"I PAID FOR THIS MICROPHONE!": THE IMPORTANCE OF SHAREHOLDER THEORY IN (TEACHING) BUSINESS ETHICS

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I. Introduction

> *How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it.* (Smith 2004: 3)

THE NORMATIVE VERSION OF STAKEHOLDER THEORY is initially attractive. It seeks to remind us that we are fully moral beings, with a full range of moral obligations, in everything we do. In other words, it challenges us to resist the temptation to leave our conscience at the door, so to speak, when we wear the hat of management. Suppliers, customers, labor, and other stakeholders are moral beings, with the full range of moral rights that anyone we deal with in our everyday lives also has. For that reason, we must not artificially elevate the moral standing and interests of shareholders. To do so would, it seems, necessarily involve us in the exploitation of other stakeholders, something that would both compromise their autonomy and deny them their intrinsic dignity.

Moreover, Shareholder Theory can appear extraordinarily narrow in its focus. In its most simplified form, Shareholder Theory seems to suggest that only the interests of shareholders matter morally when managers seek to

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conduct the affairs of the business. Since the interests of shareholders will typically be to maximize the return on their investment in the firm, the Shareholder Theory in its most simplified form seems to suggest that managers are morally obligated to do whatever will maximize shareholder return. Understood in this way, Shareholder Theory seems to be nothing more than a cover for legitimizing greed; worse, it seems to provide an endorsement of the idea that, in the pursuit of profit, moral concern for the interests of other stakeholders has no place.[1]

Despite these initial appearances, neither provides an accurate assessment of the respective views. In particular, each relies on a faulty characterization of Shareholder Theory by implying that it prescribes utter indifference to the moral interests of non-shareholder stakeholders. Arguably, each does this because it fails to consider the several ways in which the pursuit of profit on the part of the business contributes to the maximization of a wide range of moral goods for all stakeholder groups, including the improvement of material conditions and the enhancement of opportunities for the exercise of autonomy and other essential liberties, especially the natural right to property.

The remainder of this paper proceeds as follows. Section II provides brief definitions of stakeholder theory, shareholder theory, and other relevant terms and procedures. Section III examines some of the practical limitations of stakeholder theory, while section IV highlights the normative advantage of shareholder theory. Finally, section V concludes the paper by offering specific suggestions for including coverage of Shareholder Theory in business ethics courses.

II. Definitions & Initial Characterizations

A *stakeholder* is defined as "any individual or group who can affect or is affected by the actions, decisions, policies, practices, or goals of the organization" (Weiss 2006: 52). The *focal stakeholder* is the group or organization in question, while the *primary stakeholders* include owners,

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[1]This "simplified" form of shareholder theory—more pointedly, this caricature of shareholder theory—seeks to isolate the pursuit of profit as itself morally problematic. That is, the mechanism for simplifying shareholder theory consists in setting in opposition the pursuit of profit (or wealth) on the one hand, and something genuinely "other-regarding" on the other hand. It is only by forcing this oppositional characterization through, and then by assimilating the moral with the genuinely other-regarding, that the pursuit of profit (or wealth) is rendered morally problematic. Hence the overused quip concerning the apparently paradoxical nature of the very phrase, "business ethics." For more on the role of such fundamental maneuvers, see the Preface to Machan & Chesher 2002; see esp. xi–xiii.

customers, employees, suppliers, and others crucial to the organization's survival. *Secondary stakeholders* are "all other interested groups, such as the media, consumers, lobbyists, courts, governments, competitors, the public, and society" (Weiss 2006: 52).

A major purpose of stakeholder theory is to develop solutions to ethical dilemmas that tend[2] to arise in an organizational context; such solutions take into consideration the needs and interests of all stakeholders, particularly less powerful stakeholders (who are often ignored) and those who have the most to lose from the dilemma's outcome. Toward this end Joseph Weiss encourages corporate leaders to develop the following procedure for analyzing stakeholder relationships (Weiss 2006: 55–61):

- Map stakeholder relationships and coalitions
- Assess each shareholder's interest
- Assess each stakeholder's power
- Identify the moral responsibility of each stakeholder involved
- Develop strategies for addressing each stakeholder
- Monitor stakeholder coalitions

Ideally, such an approach allows managers to understand their various constituencies and develop "win-win" situations that address the needs of as many stakeholders as possible.

[2]"Tend" here need not indicate any high frequency of realization. We can grant that the organizational context tends to introduce opportunities for individual preference frustration, but we need not think of this as anything especially problematic. Emphasizing individual capacity for rational choice, for example, suggests that the frequency of preference frustration must be (identified as) relatively low, otherwise individuals would refrain from entering into relationships in an organizational context. Proponents of stakeholder theory tend instead to assert that the ways in which the organizational context renders the interests of some stakeholders—the "weak" ones—especially vulnerable requires that someone more powerful (management, activist groups, regulators) limit the ability of other powerful entities to exploit the weaker ones. Discussions of the moral status of the "at will" understanding of the employment arrangement provide a telling example of how these differences tend to play out; see, for example, the essays by Patricia H. Werhane & Tara J. Radin and Richard A. Epstein in Beauchamp, Bowie, and Arnold 2009, 113–29. At the same time, recognition of the risk associated with the pursuit of preference satisfaction within the organizational context provides an opportunity for individuals to cultivate the classical virtue of prudence; an emphasis on the role of this virtue in a comprehensive ethical defense of business is a central "theme" of Machan & Chesher 2002.

Shareholder theory sees the company's owners as the locus of ethical duty. Stockholders have purchased the property, and they hire managers to act as their agents. Managers "are empowered to manage the money advanced by the stockholders, but they are bound by their agency relationship to do so exclusively for the purposes delineated by their stockholder principals" (Hasnas 1998: 22). Thus, while managers have substantial liberty as to specific actions, they are not free to use company resources in ways that they could reasonably foresee would not advance the shareholders' interests. In this way, shareholder theory begins by recognizing the moral force of property rights.

Another factor restraining management's liberty under shareholder theory is the legal environment in which the business operates. Thus, just as stakeholder theory obligates management to conduct the affairs of the business with an eye on "external" factors (i.e., stakeholders beyond the focal stakeholder), so too does shareholder theory. An additional difference between these theories, then, is found in their respective identifications of legitimate external constraints.

On this count, once again stakeholder theory appears to have the advantage. In its willingness to countenance only the law as a legitimate external constraint on the pursuit of shareholder interest, shareholder theory seems to be vulnerable to the charge of reducing ethics to mere compliance. Still, shareholder theory continues to be the dominant paradigm among professional managers, while business ethicists and other academics are generally more supportive of stakeholder theory.[3] Is this dichotomy due to some inherent moral flaw or managerial ignorance, or are most business ethicists missing certain fundamental pieces of information? In the next section, we argue that stakeholder theory is significantly limited in ways that may be more apparent to business managers than academics.

III. Limitations of the Stakeholder Theory

The normative version of stakeholder theory is superficially a more attractive model than shareholder theory for advancing ethical behavior. Stakeholder theory explicitly requires managers to consider the interests of all affected parties and attempt to develop a solution that reflects all of their needs and values. On the other hand, shareholder theory focuses narrowly on the interests of just one interested party, potentially at the expense of the

[3]Most recent books on business ethics appear to be written from a stakeholder perspective, and some business ethics textbooks (e.g., Weiss 2006) appear to suggest that stakeholder theory is the only perspective from which to address business ethics. An obvious (though not exclusive) exception to this is Machan & Chesher 2002.

others. However, we believe there are significant limitations to stakeholder theory—and advantages to shareholder theory—that make this theory less attractive.

Obligations to Shareholders & the Necessity of an Implementable Model

Stakeholder theory requires managers to balance the competing moral claims of various actors. Unfortunately, successfully negotiating such a wide array of competing demands poses significant legal and practical difficulties for managers. The past decade's corporate scandals (e.g., Enron, Worldcom, Adelphia, etc.) suggest that management often has difficulty meeting its moral obligations to the owners. If new legislation (i.e., Sarbanes-Oxley) is necessary to force managers to honor their responsibilities to shareholders alone, it is unlikely that managers will meet moral obligations to shareholders *and* other parties.[4]

One major goal of business ethics is to "produce a set of ethical principles that can be both expressed in language accessible to and conveniently applied by an ordinary business person who has no formal ethical training" (Hasnas 1998: 19–20). Thus, for an ethical paradigm to be useful it must be applicable in "real world" settings. Stakeholder theory has severe limitations in this area. For example, at least one stakeholder theory analysis model instructs students to understand *all* moral standards and recognize *all* moral impacts before developing a resolution to a moral problem. (Hosmer 2006: 3). Such a prescription for paralysis is completely impractical as a guide to business managers.[5]

Political Strength

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[4]It must also be remembered that managers have a fiduciary responsibility to act in the best interests of shareholders. Companies and their managers have increasingly been subject to shareholder suits for actions that allegedly impaired shareholder value (usually determined by the stock price). Thus, managers who consistently subordinate the owners' interests to those of other parties expose themselves to civil liability for damages suffered by the owners. Unless and until this legal reality is changed, business ethicists should be careful about suggesting that managers must expose themselves to litigation in order to behave ethically.

[5]Proponents of stakeholder theory often point to Europe as a place where their model has been successfully employed. However, an examination of western European growth rates (especially vis-à-vis those of the more shareholder oriented United States) illustrates the costs of analysis paralysis. See the 2004 Timbro Report "EU Versus USA" for more details.

In many ways stakeholder theory appears to envision a balancing of claims more common in government operations than in the business world. In democratic political systems legislators and other government officials routinely attempt to balance the needs of competing interest groups in order to arrive at some mutually agreeable (or at least tolerable) outcome. In such an environment profit maximization and efficient utilization of resources are decidedly secondary considerations.

While such a system might appear to yield more equitable outcomes, this is frequently not the case. Any student of government knows that allocation decisions are quite often based on political power, score settling, "log rolling," and other hidden agendas totally unrelated to what is best for other stakeholders. Furthermore, the absence of a "bright-line" metric such as net income or return on investment means that the deleterious effects of such decisions can persist for many years, until other stakeholders can muster the necessary political energy to dislodge entrenched interest groups.

The suboptimal decision making process outlined above is not unknown in business. Managerial cliques can and do make decisions that serve their private interests at the expense of the company's long-term interests. However, the need to realize a return for shareholders usually places a natural limit on such behavior. Managers who consistently fail to meet the needs of owners will eventually be replaced by those who do, thereby ensuring the long-term survival of the company upon which all stakeholders' interests depend.[6]

The need to remain profitable illustrates another problem with applying a political model to business administration. Governments rarely go bankrupt regardless of the decisions they make, in large part because they can usually increase taxes to make up any shortfall.[7] Private businesses rarely have this luxury, which is why "the bottom line" tends to focus management's attention.[8]

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[6]The recent increase in corporate CEO turnover is one example of this phenomenon. While there are many reasons why corporate leaders leave, many are being forced out for failing to meet shareholder expectations.

[7]It should be noted that in cases of extreme mismanagement (e.g., New York City in the 1970s, or Buffalo, NY currently) government entities can be subjected to control boards. While this embarrasses the affected politicians and limits their autonomy, such "adult supervision" rarely leads to the political entity's liquidation, or often even the removal of the particular politicians.

[8]Of course, the recent bailout of the major financial and banking institutions is tantamount to an increase in taxes in order to make up for a (tremendous) shortfall. The many ways in which this bailout allows management not to be held accountable for its

IV. The Normative Advantage of Shareholder Theory

Is it ever morally obligatory for a manager to conduct the affairs of a publicly held business in ways designed to fail to maximize investor return, even when any available steps designed to succeed in maximizing investor return would be permitted by both law and "moral custom"[9] alone? According to the Shareholder Theory of Business Ethics, this question receives a negative answer. According to the Stakeholder Theory of Business Ethics, this question receives an affirmative answer. This seems to be the heart of the dispute between Shareholder and Stakeholder theories.

In many recent discussions of business ethics, whether by philosophers or business school faculty, Stakeholder Theory has been lauded as superior to Shareholder Theory. When these discussions are not careful, the support of Stakeholder Theory turns out to be directed at the so-called "strategic" Stakeholder Theory of Management. But the strategic version of the theory is not a normative theory of business ethics. Instead, it is a descriptive theory of successful management, where the notion of success reduces to shareholder return. In other words, what is presented as a defense of some version of Stakeholder Theory turns out to be a defense of Shareholder Theory.

Not all putative defenses of Stakeholder Theory are this muddled. Some genuinely seek to defend the thoroughly normative version of the theory. As we understand it, to defend the thoroughly normative version of Stakeholder Theory is to argue that there are conditions in which managers are morally obligated to forgo the quest for profit maximization in order to protect the moral interests of at least one other stakeholder group. For example, some would argue that, at least sometimes, it would be morally impermissible for management to change suppliers—even when such a change would contribute to increased shareholder return and would not violate any standing contracts, etc.—if this change would cause some significant harm *to the current supplier* (alone).

We may allay any worries about exploitation as apparently endorsed by Shareholder Theory by reminding ourselves of Milton Friedman's directive that management's pursuit of profit on behalf of the shareholders be restricted to means that comply with the law, and that refrain from the use of

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irresponsible exercise of power surely accounts for why most libertarians find the bailout objectionable.

[9]Let us not forget that Milton Friedman acknowledged the controlling force of both law and so-called "ethical custom" even as he launched his forceful defense of using the firm's resources exclusively to seek to satisfy shareholder interest. See "The Social Responsibility of Business is to Increase its Profits," reprinted in Beauchamp, Bowie, and Arnold 2009, pp. 51–55; see esp. 51.

deception and fraud.[10] For competition genuinely to be "free and open," all parties involved must be given the opportunity to operate with a genuine understanding of the terms of such competition. Only when such conditions are met is it genuinely the case that individual property rights are accorded the respect they deserve.

These last remarks, however, may be taken as once again pointing in the direction of the normative version of Stakeholder Theory. If the only way to assure that the pursuit of profit for the shareholders contributes to the maximization of a wide range of moral goods for all stakeholder groups is to involve those stakeholder groups in the decision making process—even if only by making available to them information about potential benefits and harms to their interests—then it seems that a background condition for the legitimization of Shareholder Theory is that we have already accepted (something like) Stakeholder Theory. In other words, the pursuit of profit is morally permissible only if we have prior reason to believe that such pursuit does not compromise the legitimate moral claims of other stakeholders. Should such pursuit in fact compromise the legitimate moral claims of other stakeholders, it would be morally impermissible. And this, let us remind ourselves, is the affirmative answer to the question with which this section began.

This suggestion, however, is not right. The only background condition necessary to make morally legitimate the pursuit of profit is that such pursuit actually refrains from deceptive, fraudulent, and illegal activities.[11] Taken together, the prohibitions on deceptive, fraudulent, and illegal activities amount to recognition of the absolute priority of autonomy for proper moral standing.

In contrast, Stakeholder Theory seems to require that managers act paternalistically toward non-shareholder stakeholders. Since we cannot in practice involve all stakeholders in every management decision, managers must act as the agents of those stakeholders (and their interests) as well. But this would require the managers, at least sometimes, to seek to act on behalf of those stakeholders without a clear understanding of what the stakeholders would wish for themselves. This is not the case in management's pursuit of the interests of the shareholders, which typically have an element of

[10]Ibid., p. 55.

[11]We must be careful, though, about assigning too much moral force to the current state of the law. *Prima facie* we should respect the law (as a whole and specifically), but we properly object when the law unreasonably restricts basic liberty, including property rights. More precisely, the context in which commerce occurs is morally legitimate to the extent that it is grounded in a recognition of the value of individual liberty.

transparency and uniformity that the other groups' interests do not.[12] What this means is that Stakeholder Theory actually compromises management's ability to conduct the affairs of the business with an eye on preserving the autonomy, or recognizing the rights, of all stakeholders.

We might set aside these observations about the weaknesses of Stakeholder Theory as a means of respecting stakeholder autonomy, noting that there are some moral concerns that are on a par with respect for autonomy. That is, rather than assigning a morally foundational role to autonomy—and seeing all other moral concerns as secondary—we might begin with a more pluralistic understanding of the demands of morality. Daniel E. Palmer attempts to outline a version of the Stakeholder Theory of Business Ethics that relies on W. D. Ross's exposition of a pluralistic deontological normative theory. Although he stops short of offering a robust defense of this version of Stakeholder Theory, he asserts that employing this kind of pluralistic understanding of moral duties "would provide a strong foundation for a viable type of stakeholder theory, since it recognizes a plurality of *prima facie* duties that are relevant to deciding what a person's actual duty is in any given situation" (Palmer 1999: 705). Moreover, Palmer concludes that Shareholder Theory is in its very nature inadequate as a theory of business ethics precisely because it cannot recognize such a plurality of *prima facie* duties.

However, Palmer fails to recognize that a Ross-style pluralism simply cannot serve as the normative basis for "a viable type of stakeholder theory," at least not if that theory is to be a theory of business ethics on Palmer's own understanding. Palmer agrees with Hasnas's characterization of theories of business ethics as attempting to identify "'intermediate level' principles to mediate between the highly abstract principles of philosophical ethics and the concrete ethical dilemmas that arise in the business environment" (Hasnas 1998: 20; quoted in Palmer 1999: 700). Palmer expands on this by noting that "the appropriate theory of business ethics will allow the business person to access most clearly those considerations that our more general normative theory tells them ought to factor into their decisions" (Palmer 1999: 700). This understanding of the function of a theory of business ethics gels nicely with a recent effort to combat the use of the label "applied ethics" to refer to areas such as business ethics, medical ethics, and engineering ethics. In the words of three leading business ethicists, "Rarely is there a straightforward

[12] We stress the "typically" in this last statement. A further complicating factor for managers as they seek to satisfy shareholder interest is the degree of plurality within the interests of the several shareholders. Recognizing this makes the task of meeting obligations to shareholders more difficult than just finding the most effective way of providing a reasonable return on investment.

'application' of principles that mechanically resolve problems. Principles are more commonly *specified*, that is, made more concrete for the context, than applied" (Beauchamp, Bowie, and Arnold 2009: 8).

But there are notorious difficulties involved in specifying a Ross-style theory into anything that can give us guidance about how to handle concrete cases. However much Ross's identification of a plurality of *prima facie* moral duties accords with common sense, there is nothing within the theory itself that can tell us how to sort out apparent conflicts among such duties. Thus, for example, most would agree with Ross that we have a *prima facie* moral duty to keep our promises, and another *prima facie* moral duty to refrain from actions that would harm others; however, we may expect widespread disagreement about how to identify in general terms under what conditions one of these duties trumps the other when they conflict.

Given these problems, we should not take hope—as Palmer does—that a Ross-style pluralism will give managers any clear guidance about how to balance the competing stakeholders' moral claims against the firm. To continue with the example sketched in the preceding paragraph, simply noting that we have *prima facie* duties to keep our promises and to refrain from harming others will not tell management what to do when it becomes clear that fulfilling a promise made to labor during the last round of negotiations will harm the interests of the firm's shareholders (some of whom, we should remember, very well could be members of the labor group, as well). Perhaps noting the conflict may be seen as an occasion for management to pursue further analysis of the situation, but suggesting as much threatens a slippery slope of analysis, one which could lead to "paralysis by analysis."

V. Conclusion: Teaching Shareholder Theory

The relationship between the degree of control one has over an asset and the effort one will put into preserving it has been recognized for centuries:

> It is a general principle of human nature, that a man will be interested in whatever he possesses, in proportion to the firmness or precariousness of the tenure by which he holds it; will be less attached to what he holds by a momentary or uncertain title, than to that which he enjoys by a durable or certain title; and of course will be willing to risk more for the sake of the one, than for the sake of the other. This remark is not less

applicable to a political privilege, or honor, or trust, than to any article of ordinary property (Hamilton 1788).[13]

By distancing management's decisions regarding the use of corporate property from any durable or certain claim by any specific entity to ownership of that property, stakeholder theory reduces the probability that any of the entities involved will sacrifice their immediate desires for the long-term health of the company. The shareholder model recognizes that one party has primary ownership of the asset, thereby providing that entity with an incentive to work for the long-term prosperity of the company, to the benefit of all of the parties that depend on it. Ironically, by vesting primary control of the company with *one* interested party (e.g., the owners), the shareholder paradigm increases the likelihood that the firm will survive in the long run and continue providing benefits to *all* interested parties.

Shareholder Theory thus has the (epistemological) advantage of allowing management to conduct the affairs of the firm with a clear eye on fulfilling its obligations to the shareholders, that one group whose interests are typically both transparent and uniform. This should not be mistaken as suggesting that management's job is easy, or that it is always clear what should be done in the pursuit of satisfying shareholders' interests. It is to suggest, however, that Shareholder Theory remains a viable normative theory of business ethics, especially when it is set against the background understanding of what makes the pursuit of profit valuable for the maximization of moral goods for society as a whole.

In light of the above characterization, we suggest that courses in business ethics better prepare future business people when they proceed from the perspective of Shareholder Theory. To proceed from the alternative perspective—that provided by the normative version of Stakeholder Theory—is to suggest to business students that the primary objective they will have to keep in mind once they enter their professional lives is the direct satisfaction of all the stakeholder groups. This is problematic insofar as it both increases likelihood of collapsing into "analysis paralysis" and removes from the conduct of business a central recognition of the ways in which

[13]As Thucydides reports it, Pericles recognized the disastrous effects of a general lack of concern for the cultivation of value from an accessible good: "each fancies that no harm will come of his neglect, that it is the business of somebody else to look after this or that for him; and so, by the same notion being entertained by all separately, the common cause imperceptibly decays" (*History* I.141). Less than a century later, Aristotle argued against communal ownership (of the sort featured in the articulation of the *kallipolis* in Plato's *Republic*) on the grounds of its incompatibility with the exercise of moral virtue, especially liberality/generosity (see *Politics* II.v).

business's creation of wealth contributes to maximal exercise of individual autonomy.

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