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A Response to "The Social Responsibility of Corporate Management: A Classical Critique"*

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Abstract

The preceding article, "The Social Responsibility of Corporate Management: A Classical Critique," argues that the Shareholder Theory, which the authors refer to as the "Friedman Paradigm" represents the only intellectually and ethically meritorious model for assessing corporate social responsibility. This response argues that the 19th Century Shareholder Theory is based upon numerous factual and legal inaccuracies and fictions when evaluated in the context of the modern era. Requiring that management serve only the interests of the shareholders is morally untenable. The authors' assertion that the competing theory, The Stakeholder Theory, is unworkable is based upon both a misunderstanding and misinterpretation of the theory. Refinements and clarifications about who qualifies as a stakeholder make the Stakeholder Theory both workable and a very useful way to improve corporate governance. Now is the time to apply the Stakeholder Theory as part of the ongoing process of improving the moral and social responsibility of corporation management.

Introduction

In their article, "The Social Responsibility of Corporate Management: A Classical Critique," authors Philip R. P. Coelho, James E. McClure and John A. Spry present impassioned arguments for the primacy, in fact the exclusivity, of what has been described as the "Stockholder Theory" or the "Shareholder Theory," which they refer to as the "Friedman Paradigm," in answering the debate over to whom and for what ends is corporate management responsible. From their perspective as economists, this is the only reasonable point of view as to what constitutes an appropriate measurement of corporate ethics and/or social responsibility.

Given their educational backgrounds, such a perspective is understandable. However, this old, simplistic theory does not represent the only useful method for determining an ethic of corporate social responsibility. Describing the principal competing theory of corporate social responsibility, the Stakeholder Theory, as "intellectually incomprehensible," "providing an opening for corruption," "causing managers (to act) deceitfully," "(creating) an ethical quagmire," "(creating) unanswerable questions," "too frequently resulting in absolute chaos or criminality" and "(being) profoundly corrosive to the practical and ethical foundation of capitalism," the authors attack the positions of many business ethicists even though a review of the business ethics or social responsibility literature reveals that the author's position, the Friedman Paradigm, is clearly a minority position, itself under attack in the literature. In fact, the authors concede this in their introduction, lamenting that few scholars seem to support their view. In spite of this, they argue that those trained in disciplines other than economics are wrong. They argue that their position is the only way to measure the ethics and/or the social responsibilities of corporate management. Given the extensiveness of discussion about the Stakeholder Theory and the refinements that have developed as the result of healthy debate in the literature, the authors have a tough hill to climb and in this response, I assert that they have not made it to the top.

Refinements and clarifications about who qualifies as a stakeholder make the Stakeholder Theory both workable and a very useful way to improve corporate governance.

The essence of the debate centers upon whether corporate management should give priority to only the interests of the shareholder owners, the position which these authors advocate and label as the Friedman Paradigm more typically described as Shareholder Theory, or the competing position, that corporate management should also show equal, comparable or similar concern for other designated interest groups in addition to the shareholders who also have a "stake" in the continued success of the corporation. These additional groups (as a short list) being suppliers, customers, employees, management and the local community.

As sharply contrasting views that square off one interest group, the shareholders, against multiple inter-

* This article is an invited response to the preceeding article.

est groups, the answers to questions raised will differ and will produce different outcomes as to what is the social responsibility(s) of corporate management. Different outcomes will also result when resolving ethical dilemmas, using either John Stuart Mill's Utilitarianism or Immanual Kant's Deontology. It is hard to argue that either of these two contrasting approaches for resolving ethical dilemmas is always wrong as the authors assert in their defense of the Shareholder Theory which, they proclaim "remains the only clear-cut business ethos extant." By "clear-cut" they seem to be really saying "simple," and "easy to apply," but that hardly makes it always correct.

Application of these two competing theories raises a host of issues as to what are the moral duties of a corporation within society and to whom are those moral duties owed. The authors either dismiss or ignore many of these issues which, in this response need to be addressed. They also fail to provide arguments in support of their position, which are without flaw. While they correctly point out some of the criticisms of the Stakeholder Theory, criticisms which both proponents for and critics of that theory have pointed out before, they find virtually no ethical value to the theory whatsoever, ignoring some of its strengths. They also fail to acknowledge recent refinements to the Stakeholder Theory which undercut many of their criticisms of its more expansive formulations. Further, they choose to ignore the several weaknesses of the 19th Century Shareholder Theory when applied in the modern era, and thereby have diminished the force of their argument in its favor.

The objective of this response is to briefly describe the basis for each theory based on its legal and moral underpinnings as developed by its principle proponents and demonstrate that:

1. The one dimensional perspective of the Shareholder Theory is inadequate to answer the questions that corporate management must now address,
2. There are moral flaws in the simplistic economic model which the authors describe as the "Friedman Paradigm," most commonly known as the Shareholder Theory,
3. There are strengths to the Stakeholder Theory which have been dismissed or ignored, and
4. There have been recent refinements that address several of the flaws which critics have found in the Stakeholder Theory and these refinements make the theory more useful for managerial decision making.

For all of these reasons, as the authors acknowledge, few scholars support their view.

The authors' vigorous attack on the Stakeholder Theory is based upon a fundamental misconception about how the theory works in practice, a meaningful component of which is addressing questions of corporate social and moral responsibility with the stakeholder groups, yet giving management the final decision making power. I will argue that the authors, highly trained economists who have made forceful arguments for the position they favor, have succumbed to the temptation of both over-complicating the Stakeholder Theory in particular and over-simplifying the discipline of business ethics in general. In doing so, the authors have presented analysis and argumentation that misses some of the central inquiries that I believe ought to be the ethical duties and social and moral responsibilities of corporate managers, after receiving wise consultation from the stakeholder groups.

The Legal, Moral and Social Bases of the Two Competing Theories

A Description and Critique of The Shareholder Theory

My objective in this section is to describe the Shareholder Theory and its more recent formulation as the Friedman Paradigm. A critique of the theory will follow with my views and the positions of several prominent business ethicists who have found the Shareholder Theory to be factually inaccurate in its several legal bases, overly simplistic and morally untenable in the modern pluralistic society in which democratic capitalism functions today.

The old 19th century Shareholder Theory is well established in state corporation laws because, from a legal perspective, placing legal accountability on officers (managers) and directors to the shareholder owners (those owning corporate stocks) originally made sense because they are the legal owners (as a group) of the corporation. Also, under two other legal formulations, contract or agency theory, the assertion is made that the shareholders have a contract with and/or an agency relationship with management (Maitland 1995). Thus, the law imposes "fiduciary duties" upon the shareholder group (Boatright 1994, Friedman 1970). Under that view, legal responsibility equates with moral and social responsibility and a minimalist responsibility emerges to simply follow the moral minimums embodied in the law. Friedman developed his now famous admonition to management that following the law constitutes complete fulfillment of all social responsibilities when he asserted "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" (Friedman 1970). It takes quite a leap of faith to equate legal minimums with the aspirational normative goals of business ethics, which are premised upon making the right decision as opposed to just the legal decision. Kaler (2002) notes the simple truism that legality is no guarantee of morality since the law being relied upon may itself be immoral. He argues that if the goal of business ethics is to require stakeholders to "improve the moral conduct of

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business, it follows that the (claim made by a stakeholder) must be moral as it is only in being directed towards meeting moral claims that stakeholding can be such a vehicle."[1] 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?[2] 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 decision.

The economic paradigm is capitalism as developed by Adam Smith, which has proven to be the most successful engine of progress, especially notable since the demise of many competing socialist regimes in the 1990s. The strengths of the capitalist system consist of the free market and its elements of: the profit motive; consumer free choice; competition between sellers and buyers; and the discipline of the market itself, the so-called invisible hand. The free market system is certainly not without flaws and the law has increasingly stepped in to correct them. Imperfections that have been corrected through legislation and regulation, or those that have not yet been corrected, include:

1. improper market power when there are too few sellers or buyers,
2. barriers to entry into markets that represent artificial conditions to discourage competition,
3. imperfect information flowing to consumers,
4. externalities and
5. the agency cost problems associated with large corporations where there is a separation of ownership and control, which is uniquely germane to the social responsibility debate.

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?). Basing management decisions solely upon increasing profits does not satisfactorily answer the social responsibility issues unless the corporation has no social responsibility beyond increasing profits, which most business ethicists believe it does.

The other constraint of the Friedman admonition was "... 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" (Friedman 1970). This means that corporate management, when reaching a decision about some future conduct must ask itself—Is this legal? An affirmative answer to the question, again, supposedly resolves any social responsibility issues. This 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. The law does provide a powerful series of mechanisms to influence ethical behavior by facilitating the transactions of business through binding contracts, preventing predatory financial behavior through usury laws and discouraging the selling of unsafe products through product liability litigation. Ethical behavior is further influenced by regulation from the Consumer Product Safety Commission; requiring the fair treatment of employees through the Federal Anti-discrimination Law (Title VII), The Age Discrimination In Employment Act (ADEA), The Americans with Disabilities Act (ADA), The Immigration Reform and Control Act (IRCA), The Federal Labor Laws (NLRA), The Fair Labor Standards Act (FLSA), The Employment Retirement Income Security Act (ERISA), and the fifty different State Worker's Compensation Acts; requiring safe workplaces through the Occupational Safety and Health Act (OSHA). The law provides forums for settling business disputes through federal and state court systems and the more progressive forms of Alternative Dispute Resolution (ADR) including arbitration, mediation and other hybrid versions of ADR. Transparency is encouraged in the mechanisms for initial and additional offerings of equity instruments through Securities Laws and the many stock exchanges. An abundance of industry specific regulatory agencies (DOT, FAA, FDA) encourage ethical behavior by their scrutiny over industries within their jurisdiction.

But, despite the law's acknowledged role as a transaction facilitator, safe workplace encourager, fair employee treatment regulator, capital raising mechanism provider and dispute settler, do these attributes of the law insure that corporate management will act ethically? Experience certainly says no and this is precisely because, just like the free marketplace is imperfect, the law and the whole legal system is also imperfect. Imperfections will always plague the law and the legal system for the following reasons:

1. It can be very profitable to violate the law and the probability of being caught is often small;
2. Penalties and fines are often small and serve as a weak deterrent to the corporate manager insulated within the corporate framework who will not personally pay the fine anyway;
3. Regulatory enforcement schemes often seem inconsistent and haphazard which further gives the

management group the belief that they will not be caught;

4. Laws and regulations often seem so complicated that businesses who are regulated are often unsure how to comply;
5. The legislative process of enacting laws is too heavily influenced by special interests and
6. Some regulations are so strenuously opposed by business interests as to appear to lack legitimacy.

With these many imperfections in the law, can it be said that the law, "the rules of the game," will always produce socially responsible decisions on the part of corporate management? The Friedman version of the Shareholder Theory states that this is the only duty that corporate management has and that following an imperfect legal system with its many flaws will be sufficient to produce a corporate social responsibility. Social responsibility based solely on following the "rules of the game" does not produce socially responsible decisions unless all that is required to be socially responsible is to follow the law, with which most business ethicists would not agree—the law being nothing but a reflection of the lowest moral minimums and hardly the aspirational normative goals of ethical reasoning. This then challenges management to ask, "Is this the right decision and why?" These questions must be asked to determine what effects the decision has on those affected. In the context of the corporation, what effects does the decision have on those who have a direct "stake" in the continued success of the corporation.

There are criticisms of the shareholder theory. Boatright (1994) argues that one of the central premises upon which Shareholder Theory rests—that the shareholder group is the legal owner of the corporation property and, therefore, their interests come first—is simply not true, based upon a detailed analysis of their actual ownership interests in the modern corporation. Their ownership is not at all like the ownership of tangible personal property (an automobile) where the owner actually possesses and uses the property. In fact, shareholders have no claim to possess or use specific corporate assets. Nesteruk (1989) 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." Further, because the law recognizes a corporation as an artificial distinct legal person that only acts through its agents (management), this group must have considerable discretion to make decisions and along with that discretion (power) goes moral responsibility for exercising those decisions (Nesteruk 1990). This has been described as a disaggregation of ownership where the separation of control from ownership due to the hiring of professional managers to run the cooperation, relegates legal ownership to something much less than what is represented by the usual legal ownership of

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property. This phenomenon has been documented for years (Berle and Means 1932). As Nesteruk argues, "the central thrust of corporate social responsibility (is) summoning management to exhibit a concern for the social good throughout its assumption of a new role, that of corporate good citizen" (Nesteruk 1989).

Shaw and Post (1993) argue that the ownership role of the shareholder has now become even more remote. Shareholders can be characterized as mere beneficiaries of the results of corporate success—beneficiaries who have no real input or impact upon corporate decision-making. Sommer (1991) notes that about thirty states have adopted "other constituency" corporate statutes, which permit or require corporate directors to consider the interests of groups other than just shareholders when making decisions. This reflects acknowledgement within a majority of state legislatures that the very diminished "legal ownership" role of the shareholders requires a change in the law away from the old traditional legal conception of their primacy, upon which the Shareholder Theory is based.

Boatright (1994) discusses what he describes as the "equity argument" for the primacy of shareholder interests and concludes that it does not succeed. The argument in favor of their primacy of interest is that shareholders need special protection, since unlike other interest groups (employees, suppliers etc.), they do not have actual contracts that would come up for renewal and could be renegotiated. Also, their investment is not directed toward specific assets like other groups (suppliers – inventory, receivables, landlord–the building) that can be protected by contractual provisions, which necessitates their special protection. However, they do enjoy two types of special protections that none of the other groups have and these protections defeat the "equity argument." Under the law of corporate governance, shareholders have the right to elect directors, vote on shareholder resolutions and have the right and ability to unload their shares of stock easily if they become dissatisfied with corporate performance. No other interest group has these rights or abilities. Banks are often left with bad loans, employees can not easily change employers and communities have little to say about the day-to-day operation or the sudden closing of local corporations. Thus, the equity argument fails to justify the primacy of the shareholders interests. Manning (1958) argues that with the huge diminution from what was once described as legal ownership that has occurred in the modern corporation, shareholders are not really "corporation owners" at all, but simply "stock owners," and as bondholders own their bonds, stockholders own their stock.

Another argument for the primacy of shareholder interests is that their ownership rights are derived from a contract they enter, as owners, with management, which obligates management to fulfill the terms of this contract. Boatright (1994) argues that for such a "contract theory" to prevail, there must be some contract identified between management and the shareholders. The facts of the relationship demonstrate that no such contract exists. There is no express contract that the parties sign, since shareholders buy their stock from previous owners, not the corporation. In an initial offering, the only legal document specifying the conditions of the purchase is the prospectus which does not constitute an express contract with management who often remain to be hired in the future. There are never any face-to-face dealings between management and the shareholders as to the operation of the corporation, which typically occurs when express contracts are agreed upon. There are none of the components associated with entering into a contract: negotiation between the parties, offer by the offeror communicated to the offeree who accepts the offer, legal detriment (consideration) assumed by both parties and a change in ownership of tangible property from the offeror to the offeree. State legislatures and subsequent court interpretations of each state's statutory language set the terms of the relationship between the shareholder and corporation. Also, the offer is on a "take it or leave it" basis. There is no offer communicated, no negotiation of terms, no legal detriment assumed by management and no subsequent agreement [between shareholder and corporation].

Boatright (1994) also correctly dismisses any implied contract as supporting a "contract theory" of primacy of shareholder interests. The above arguments emphasize the lack of face-to-face dealings between management and shareholders and the lack of any representations by management about what the contractual relationship will produce, which the shareholders would then accept. These arguments militate against establishing facts that would fulfill the standard legal conditions for a court to find an implied contract based upon the conduct of the parties. Therefore, using an express or implied contract theory as a basis for asserting the primacy of shareholder interests simply fails because management and the shareholders do not negotiate a set of mutual obligations governing specific interactions. There is no time when the parties negotiate the terms of the relationship (Boatright 1994). Further, while the shareholders assume legal detriment (consideration) by giving up money to buy the stock, management assumes no legal detriment in the exchange of shares of stock on the many stock exchanges. There is no contract entered into between the parties.

Another argument for the primacy of shareholders interests is the agency relationship between management and the corporation. The argument is that since the corporation is an artificial legal person that can only operate through representatives (agents) acting on its behalf and

...an implied contract theory fails... because management and the shareholders do not negotiate a set of mutual obligations governing specific interactions.

the shareholders have an ownership interest, this then creates a special legal relationship justifying primacy of their interests over other groups. Boatright (1994) addresses this argument and demonstrates that it also fails to make the case for the primacy of interests because management acts as the agent for the artificial legal person (the corporation), not the shareholders. According to *The Restatement of Agency*, an agency relationship (where one party acts as a fiduciary on behalf of another, acting exclusively in their interest and on their behalf) can only exist where (1) there is consent to the relationship, (2) the agent acts on the principal's behalf and (3) the principal controls the agent. None of these three elements of the agency relationship exist between management and the shareholder group. Directors and officers, agree (consent) by virtue of their legal capacity, to comply with their statutory duties as set out in the appropriate state corporation statute. 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. Finally, management is not under the control of the shareholders in the ongoing operation of the corporation and does not need shareholder authorization to function. In the modern corporation, the shareholders are simply beneficiaries who own stock, none of the legal elements necessary to establish an agency relationship are present (Boatright 1994).

As explained by Boatright (1994), the shareholder model of social responsibility is descriptively inaccurate, in that the legal underpinnings upon which it is based do not represent a factual description of the relationships between the parties. Legal ownership of corporate property with the ability to possess and use it, is descriptively inaccurate. The existence of an express or implied contract between management and the shareholders is descriptively inaccurate. The existence of an agent principal relationship between the officers and directors (management) and the shareholders is also descriptively inaccurate. These factual inaccuracies prevent building a legal foundation for the primacy of shareholder interests.

Viewed from another perspective, the normative formulation of the Shareholder Theory, which addresses the moral propriety of the behavior of corporations and/or their managers, the question becomes not what happens (factually) in this relationship but what should (ought to) happen (Jones 1995). Donaldson and Preston (1995) argue that not only is the Shareholder Theory descriptively inaccurate but it is normatively unacceptable also. Based upon their review of the most recent *American Law Institute Report*, Principles of Corporate Governance (1992), they note that while the document references the central goal of "enhancing corporate profit and shareholder gain" the text substantially qualifies this "central goal" by stating "Even if corporate profit and shareholder gain are not thereby enhanced" the corporation must abide by law and may "take into account ethical considerations" and engage in philanthropy (Sec. 2.01:69, 1992), which as Donaldson and Preston observe, represents an explicit acceptance of the Stakeholder Theory and contradicts any argument that directors and officers are required by law to place the interests of shareholders first (Donaldson and Preston 1995). The commentary explaining the rationale for a legal affirmation of the Stakeholder Theory states:

> *The modern corporation by its nature creates interdependencies with a variety of groups with whom the corporation has a legitimate concern, such as employees, customers, suppliers, and members of the communities in which the corporation operates. (1992:72)*

This is the exact short list of stakeholders envisioned by R. Edward Freeman in his version of the Stakeholder Theory that I will summarize in this paper. Mention is made in the commentary that social and ethical considerations are consistent with increases in profit and value. The commentary further notes that:

> *Nevertheless, observation suggests that corporate decisions are not infrequently made on the basis of ethical consideration even when doing so would not enhance corporate profit or shareholder gain. Such behavior is not only appropriate, but desirable. Corporate officials are not less morally obliged than any other citizens to take ethical considerations into account, and it would be unwise social policy to preclude them from doing so...[The text] does not impose a legal obligation to take ethical consideration into account. However, the absence of a legal obligation to follow ethical principles does not mean that corporate decisionmakers are not subject to the same ethical considerations as other members of society. (American Law Institute 1992, pp. 80-82)*

Donaldson and Preston (1995) argue that the normative basis for the superiority of the Stakeholder Theory is now accepted based upon these changes in current mainstream legal thinking.

Further developing the Boatright (1994) criticism of legal ownership of property (stock ownership) as a basis of the primacy of the shareholders interests, Donaldson and Preston (1995) develop an original "Theory of Property" argument that turns the traditional property ownership

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argument supporting the Shareholder Theory upside down and demonstrates 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.

This theory is based upon a reappraisal of what property ownership really means, based upon the limitations that exist on claims of ownership. The assault on traditional notions of ownership rights being absolute began when arguments were made that ownership of property is really a bundle of many rights of use, some of which may be limited by legal restrictions on use imposed by government (Coase 1960). Ownership of an automobile does not mean that using it as transportation gives the owner the right to drive it anywhere, anytime, at any speed, without first becoming a licensed driver, obtaining a license for the vehicle or obtaining insurance. We may dislike but still accept the limitations of pure legal ownership of an automobile. The same can be said for owning land, owning buildings, owning thoroughbred racehorses and owning corporate stock. Thus, property ownership rights are limited by restrictions on uses against the human rights interests of others (Donaldson and Preston 1995). The argument advances the position that the theoretical notion of "legal ownership" of private property does not allow unlimited ownership rights and, therefore, does not support the shareholder theory that "legal ownership" of stock alone requires that management consider only the interests of the shareholders. Quite the opposite is true because of limitations on use of property. Other groups who may be harmed by the owner's use of the property must have their interests considered, which makes the case for considering the interests of other groups (Donaldson and Preston 1995). 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.

According to Social Contract Theory, which is one approach used to explain the operation of the Stakeholder Theory, the emphasis on uses of private property is dependent upon implied or expressed understandings among stakeholders (the groups with interests in the legal and/or wise use of the property other than the owners) as to proper distributions and uses of that property. This new version of a "Property Theory," which reverses the principal old corporation law argument expressed in the Shareholder Theory is a factually accurate description of present day limitations on use of private property and is consistent with the transition in shareholder owner status from "owner" to "beneficiary" (Nesteruk 1989) and with the legal position of shareholders having no claim to possess or use any specific corporate assets (Boatright 1994). If this contemporary pluralistic theory of property correctly depicts the present day, then there is a direct connection between the Theory of Property and Stakeholder Theory because several groups: suppliers, customers, employees, management and the local community all have the right to not be harmed by the owner's use of the property (Donaldson and Preston 1995). In fact, as has already been argued, employees, who in the modern world cannot easily switch their jobs and who do not have diversified portfolios of job interests, actually have a greater stake in the success of the corporation than investor owners, who usually hold a diversified portfolio of stocks and the ability to easily sell poor performers. The same arguments can be made for the other stakeholders: *management*—their jobs and their economic livelihoods are at stake to almost the same extent as those of the employees; *local community*—grants the corporation the right to build facilities and benefits from the tax base and the economic stimulation to the community from wages paid and any other social contributions of the corporation; *customers*—they pay money to the corporation in exchange for the goods and services produced and receive the benefits to their lives of those goods and services; and *suppliers*—they provide raw materials needed to produce the goods and services, receive revenue and help to determine quality and price (Freeman 1993). In view of the realities of our modern interdependent pluralistic society, to use the 19th century Shareholder Theory, which the authors call the Friedman Paradigm, is inadequate. Relying upon his admonition that "there is one and only one social responsibility of business...to increase its profits (for the shareholder owners)" as the model for answering the question: "To whom and for what ends is corporate management responsible?" is simplistically harsh to too many interests and devoid of any real moral substance.

A Description and Critique of the Stakeholder Theory

My objective in this section is to describe the Stakeholder Theory; present some of its strengths as argued by its proponents, present some of its weaknesses as argued by its critics and discuss some of its recent refinements that answer the critics' arguments. In contrast to the two main strengths of the Shareholder Theory: definitional simplicity and ease of application, the Stakeholder Theory cannot be defended for these reasons. However it is not "incomprehensible," "unanswerable" or "profoundly corrosive to capitalism" as the authors assert.

The expanded view of social responsibility was first argued by Merrick Dodd in 1932, who contended that the powers of corporate management are held in trust for the entire community (Boatright 1994). The popularity of a new identifiable Stakeholder Theory, however, is best attributed to R. Edward Freeman, who wrote a textbook explaining the concept (Freeman 1984) and more recent articles that further refined the theory, particularly his attempt to tie the theory to Kantian Deontology which produced Kantian capitalism (Evan and Freeman 1993). It is this formulation which I will use to sketch the parameters of Stakeholder Theory, which entails more than "just considering" the interests of multiple interest groups. There is a process of analysis that Freeman articulates which, while not simplistic or easy to apply, is also not "incomprehensible" or a recipe for corporate "chaos or criminality."

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Shareholder Theory, which it can be argued, is an ethical egoist approach stating that the corporation is to be managed for the sole interest of just one group, is rejected. Using a utilitarian approach, that the corporation is to be run for the benefit of only the stockholder group because this will "maximize the greatest good for the greatest number," is also rejected. The corporation is to be managed under Kant's principle of respect for (all) persons as ends in themselves. The corporation serves at the pleasure of its stakeholders and none may be sacrificed as a means to the ends of another without participatory rights (Evan and Freeman 1993). The logic is that the corporation is a forum for stakeholder interaction. The interests of all stakeholders outweigh those of any one stakeholder group. Management acts as the fiduciary to the whole forum. Management through its capacity as the group who operates the entity must resolve differences within the whole group by considering the different positions, negotiating with the groups and then making management decisions after considering the interests of all stakeholders. Management must try to balance relationships, not always side with just the interests of the shareholders, as required by the Shareholder Theory or side with just its own interests, which all too often has been the case recently with noteworthy examples being the cases of Enron and WorldCom. In these examples there was total disregard for the interests of any group other than management that destroyed many executive careers, cost thousands of jobs (with resulting loss of livelihoods) and decimated the value of thousands of retirement plans. Neither asserting the primacy of shareholders' interests nor caring only for management interests is the benchmark of the Stakeholder Theory (Evan and Freeman 1993).

In addition to the principle from Kant's deontology, respect for persons as ends in themselves, Freeman also borrows principles from Social Contract Theory in his formulation of two Stakeholder Management Principles which are meant to focus and prioritize the decision making process. The first of these principles is *P1-The Principle of Corporate Legitimacy*:

> *The corporation should be managed for the benefit of its stakeholders: Its customers, suppliers, owners, employees and local communities. The rights of these groups must be ensured, and, further the groups must participate, in some sense, in decisions that substantially affect their welfare.*

Evan and Freeman (1993) argue that groups with a stake in the success of the corporation have rights because there is a social contract required to justify the existence of the corporate form and since there are harms, benefits and rights of stakeholders that are associated with running the modern corporation, then *P1* is the "starting point" for guiding corporate decisions.

The second of these principles is *P2- The Stakeholder Fiduciary Principle*:

> *Management bears a fiduciary relationship to stakeholders and to the corporation as an abstract entity. It must act in the interests of the stakeholders as their agent, and it must act in the interests of the corporation to ensure the survival of the firm, safeguarding the long-term stakes of each group.*

Evan and Freeman (1993) argue that *P2* requires management to recognize claims by groups other than the shareholders. The final consideration of management is the long-term best interest of the corporation, which outweighs the interests of any one group or groups. This is because, in most all instances, the interests of all groups are served if the corporation survives as a successful business, and that must be the final focus point of management decisions. There is an acknowledgement that management will be unable to satisfy the interests of each group all the time, but at least management, under the guidance of *P2,* is required to reconcile the interests of the different stakeholder groups (when their interests really do differ, which may not be as often as critics claim) with the corporation's long-term survival being uppermost. This is in sharp contrast to the Shareholder Theory, which instructs management to consider only the interests of shareholders. Management must go much further by negotiating differences after learning the positions of different groups in an open forum before making its decisions. That is exactly what management is paid to do anyway, only now it must consider more interests under a different set of guidelines. Yet, in the end there is always a tiebreaker that determines the interest to be weighed the most heavily, the long-term survival of the corporation.

This process is analogous in the legal system to management assuming two roles: that of a *mediator* (a message carrier and lubricator, trying to settle (mediate) differences in positions expressed by the groups) and an

...there is always a tiebreaker that determines the interest to be weighed the most heavily, the long-term survival of the corporation.

arbitrator (a judge who makes a final decision on who wins and who loses based upon a set of guidelines) which are roles that management is well equipped to assume. Mediated settlements of disputes always produce the best outcomes because the disputants have a hand in settling their dispute and take ownership of the solution. It can easily be predicted that management, acting in a mediating role, will usually enable disputing stakeholder interests to be reconciled based upon open discussion, negotiation and the techniques used in mediation. If settlement is not possible, management then assumes the role of the arbitrator and makes the judgement call with the long-term survival of the corporation being the uppermost consideration. At that time, some stakeholder groups will win and some will lose, which is consistent with the theory, but all will have participated in the process. Analyzed in this manner, arguments that Stakeholder Theory is "impossibly difficult" are simply without merit. If the argument is that management is not knowledgeable about such skills, a business school course and/or a professional seminar can easily solve that problem. Since managers must master leadership skills in group settings, it seems hard to imagine that they could not easily assume these roles.

Posited as a new theory of social responsibility, Evan and Freeman acknowledge that some refinements in state corporation law may be necessary. They also argue that the makeup of the Board of Directors should be changed to insure that each stakeholder group has representation on the Board and they propose a Director, describing him/her as a "metaphysical director" who represents the interests of the entity itself. This, they assert, would prevent certain interest groups from ganging up on the other groups based upon their numbers of representatives on the Board. This is a problem that I doubt would ever emerge based upon the previously described principles of *P1* and *P2* since the six interest groups who have a stake in the success of the corporation must already have their interests considered. However, if the method for creating the forum for stakeholder interaction is through the stakeholder board of directors, then the concept makes sense.

While the Stakeholder Theory is not simple or easy, it can certainly be applied in corporate settings. It has generated extensive thoughtful discussion in the literature and with recent refinements, represents a method for corporate governance that brings the six interest groups whose own success is dependant, more or less, on the success of the corporation to the discussion table. 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 "profoundly corrosive to the practical and ethical foundations of capitalism?"

The Stakeholder Theory has critics other than these authors. The criticisms can be overcome based upon refinements that have clarified and simplified the implementation of the theory and counter arguments that either effectively challenge the criticism or demonstrate that it is not a criticism at all, just a misunderstanding or misinterpretation of the Stakeholder Theory. Marianne A. Jennings presents a series of arguments against the Stakeholder Theory that represent an amalgam of the types of criticisms raised. While there is an even more exotic philosophical debate that continues in the literature, many of the philosophical arguments seem to cancel each other out, leaving a reader with his/her choice as to which side of the argument to accept. An ongoing philosophical debate is healthy and thought provoking, but its presence in the literature does not prevent use of the Stakeholder Theory in the form summarized in this paper.

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Jennings (1998) presents several reasons why the Stakeholder Theory is not about business ethics, but about management strategy. However, I contend that her arguments are based upon a misinterpretation of how the Stakeholder Theory operates and who the stakeholders are, and as such, they can be overcome. Jennings presents her arguments against the Stakeholder Theory in the context of teaching business ethics to business students. She asserts that Stakeholder Theory is about business strategy, not business ethics, and that is where the theory should be taught. Her arguments against using it as a business ethics model represent many of the most cogent criticisms of the Stakeholder Theory. Some of her arguments are the same as those of 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.

Jennings (1998) argues that Stakeholder Theory fails as an ethical theory because it suffers from "sloppy imprecision" in formulations of how many stakeholders there are or may be. As a relatively new theory being debated by scholars, twenty-eight different definitions of stakeholders have been proposed between 1963 and 1995 (Mitchell et al. 1997). Jennings observes that the theory is in trouble if there is no agreement on the definition of stakeholder. Building upon this claimed problem, Jennings (1998), using a very expansive definition, then argues that the theory violates basic legal principles of property ownership, due process and corporate governance because stakeholders with very limited ownership interests can have veto power over management decision making. Finally, Jennings (1998) again takes the "sloppy imprecision" arguments and argues this turns business ethics into moral relativism.

The foundation of all her criticisms is the "sloppy imprecision" argument. Recent refinements identifying who stakeholders should be refute this criticism. Kaler (2002) categorizes one classification of stakeholder definitions as being "influencer" based, requiring that stakeholder status is achieved by any interest group that has the capacity to influence the workings of the business. This is a very expansive formulation since "just about anyone in any sort of causal interaction with a business is going to be capable of influencing (or being influenced by) its operations."[3] Kaler lists competitor firms and terrorists as stakeholders under this definition. Jennings, (1998) making fun of such an expansive definition, lists "our good friends in Mister Rogers' neighborhood and all the fowls in the air and creatures in the sea and critters in our woodlands."[4] She also reminds us that other scholars have similar wildly expansive views including Singer (1993) who includes dogs, Starik (1993) who includes slaves, indigenous peoples, women, minorities, the homeless, abused children and political prisoners—all of whom have been "affected" by corporation actions and, therefore, should be stakeholders and Stone (1972) who, in describing who should have legal rights, includes a cluster of deciduous trees, a star filled evening, or a pool of diving whales. This might even be the type of expansive list of stakeholders that the authors envisioned when they commenced their vigorous attack on the unworkability of the Theory.

Kaler (2002) rejects this definition and argues that the proper list is a "claimant definition," requiring that "stakeholders in a business have to be people with a role specific, strong or weak, morally legitimate claim to have their interests served by that business."[5] Kaler reasons that if stakeholding requires a business to serve more than just the interests of the owners, those interests should be held by people with claims on the services of the business. This definition significantly collapses the potential group of stakeholders envisioned by some scholars down to a small identifiable group. Also, it is noteworthy that Freeman (1993) wrote of only six stakeholders. Kaler (2002) identifies a combination of the "influencer" and the "claimant" definitions, which he defines as a "combinatory" definition, which he also rejects. Based on this refinement, the argument of Jennings (1998) that Stakeholder Theory suffers from "sloppy imprecision" can be easily overcome with the narrow "claimant" definition. Her additional argument that Stakeholder Theory violates basic legal concepts of property ownership, due process and corporate governance suffers from two weaknesses. It is based first on an incorrect overly broad definition of stakeholder that includes almost anybody, (dogs, trees, and whales,etc.) and second, on the simplistic legal notion of what property ownership entails, which has been thoroughly dismantled by several scholars earlier in this paper (Boatright 1994, Donaldson and Preston 1995).

Finally, Jennings argues that Stakeholder Theory reduces ethics to (moral) relativism. Her argument seems to be that if stakeholder groups "dictate" their views of what social responsibility should be, with management serving both a mediating and decision-making role, this leads to the "troubling assumption that those outside the ownership loop have a better set of standards than business owners have."[6] She argues that the corporation's goals will be diverted to some radical purpose because of some pressure group emerging within the stakeholder groups. This argument, it seems, stems from a fundamental misunderstanding about how the Stakeholder Theory operates, as has been set out earlier, and who the groups are who attempt to influence management decisions. Again, for this argument to make any sense, one has to assume that stakeholders include almost anybody, (dogs, trees, whales, political prisoners and terrorists, etc.). But with the short list of six stakeholders; employees, management, shareholders, suppliers, customers, and the local community, it is illogical to assume that any of these groups will press for radical new directions in corporate decision making or establish a coalition of groups to achieve such an objective. Again, management makes the final decisions based upon its judgement regarding what is in the best interest for the long-term survival of the corporation. The arguments Jennings advances can be overcome with a short list of stakeholders and the role of management in guiding corporate policy and decisions.

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Conclusion

The authors contend that the Friedman paradigm or formulation of the Shareholder Theory is the only method for assessing corporate social responsibility. They dismiss or ignore the conclusions of numerous scholars who have demonstrated convincingly the factual and legal inaccuracies and fallacies upon which it is based. These include arguments that: (1) economic considerations do not always resolve ethical questions; (2) legal rules do not always resolve ethical questions; (3) the legal ownership rights of the shareholder have been diminished; (4) the equity argument for the primacy of shareholder interests fails; (5) the express contract theory for the primacy of the shareholder interests fails; (6) the implied contract theory for the primacy of the shareholder interests fails; (7) the agency theory for the primacy of shareholder interests fails; (8) state corporate laws do not prohibit the use of the Stakeholder Theory; (9) the American Law Institutes *Principles of Corporate Governance* do not prohibit the use of the Stakeholder Theory, and (10) changes in the theory of property ownership which, in a factually accurate manner, depict a new pluralistic theory of property advances the Stakeholder Theory, not the Shareholder Theory.

The authors assert that the Stakeholder Theory has no value whatsoever in that it is "so ambiguous that it can be interpreted in almost any way to accomplish anything" and further that it is "intellectually incomprehensible" and "profoundly corrosive" to the practical and ethical foundations of capitalism. These claims about Stakeholder Theory are based upon both an over-complication of the Stakeholder Theory because of some of its wildly expansive speculative formulations in the literature and an over-simplification of what the role of the modern corporation should be to at least the six interest groups who are people with role specific claims or stakes in the long-term survival of the corporation, stakes that are mediated and then resolved by the management group. Implementing management principles derived from Stakeholder Theory will broaden and enhance the moral quality of decisions. In the modern era, having management serve only the interests of the shareholder or itself is morally untenable. All six interest groups should participate in some way to raise the quality of discourse from the legal moral minimums that represent the lowest minimal level of morality required by law, the standard under the 19th Century Shareholder Theory.

It is time to get beyond a begrudging reliance upon factual and legal fictions, which cloud our thinking and impede our progress in improving the moral and social responsibilities of corporation management. I feel compelled to make the same assertion as the authors did in their conclusion as related to my success or failure in responding to their vigorous attack on the Stakeholder Theory. This response is an attempt to expose the inadequacies of the Shareholder Theory and defend the intellectual and ethical merits of the Stakeholder Theory. If I have succeeded in its defense, it is because its merits are manifest; if I have failed; it is because I was inadequate to the task. ■

Notes

1. Kaler, p. 94

2. I owe the formulation of this three-dimension analysis to several conversations with, and a review of the writings of Professor Ed Conry of the University of Colorado at Denver. This occurred over ten years ago and enabled me to develop

my own approach to teaching business ethics to my students. I start with the economic implications of management decisions-showing both the value of democratic capitalism and its shortcomings. I then move into the legal implications of management decisions-showing the pervasive role of the law and its imperfections. I end with the ethical implications of management decisions, which moves us into discussions about how one reasons through ethical dilemmas using teleological reasoning (ethical egoism and the utilitarianism of John Stuart Mill) and deontological reasoning (the deontology of Immanuel Kant, the deontology of John Rawls and the deontology of Judeo-christian belief systems). I offer my opinion that many of the problems in corporate America today stem from the fact that my generation was never exposed to such 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.

3. Kaler, p. 95

4. Jennings, p. 204

5. Kaler, p. 95

6. Jennings, p. 222

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