally untenable.[7]

Donaldson's and Preston's argument for non-contractual rights crumbles if the argument is reversed. Suppose long-term employees, say faculty members, wish to leave their present employment in favor of other employers. Surely their current colleagues, administrators, staff, students, and others in the local community have invested support, time and efforts in the endeavors that made them attractive to alternative employers; are not these faculty, students, administrators, et cetera stakeholders in the success of the faculty who have been approached by other employers? Are Post and company consistent in their argument that it would be morally untenable for such employees to leave without the agreement of the other stakeholders, or does it depend upon whose ox is being gored? Ronald H. Coase (1960) summarized the case against this rationale for the stakeholder paradigm: "Nothing could be more 'anti-social' than to oppose any action which causes any harm to anyone." (p. 35)

A fourth and final difficulty with the six-pack solution is that it would enervate or destroy the corporate form of governance. Corporations are formed because entrepreneurs and capitalists believe that they offer advantages over other organizational forms. The expropriation of part or all of shareholder wealth reduces the advantages of the corporate form of governance. We find it difficult to believe that the Walmart Corporation would have been established as a *corporation* if Sam Walton had to share his wealth with the "suppliers," the"local community," and other stakeholders wherever he built his stores. As a matter of fact he did not indulge in this practice on a regular basis, so we can say observationally that this procedure would have been less desirable to him relative to the one he actually chose.

Final Remarks

Post's article, like the stakeholder paradigm it defends, is vague, ambiguous and inconsistent; it stands in stark contrast to Friedman's (1962, p. 133) forthright declaration 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." "Without deception or fraud" means that managerial actions are transparent and available to public scrutiny. Can the proponents of the stakeholder theory identify *just one* ethical problem that management faces that would be better resolved by their stakeholder paradigm than simple transparency (neither deception, nor fraud)? They cannot.

In a series of questions Post asks how the stakeholder theory can be detrimental:

> *How can this have no ethical value? How can this always be bad? How is considering the interests of groups who have a stake in the success and long-term survival of the corporation [be] "profoundly corrosive to the practical and ethical foundations of capitalism?"* (pp. 32-33)

The answer to these questions is simple: The stakeholder theory is so void of intellectually consistent content that it provides a refuge for knaves and/or fools. It is "bad" because it provides no practical guidance and it has no positive ethical value. The difficulties of contemporary corporate governance have nothing to do with management promoting shareholder values too zealously, but, on the contrary, it reflects that management has not taken its fiduciary duties to shareholders seriously enough. The stakeholder theory of corporate governance provides an ethical facade for self-serving management.[8] Take the example of Mr. Jeffrey K. Skilling who was president of the Enron Corporation and is currently defending himself against a variety of security law violations. Before his current legal difficulties surfaced,[9] Skilling was lauded (as was Enron) for integrity; during this time Skilling cooperated in a case study on corporate integrity for the Darden Graduate School of Business Administration at the University of Virginia. In the study, Skilling stated that potential customers have no concerns about dealing with Enron because: "They know it is clean, absolutely clean, because Enron's involved. That's the way we do business."(Katherine S. Mangan, p. 1, 2002). While President of Enron, Skilling certainly did well, but did he do good? Were Mr. Skilling's alleged violations of various state and federal statutes unethical? If we accept the Friedman Paradigm, the actions were unethical. If, instead, we were to rely upon the stakeholder theory for ethical guidance, then Skilling would have a reasonable ethical defense against any indictment. (He could simply say he was just balancing the claims of various stakeholders and, in his judgement, what he did was right for the stakeholders who needed it most.) The point is that the stakeholder theory is so broad and vague (even limiting stakeholders to Post's "short list") it can justify virtually any managerial behavior. If a CEO wishes to use corporate funds to purchase a shower curtain costing thousands of dollars for his personal use, employing the stakeholder concept he can rightfully claim that as management he is a stakeholder and, after long and arduous deliberation, he found his needs to be greater than those of other stakeholders. Whether the CEO truly believes this (the "fool") or is disingenuous (the "knave") is almost moot: more importantly it is wrong.

Post has mounted an energetic defense of the stakeholder paradigm in spite of his awareness that "the Stakeholder Theory is not simple or easy." (p. 32) This rejoinder has established that stakeholder theory: 1) is not simple because it is contradictory and inconsistent; and 2) is not easy because it does not rely on principles, instead it is founded upon the idiosyncratic beliefs and assertions of its advocates. To defend the stakeholder paradigm Post has to: 1) rely upon the arguments of "business ethicists" despite errors of fact and logic; 2) advocate that the rule of law should be superceded by the rule of men; 3) deny explicit laws and precedents establishing shareholders as owners of corporations; and 4) advocate policies that would destroy the foundations of corporate governance. Our original article and this rejoinder constitute efforts to elucidate the ethical obligations of management. Because stakeholder theory imposes fewer constraints upon management professionals it is attractive to them and aligns their self-interest with those "business ethicists" who advocate the stakeholder paradigm; this makes the paradigm neither ethical nor moral. On the contrary, the stakeholder paradigm's utter lack of intellectual and practical coherence make it an indefensible ethos. ■

Notes

1. We believe Nesteruck (1989) makes a number of errors, among them are: 1) shareholders are not the owners of corporations, 2) corporations are responsible to society writ large, and 3) shareholder wealth does not depend upon the profits of any particular firm.

2. When bankrupt corporations go into liquidation, after paying creditors, shareholders receive any residual values.

3. The trivial exception to this statement is that the individual is assumed to be a perfect agent for him or herself.

4. Post denies the existence of a principle-agent relationship between shareholders and managers and fails to respond to our discussion of how to overcome the practical difficulties of implementing the fiduciary duties owed to shareholders.

5. This argument is ***not*** made by Post as a response to our critique of the stakeholder theory. Instead, Post's argument is a response to an article written by Marianne A. Jennings (1998) that Post explicitly recognizes is less comprehensive than is ours: Her arguments against using it [the stakeholder paradigm] as a business ethics model represent many of the most cogent criticisms on the Stakeholder Theory. ***Some*** of her arguments are the same as the authors. Therefore, I have chosen her criticisms as those that I will attempt to overcome in my defense of Stakeholder Theory as a business ethics model that promotes more morally and socially responsible management decisions. (Post, p. 33; emphasis added) Post's response to Jennings's arguments is obviously not germane to our argument. But since it is Post's proffered alternative to shareholder primacy, we have addressed it in the text above. Post's critique of Jennings allowed him to bypass an argument of ours that directly contravenes the claim that his "short list of six stakeholders" (p. 34) is workable and/or useful:

   > Suppose a drug company discovers a cure for a disease that causes a slow and painful death in those it strikes.

How should the interests of shareholders be weighed against the victims of the disease, and how much should the employees receive? We can say that we should be fair to all these groups but that is identical to saying we have no idea how we should treat these disparate stakeholders. If the wealth of shareholders is not paramount, who should get the drug? Should it be the youngest (those with the most years left to live), those with the most dependents, people who contribute the most to advances in the medical sciences, people who are the most beloved by society (celebrities), or who? The list of worthy recipients for the drug is virtually endless. And this is just one aspect of the stakeholder paradigm. Another list can be made on how much to reward each employee, another of charity institutions that should be supported from any unassigned profits derived from the drugs, and another list of the future illnesses to be researched. These lists are limited only by the imagination of the putative stakeholder and/or their advocates, and the patience of the reader (Coelho, McClure, and Spry; p. 19).

6. "This [resolving social responsibility issues by having management follow the law] relies upon the huge assumption (leap of faith) that the law somehow causes management to act ethically even though the past two years of behavior in corporate America has often demonstrated the opposite." (Post, p. 27)

7. First it is a stretch to argue that this is the position of Donaldson and Preston (see pp. 80-81). Second, this is not an original argument, its origins go back at least a thousand years to the customs of the manor and medieval serfdom. Third, and most importantly, there is always someone who is harmed by the transactions of other parties. The sale of drugs that cure baldness harms the makers of hairpieces.

8. Long before "business ethicists" got involved in the business of supplying managerial ethics, managers believed that they were responsible to a broad group of stakeholders and not solely to shareowners. Donaldson and Preston (p. 75) record that surveys taken in the 1960s suggest that managers believed themselves responsible to a broad variety of stakeholders. And, in a 1989 survey, managers "... did not believe that the corporate governance roles of any stakeholders, including shareowners, should be increased. Perhaps not surprisingly, they strongly favored increased dominance of corporate governance by management."

9. It should be noted that the outrage over Enron directly contradicts Nesteruk's (p. 460) argument (that Post cites and relies upon) that: "... the shareholder's interest lies with the prosperity of the business sector in general rather than the advancement of any particular corporation."

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