

# Stakeholder Theory and “The Corporate Objective Revisited”: A Reply

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Freeman et al. (2004) offer a spirited rebuttal to our paper “The Corporate Objective Revisited” from the perspective of stakeholder theory. However, they fall short in making a case against the logic of shareholder value maximization. The authors confound issues of “value” and “values,” ignore the rich history of scholarship on related questions, and perhaps misinterpret some of our core arguments. Most importantly, proponents of stakeholder views such as Freeman et al. appear to be unable to go beyond critiques of the shareholder view by failing to offer an empirically supportable alternative theory.

*Key words:* shareholder value; stakeholder theory; corporate goal; corporate governance

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We are grateful for the opportunity to respond to the spirited critique from Freeman et al. (2004) to our article on the primacy of the shareholder value maximization logic. As their critique demonstrates, the debate on the purposes and the accountability of the corporation continues to be both important and controversial. At the outset, we affirm our complete agreement on one point. No one can quarrel with their overarching premise that managers must develop relationships, inspire stakeholders, and create communities that provide a context in which everyone aspires to do their best to deliver value. That position is also in our article: “The heart of our argument has been a case for why the shareholder value maximization view is, at its core, inconsistent with exploitation or alienation of the firm’s other constituencies. Such strategies offer no basis for long-run value creation.” (Sundaram and Inkpen 2004).

We are somewhat taken aback, however, by their implications that: (1) our arguments ignore issues of morality in decision making and (2) the pursuit of shareholder value and “values” are mutually exclusive. Nowhere do we claim, or even imply, that morality is irrelevant. Managers have moral and ethical responsibilities to all stakeholders, including shareholders. Firms that treat their stakeholders in a less than ethical or moral manner will not continue in business—let alone create value—for long. However, the reality of day-to-day managerial decision making is one that is replete with trade-offs and competing claims to resources and outcomes. Thus, the issue to address head-on is: Faced with the task of mediating conflicting stakeholder interests, what decision criterion should a manager adopt as a guideline? Freeman et al. (2004) are silent here. They offer suggestions such as “managers must see stakeholder interests as [being] fundamentally joint,” but unfortunately such

well-meaning sentiments are not guidelines for decision making. Our basic argument is that the objective of shareholder value maximization matters because it is the *only* objective that leads to decisions that enhance outcomes for all stakeholders. Also, this follows from the residual claimant status of the shareholder. Although they accuse us of falling prey to the “separation thesis,” we suggest that it is Freeman et al. that have artificially separated the issue of shareholder value and values, with their obvious and we might add extreme implication that the pursuit of shareholder value is inherently immoral.

There are several areas where Freeman et al. (2004) appear to misinterpret our intentions or arguments. First, they seem uninterested in and even dismissive of our attempt to anchor the arguments in 150 years of corporate history and the substantial scholarship that has grappled with the very essence of these issues over a long period. Their dismissal of important considerations in the evolution of law and the practice of management, such as the early conception of the corporation as an entity that should serve the public good, the Berle-Dodd debates of the mid-1900s, or the adoption by states of stakeholder statutes, is disappointing. The dismissal suggests that modern stakeholder theories (and theorists) fail to see the need to anchor their views in the rich historical, philosophical, and legal debates on the purposes and accountability of the corporation. The concept of the stakeholder, the role of the manager in addressing stakeholder concerns, and the larger debates surrounding the role of the corporation in society vis-à-vis questions of efficiency versus equity have been around for decades. Such concerns have played a central role in the evolution of laws, and even social and political norms governing the corporation. In the process, they have substantially shaped managerial practice.

Second, Freeman et al. (2004) claim that we forget that shareholders are stakeholders too. In the theory section of our paper, we make a clear distinction between *nonshareowning* and *shareowning* stakeholders. Our central theoretical argument (and one that appears to have been missed) concerns the primacy of the *residual*, as opposed to the fixed, claimant. We have no problem with, and our arguments would apply to, *any* constituency that is willing to derive its claim to the corporate pie solely from residual cash flows. We agree wholeheartedly that “shareholders are stakeholders too.”

Third, we are puzzled by the view of Freeman et al. (2004) that “economists as ideologists” and their dismissal of the “scientific” approach as opposed to the “pragmatic” approach. Ignoring the merits or demerits of science, we fail to see how managing on behalf of all stakeholders is either pragmatic or practical. Freeman et al. separate the scholarly world into a  $2 \times 2$  based on the “pragmatic-philosophical” dimension versus the “pluralistic-single theory” dimension; i.e., the supposedly pragmatic/pluralistic view they adopt versus our (purported) philosophical/single-theory lens. We are puzzled because the main thrust of our argument is that the shareholder value maximization view *is* the most pragmatic approach. In other words, ours is a pragmatic/single-theory view that lies outside the diagonal of their somewhat oversimplified  $2 \times 2$  world.

Fourth, in rebutting some of our propositions, they ignore the basis of our arguments. For instance, Point 5 in our paper (Sundaram and Inkpen 2004), which argues that stakeholders have remedies that shareholders do not have, addresses the limitedness of shareholders’ *legal* recourse. In suggesting that Point 5 involves asset specificity, Freeman et al. (2004) seem to misinterpret the foundations of our reasoning. As the appropriate citations in that section point out, our arguments are simply a synthesis of well-known corporate law scholars’ views that nonshareowning stakeholders have judicial recourse through invocation of contract and tort laws that shareholders in their dealings with the corporation typically do not. Freeman et al. do the same with Point 4 (Sundaram and Inkpen 2004), which argues that it is easier for nonshareowning stakeholders to become shareholders than the reverse. Surely, for example, it is far easier for an employee or supplier to become a shareholder than for a shareholder to become an employee or supplier of the corporation.

Fifth, Freeman et al. (2004) find it hard to imagine how anyone can look at the recent wave of business scandals such as Enron and argue that shareholder value maximization is a good idea. However as we made clear, these corporate governance scandals are little more than grotesque portraits of insiders and their cronies

expropriating shareholders’ wealth, certainly not shareholder value maximization. If Enron’s managers had actually been focused on long-run shareholder value creation, the outcome might have been very different. As the recent statement of contrition from former Enron CFO Andrew Fastow, now criminally indicted and facing jail time, admits: “I . . . engaged in schemes to enrich myself and others at the expense of Enron’s shareholders and in violation of my duty of honest services to those shareholders” (*Wall Street Journal* 2004, p. A14).

Finally, Freeman et al. (2004) concede that there is no need to posit stakeholder and shareholder theories as oppositional. We agree. We would then simply suggest that the stakeholder arguments advanced by Freeman et al. perhaps are in our camp because all we advocate is a decision-making rule that enlarges the pie for everyone. And that rule is: “Maximize the value of your shareholders’ wealth in the long run, and you will maximize the value of the firm.” Consider Merck, a company identified by Freeman et al. (2004) as exemplifying stakeholder-oriented management. The articulation of Merck’s values as a part of its mission statement includes the following: “Our ability to meet our responsibilities depends on maintaining a financial position that invites investment in leading-edge research and that makes possible effective delivery of research results” (See <http://www.merck.com/about/mission.html> (website last visited March 8, 2004)). In other words, achieving a fair rate of return for its shareholders is the *sine qua non* for companies such as Merck to fund the investments required to make the world a better place for all its stakeholders.

Regardless of the camp to which we belong, one premise should be clear: All of us seek a path to a promised land in which accountable corporations managed by ethical decision makers create the greatest value for the greatest number of stakeholders. We have argued that the shareholder value maximization logic offers such a path. If managing on behalf of “stakeholders” is instead the desired goal, proponents of such a view must go beyond critiques of the shareholder view to offer a robust alternative theory that is compatible with the naturally occurring incentives, impulses, and imperatives of market- and property rights-based economies in democratic-capitalist societies. If such a theory is developed and can be empirically supported, we would be the first to welcome it.

## References

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