Article # 6

The Social Responsibility of Management:
A Critique of the Shareholder Paradigm and Defense of Stakeholder Primacy

[Response to *The Social Responsibility of Management: A Critique of the Stakeholder Paradigm and Defense of Shareholder Primacy* by Philip R.P. Coelho, James E. McClure, and John A. Spry]

Frederick R. Post, *University of Toledo*

"Shareholder Theory allows management to ignore the interests of the other constituencies while pursuing its own narrow self-interest under the guise (the ethical facade) of promoting the interests of the shareholder owners. The Shareholder Theory does not provide any relistic counterweight against management abuse. The Enron example strengthens the arguments for the use of Stakeholder theory and exposes the utter failure of the Shareholder Theory."

— Frederick R. Post

Introduction

In their second attempt to resuscitate the old simplistic Adam Smith theory of shareholder primacy, the Shareholder Theory, authors Philip R. P. Coelho, James E. McClure and John A Spry (hereinafter referred to as the authors) again mount a vigorous attack on the Stakeholder Theory in the preceding article. They persist in an effort to discredit the Stakeholder Theory by declaring it unworkable because it is vague, ambiguous and inconsistent. The authors rest their defense of Shareholder Theory on their belief that profit maximization for the shareholder owners while staying within the boundaries of the law produces ethical decisions, subsumed within their unique definition of how an ethical decision is measured. New is an assault on my response article, characterizing it as factually mistaken, inconsistent and confused about the contents of their first article, about how (they believe) corporate capitalism works and about how I do not understand the dire consequences of the stakeholder theory. New also is the assertion that shareholder theory actually involves ethical reasoning. This "reasoning" evaporates when analyzed in the context of the hypothetical examples presented by the authors.

Misbehavior in many large publicly traded corporations has reached such an epic level in the last decade that Friedman's admonition "to make as much money as possible for the owners and follow the law" seems irrelevant. The virtually unchecked, unregulated concentration of power in the hands of a tiny elite few has wreaked havoc on all of the other stakeholders who depend upon long-term corporate survival for their own livelihood. The authors have rhetorically questioned the ability of proponents of the Stakeholder Theory to "identify just one ethical problem that management faces that would be better resolved by their stakeholder paradigm than simple transparency (neither deception nor fraud)." I will provide them thirteen examples of presently occurring, often perfectly legal, gross abuses of corporate power by the tiny elite few that operate to the detriment of other stakeholders. I contend that these abuses would stop or be significantly reduced if held to account by the other five stakeholders based upon the controlling test: does this act/practice result in the best long-term survival interests of this corporation? I do not expect to convince these authors of the veracity of my positions. Whatever strength my arguments may have, the authors will still hold their same opinion. I do hope to address the readership so they will have a better understanding of the issues and why the Stakeholder Theory better addresses those issues.

The purpose of this article is to first, correct the misrepresentations and misstatements about the positions presented in my first article and, second, to clarify these positions and address the criticisms made about them. Finally, in my conclusion, I will answer their rhetorical question by providing thirteen examples of presently occurring management abuses and demonstrate why the Shareholder Theory tolerates them but the stakeholder theory would put an end to them.

Correcting Misrepresentations and Misstatements

In their second article, the authors assert that my solution (p. 35) to the amoral vacuum within which corporate decision making occurs under the Shareholder Theory is for universities to teach deontological reasoning (Kant, Rawls and Judeo Christian Belief systems) to students. This significantly misrepresents my solution. A careful reading of footnote 2 (p.35) shows that my solution is for universities to teach the strengths and weaknesses of capitalism (p. 27), the strengths and weaknesses of the law (p. 27-28) and the strengths and weaknesses of both Teleological and

Deontological ethical reasoning. In many respects, Deontological reasoning is of minimal value in a business context, especially the hypothetical just society proposed by John Rawls (1971). Eliminating a thorough review of the first two dimensions (Economics and Law) and chopping the third dimension in half (no teleological reasoning) makes for a very incomplete solution. Having not been so taught, business persons do fall into moral relativism (moral views represent how a person feels or how a culture accommodates those feelings, therefore, rightness or wrongness are meaningless notions apart from the specific cultural context in which they arise) (Beauchamp and Bowie 1988) and ethical egoism, technically egoistic hedonism,—the pursuit of one's own pleasure is the highest good and the criterion of right action, therefore, what makes an act right is that it is to one's own advantage or self-interest (Miller 1987). I stand on my assertion in footnote 2 (p.35) that my generation was not exposed to ethical reasoning and most do not even know how to reason through such problems if they even see them as such. Shareholder Theory requires no ethical reasoning, because if a management decision is profitable and legal, it is ethical. Therefore, there is no need for the discipline of business ethics. In the context of business decisions, this is what the authors believe and they assert this in their first article "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" (p.17). This is moral relativism–rightness to you is right.

The authors also assert that I appealed to Rawl's theories of social justice in advocating the short list of six stakeholders (with the sarcastically clever label 'Post's six-pack proposal') with the implication that this was my original idea. This misrepresents my position about the deontology of Rawls, as it only represents a teaching tool to force students to think. The purpose of a Business Ethics course is to teach students how to think through ethical problems that occur in business–especially when one is in management where decisions affect others: employees, the community, suppliers, the shareholders and the customers.

Clarifying Positions and Addressing Criticisms

My arguments against the value of the one-dimensional simplistic 19th century Shareholder Theory are directed squarely at the theory itself, not these authors. My criticisms are based upon its inability to provide a useful framework for socially responsible governance of large, publicly held corporations in America. While I have presented the arguments against the Shareholder Theory, there was ample attribution for scholars who originally developed the arguments, particularly to the Freeman (1984) paradigm with its succinct formulation of the Stakeholder Theory and its later evolution to Kantian Capitalism (Evan and Freeman1988) with principles P1 and P2 (p. 32). It is surprising that these authors never mentioned the Freeman Paradigm in their first article. For an assault on a competing theory to have the most impact, these authors should direct their arguments to the principal source of the theory. More surprising is the author's failure to mention Freeman in their second article, after my article placed the Stakeholder Theory in its recent historical context. The scholars cited by the authors in their first article (p.15) are commentators on the Freeman paradigm, and do not waste time or space mentioning Friedman because like them, he is merely a commentator on the Adam Smith paradigm which became known as the Shareholder Theory.

In both articles, the authors make a curious argument, which they attribute definitionally to Friedman, that "without deception and fraud" means that managerial actions are transparent and available to public scrutiny. In their first article they state in footnote 1 (p.22) that the most detailed perspective on what the Friedman admonition means is to be found in his 1970 article in the New York Times magazine. A careful review of that article reveals that Friedman does not define "without deception and fraud" as transparent managerial actions that are available for public scrutiny. The authors do state in the first article that the literature concentrates on three methods to motivate agents (management) to act on behalf of their principals (owners). The first and foremost being transparency (p.21). In their hypothetical logging example (p. 16), the authors define transparency in decision making as a requirement that management, after making a bad decision, (in the logging hypothetical, the logging causes a disastrous flood) must admit to the citizenry that the flood was a consequence of their decisions. This supposedly will allow the citizenry "to address what they see as ethical issues" (p.16). This can only mean that management must admit liability publicly so the corporation can be more easily sued in court. The authors then assert "ethical executives will provide information that allows an informed public to act" (p.16). This would mean that the informed public would commence litigation against the corporation where liability has already been admitted. Is this what an ethical executive is supposed to do? Act however he wants (moral relativism/ethical egoism) and then if things go wrong, admit it publicly? Such a reasoning process for defining what an ethical executive is has virtually nothing to do with ethical reasoning.

Logically this analysis makes no sense because no corporate executive is going to make such an admission against interest–either his personally or that of the corporation. Yet the authors in their second article place great emphasis on this process being the check and balance that will insure ethical decisions by management. It is both illogical and flies in the face of all experience to expect such behavior. This example which supposedly defines ethical reasoning makes no sense.

The author's use of the Jeff Skelling/Enron example in their second article represents the total failure of the shareholder theory to reign in management practices that are out of control. The Enron practices produced enormous detriment to all of the other five stakeholders–not just the shareholder owners. This example demonstrates the complete inability of the Shareholder Theory to correct/stop/force the cessation of illegal and ethically reprehensible behavior. To the contrary, if the management group at Enron had been put under the scrutiny of the five other stakeholders, the whole debacle would never have happened. Why? The other stakeholders would never have supported such acts/practices. The Enron example strengthens the arguments for the use of Stakeholder Theory and exposes the utter failure of the Shareholder Theory. This same stakeholder accountability when applied to Tyco, Worldcom, Adelphia, Global Crossing, Qwest, Xerox and Merrill Lynch shows why the "first and foremost" (p.21) counterweight against a crushing disregard by management of all other interests than its own–that managerial actions are to be transparent and available to public scrutiny–is a theoretical fiction which does not occur in practice.

The Shareholder Theory does not provide any realistic counterweight against management abuse. Management knows that the imperfect legal system will either fail to discover the illegal conduct or feel perfectly justified about their behavior because the acts/practices are actually legal anyway–though certainly not ethically justifiable nor capable of support if held up to the scrutiny of the five other stakeholder groups.

In their second article, the authors challenge the assertions made by several scholars Boatright (1994), Nesteruk (1990), Nesteruk (1989) and Shaw and Post (1993) that shareholders, while the legal owners of their stock, have greatly diminished ownership rights from what legal ownership of tangible property ordinarily represents (p. 28). My example of the many "uses" of a personal automobile is used as a metaphor for demonstrating the difference (p. 28). Later, I observe that even automobile usage is limited in many ways to insure that usage does not harm other person's rights (p. 30). Many property ownership rights are limited by restrictions on uses against the human rights interests of others (Donaldson and Preston 1995). The authors then misrepresent my metaphor by asserting that I think that only tangible personal property is actually legally owned. Arguing from this misrepresented position they then assert that because I think there is no legal ownership of other forms of intangible property, specifically intangible intellectual property rights, this would result in the destruction of entire industries. This specious argument is akin to "the sky is falling." When a line of argument is premised upon a misrepresentation that is then taken to an absurd extreme, it becomes clear that these authors cannot accept the obvious. It might be more intellectually honest to accept the present legal status of shareholders: the legal ownership interests in stock are now at the barest minimum–beneficiaries holding an intangible property right over which they have no usage other than keeping it or selling it. Further, relying on this same line of argument—that shareholders no longer own their stock—the authors then argue that shareholder derivative lawsuits must be dismissed by the court system because shareholder plaintiffs could no longer argue that they had standing to bring such lawsuits because they are no longer owners. The authors then remind us that the courts still accept such lawsuits, which means that the courts still accept shareholders as the legal owners of their stock.

The authors do not recognize that limitations on the rights of ownership of property that exist today support the Stakeholder Theory and not the Shareholder Theory. This argument was developed by Donaldson and Preston (1995) and set forth in detail in my first article (p. 30-31). The authors also do not recognize that their reversal of the argument hypothetical about university professors having to get permission from the other faculty, administrators, staff, students and the local community before they can en masse change jobs is completely nonsensical. Universities are not private for profit publicly held corporations. The above list of supposed "university stakeholders" who must grant "permission" are in no way analogous to the six stakeholders envisioned by Evan and Freeman (1988). The hypothetical is illogical because faculty members do not en masse suddenly change careers. Furthermore, these authors misstate Donaldson and Preston when they attribute to them the argument that long-term employees have non-contractual rights to employment. Nowhere in my analysis of their argument (p. 30-31) do they, or I, make such a claim.

Another line of reversed argument that these authors assert is that the Stakeholder Theory provides an ethical facade for self-serving management unlike the Shareholder Theory. Exactly the reverse of their argument is what happens under the Shareholder Theory. This is because the Shareholder Theory allows management to ignore the interests of the other five constituencies while pursuing its own narrow self-interest under the guise (the ethical facade) of promoting the interests of the shareholder owners. No other interests need be considered as long as, in the judgement of management, short-term profits are being sought–certainly not the long-term survival of the corporation which would protect the interests of the other five stakeholders which is required under the Stakeholder Theory.

The author's final argument is also curious. They assert that the corporate form of doing business would not be chosen if an entrepreneur/capitalist had to share his wealth with suppliers, the local community and the other stakeholders. Referencing Sam Walton, who built Wal-Mart into a mega-retailer, the authors observe that he certainly did not share his wealth. This argument suggests that the adoption of the Stakeholder Theory will cause publicly held corporations to cease to exist because the owners will be required to share their wealth. The Stakeholder Theory is not about sharing wealth and promoting corporate handouts. Considering the interests of the other five stakeholders to insure the long-term survival of the entity is not premised upon philanthropy. Possibly, the confusion demonstrated by these authors about the operation of Stakeholder Theory as developed by Evan and Freeman (1988) is because in neither of their two articles do they make any attempt whatsoever to acknowledge that they are even aware of the paradigm from which the theory has evolved. A more recent expanded theoretical iteration of the Freeman paradigm argues persuasively that a single focus on pursuing wealth (the bottom line) often produces the opposite result. The "Paradox of Profit" evolves from the hedonic paradox–the more you consciously seek happiness the less likely you are to find it. The article argues that management should change its focus to high quality products for customers, and if this is their focus, profits will likely occur (Bowie 1998).

Conclusion

The case for Stakeholder Theory has been strengthened significantly because the several lines of criticisms raised by these authors can all be refuted. Further these authors have failed to mount a direct attack on Freeman's paradigm which is the model for evaluating Stakeholder Theory. When will public outcry over the wrongs legally committed under Shareholder Theory lead to reform? The evidence is certainly available based upon recent events in corporate America.

As to the authors' rhetorical question: whether proponents of Stakeholder Theory can identify "just one ethical problem that would be better resolved by their stakeholder paradigm than simple transparency (neither deception nor fraud)". It is quite easy to come up with numerous examples of often perfectly legal but ethically unjustifiable management abuses condoned by the Shareholder Theory. Following are thirteen examples of profoundly unethical abuses that would surely be vigorously challenged by the other five stakeholders when contemplated by management and condoned by the Board of Directors. First, I will list three both illegal and unethical practices:

1. The discharge of polluting waste into the air and water for economic purpose.
2. Employment policies that discriminate against women and minorities.
3. Downsizing older employees solely for economic purpose.

Second, I will list ten legal but unethical practices:

4. Exorbitant executive compensation not tied to corporate performance.
5. Executive bonuses not tied to executive performance.
6. Relocation of production facilities out of America solely for economic purpose.
7. Executive pensions secretly placed in trusts so they cannot be attached in bankruptcy proceedings like all other pensions.
8. Unchallenged huge amounts of corporate funds spent on soft-money political contributions.
9. Supplemental executive retirement plans (SERPS) given to executives that explode pension payouts.
10. Crediting decades of extra service credit in pensions for short-term executives.
11. Exorbitant company financed loans to executives, later forgiven.
12. Legally corrupting outside directors by bribing them with extra fees and payments.
13. Placing retired politicians on corporate boards who have no private sector business experience to gain political favors.

These acts/practices by management and the Board of Directors of large publicly held corporations under the Shareholder Theory are not ethically justifiable under either teleological or deontological reasoning. Using the utilitarian analysis of John Stuart Mill, that these thirteen practices would have to produce the greatest good for the greatest number of persons affected by them, the practices are ethically unjustifiable because they do not produce the greatest good for the other five constituencies. Many of these practices produce no good whatsoever for any constituency other than management and most certainly do not promote the long-term survival of the corporation. The consequences of these practices make them unethical under teleological reasoning. Using the deontological analysis of Immanuel Kant in his first formulation of the categorical imperative, actions are only moral if when universalized everyone can act that way without the principle of the action becoming a self-defeating contradiction. The practices would have to be applied the same, where applicable, to the other stakeholders. If this absurd largesse were applied to all of the employees, would that enhance long-term survival of the corporation? Applying such practices across the board would create financial chaos for the corporation. Again, these absurd economic benefits are not tied to executive performance, corporation performance or executive length of service. If these practices were "universalized" for all the employees the practices would result in a self-defeating contradiction. These practices are unethical under deontological reasoning. Applying either form of reasoning to these practices demonstrates that they are unethical business practices. Under the Stakeholder Theory, they would face stiff challenges from the other stakeholders. Under the Shareholder Theory, there is no challenge. ■

References

Beauchamp T. and N. Bowie. 1988. *Ethical theory and business.* 3d ed. New Jersey: Prentice Hall.

Boatright, J. 1994. What's so special about stakeholders? *Business Ethics Quarterly* 4:4.

Bowie, N.E. 1998. A Kantian theory of capitalism. *Business Ethics Quarterly* (The Ruffin Series) 1:37-60.

Coelho, P.R.P., J.E. McClure, and J.A. Spry. 2003. The social responsibility of corporate management: A classical critique, *Mid-American Journal of Business* 18(1):15-24.

Donaldson, T. and L.E. Preston. 1995. The stakeholder theory of the corporation: Concepts, evidence, and implications. *Acad-*

emy of Management Review* 20:65-91.

Evan, W.M. and R.E. Freeman. 1988. A stakeholder theory of the modern corporation: Kantian capitalism. Eds. T. Beauchamp and N. Bowie. *Ethical theory and business.* 75-93. Englewood Cliffs, NJ: Prentice Hall.

Freeman, R.E. 1984. *Strategic management: A stakeholder approach.* Boston: Pitman.

Friedman, M. 1970. The social responsibility of business is to increase its profits. *New York Times Magazine,* 32:13 Sept., 122-126.

Miller, E.L. 1987. *Questions that matter. An invitation to philosophy.* 2d ed. New York: McGraw-Hill.

Nesteruk, J. 1990. Persons, property, and the corporation: A proposal for a new paradigm. *DePaul Law Review* 39:543-565.

__________. 1989. Corporations, shareholders, and moral choice: A new perspective on corporate social responsibility. *Cincinnati Law Review* 58:451-475.

Post, F.R. 2003. A response to 'the social responsibility of corporate management: A classical critique.' *Mid-American Journal of Business* 18(1):25-35.

Rawls, J. 1971. *A theory of justice.* Cambridge, MA: Harvard University Press.

Shaw, B. and F. Post. 1993. A moral basis for corporate philanthropy. *Journal of Business Ethics* 12:745-751.

About the Author

Frederick R. Post, J.D., M.B.A. is an Associate Professor of Business Law and Ethics in the College of Business Administration at the University of Toledo. His research interests include labor and employment law, conflict resolution and corporate governance. He has published in numerous prestigious journals including *Business Horizons, The Journal of Business Ethics, The International Journal of Conflict Management, The Connecticut Law Review* and *The Journal of Legal Studies Education.*