Corporate Social Responsibility and the Legitimacy of the Shareholder Primacy Norm: A Rawlsian Analysis

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Abstract

The shareholder primacy norm (SPN) is considered a major impediment to corporate social responsibility. We argue that although the SPN is not legally enforceable, it is a powerful social norm among managers. Applying Rawls' social contract theory, we evaluate the legitimacy of the SPN, concluding that it would endorse a principle of governance in line with shareholder primacy rather than stakeholder theory. Nonetheless, we also argue that justice considerations of Rawls' theory impose exogenous constraints on shareholder primacy, primarily through legislation.

The Shareholder Primacy Norm (SPN) is the part of a manager's fiduciary duty that requires managers and company directors to make decisions on behalf of the corporation that further the interests of shareholders. It has been treated as a major obstacle to Corporate Social Responsibility (CSR) because it is said to hinder managers from considering the interests of other corporate stakeholders besides shareholders (Boatright, 1994; Campell, 2007; Dodd, 1932, Evan and Freeman, 2003; Hinkley, 2002; Phillips, Freeman and Wicks, 2003; Testy, 2002). More recently, in the light of the global financial crisis that started in 2008, the legitimacy of managerial focus on shareholder wealth maximization is also being questioned from quarters that are not usually associated with the advocacy of CSR (e.g., Financial Times 2009).

CSR has been defined in many ways. In general, however, "it means that the private corporation has responsibilities to society that go beyond the production of goods and services at a profit… a corporation has a broader constituency to serve than stockholders alone" (Buchholz and Rosenthal, 2002: 303). In other words, CSR contains a prescription for corporations to pursue ends that go beyond merely pursuing the interests of shareholders. Thus the definitions of the SPN and CSR suggest that they are in conflict as prescriptive concepts. As a consequence, the legitimacy of the SPN is at the core of what has been called the "basic debate" in business ethics, between whether managers should focus on shareholder or on stakeholder interests (Agle and Mitchell 2008; Boatright, 2002; Campbell, 2007; Freeman, 1994; Phillips, 1997). By "legitimacy" in this context we mean that the actions of corporations when based on the SPN "are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions" (Suchman, 1995: 574).

The SPN is closely associated with the notion of Shareholder Value Maximization (SVM), because if one merges the SPN with an assumption that the interests of shareholders is the pursuit of profit, then this results in a prescription to managers to maximize shareholder value. Thus the

legitimacy of the SPN also has an important bearing on the goal of the corporation and whether it should be a vehicle for the pursuit of shareholder interests (Friedman, 1998; Jensen, 2002), or a vehicle for managing stakeholder interests (Freeman, Harrison, & Wicks, 2007). If the interests of shareholders are primary, then their interests will decide what goal the corporation should pursue, whether it is SVM or something else.

The large-scale destruction of shareholder value accompanying the financial crisis casts doubt on the extent to which managers in practice give shareholders primary consideration, at least in financial institutions. Former U.S. Federal Reserve Chairman Alan Greenspan has recognized that the risk management of these institutions rested on the premise that the enlightened self-interest of their managers and owners would ensure their long-run health and this premise failed (Greenspan, 2009). Some commentators have blamed the crisis on SVM specifically. Jack Welch, former General Electric CEO, called it the “dumbest idea in the world” (Financial Times, 2009). Skapinker (2009), noting that people like simple stories, observed: “A common justification for the shareholder value movement was that it provided managers with a clear view of what their purpose was. Suggesting that they serve other stakeholders too… was held to be too vague and confusing.” While multiple explanations have been offered for the crisis, the legitimacy of shareholder primacy certainly has come into question, as well as the system of regulation and constraints on the pursuit of shareholder interests.

Business ethics as an academic field has reacted disapprovingly to the shareholder primacy of the so-called Shareholder Theory of Milton Friedman, who asserted that the social responsibility of business is “to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game” (1962: 133) In contrast, Freeman (1984) advanced Stakeholder Theory, with its prescription of balancing the interests of different stakeholder groups and this has become one of the most prominent managerial theories within

business ethics (Phillips, 2003) and has emerged as a dominant paradigm in CSR (McWilliams and Siegel, 2001).[1] If the legitimacy of the SPN can be maintained, this need not be understood as a death blow to CSR, but it does mean that CSR should be seen primarily from a strategic perspective rather than a moral perspective, and that CSR activities should be justified through "business case" reasoning (e.g., Porter & Kramer, 2006).

The purpose of this paper is to evaluate the legitimacy of the SPN, as well as considering justifiable constraints on that primacy, by using social contract theory (SCT). We employ SCT because of the intuitive fit between the contractualist framework and the common depiction of corporations as nexuses of contracts (Van Oosterhout, Heugens and Kaptein, 2006). We apply the SCT of Justice as Fairness (Rawls, 1996; 1999; 2001) because it aims to develop the fundamental principles that are to govern the basic institutions of society and the corporate legal form may be considered to be such an institution. Furthermore, we use SCT because it is becoming a core theory within business ethics (Wempe, 2005) and Rawls' theory in particular because it is widely considered one of the most influential political theories of the 20th century.

Before evaluating the legitimacy of the SPN we need to understand what it is and what enforces the norm. Thus we start by describing the SPN from a legal perspective, but subsequently maintain that it is primarily operative as a social norm in business. Having understood how the SPN is *descriptively* operative we look at the SPN in the light of Rawls' theory of justice in order to evaluate *prescriptively* if it ought to be operative, thus shedding light on the norm's legitimacy. In contrast to previous applications of Rawls' theory within business ethics (Evan and Freeman, 1990; Hartman, 1994; Moriarty, 2005) that (mis)apply his political theory directly to the governance of corporate organizations (Phillips & Margolis, 1999), we look at the governance implications of Rawls' theory for the corporation as an institution that is part of the basic structure of society. We argue that the primary determinant for a norm of corporate

governance in a "Rawlsian society" is economic efficiency. However, corporate behavior would not be unfettered because it is subject to the exogenous constraints (primarily legislation) that are given by the basic structure. We conclude by showing that the core of the basic debate in business ethics between Shareholder Theory and Stakeholder Theory translates into a debate between externally imposed exogenous constraints vs. self-imposed endogenous constraints, which at its core is a debate between political liberalism vs. libertarianism.

EXPLICATION OF THE SPN

The SPN has its origins in corporate law, but our explication of the SPN maintains that its use today is not as a legally enforceable norm but as a social norm among managers. Furthermore, we maintain that even though normative pressures are mounting on managers from several non-shareholder constituencies, the SPN is still relied upon by managers because it is reinforced by the structure of corporate law which is geared towards shareholder primacy. Thus it is primarily the legitimacy of shareholder primacy as part of the *structure* of corporate law that we evaluate.

SPN as a Legally Enforceable Norm?

Corporate law in the US and UK, comprised of both common law and statutory law, is structured to ensure that corporations work in the interest of shareholders. However, this primacy of shareholders has not been formally identified in statutory law (Fisch, 2006). Common law provides the clearest articulation of shareholder primacy—in the numerous court cases specifying that managers and directors owe fiduciary duties to shareholders. Thus the debate about the SPN has focused on its efficacy and legitimacy as a norm stemming from judicial decisions.

As a development of common law, the SPN is the part of the fiduciary duty of managers to make decisions that are in the best interest of shareholders (Smith, 1998). The most famous articulation of the norm comes from the 1919 minority oppression case, Dodge v. Ford Motor Co. In delivering the opinion of the court (in favor of Dodge), Chief Justice Ostrander said:

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

This fiduciary duty in part consists of a duty of loyalty and a duty of care to shareholders (Clark, 1985). "Loyalty" implies that managers should promote the interest of shareholders but also that they should not put themselves in a position where their interests might conflict with those of the shareholders. An example would be if a director stood to benefit directly from a corporate contract. "Care" implies that managers are expected to make decisions that ordinary, prudent individuals in a similar position would make under similar circumstances for the benefit of shareholders (Clark, 1985; Paine, 2006). The primacy of shareholders is manifest in that they are, in the normal course of business, the sole corporate constituency to be granted fiduciary protection by the courts (Fisch, 2006).[2]

The judicial development of the SPN has a long history, dating back well before it became operative in the courts in the 1830s (Smith, 1998). Much current interest in the SPN stems from the flourishing advocacy of CSR, with progressive legal scholars, as well as business ethicists and corporate directors, viewing the SPN as a major impediment to managers including the interests of stakeholders other than shareholders in their decision making (Testy, 2002).

For much of the 19th century, this analysis was probably correct. However, with the development of the business judgment rule in common law in the 19th century and more recent statutory developments, managers today have significant discretion in addressing non-shareholder interests. Smith (1998: 280) concludes that "application of the shareholder primacy norm to publicly traded corporations is muted by the business judgment rule."

The business judgment rule is the presumption that directors have not breached their fiduciary duty of care. It is called the "business judgment rule" because it relieves the court of

any duty to make evaluations of the business judgment of a director.[3] For example, if a board of directors decides to donate a million dollars of corporate resources to the Tsunami Relief Fund of the Red Cross, shareholders might try to sue the directors personally for breaching the shareholder primacy norm; that is to say, for using corporate funds in a manner that does not further shareholder interests. But the business judgment rule relieves the court from considering whether or not the donation is a good business decision (and it might be, if favorable publicity were to result). In effect, the rule makes the fiduciary duty of care unenforceable because the court will not consider the quality of business decisions which would otherwise be the primary evidence for lack of care.

The business judgment rule makes sense because evaluating the quality of business decisions is difficult and this is not the primary competence of the courts. Many decisions in business do not have direct or measurable economic returns, such as improved working conditions for employees or advertising expenditures. Decisions like these can usually be rationalized as having indirect benefits such as improved brand image or employee productivity and thus might be in the interest of shareholders. An investment may have a large direct cost for a corporation, but whether or not it was indirectly profitable may be difficult to measure. It is rare for shareholders to succeed in derivative suits against directors on claims of a breach of care (Cohn, 1983).[4] Instead it is generally only the duty of loyalty that courts will consider when derivative suits are brought against directors. However, evaluating whether directors acted in bad faith is also difficult to determine because most business decisions seen as unfavorable to shareholders can be rationalized to seem reasonable at the time they were made. Thus courts primarily consider whether any self-dealing has occurred when evaluating breaches of loyalty.

Managers' fiduciary duties notwithstanding, the American Law Institute's (1994: 55) *Principles of Corporate Governance* provides considerable latitude for managers to act beyond

the apparent dictates of the SPN. Section 2.01 states: "Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business: 1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law; 2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and, 3) May devote a reasonable amount of resources to public welfare, humanitarian, educational and philanthropic purposes." This consensus document has been regularly cited and relied upon by U.S. courts.

Fiduciary duties developed in common law have been explicitly defined by the incorporation statutes of most states in the U.S. For example, the Model Business Corporation Act (2002) prepared by the American Bar Association and adopted by 24 states (but not Delaware) says (section 8.42 Standards of Conduct for Officers): "An officer, when performing in such capacity, shall act: (1) in good faith; (2) with the care that a person in a like position would reasonably exercise under similar circumstances; and (3) in a manner the officer reasonably believes to be in the best interests of the corporation."

Item (1) states the duty of loyalty, (2) states the duty of care, and (3) can be interpreted as referring to the SPN. Whether or not "the best interests of the corporation" includes non-shareholder interests is not entirely clear. Millon writes that "corporate law has avoided such puzzles by, for the most part, equating the duty to the corporation with a duty to act in the best interest of its shareholders" (1991: 228). But this does not per se exclude directors from considering the interests of non-shareholders. In Delaware, where 56% of U.S. corporations are registered (Eisenberg, 2000) and which is generally considered to have the most shareholder friendly statutes, there is no explicit statutory requirement that managers should only consider the interests of shareholders in their decision making. Moreover, most states have adopted "non-shareholder constituency statutes" that explicitly allow managers to consider the interests of non-

shareholder constituencies when making decisions (McDonnell, 2004). Pennsylvania was first to adopt such a statute in 1983, states such as New York and Nevada have followed suit (Delaware, however, has not). These statutes do not *require* managers to consider the interests of non-shareholders, but they make explicit that managers are not prohibited from doing so.

Similarly, the U.K. has also seen the introduction of statutes that explicitly allow managers to consider the interests of multiple stakeholders in their decision making. This U.K. development first occurred with the Companies Act of 1985, where section 309 made a statutory augmentation to the primacy of shareholders by stating that directors must take into account the interests of employees when performing their functions for the company and that this is to be regarded as a fiduciary duty owed to the company. In the Companies Act of 2006 directors are further required to take into account the interests of other stakeholders such as business relationships (e.g. suppliers and customers) as well as the community and environment. However, as in the U.S., the act does not give non-shareholder stakeholders the right to challenge decisions of directors in court if they feel their interests have not been taken into account. While this would suggest that directors still have only fiduciary duties to shareholders, they are now also at liberty to take into consideration the interests of a wider constituency of stakeholders.

Thus, potential common law restrictions on managerial discretion for considering non-shareholder interests have largely disappeared; the SPN is muted by the business judgment rule and recent statutory provisions in most U.S. states and the U.K. explicitly allow managers to consider non-shareholder constituencies in their decision making. We may then justifiably question the claim that managers are legally bound to disregard non-shareholder interests that conflict with those of shareholders. Progressive legal scholars and others are correct in pointing out the importance of the SPN, but not as a *legal* norm. There are good reasons to think that

managers follow the SPN, not because they are legally bound to do so, but because the SPN is a *social* norm in the business community.

SPN as a Social Norm

Anderson defines a social norm as "a standard of behavior shared by a social group, commonly understood by its members as authoritative or obligatory for them" (2000: 170). We maintain that managers as a social group, both within and between corporations, are generally guided by a social norm of shareholder primacy.

Business schools teach as part of the "Theory of the Firm" that profit maximization is the purpose of the corporation in society and that it is the duty of managers to pursue this end on behalf of shareholders as their agents (Gentile, 2004; Ghoshal, 2005). Consequently, when their students get jobs in the corporate world they are working to an implicit assumption of shareholder primacy. Dobson (1999: 69) suggests they "will have had drummed into them that the ultimate objective of all activity within the firm is the maximization of shareholder wealth." Various commentators (e.g., Gardiner, 2009; Holland, 2009) have suggested that a disproportionate focus on SVM by business schools was a contributory factor in the 2008 financial crisis.

There are signs of change. Four out of five executives surveyed by the consulting firm McKinsey thought that "generating high returns for investors should be accompanied by broader contributions to the public good" (2006: 1). However, almost 90% of respondents said they were motivated to champion social or environmental causes by profitability or improving public relations. Although many executives think that they should consider the interests of non-shareholders this would seem to hold true primarily when they don't conflict with shareholder interests and in particular when both go hand in hand (i.e., the "business case" for CSR).

While the SPN is prevalent among managers there may be other, potentially countervailing social norms. For example, championing CSR and environmental friendliness may

be emerging as a social norm among managers in many large corporations. Nonetheless, some surveys suggest that U.S. managers believe the law requires them to maximize shareholder wealth and hinders them from pursuing interests that conflict with shareholder interests (Gentile, 2004; Rose, 2007). As we have shown, corporate law in the U.S. does not require the single-minded maximization of shareholder wealth nor does it hinder managers from pursuing non-shareholder interests. Many managers may believe they are following a legal norm, but it would seem that they are simply following a social norm which they believe is legal because of its pervasiveness in business.[5] Nevertheless, we maintain that the social norm of shareholder primacy is reinforced by the *structure* of corporate law which is geared towards shareholder primacy: shareholders exert control over the corporation primarily through their right to elect and dismiss directors.

The fiduciary duties imposed on managers in common law are due to early judicial depictions of their relationship with shareholders as one of trust (e.g. Berle, 1931; 1932). Managers were considered *trustees* for the shareholders who were the *owners* of the corporation. However, the corporation was legally separated from its shareholders in the mid-19th century and considered to own itself, whereas shareholders were considered to own shares as a separate form of property (Pickering, 1968). Despite the legal separation of the corporation from its shareholders in terms of ownership, important features of the structure of corporate law that came with the earlier depiction remained, both in terms of fiduciary duties and more importantly in terms of voting rights of shareholders.

Because shares generally confer voting rights to shareholders, which gives them the power to elect and dismiss the board of directors, there is a real sense in which the directors of the corporation act as agents representing the interests of the shareholders; quite simply, if they do not they may be dismissed (Kraakman et al., 2004). The shareholders may not have the type of

direct control necessary for a legal characterization of a principal-agent relationship, but they do have sufficient indirect control for that characterization to be made more generally. For example, the academic literature on agency costs typically describes managers as agents of the shareholders (Clark, 1985). The legal power of shareholders to vote for the board of directors helps perpetuate the SPN as a social norm, not as a principle of law likely to be upheld in court.

To summarize, the SPN is the part of managers' legal fiduciary duty which obliges them to consider primarily the interests of shareholders in their decision-making. They are allowed to consider the interests of other stakeholders, but do not have a duty to do so (except under statutes specifically directing such an obligation). Yet the SPN is virtually unenforceable due to the business judgment rule and so the view of CSR advocates that a legal norm prohibits managers from considering the interests of multiple stakeholders lacks credence. However, the SPN is still very much alive as a social norm. Managers find it in their best interest to please shareholders because of shareholders' legal right to elect the board and dismiss its directors (even if this rarely occurs). Managers wish to please shareholders and keep their jobs and this perpetuates the SPN as a social norm. As long as shareholders have the sole right to vote for the board of directors then it seems likely that the SPN will continue to be an operative prescription for managers.

In the next section, we evaluate the legitimacy of shareholder primacy as a principle governing the *structure* of corporate law. In particular, we explore whether Rawlsian social contract theory would endorse shareholder primacy and whether it provides reasonable constraints on that primacy.

JUSTICE AS FAIRNESS AND THE SPN

What is Justice as Fairness?

Rawls (2001) calls his theory of justice "Justice as Fairness." It is a form of political liberalism that assumes as fundamental the fact of reasonable pluralism, which is to say that

citizens in any society will have profound and irreconcilable differences in their reasonable comprehensive religious and philosophical conceptions of the world. It is therefore the task of political liberalism, and Justice as Fairness in particular, to put forward a view of political justice that the spectrum of reasonable comprehensive conceptions can endorse. For this to be realized, Rawls suggests that we should reason as if we are putting together a social contract.

According to Rawls, the "basic structure" of society is the primary subject that should concern the contracting parties, which is to say how the main political and social institutions in society fit together into one system of social cooperation. Importantly, for our purposes, this includes not only the political constitution with an independent judiciary, but also the legally recognized forms of property and the structure of the economy. The most fundamental idea in Justice as Fairness is that society is regarded as a system of social cooperation and therefore it is the goal of the contracting parties to specify the principles of justice that are to govern the basic structure so that they fairly "assign basic rights and duties and regulate the division of advantages that arise from social cooperation over time" (Rawls, 2001: 10).[6]

To explicate the reasoning for his principles, Rawls introduces a representation device called the original position. This is a hypothetical state of nature scenario—an approach employed by philosophers such as Hobbes, Locke and Rousseau where we are asked to envision a scenario before social cooperation among individuals. Under Rawls, we imagine that the representatives of the relevant social positions in society come together to contractually agree on the principles of justice. In order to reach an agreement that would be acceptable to the spectrum of comprehensive views, the parties are placed behind a "veil of ignorance" in order to model impartiality. The veil of ignorance keeps them from knowing things that would make them partial in a contracting situation such as their social status, gender, race, natural assets and their conception of the good. Instead of their own comprehensive conception of the good they are

assumed to want as much as possible of social primary goods, which are liberties, opportunities, wealth, income and a social basis for self-respect. These are all purpose means that, Rawls asserts, anyone would want irrespective of their goals in life. Rawls (2001: 42) argues that the contracting parties would reach agreement on the following two principles of justice:

1. Each person has the same indefeasible claim to a fully adequate scheme of liberties, which is compatible with the same scheme of liberties for all (*liberty principle*); and

2. Social and economic inequities are to satisfy two conditions: first, they are to be attached to offices and positions open to all under conditions of fair equality of opportunity (*equality of opportunity principle*); and second, they are to be to the greatest benefit of the least-advantaged members of society (the *difference principle*).

The first principle is prior to the second, and in the second principle the "equality of opportunity" is prior to the "difference principle". These priorities signify that each principle is fully realized by the basic structure of society before the next is applied.

Criteria for Evaluating the Legitimacy of the SPN in Justice as Fairness

To evaluate the legitimacy of the SPN using Justice as Fairness, we ask two questions:

1. How does Justice as Fairness have bearing on the SPN, if at all?

   - Would a Rawlsian society have private ownership in the means of production? For Rawls' theory to have any bearing on the SPN—which is a characteristic that exists in part due to the *private* ownership of corporate shares—we need first to establish that a Rawlsian society would have private ownership as part of the means of production.

   - Would corporations exist in a Rawlsian society? The SPN is a characteristic of the corporate legal form, so we need also to show that this would exist in a Rawlsian society.

   - What is the main criterion for choosing among alternative norms of corporate governance in a Rawlsian society? For Justice as Fairness to have bearing on the SPN it needs to give guidance as to how one should evaluate the legitimacy of the SPN.

2. Would Justice as Fairness endorse the SPN? With the appropriateness of using Justice as Fairness established, we are in a position to evaluate whether or not it would endorse the SPN.

How Does Justice as Fairness have Bearing on the SPN?

Rawls insists on competitive markets in part because they "allow for more efficient allocation of factors of production" (S. Freeman, 2008: 222), but more importantly because "markets provide an essential means for ensuring equal liberty and fair equality of opportunity" (Krouse and McPherson, 1988: 81). However, a market economy is compatible with both private and public ownership of the means of production. Rawls' theory is strictly speaking indeterminate as regards the public or private ownership of the means of production, but "in existing conditions it [private ownership of the means of production] is the most effective way to meet the principles of justice" (2001: 177). For the purposes of this paper therefore we assume a Rawlsian society in which the means of production may be privately owned.

Given that Justice as Fairness allows and "in existing conditions" even endorses private ownership in the means of production, some form of legal vehicle is needed through which citizens own (and organize) productive means as distinct from their private property. In our current societies there are several legal forms that enable the economic enterprise of citizens, such as sole proprietorship or partnerships, but by far the most dominant are corporations. "They [corporations] are the grand social institutions of our time" (Phillips & Margolis, 1999: 619). The success of the corporation as a vehicle for production and economic growth has been evident since the industrial revolution. In particular the legal attributes of limited liability and the transferability of shares have been instrumental to facilitate the pooling of capital necessary for large scale investments and enabling liquid stock markets (Easterbrook and Fischel, 1985). Although there is little in Rawls' theory to suggest the exact attributes of the corporate legal form, given the proven benefits of this form of productive association there seems little reason to think

that a vehicle of this type should not be made available to citizens to engage in commercial enterprise. Therefore, for the purposes of this paper, we assume that a vehicle like the corporate legal form would exist in a Rawlsian society.[7]

As Rawls observes, "the basic structure does not provide a sharp definition, or criterion, from which we can tell what social arrangements, or aspects thereof, belong to it" (2001: 12). However, as noted, it does include the legally recognized forms of property. Given that the corporate legal form is a legal vehicle through which citizens can own means of production this should make it a manifestation of the basic structure. This would suggest that the corporate legal form needs to comply with the principles of justice. Justice as fairness then bears relevance on the SPN because it arises due to the voting rights that are conferred upon shareholders as a part of the corporate legal form which is part of the basic structure. What then is the main criterion for choosing among alternative norms of corporate governance in a Rawlsian society?

A common approach when employing Rawls in business ethics is to take the representation device of the original position and apply it to corporate stakeholders. For example, one approach is to place all stakeholders behind a veil of ignorance, depriving them of the knowledge of what stakes they have, to determine the rules of "fair contracting" among them (Evan and Freeman, 1990). However, this should not be understood as an exercise in applying Rawls' theory, but merely the use of the original position as a device for one's own purposes. Under Rawls, the relevant contracting parties are *citizens* and not corporate *stakeholders*. Rawls' theory applies to the basic structure seen as a coherent system of social cooperation and therefore the relevant contracting parties are defined in terms of free and equal citizens distinguished by their "different expectations for the unequally distributed primary goods" (Rawls, 1999: 82).

When we understand how the relevant social positions are defined in Rawls' theory it also becomes easier to see that the theory cannot be applied directly to corporate stakeholders, in part

because it does not speak directly to those parties as defined. According to Rawls, the Liberty Principle can be specified by a list of equal basic liberties that include "freedom of thought and liberty of conscience; political liberties (e.g., the right to vote) and freedom of association, as well as the rights and liberties specified by the liberty and integrity of the person" (2001: 44). Thus, as an example, the right of citizens to vote for government representatives does not extend the right to partake in corporate decisions to stakeholders.

At this point, one might ask whether Justice as Fairness bears any relevance to the SPN if it does not speak to stakeholders. However, the theory is relevant to the norm for corporate governance even though it does not speak to stakeholders per se because the norm has consequences for citizens as it affects the efficiency of the economic system in society. Moreover, as we later show, how a corporation treats citizens (in particular its stakeholders) is accounted for in Justice as Fairness through exogenous constraints.

Rawls says that "a scheme of cooperation is given in large part by how its public rules organize productive activity" (2001: 63) and that, other things being equal, the difference principle directs society to aim for a system that is to the greatest benefit of the least advantaged members in society (defined in terms of the primary goods of income and wealth). In Justice as Fairness, issues of justice are prior to efficiency (Rawls, 1999). However efficiency is not disregarded. Rawls says that "a political conception of justice must take into account the requirements of social organizations and economic efficiency" (2001: 123). This is in part manifested by the lexical priority of the principles of justice which guarantees that the liberty principle and the equality of opportunity principle are fully realized before the difference principle is applied (which takes into account the need for efficiency through incentive bearing economic differences between citizens). Although the second principle does not per se act as a criterion for evaluating a governance norm (as the principle does not speak to differences among

stakeholders), the second principle is part of a broad conception asserting that a theory of justice cannot ignore issues of efficiency. Consistent with Rawls, when the basic liberties and equal opportunities are satisfied, a more efficient system of cooperation is preferable to a less efficient one, as it benefits everyone, including the least advantaged.

The efficiency of a macroeconomic system is in part given by the efficiency of the microeconomic system of corporations within it. An economic system is more efficient if it can provide more goods and services without using proportionately more resources. Thus, central to our Rawlsian analysis of the legitimacy of the SPN is whether it is more efficient to give all firm stakeholders a right to vote or to only give this right to shareholders. This we turn to next.

Would Justice as Fairness Endorse the SPN?

We have argued that a Rawlsian society would likely have a legal vehicle for private ownership of the means of production with the central legal attributes of the corporate legal form as we know it, such as limited liability and the transferability of shares. Yet when it comes to the goal for which the means of production are put to use, what type of norm should govern such a vehicle? Would the SPN or some alternative norm be endorsed by Justice as Fairness? We have already said that economic efficiency is the main criterion for choosing a norm of corporate governance in Justice as Fairness. We now need at least one alternative norm of governance to the SPN in order to evaluate if the SPN is more efficient in relation to some viable alternative.

With the SPN allied to Shareholder Theory, we turn to Stakeholder Theory to identify a competing norm of governance. As earlier noted, these contrasting theories cut to the heart of the "basic debate" in business ethics regarding whether managers should focus on satisfying shareholder or stakeholder interests. Hence the most appropriate alternative against which we might evaluate the SPN would appear to be a norm of governance that reflects the content of Stakeholder Theory. What would such a norm look like?

Shareholder Theory holds that the purpose of the corporation is to be a vehicle for pursuing shareholder interests (Friedman, 1998), while Stakeholder Theory holds (as a normative theory and not merely an instrumental theory) that the purpose of the corporation is to be a vehicle for managing stakeholder interests (Evan and Freeman, 2003).[8] The term "purpose" of the corporation is here somewhat ambiguous and may refer to "role" or "goal" or both. The distinction between the role of a corporation and its goal is that the former refers to the purpose of a corporation from the perspective of society while the latter refers primarily to its purpose seen form the perspective of the corporation itself. While it is clear that Shareholder Theory takes its prescription to apply to the goal of the corporation, it is less clear if Stakeholder Theory refers to the role or goal (or both) of the corporation.

Under the stakeholder view, it is often said that the discretion of decision-making should be based with top management together with stakeholder representatives (Melé, 2008). However, unless these representatives are given real power, such as an equal right to vote, we still have, ultimately, a situation of shareholder primacy (even though it might be better informed by the different interests of constituencies). Accordingly, a viable formulation of a norm of governance for Stakeholder Theory would seem to lie in the idea of a Stakeholder Equality Norm (SEN). The SEN would be a norm enforced by the fact that all Stakeholders have representatives as members of the board with an *equal* right to vote (otherwise one stakeholder group will have primacy). Indeed, Evan and Freeman argue in their application of the original position to the contracting of stakeholders, that in order to avoid unilateral policies that are detrimental to stakeholders, "it is rational for stakeholders to choose voting membership on the board, in addition to whatever other safeguards may be feasible" (1990: 35). Moreover, Donaldson and Preston note regarding stakeholder theory that "its very foundation prohibits any undue attention to the interests of any single constituency" (1995: 87). Therefore the notion of *equality* seems appropriate for a norm

representing stakeholder theory because if stakeholders are not equal in the eyes of management then one group must be primary.

The SEN would also need to include a right for stakeholders to vote for their representatives on the board (in order to achieve proper representation) which would lead to the removal of shareholder primacy (as it is the unique right to vote for the board that establishes shareholders' current primacy).[9] This would have the effect of extending the fiduciary duties of directors and managers to all stakeholders, thus charging them with the task of managing and balancing the pursuit of stakeholder interests.[10]

Our formulation of the SEN is not to create a "straw-person"—a misrepresentation of Stakeholder Theory that is set up to be easily shot down and an approach said to be used often by its critics (Phillips, Freeman, & Wicks, 2003). The SEN extends an equal right to vote to stakeholder representatives on the board which guarantees equal representation for each constituency. However, this does not necessarily mean that they are given equal consideration on every corporate decision that is made. The board (with its stakeholder representatives) chooses the CEO who is given the task of running the daily operations of the corporation and whose responsibility it is to balance the interests of stakeholders depending on the particular circumstances at hand, which does not necessarily demand equal consideration of all stakeholders in all circumstances. In this way the SEN is consistent with the usual depiction of Stakeholder Theory which says that: "(1) all stakeholders have a right to participate in the corporate decisions that affect them, (2) managers have a fiduciary duty to serve the interests of all stakeholder groups, and (3) the objective of the firm ought to be the promotion of all interests and not those of shareholders alone" (Boatright, 2002: 1839), but it "does not imply that all stakeholders should be equally involved in all processes and decisions" (Freeman & Phillips, 2002: 340). The SEN adds to this depiction with the introduction of equal voting rights for stakeholder board

representatives (arguably, previous scholars have not sufficiently appreciated the importance of voting rights for maintaining the primacy of shareholders among stakeholders).

We may now ask which of the two norms of governance would be endorsed by Justice as Fairness. It is not our aim here to make a decisive choice between the SPN and the SEN. The primary insight we aim to convey, from a Rawlsian perspective, is that the choice—whichever it is—hinges primarily on the issue of which norm is best in terms of economic efficiency. Nevertheless, we argue in favor of the SPN largely on two counts. First, the SEN applies the political conception of equality to a private association where it does not necessarily belong. Second, and more important, the SPN is arguably a more efficient organizing norm than the SEN.

1) The SEN applies the political conception of equality to a private association. The intuitive appeal of the SEN as a principle of corporate governance is that it seems fair to let stakeholders have a right to voice their concern and be part of the decision process for issues that affect them. This would seem justified on the grounds that Justice as Fairness is to be understood as a broad egalitarian conception only to be departed from when it is to the benefit of the least advantaged. However, it is essential to recognize that Rawls' theory is narrow in scope and only applies to the basic structure. Justice as fairness does not concern itself with inequalities among stakeholders, but rather potential inequalities among the relevant parties in the original position who view the most and least advantaged in terms of income and wealth, not what stakeholder group they belong to. From the perspective of the original position, the equal basic liberties of all stakeholders are guaranteed by the basic structure for all *citizens*.

Phillips et al. (2003: 493) note that "organizations are, to use Rawls' (1993) terms, voluntary associations rather than a part of the basic structure of society." This is correct. However there is a difference between the corporate legal form, which is part of the basic structure, and the "associations" (organizations) that citizen create when they engage in

commercial enterprise through the corporate legal form. "The principles of justice restrict the form these arrangements [associations] can take" (Rawls, 2001:73), but they do not apply directly to or regulate them internally.

Rawls (2001: 11) writes: "One should not assume in advance that principles that are reasonable and just for the basic structure are also reasonable and just for institutions, associations, and social practices generally. While the principles of justice as fairness impose limits on these social arrangements within the basic structure, the basic structure and the associations and social forms within it are each governed by distinct principles in view of their different aims and purposes." This does not *per se* identify the SPN as a preferable norm of corporate governance, but it does suggest that the SEN tries to extend a political conception of fairness to a private association where it does not necessarily belong.[11] Inequalities of status among members of private associations are entirely permissible, and furthermore it is this which the difference principle sanctions to create the necessary incentives in society for productivity.

2) The SPN is arguably a more efficient organizing norm than the SEN. Jensen (2002), Sundaram and Inkpen (2004a,b), Williamson (1984) and others have argued for the superior efficiency of shareholder primacy (generally construed as SVM) over stakeholder theory. The most forceful efficiency arguments in favor of the SPN are: a) economic efficiency requires governance with a single objective function, and b) control is best exercised by residual claimants.

a) Economic efficiency requires governance with a single objective function. The normative notion of equality among citizens is appropriate to Rawls' project of specifying the principles of justice for a society seen as a fair system of cooperation. However, this notion of equality is not appropriate for corporate stakeholders (represented by the SEN) in a system of competitive markets. The fact that corporations are exposed to competition frequently threatens their very survival and places them in a position to make strictly financial priorities in a way that

citizens deciding on how to distribute primary goods in a system of cooperation does not. Instead, a financial measure for deciding better from worse performance is required, in order to evaluate and attain efficient use of resources in the organization. Jensen (2002: 239-240) observes:

> "Much of the discussion in policy circles concerning the proper corporate objective casts the issue in terms of the conflict among various constituencies or "stakeholders" of the corporation. The question then becomes whether shareholders should be held in higher regard than other constituencies… The real issue to be considered here is… what behavior will get the most out of society's limited resources."

Economic efficiency requires that as much output as possible is produced with a given set of inputs. The output in a market economy is economic value which is measured by consumers' willingness to pay for the goods and services that they receive. Our question then becomes what norm of corporate governance will produce the most value for the economy?

One might argue that the notion of economic efficiency defined above contains within itself the notion of a single value objective for the corporation. If the output to be measured is economic value then the sole efficiency that we are seeking to measure is productivity. Obviously, if one has more than one objective these can be pursued more or less efficiently judged on their own merits. The primary point we are making here is that, if an organization has multiple goals, such as enhancing employee wellbeing, caring for the environment, and producing efficiently, it is likely that it will produce less efficiently than if it only had the goal of efficient production.

Stakeholder Theory, and the SEN in particular, implies that the board (and by extension the management) have a number of constituencies towards whom they are accountable. Although this does not strictly speaking require multiple objectives for management—the constituencies might all unite behind one objective (see Freeman et al. 2007)—it does seem likely that it would given their often different needs. As Williamson suggests, the fear is that public representation on the board "would come at a high cost if the corporation were thereby politicized or deflected from its chief purpose of serving as an economizing instrument" (1984: 1215).

According to Jensen, Stakeholder Theory is "fundamentally flawed because it violates the proposition that any organization must have a single-valued objective as a precursor to purposeful or rational behavior" (2002: 237). The purpose of producing value for the economy would not be efficiently realized with multiple corporate objectives because "it is logically impossible to maximize in more than one dimension at the same time" (Jensen, 2002: 238). Instead, by focusing on profit as a measure of success it gives "one objective function that will resolve the trade-off problem among multiple constituencies. It tells the firm to spend an additional dollar of resources to satisfy the desires of each constituency as long as that constituency values the result at more than a dollar" (Jensen. 2002: 239).[12] This objective function directs the corporation to allocate resources efficiently to produce output that is valued more than its inputs.

Phillips, Freeman, & Wicks concede that Stakeholder Theory cannot provide a *specific* objective function: "Stakeholder theory does fail to provide an algorithm for day-to-day managerial decision-making" (2003: 485). They contend that this is due to the level of abstraction at which the discussion takes place and that Shareholder Theory is susceptible to the same criticism because "the managerial dictate to maximize shareholder wealth stands mute when queried, How?" (2003: 485). Although correct, this misses the point because the criticism concerns not the *specificity* of Stakeholder Theory but the fact that it promotes a multitude of objectives to be followed rather than a single objective.

Jensen (2002) and Phillips et al. (2003) appear to be talking past each other. Stakeholder Theory on its instrumental interpretation functions on a managerial level by advising managers to manage stakeholder interests in order to reach corporate goals (and on a normative interpretation those goals will certainly be multiple because stakeholder interests ought to be treated as ends in themselves). On the other hand Jensen is setting out an efficiency argument for a single objective function, on the level of the goal of the corporation. This is intended as a scorekeeping device to

measure success and it might be that managing stakeholders instrumentally is a good means for achieving the corporation's single goal. This is not inconsistent with Freeman, who believes that one should not consciously manage with the explicit goal of maximizing profits: "If a business tries to maximize profits, in fact, profits don't get maximized, at least in the real world" (2008: 18). But this is not the main point of Stakeholder Theory, for which, according to Donaldson and Preston, "success in satisfying multiple stakeholder interests—rather than in meeting conventional economic and financial criteria—would constitute the ultimate test of corporate performance… No theorist, including Rawls, has ever maintained that bargains reached on the basis of the "veil of ignorance" would maximize efficiency" (1995: 79-81).

The SPN does not specify a corporate objective function, but the pursuit of profit is assumed by default. It is assumed that by having this *goal* for the corporate legal form, corporate organizations more generally manage to fulfill a social *role* as efficient producers achieved by coordinating and sufficiently satisfying the various stakeholders. Stakeholder Theory appears to confuse the role of corporations for managing stakeholders in society, with the goal of the individual corporation. According to Donaldson and Preston (1995) the descriptive, instrumental and normative interpretations of Stakeholder Theory are intertwined. This might help explain stakeholder theory's conflation of the corporation's role and goal because the theory describes the role of the corporation as one of coordinating stakeholder interests, but the theory also sees this normatively and instrumentally as the *goal* of management.

b) Control is best exercised by residual claimants. To argue in favor of the SPN does not mean that stakeholder interests are ignored: "long run value maximization cannot be realized by ignoring or mistreating any corporate stakeholder, be it customers, employees, suppliers, or community" (Jensen (2008: 23). Indeed, as an instrumental theory, Stakeholder Theory makes good sense in that a corporation must satisfy its different stakeholders in order to gain their

cooperation so that it can in turn achieve its goals.[13] Indeed, Hillman and Keim (2001) have found empirical support for the notion that stakeholder management for "primary stakeholders" leads to improved shareholder value. However, engaging in stakeholder management is not the same as extending control rights to non-shareholding stakeholders.

Non-shareholding stakeholders, such as employees, customers, and suppliers, are contractual claimants on the firm's financial resources. Their remuneration is (generally) fixed and specified in legally enforceable contracts. It is only after these contracts have been honored (and all other costs deducted from revenues) that shareholders may receive dividends if there is a residual (profit). It is thus primarily in the interest of shareholders as residual claimants that the organization is efficiently run in order to obtain the best chances of a residual. Fixed claimants' pecuniary incentives for financial success disappear after break-even (when their claims are assured). As Sundaram and Inkpen note: "Control rights should go to shareholders, because as residual claimants, they are the constituency that will value this right most" (2004: 354). While employee salaries may include a variable component that is tied to the size of the residual, (e.g., a bonus), and this does make employees value the residual more, unless their entire salary is variable, they will not value the residual as much as the shareholders.

Fixed claimants have made agreements in the form of contracts that they expect to see honored as part of what Rawls calls their "legitimate expectations" (1999: 74). Shareholders have no such explicit contracts as the residual amount cannot be specified *a priori* in a competitive system. One might say that they have an implicit contract with the legitimate expectation to receive a residual in proportion to the risk of their investment. Phillips et al. (2003: 489) suggest that under their conception of Stakeholder Theory, shareholders would get "a fair return on their investment," but they do not specify whether or not this would be proportional to risk. There needs to be incentives for the firm to focus on seeking a residual so as to realize the legitimate

expectation of shareholders, and this involves an indeterminate process that cannot be completely specified in a contract. This also provides justification for why shareholders are the sole stakeholder group towards which management owes a fiduciary duty (Easterbrook and Fischel, 1993). This duty would be difficult to enforce without the sole voting rights of shareholders.

It is also likely that potential incorporators would not find incorporation attractive if it meant they lost considerable control upon incorporation and were not given priority as residual claimants. In effect, it would mean that the very purpose of having a corporate legal form in society for productive cooperation would largely be lost because a main benefit of this legal form is the pooling of investment capital; while limited liability and other characteristics are beneficial to shareholders, would they wish to invest in a vehicle that did not have seeking a residual as its priority? There needs to be a proportionally expected upside to the risk taken; unlike investing in bonds where a fixed return is (virtually) guaranteed. All non-shareholding stakeholders can contractually expect to see their legitimate expectations honored, but shareholders could not legitimately expect a guaranteed return in a competitive environment.

Although it has been asserted that control is best exercised by residual claimants it is uncertain if sole voting rights for the board of directors constitute sufficient control to incentivize managers to pursue shareholder interests effectively. For example, Berle and Means (1932) argued already in the 1930's that shareholders of large corporations with dispersed shareholdings had lost their de facto control to corporate managers because of diluted voting power. In a Rawlsian society the primacy of shareholders should be properly understood as furthering the *long-tem* interests of shareholders, because corporations that use resources efficiently avoid situations where capital is destroyed over the long-term for a quick profit in the present. It has been suggested that the 2008 crisis was triggered by a short-term focus on corporate profits aimed to further the remuneration of top-level management (see e.g. Financial Times, 2009). To the

extent that this is a correct assessment a Rawlsian society would seek to institute rules of corporate governance (beyond merely assigning sole voting rights to shareholders) as part of the corporate legal form to ensure the long-term interest of shareholders. For example, Jensen, Murphy and Wruck (2004) suggest that tying executive remuneration to equity based plans (such as stock options) has lead to excessive short-term focus on stock price. This would suggest a move away from performance based executive pay or at least towards remuneration that is tied to long-term performance.[14]

Lynn Stout (2002) has objected that it is empirically incorrect to describe shareholders as residual claimants because they have no legal claims to make on the financial resources of the corporation (only when it is in bankruptcy). It is up to the discretion of the board of directors to decide what if any dividends to pay the shareholders. Although Stout makes a descriptively correct reading of the letter of the law it is arguably the case that shareholders, who are the only constituency who's entire remuneration is entirely dependent on the production of a residual, should be vested with corporate control powers because they have the greatest incentive for efficient production.[15]

Our preceding analysis shows that from a Rawlsian perspective the main arbitrator for the basic debate in business ethics between Shareholder Theory and Stakeholder Theory is not an ethical or political consideration, but simply which norm of governance is more efficient. We have argued that the SPN is more economically efficient than the SEN. Now we turn to what Justice as Fairness has to say with regard to potential constraints on the SPN.

Would the SPN be Unfettered in a Rawlsian Society?

According to Rawls, the principles of justice are realized in a "property-owning democracy" (though his theory is strictly indeterminate with regard to private or public ownership of the means of production and thus the principles of justice can be realized in other

societies that do not have such private ownership). Such a society would ensure the widespread ownership of productive assets and human capital *ex ante* (rather than redistribute *ex post*) so that the distribution that results from the exchanges and agreements of citizens is just as a matter of pure procedural justice. Once the basic structure is set up, "individuals and associations are then left free to advance their (permissible) ends within the framework of the basic structure, secure in the knowledge that elsewhere in the social system the regulations necessary to preserve background justice are in force" (Rawls, 2001: 54). For example, this means a set up with appropriate political institutions (Liberty Principle), a public education system (Equality of Opportunity Principle), and inheritance taxes (Difference Principle). By following the publicly recognized rules, the basic liberties and the fair distributive shares of citizens are realized.

Samuel Freeman believes that we might find in a Rawlsian property-owning democracy corporations "with perhaps varying degrees of worker participation and democratization of management. Presumably these might include anything from traditional owner-controlled firms to obligatory consultations with employees where owners make final decisions, co-determination by management and workers (as in Germany and other West European social democracies), and fully fledged workers' ownership and management" (2008: 220). These models bear some similarity to the co-determination among stakeholders advocated by some adherents of Stakeholder Theory but, while conceivable, there is nothing in Rawls' writing to suggest the democratization of corporate management or worker participation in management, except insofar as capital is widely spread among citizens (in part through the ownership of corporate shares) which would in turn confer control rights. If citizens own shares in corporations where they work then there is a form of decision-making participation, but only indirectly through their status as shareholders and thus the primacy of shareholders is unchanged.

In a Rawlsian society the SPN would not be unfettered because the corporation is embedded and regulated by the basic structure. Krouse and McPherson observe that "Pure procedural justice requires that competitive markets be set within a framework of 'appropriate background institutions'. A just basic structure requires a background of legal and political institutions that regulate the overall trend of economic events and preserve the necessary social conditions" (1988: 82). When this is achieved, markets and the actors within them can be left to take care of themselves, although the pursuit of shareholder interests would be constrained by regulation. Specifically, this is likely to imply such SPN restrictions as employment law (e.g., to ensure equal opportunity), market regulation (e.g. to regulate product safety), competition law (e.g., to avoid excessive market power), environmental law (e.g., to regulate externalities), tax legislation (e.g., to provide redistributive effects). When this system of background justice is in effect, corporate activity governed by the SPN will result in social cooperation (internally) and competition (between corporations) that is just for society as a matter of pure background procedural justice.

Boatright notes that "the stockholder and stakeholder theories disagree not about whether third parties ought to be protected from unjust harm, but how best to provide this protection" (2002: 1849). Many of the concerns that Stakeholder Theory wishes to address are taken care of by the background institutions in Rawls' theory and primarily through laws protecting the interests of the different stakeholder groups, as suggested above. Referred to as *exogenous* safeguards (external to the firm) by Freeman and Evan, they "effectively constrain the pursuit of stockholder interests at the expense of other claimants of the firm… they force management to balance the interests of stockholders and themselves on the one hand with the interests of customers, suppliers and other stakeholders on the other" (1990: 346-347).[16]

One can also imagine exogenous constraints on corporate behavior that are part of the basic structure beyond mere legislation. For example, the state can grant legal forms, such as the non-profit corporation, that act as vehicles through which citizens can organize to pursue special interests. One such special interest can be the monitoring of corporate behavior, as is currently the case with some nongovernmental organizations (NGOs). As Campbell observes, "Corporations will be more likely to act in socially responsible ways if there are private, independent organizations, including NGOs, social movement organizations, institutional investors, and the press, in their environment who monitor their behavior and, when necessary, mobilize to change it" (2007: 958). However, NGOs themselves cannot be allowed free rein in their activities merely because they do not operate with a profit motive and they can suffer from the same legitimacy problems as corporations, not being democratically legitimate representatives of the citizens (Scherer & Palazzo, 2007).

Instead of such exogenous safeguards, Evan and Freeman propose a theory with *endogenous* safeguards that do not externalize the costs of activities among contracting parties on others. (A simple way to understand the demarcation between endogenous vs. exogenous constraints is that the former involves corporate self-constraint while the latter involves externally imposed constraints on the corporation.) However, for Rawls it is essential that the safeguards are exogenous as his theory regards the basic structure as the primary subject of justice. The justificatory difference between Freeman (on a normative interpretation of Stakeholder Theory) and Rawls, stems largely from their different philosophical starting points. Rawls is putting forward a theory of political liberalism (Rawls, 1996; 1999; 2001) while Freeman advances Stakeholder Theory on libertarian grounds (Freeman and Phillips, 2002), based on fundamental moral rights of individuals (Evan and Freeman, 2003). On the one hand, Rawls starts with the idea of society seen as a system for social cooperation for which the

primary subject of justice is to specify the principles that are to govern its basic structure. On the other hand, libertarians commence with the atomistic individual who possesses fundamental rights as the basic unit of analysis and from there proceed to evaluate the (limited) role of government in enabling social cooperation by protecting the rights of individuals. Freeman and Evan object to exogenous constraints primarily on two fronts: 1) that endogenous constraints are more effective in protecting stakeholder interests and 2) that exogenous constraints externalize contracting costs onto society.

First, Freeman and Evan wish to grant stakeholder voting membership on the board because granting such membership is seen as more *effective in protecting* the interests of stakeholders (1990). In essence, they take the view that safeguards that are created endogenously to the corporation through bilateral contracting between the corporation and stakeholders, together with the more general safeguard of board stakeholder representation, will always be more effective than exogenous stakeholder safeguards imposed by government. This is seemingly maintained because government cannot legislate in a manner that is tailored to the particular circumstances of stakeholders in individual corporations (Freeman and Evan, 1990).

It is by no means clear that endogenous safeguards always are more effective or for that matter more efficient for protecting stakeholder interests. Although Freeman and Evan are correct in their view that government cannot tailor its safeguards to every corporation, there will be many circumstances when exogenous safeguards through government regulation are both more effective and more efficient. For example bilateral-agreements may not give *effective* protection to one party if the other party is in a significantly stronger bargaining position, and this is not circumvented by equal voting membership on the board because any stakeholder group in a system of voting is subject to the risk of minority oppression. Exogenous safeguards can on the other hand give protection to stakeholder groups irrespective of the internal contractual dynamics

of the corporation. Boatright believes that stakeholder theorists regard the shareholder-management relationship as an ideal for treating all stakeholders, but that "stakeholders usually derive little benefit from the set of rights negotiated by shareholders and generally prefer other safeguards for their interests. Instead of seeking a seat on the board of directors or the benefit of fiduciary duties, consumers, for example, settle for manufacturers' warranties, consumer and product safety laws, and a tort liability system" (2002: 1842).[17]

Furthermore it can also be argued that exogenous stakeholder protections that are applicable to all corporations can be much more *efficient* for protecting the interests of stakeholders as it saves the contracting of each of these safeguards for every corporation for every stakeholder group (Child and Marcoux 1999). Moreover, although formal constraints (endogenous or exogenous) on the SPN are important, one should not characterize stakeholders as helpless minions at the mercy of all-powerful managers. Stakeholders are capable of engaging in strategies to further their own ends (Frooman, 1999). A Rawlsian society would endorse the management of stakeholders in such a way that managers follow the SPN in their interactions with stakeholders. However, in a similar vein, stakeholders can engage in the management of managers, though there will be differing power relationships and therefore different strategies across stakeholders if they are to get what they want (Mitchell, et al. 1997).

Second, Freeman and Phillips think that "Rawls's first principle of justice is a paradigm case of a libertarian principle" (2002: 335). The first principle apparently accords with them because it sets out the liberties of individuals and essentially puts forward negative rights of non-interference. However, the second principle would seem to be unacceptable because it affords citizens of the state positive rights which require the use of social resources that involves a redistribution of wealth. For libertarians, positive rights only arise through individual consent and, moreover, state aid may violate some negative rights (such as the right not to have one's property

infringed upon) through the need for taxation (Nozick, 1974).[18] This helps explain Freeman and Evan's second objection to exogenous safeguards that their costs "are spread over the entire society" (1990: 347). The cost of legislating and enforcing government regulation is spread across citizens, usually through taxation. This is objectionable to libertarians because it imposes costs on third parties to corporate contracting (without their consent) which is a violation of what is perceived as an *absolute* right to their property. In other words those, and only those, who engage in contracting should bear the full costs that result from their agreements. For liberals, and Rawls in particular, there is nothing objectionable per se for society to bear third party costs if this results in a fairer basic structure. Furthermore, it would be practicably unworkable and inefficient to internalize all the potential external costs of contracting as every potentially affected third party would need to engage in the contracting and be compensated bi-laterally (Child and Marcoux, 1999).

In a Rawlsian society the corporate legal form, as part of the basic structure, would be regarded as an instrument to be used by citizens as allowed by the state. On the other hand Freeman, and libertarians more generally, regard the corporation as a nexus-of-contracts where the corporation is conceptualized as a set of voluntary agreements that should be self-enforcing in order to limit the role of the state (Freeman and Phillips, 2002). This helps explain the different uses of exogenous and endogenous controls. With Rawls, the state provides a corporate legal form which is part of the basic structure where the exogenous controls provide a playing field that procedurally leads to a just outcome when individuals act within the rules, while for Freeman justice results from responsible individuals respecting the fundamental rights of others when contracting freely and through this process of contracting form corporations.

Both Shareholder Theory (Friedman) and Stakeholder Theory (Freeman) are capable of sharing libertarian foundations through a nexus-of-contracts view of the corporation. On a

libertarian interpretation, Shareholder Theory results from the nexus-of-contracts when a strong focus is placed on the property and control rights of shareholders, while Stakeholder Theory results when a greater emphasis is placed on the fundamental rights of stakeholders that must be respected by managers when making corporate decisions.

Nevertheless, Shareholder Theory is also capable of having foundations within political liberalism and we claim it is supported by Rawls' theory of justice in particular. We argue that Rawls' theory would endorse the SPN on efficiency grounds while constraining the primacy of shareholders with legislation. Rawls' political liberalism advocates exogenous safeguards in order to protect citizens and as such protects them across the range of stakeholder hats they may wear. Although Friedman (1962) would regard extensive regulation to be a distortion to the efficiency of the market, Rawls would regard it as essential to frame the market so that the interactions lead to a just result.

The basic debate about stakeholder theory (in its Freemanite guise) vs. shareholder theory (in its Rawlsian guise) becomes largely a debate between endogenous vs. exogenous constraints, which in turn is in fundamentally a debate between libertarianism vs. liberalism. Thus, political philosophy turns out to be highly relevant to business ethics, not because the corporation resembles the state, but because of the constraints placed on the corporation by the state.

CONCLUSION

At the core of the "basic debate" in business ethics is the legitimacy of the SPN and thus whether managers should focus primarily on shareholder or stakeholder interests. As we have shown, shareholder primacy does not dictate that managers should ignore other stakeholders. Even if the interest of shareholders is assumed to be solely shareholder value maximization, there are incentives for managers to attend to the interests of other stakeholders if they are to maximize returns to shareholders as residual claimants. However, stakeholders are given attention only

insofar as this ultimately serves the economic interests of shareholders and any justification for CSR rests on business case reasoning—assuming, of course, the legitimacy of the SPN.

Managers often refer on legal grounds to their fiduciary duties to shareholders specifically as a basis for asserting the legitimacy of the SPN and, indeed, for limiting CSR to activities that serve shareholder interests. However, we make the case that this justification is flawed. We have argued that the SPN is no longer effectual as a legal norm that is likely to be upheld by courts of law. This is because the SPN is muted by the business judgment rule in the U.S. and explicitly constrained by non-shareholder constituency statutes in both the U.S. and the U.K. Nonetheless, the SPN is still very much alive in the business community and in business schools and, as a social norm, is reinforced by the power that shareholders wield over who sits on the board of directors through their sole legal right to vote for the board of directors. In this sense, the structure of corporate law is geared towards shareholder primacy.

With legal prescriptions for the SPN found to be lacking, we turn to Rawls' theory of justice as a basis for evaluating the legitimacy of the SPN as a social norm that is supported by the structure of corporate law and whether, prescriptively, it ought to be operative. Rawls' Justice as Fairness is particularly appropriate given the rise to prominence of social contract theory in business ethics and the influence of Rawls' theory more generally. We conclude that a Rawlsian society would be likely to endorse shareholder primacy as part of the structure of corporate law.

Drawing on Stakeholder Theory as the competing theory to Shareholder Theory, we formulate a Stakeholder Equality Norm as the alternative to the SPN. Contrary to what one might first assume, we argue that the choice between shareholder primacy and broader stakeholder considerations does not hinge on deliberations of fairness in a Rawlsian society but on which governance principle is best from the perspective of economic efficiency. This is because the unit of analysis for Rawls is the citizens of society and not corporate stakeholders. Hence, when the

basic structure fully realizes the two principles of justice, the primary arbitrator among economic systems is economic efficiency which benefits all citizens. Based on the views that economic efficiency requires governance with a single objective function and that control is best exercised by residual claimants, we have suggested the SPN is a more efficient norm of corporate governance than the SEN. Thus we claim that the SPN would be endorsed by justice as fairness.

However, there are limitations to our analysis that should be noted. First, we recognize that Rawls' theory of justice is not the last word within political philosophy. A common criticism against his theory is that the original position does not so much argue for his principles of justice as merely act as a heuristic device for articulating his preconceived political intuitions (see Kymlicka 1990 for an account of common criticisms leveled against Rawls' theory). Second, in our application of Rawls we have generally assumed that the SPN equates to SVM, whereas shareholders might have various objectives other than SVM. Third, and most important, is the idealized nature of Rawls' theory, under which the basic structure is governed by the two principles of justice and imposes exogenous constraints on the pursuit of shareholder interests.

While we claim that Rawls' theory is more supportive of the SPN than the SEN, this is not an unqualified endorsement of Shareholder Theory, at least as advanced by prime exponents such as Friedman (1962), who furthermore advocate unfettered free market competition. While we endorse the SPN as a corporate norm of governance, consistent with Friedman, we find support in Rawls' theory for this view so long as there are the necessary exogenous constraints in place which would direct actions towards a fair outcome, primarily—but not solely—in the form of legislation.

Simply put, there is nothing wrong with shareholder primacy, provided the basic structure is in place and thus the demands of Rawls' two principles of justice are met. Political theories idealize and prescribe what justice should be like, but given that no countries in the real world

have Rawlsian societies it is not possible to fully endorse the single-minded pursuit of shareholder interest within constraints if the postulated system of fair constraints is absent or incomplete.

It is beyond the scope of this paper to consider the adequacy of the exogenous constraints in place in the world today. Suffice to note, however, that evidence of the inadequacy of the exogenous constraints certainly can be found to the extent that the 2008 financial crisis is attributable to regulatory failure. The main implication of this analysis for CSR may well be that attention to shareholder primacy is misplaced and, instead, CSR advocates should look to the adequacy of exogenous constraints on the exercise of that primacy.

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ENDNOTES

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[1] Freeman's formulation of stakeholder theory does not deny that profitability should be *a* goal of corporations, however he sees the *primary* purpose of the corporation as being a vehicle to manage stakeholder interests.
[2] It is generally accepted that an incentive problem occurs when a corporation is near insolvency. This is because the closer the corporation is to being insolvent, the less the corporation is worth, and therefore due to limited liability the corporation has "nothing to lose" in making very risky decisions. In the US, this has been addressed by affording fiduciary duties to creditors when the corporation is near insolvency.
[3] A consequence of the business judgment rule is that directors' fiduciary duty becomes a negative duty to not act in bad faith. The fiduciary duty of directors seems at first glance to be a positive duty to pursue the interest of shareholders. However, courts do not sanction directors for not pursuing profitable opportunities that are open to the company, but rather for acting in bad faith with regard to the opportunities they do pursue. The courts find that it is not their place to make judgments about the merits of directors' business strategies; that issue is up to the market and the shareholders to decide.
[4] A shareholder derivative suit is a lawsuit brought by one or several shareholders of a corporation, on behalf of the corporation, against parties who are claimed to have harmed the corporation. Such suits are generally instigated against directors or managers for their alleged breach of their fiduciary duties. Proceeds from successful litigation are awarded to the corporation and not directly to the shareholders.
[5] That managers *believe* that the SPN is legally enforceable might be interpreted as something more than a social norm. Although legal action against corporate management for breaching the SPN is unlikely to be successful the threat of such action might act as a reinforcement of the SPN. This does not make the SPN a legal norm as such managerial belief is based on a misinterpretation of the law. However, this misinterpretation reinforces the SPN as a *social norm* because managers *believe* that they are legally required to follow the SPN.
[6] Rawls introduces a further five core ideas in order to justify his principles of justice: the idea of a well-ordered society; the idea of the basic structure as the primary subject of justice; the idea of an original position; the idea of free and equal citizens; and, the idea of public justification.
[7] By "like the corporate legal form" we mean a corporate legal form with at least the central characteristics as we know it. Kraakman et al (2004) cite five central attributes of the corporate legal form: corporate personality, delegated management, transferability of shares, limited liability, and investor ownership.
[8] Stakeholder Theory has two prescriptive interpretations, one normative and the other instrumental (Donaldson & Preston, 1995). As we are evaluating the alternative norms of governance based on economic efficiency it might seem appropriate in this instance to employ the instrumental interpretation of Stakeholder Theory. However, according to Donaldson & Preston (1995: 86) "stakeholder theory is fundamentally normative." Furthermore, an instrumental interpretation would not provide a point of demarcation from Shareholder Theory, because it simply says that management should give consideration to stakeholder interests as this will improve performance relative to financial goals.
[9] There are important practical difficulties to be overcome in identifying relevant stakeholders for the suggested Stakeholder Equality Norm. Who are the relevant stakeholders? How do they vote for their representatives on the board? Are we concerned with relevant stakeholder groups or relevant stakeholder individuals? Does each member of a stakeholder organization get to vote or does only the organization as a whole get a vote? Is the size of the stakeholder organization important? Who makes these decisions; the corporation or the state? These practical difficulties are important and any advocate of stakeholder theory that appreciates the significance of voting rights for the entrenchment of the SPN would have to overcome them. Nevertheless, as long as the SEN is a faithful representation of stakeholder theory (once the importance of voting rights is appreciated), then these practical difficulties are not crucial for our present purposes. Our aim is not to solve the problem of how to operationalize stakeholder theory but rather to offer a competing norm of governance to the SPN that does not give primacy to any stakeholder group.
[10] The SEN could also be formulated by removing shareholder voting rights thus making all stakeholders equal with respect to lacking voting rights. In this manner the primacy of shareholders would be removed. In order to establish equal stakeholder consideration (in the absence of voting rights) one could envisage that managers are (through statutory law) charged with duties of equal consideration for all stakeholders. By formulating the SEN in this manner one overcomes the problems of identifying relevant stakeholders to give equal voting rights to. However, the problem of who the "relevant stakeholders" are that management owes equal consideration to is still left opaque as well as creating the difficulty of who should appoint the board of directors if there are no voters that decide. Nothing

in this paper crucially hinges on the "no voting rights" or "equal voting rights" interpretation of the SEN as long as no constituency can impose themselves as primary. We will focus on the "equal voting rights" interpretation of the SEN despite its practical difficulties because it is truer to the spirit of stakeholder theory as it seeks to empower stakeholders equally with voting rights.

[11] It should be highlighted that Stakeholder Theory in its usual depiction (which does not explicitly include equal voting representation for stakeholders on the board) is not susceptible to this criticism. Phillips et al. (2003) correctly point out that Stakeholder Theory does not confuse an organization with the state. However, to the extent that Stakeholder Theory is inconsistent with shareholder primacy it would have to accept a method (such as the SEN) for ensuring that shareholders are not the sole stakeholders with a right to vote.

[12] It might be objected that a single value objective for the corporation expressed purely in financial terms will not enable the corporation to properly value or make use of society's resources that are not part of its production function (for example, negative externality effects on the environment). This is correct if we were to regard the corporation as an atomistic entity decoupled from a political context. However, in a Rawlsian society it is essential that corporations are embedded in a political context. For example, one would imagine the existence of environmental regulation that either prohibits certain behavior or taxes the behavior to internalize the cost of pollution into the production function. It should also be noted that the argument here focuses on the *economic* efficiency of the corporation as a producer of goods and services, and it is with regard to this that we maintain that a single objective is more productive than multiple objectives. Note that Jensen argues that society's resources are most efficiently utilized when corporations aim to maximize the long-term total firm value as distinct from shareholder value more specifically (2002).

[13] One way of distinguishing between the instrumental and normative interpretations of Stakeholder Theory is to look at the criterion of demarcation for the relevant stakeholder groups. One might say that as a managerial theory the stakeholders are those groups that can affect the corporation's ability to achieve its goals, while as a normative theory stakeholders are those groups that can affect or are affected by the corporations, thus including constituencies whose interest should matter in a non-financial sense to the corporation.

[14] Furthermore Benz and Frey (2007) have made reasonable suggestions that corporate governance has much to learn from public governance. Fore example, by instituting proper division of power between CEO and the board and having a real competitive voting process for board positions, corporations will be more accountable to the shareholders and thus be more likely to further their long-term interests.

[15] Does the assignment of voting rights have to be part of the corporate legal form? Strictly speaking, the corporate legal form can be agnostic with regard to the distribution of voting rights to stakeholders. However, in an economic system with private ownership in the means of production the SPN will obtain as a norm of governance by default. The concept of ownership involves a significant element of control over the property owned. The very point of an economic system with private ownership in the means of production is that citizens, as opposed to the state, control the means of production. Corporations are created by investors coming together and incorporating. They then elect a board that employs managers that in turn contracts with different stakeholders. They may even, if they so wish, extend voting rights to other stakeholders. The point is that all of is done at the discretion of the shareholders. Simply by being the first stakeholders they become the primary stakeholders. In a private property system, control over assets are exercised by the owners, and you cannot have a shareholderless for-profit corporation (though clearly there are models where the owners might be employees too). The shareholders arrive first. Therefore, unless it is written into the corporate legal form that all stakeholders must have an equal right to vote, then the default becomes shareholder primacy.

[16] Note that voting rights for the board of directors in a Rawlsian society qualify as an exogenous safeguard because they are part of the corporate legal form that is part of the basic structure. However, voting rights have the property of operating internally by making directors and managers responsive to the interests of the voting right holders.

[17] The preceding discussion presents a fairly sharp dichotomy between endogenous and exogenous constraints. In the theoretical ideal with a "perfect" legislature a sharp dichotomy in favor of exogenous constraints might seem reasonable. However, in practice legislatures are often far from perfect and therefore the moral sensibilities of managers may serve as a useful endogenous gap-filler to imperfect exogenous legislation.

[18] Rawls and other liberals do not consider rights of non-interference, especially not the right to hold private property, to be absolute. They hold that positive rights, which may interfere with some negative rights, are necessary to make the negative rights meaningful. For example, the liberty to pursue one's own destiny is vacuous unless one has some means (income and wealth) with which to pursue it (Nagel, 1975).