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

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Abstract

Shareholder primacy is considered a major impediment to corporate social responsibility. This paper examines the status of the Shareholder Primacy Norm under US and UK law and shows that it is no longer legally enforceable, but remains a powerful social norm among managers, in part because of the sole voting rights of shareholders. Accordingly, we apply Rawls' social contract theory to evaluate the legitimacy of shareholder primacy as manifest through the voting rights of shareholders and assess whether this principle of governance would be endorsed or the Stakeholder Equality Norm, a competing norm proposed here as an operationalization of stakeholder theory. Contrary to expectations, we find that a Rawlsian analysis is more supportive of shareholder primacy than stakeholder theory because it dictates that economic efficiency would determine the best governance principle and shareholder primacy would likely be more efficient. However, shareholder primacy would not be unfettered because justice considerations of Rawls' theory impose exogenous constraints, primarily in the form of legislation. We conclude by showing that the on-going debate between shareholder primacy and stakeholder theory is in many respects about the choice between exogenous vs. endogenous constraints and essentially a debate between political liberalism and libertarianism.

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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; Campbell, 2007; Dodd, 1932, Evan and Freeman, 2003; Hinkley, 2002; Phillips, Freeman & Wicks, 2003; Testy, 2002). More recently, in 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 not usually associated with the advocacy of CSR (e.g., Financial Times 2009a).

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, 2001; Jensen, 2002) or 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 critical

importance of this debate was expressed forcefully by Walsh (2004: 349) in *Organization Science*: "Since the rise of the first corporations two thousand years ago, we have been trying to develop a theory of the firm that explains and guides firm behavior… This is arguably the most important theoretical and practical issue confronting us today." Subsequent events lend yet more weight to his claim.

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 (2009) 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 clearly proved false. 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, 2009a). 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" (2001: 55). In contrast, Freeman's (1984) seminal formulation of Stakeholder Theory, while not denying that profitability should be *a* goal of corporations, sees the *primary* purpose of the corporation as being a vehicle to manage stakeholder interests. This theory has become one of the most prominent managerial theories within business ethics (Phillips, 2003) and it has emerged as a dominant paradigm in CSR (McWilliams and Siegel, 2001). 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).

Thus the purpose of this paper is to evaluate the legitimacy of the SPN and to consider justifiable constraints on that primacy. Critically, any evaluation of legitimacy requires a normative framework within which that evaluation of legitimacy takes place. Assuming that we wish to stay within the tradition of liberal political philosophy founded on individual liberties, then we are primarily confronted with a choice between utilitarian or social contract normative frameworks (Clark & Gintis, 1978: 304). It is not our aim here to try and settle the age old question of which of these two frameworks is superior, but it was part of Rawls' (1999) project to develop a social contract theory (SCT) that he regarded as superior to utilitarianism. Rawls' (1999: 23-24) summarized his criticism of utilitarianism as follows:

> The striking feature of the utilitarian view of justice is that it does not matter, except indirectly, how [the] sum of satisfactions is distributed among individuals any more than it matters, except indirectly, how one man distributes his satisfaction over time... Utilitarianism does not take seriously the distinction between persons.

It is central to Rawls' project to develop principles that distribute rights, liberties, income and wealth in a manner that takes the distinction between persons seriously. Our sympathy for Rawls' theory is only part of the reason for employing his normative framework in the evaluation of the legitimacy of the SPN. We have chosen to employ Rawls' SCT (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 regarded as such a basic institution. Furthermore, social contract reasoning fits intuitively with the common depiction of the corporation as a nexus-of-contracts consistent with how we are evaluating the legitimacy of the power relations among corporate stakeholders (Van Oosterhout, Heugens and Kaptein, 2006). Finally, SCT is established as a core theory within business ethics (Wempe, 2005) and Rawls' SCT in particular is widely recognized as one of the most influential political theories of the 20th century.

Before evaluating the legitimacy of the SPN we need to understand what the norm is and what enforces it. 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 then 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 its legitimacy—and with what constraints.

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.

The SPN is not a Legally Enforceable Norm

Corporate law in the US and UK, comprising 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). Thus the SPN is a development of common law and debate about its efficacy and legitimacy is as a norm stemming from judicial decisions. Common law provides the clearest articulation of shareholder primacy in the court cases specifying that managers and directors owe fiduciary duties to shareholders and must make decisions that are in their best interests (Smith, 1998). The most famous articulation of the norm comes from the 1919 case of Dodge v. Ford Motor Co., wherein 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).

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 subsequent development of the business judgment rule in common law and more recent statutory developments, managers today have significant discretion in addressing non-shareholder interests. Thus 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, so-called because it relieves the court of any duty to make evaluations of the business judgment of a director. 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 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)—evaluating the quality of business decisions is difficult and this is not the primary competence of the courts. In effect, the rule makes the fiduciary duty of care unenforceable because courts will not consider the quality of business decisions which would otherwise be the primary evidence for lack of care (Cohn, 1983).

Shareholders rarely succeed in derivative suits against directors on claims of a breach of care. 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.

Fiduciary duties developed in common law have been explicitly defined by the incorporation statutes of most states in the US. 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 (1991: 228) 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." 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.[1]

The UK has also seen the introduction of statutes that explicitly allow managers to consider the interests of multiple stakeholders. The 1985 Companies Act stated 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. Under the 2006 Companies Act, directors are further required to take into account the interests of other stakeholders such as suppliers, customers, the community, and the

environment. However, as in the US, 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 suggests directors still only have 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 US states and the UK 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.

The SPN as a Social Norm

Anderson (2000: 170) 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." 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—an assumption often reinforced by compensation packages tied to the share price. 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 (2006: 1) thought that "generating high returns for investors should be accompanied by broader

contributions to the public good." 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 appears to mostly hold true when they don't conflict with shareholder interests and in particular when both go hand in hand.

While the SPN is prevalent among managers there may be other, potentially countervailing norms. For example, championing CSR and environmental friendliness may be emerging as a social norm among managers in many corporations. Nonetheless, some surveys suggest that US 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). Managers may believe they are following a legal norm, but it would seem that they are following a social norm which they believe is legal because of its pervasiveness in business.[2] 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 legal 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). 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). Although the threat of dismissal / non-reelection to the board is real it should be acknowledged that it rarely happens in practice in large public corporations (Benz & Frey, 2007). However, there are usually other incentive structures in place that aim to align shareholder interests with those of top management; for example, the issuing of shares or stock options and payment of bonuses tied to corporate financial performance. Voting rights matter even in this context because it is common practice for shareholders to approve top management's remuneration by voting. The legal power of shareholders to vote for the board of directors and their remuneration 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. Yet 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) and, furthermore, the SPN is virtually unenforceable due to the business judgment rule. Therefore, the view of CSR advocates (see e.g., Boatright, 1994; Campbell, 2007) that the SPN legally 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) and because their remuneration is often tied to corporate financial performance. 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 this prescription as a principle governing the structure of corporate law. Normative theory is necessary for this evaluation and thus we turn to one of the most prominent examples in exploring whether Rawlsian social contract theory would endorse shareholder primacy and what constraints it might impose on that primacy. In contrast to previous applications of Rawls' theory within business ethics (Evan and Freeman, 1990; Hartman, 1994; Moriarty,

2005) that have been said to misapply 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.

JUSTICE AS FAIRNESS AND THE SPN

Justice as Fairness

Rawls (2001) "Justice as Fairness" theory 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 thus the task of political liberalism, and Justice as Fairness especially, 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).[3]

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 also 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 the parties

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 the parties 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 “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. In short, Justice as Fairness is an *egalitarian* conception of rights, liberties and distributive shares, where inequalities of income and wealth are only justifiable if they are to the benefit of the least advantaged members of society.

How Justice as Fairness Relates to the SPN

To evaluate the legitimacy of the SPN using Justice as Fairness, we must first demonstrate its appropriateness to the task. This includes establishing that a “Rawlsian society” would have private ownership as part of the means of production and the corporate legal form, as well as identifying the main criterion for choosing among alternative norms of corporate governance under Rawls’ theory.

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’ (2001: 177) 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." Hence, for the purposes of this paper, 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). Rawls' theory does not specify the exact attributes of the corporate legal form, but 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, we assume that a vehicle like the corporate legal form would exist in a Rawlsian society (i.e., with at least the central characteristics as we know it: corporate personality, delegated management, transferability of shares, limited liability, and investor ownership (Kraakman et al., 2004)).

Thus, while Rawls (2001: 12) observes that "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," 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 and, therefore, it needs to comply with the principles of justice. Hence Justice as Fairness is relevant to an evaluation of the legitimacy of the SPN because, as we have shown, this norm is attributable to the voting rights that are conferred upon shareholders as a part of the corporate legal form, which is part of the basic structure. With the appropriateness of using Rawls' theory established, we now turn to identifying the main criterion for choosing among alternative norms of corporate governance.

Justice and the Criterion of Efficiency

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 method 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 is more accurately seen as using the original position as a device for one's own purposes rather than as an exercise in applying Rawls' theory. Under Rawls, the relevant contracting parties are *citizens*, not corporate *stakeholders*. Rawls' (1999: 82) 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."

While Rawls' theory does not speak directly to stakeholders, it is relevant to the norm for corporate governance because the norm has consequences for citizens (and thus indirectly for stakeholders) as it affects the efficiency of the entire economic system in society. This is accounted for in the difference principle. Rawls (2001: 63) says that "a scheme of cooperation is given in large part by how its public rules organize productive activity" 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).

The lexical priority of the principles of justice guarantees that the liberty principle and the equality of opportunity principle are fully realized before the difference principle is applied. However, as Rawls (2001: 123) states, "a political conception of justice must take into account the requirements of social organizations and economic efficiency." While the difference principle does not speak to differences among stakeholders, it is part of a broad conception asserting that a theory of justice cannot ignore issues of efficiency. Consistent with Rawls (1999: 58), when the basic liberties and equal opportunities are satisfied, a more "pareto 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 systems 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 corporate stakeholders a right to vote or to only give this right to shareholders.

The Stakeholder Equality Norm

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? With economic efficiency identified as the main criterion for choosing a norm of corporate governance, we now need at least one alternative to the SPN in order to evaluate if it 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.

Shareholder theory holds that the purpose of the corporation is to be a vehicle for pursuing shareholder interests (Friedman, 2001). In contrast, stakeholder theory holds, as a normative theory and not merely an instrumental theory (and Donaldson and Preston (1995: 86) assert that it is "fundamentally normative"), that the purpose of the corporation is to be a vehicle for managing stakeholder interests (Evan and Freeman, 2003). The term "purpose" of the corporation may refer to "role" or "goal" or both. The distinction between the role of a corporation and its goal is largely that the role refers to the purpose of a corporation from the perspective of society, while the goal refers primarily to its purpose seen from 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 unclear whether stakeholder theory's prescription applies to the role or goal of the corporation. According to Donaldson and Preston (1995) the descriptive, instrumental and normative interpretations of stakeholder theory are intertwined and thus it appears to conflate the corporation's role and goal because the theory describes the *role* of the corporation as one of coordinating stakeholder interests, but also sees this normatively and instrumentally as the corporation's *goal*.

Under the stakeholder view, it is often said that the discretion of decision-making should lie with management together with stakeholder representatives (Melé, 2008). However, unless these representatives are given real power, such as an equal right to vote, ultimately we still have a situation of shareholder primacy (even if it is 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 (equal otherwise one stakeholder group will have primacy). Indeed, Evan and Freeman (1990: 35) argue in their application of the original position to the contracting of stakeholders that "it is rational for stakeholders to choose voting membership on the board" to avoid unilateral policies that are detrimental to stakeholders. Moreover, Donaldson and Preston (1995: 87) note that stakeholder theory "prohibits any undue attention to the interests of any single constituency." Therefore the notion of *equality* seems appropriate for a norm representing stakeholder theory because if stakeholders are not equal in the eyes of management, one group must be primary.

The SEN would presumably 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). 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.

Implementing stakeholder theory has received insufficient attention in the literature to date. Our formulation is not intended to be a "straw-person"—a misrepresentation of stakeholder theory that is easily shot down and an approach often used by its critics (Phillips, et al., 2003). However, clearly there

would be major practical difficulties in applying the SEN (e.g., how are the relevant stakeholders to be identified? is the size of the stakeholder organization important? how would they vote for their representatives on the board?). Nonetheless, provided the SEN is a faithful representation of stakeholder theory (once the importance of voting rights is appreciated), 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 norm of governance that does not give primacy to any stakeholder group.[4]

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 in 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 (Boatright, 2002: 1839), in 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." Further, 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 the equal voting rights for stakeholder board representatives because, in our view, previous scholars have not sufficiently appreciated the importance of voting rights for maintaining the primacy of shareholders among stakeholders.[5]

ASSESSING THE TWO NORMS OF GOVERNANCE UNDER 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 hinges on which norm is best in terms of economic efficiency. Nevertheless, we conclude in favor of the SPN largely on two counts: 1) the SEN applies the political conception of equality to a private association where it does not necessarily belong; 2) more importantly, the SPN is arguably a more efficient organizing norm than the SEN.

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. It seems 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 relevant parties in the original position who view the most and least advantaged in terms of access to social primary goods, 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. 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 (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). 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.

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: 1) economic efficiency requires governance with a single objective function; and 2) control is best exercised by residual claimants.

Economic efficiency requires governance with a single objective function. Equality among citizens is appropriate to Rawls' project of specifying the principles of justice for a society seen as a fair system of cooperation. But this normative 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 overriding goal of efficient production.

Stakeholder theory, and the SEN in particular, implies that the board and management have a number of constituencies towards whom they are accountable. This does not require multiple objectives for management—the constituencies might all unite behind one objective (see, Freeman et al. 2007)—but it does seem likely given their often different needs. As Williamson (1984: 1215) 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."

According to Jensen (2002: 237), 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." 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, focusing on profit as a measure of success 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).[6] This objective function directs the corporation to allocate resources efficiently to produce output that is valued more than its inputs.

Phillips, et al. (2003: 485) 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." 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. 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 (2008: 18), who observes that, "If a business tries to maximize profits, in fact, profits don't get maximized, at least in the real world." But unlike shareholder theory, maximizing profits is not the main point of stakeholder theory. Donaldson and Preston (1995: 79-81) maintain that success for stakeholder theory lies "in satisfying multiple stakeholder interests—rather than in meeting conventional economic and financial criteria… No theorist, including Rawls, has ever maintained that bargains reached on the basis of the "veil of ignorance" would maximize efficiency." Similarly, Collins (1997) maintains that irrespective of the efficiency of "participatory management" in corporations, the primary reason for adopting such a system of governance rests on its supposed ethical superiority.

That the single objective function of profit leads to economic efficiency does not per se single out shareholders as the sole group that should be extended voting rights. It is possible for other corporate stakeholders, in particular employees, to have their remuneration tied to corporate profits. However, shareholders are special in that their entire remuneration is tied to the potential profits of the corporation.

Control is best exercised by residual claimants. To argue in favor of the SPN does not mean ignoring stakeholder interests: "long run value maximization cannot be realized by ignoring or mistreating any corporate stakeholder, be it customers, employees, suppliers, or community" (Jensen (2008: 23). Instrumental stakeholder theory recognizes that a corporation must satisfy its different stakeholders so as to gain their cooperation and achieve its goals.[7] Indeed, Hillman and Keim (2001) found that stakeholder management 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 (2004: 354) note: "Control rights should go to shareholders, because as residual claimants, they are the constituency that will value this right most." Employee salaries could be linked to the residual (e.g., a bonus) and thus they would value the residual more, but not in principle as much as shareholders, unless their entire salary is variable.

Fixed claimants have made agreements in the form of contracts that they expect to see honored as part of what Rawls (1999: 74) calls their "legitimate expectations". 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" (they do not specify whether or not this would be proportional to risk). However, shareholder theorists argue that there needs to be incentives for the firm to focus on seeking a residual so as to realize the legitimate expectations of shareholders. This outcome of an indeterminate process cannot be completely specified in a contract, arguably providing justification for shareholders as the sole stakeholder group towards which management owes a fiduciary duty (Easterbrook and Fischel, 1993), a duty difficult to enforce without the sole voting rights of shareholders.[8]

Potential incorporators could well not find incorporation attractive if it meant they lost considerable control upon incorporation and were not given priority as residual claimants. The very purpose of having the corporate legal form for productive cooperation could be undermined 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 prioritize seeking a residual? There needs to be a proportionally expected upside to the risk taken. Unlike investing in bonds where a fixed return is (virtually) guaranteed, shareholders cannot legitimately expect a guaranteed return in a competitive environment. That said, shareholders have been able to "guarantee

partially their income" over the last 20 years, with US data suggesting that dividends have been steadily increasing without corresponding increases in profits (Aglietta & Rebérioux, 2005: 35). Nonetheless, there are no legally guaranteed returns for shareholders, whereas all non-shareholding stakeholders expect to see their legitimate contractual expectations honored, at least assuming the backing of the judicial system.

Notwithstanding the widely-asserted claim that control is best exercised by shareholders as residual claimants, it is uncertain if their sole voting rights for the board of directors constitutes sufficient control. Long ago, Berle and Means (1932) argued that shareholders of 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.[9] 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 (e.g. Financial Times, 2009a). 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 the firm and its shareholders. For example, Jensen, Murphy, & 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, which argues against performance based executive pay or at least for remuneration tied to long-term performance.

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 (except in bankruptcy); the board of directors decides what if any dividends to pay shareholders. This is a descriptively correct reading of the law. However, it is arguably the case that shareholders, as the only constituency whose remuneration is entirely dependent on a residual, *should* be vested with real corporate control powers (see, Benz & Frey, 2007), because they have the greatest incentive for efficient production.

In sum, our analysis suggests that from a Rawlsian perspective the main arbiter in the debate between shareholder theory and stakeholder theory is not an ethical or political criterion, but which norm

of governance is more economically efficient. We have argued that the SPN is more efficient than the SEN and thus would be more likely endorsed by Justice as Fairness. At first, this might seem inconsistent with Rawls as he is generally understood. However, our argument is very much in keeping with Rawls' egalitarianism. His project is *political* and aims at the basic structure of society (i.e. its institutions) and how they enable the ambitions of all *citizens* equally.[10] The basic structure seen as a coherent whole is egalitarian in its treatment of citizens, but that does not necessarily translate into egalitarian principles of how managers treat different stakeholders. The SPN is endorsed as an efficiency concern which is part of an entire egalitarian system. However, Justice as Fairness also would impose constraints on the SPN.

The SPN would not be Unfettered in a Rawlsian Society

According to Rawls (2001), the principles of justice are realized in a "property-owning democracy" (though they could also be realized in 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 redistributed *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.

In a Rawlsian society the SPN would not be unfettered because the corporation is embedded and regulated by the basic structure. As Krouse and McPherson (1988: 82) observe: "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." When this is achieved, markets and the actors within them can be left to take care of themselves. However, the pursuit of shareholder interests

would be constrained by regulation, such 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), and 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 (2002: 1849) 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." Many concerns that stakeholder theorists wish 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 (1990: 346-347), 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."[11]

Exogenous constraints on corporate behavior that are part of the basic structure can stretch beyond legislation. For example, the state can grant other 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 many nongovernmental organizations (NGOs) (Campbell, 2007). Nevertheless, NGOs cannot be allowed free rein in their activities merely because they do not operate from a profit motive. They can suffer from the same legitimacy problems as corporations, not being democratically legitimate representatives of the citizens (Scherer & Palazzo, 2007).

Endogenous vs. Exogenous Safeguards

Instead of such exogenous constraints, Evan and Freeman (2003) 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.) 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 (1990) 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 (1990) wish to grant stakeholder voting membership on the board because it is seen as more *effective* in protecting stakeholders' interests. 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 view is maintained because government cannot legislate in a manner that is tailored to the particular circumstances of stakeholders in individual corporations. However, it is by no means clear that endogenous safeguards always are more effective (or 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 (2002: 1842) 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." 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 (2002: 335) think that "Rawls's first principle of justice is a paradigm case of a libertarian principle." 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).[12] 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. However, 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 (2001) 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.

Thus 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. Accordingly, political philosophy turns out to be highly relevant to both business ethics and corporate governance, 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. This paper offers five key conclusions on the debate: 1) The SPN is not enforceable as a legal norm but it is alive as a social norm among mangers due to the structure of corporate law that empowers shareholders with sole voting rights for the board of directors; 2) An appropriate operationalization of stakeholder theory identifies the Stakeholder Equality Norm as a competing norm of governance to the SPN; 3) A Rawlsian society would endorse the SPN because it is more economically efficient than an SEN; 4) However, the SPN would not be unfettered in a Rawlsian society because it would be constrained by the basic structure of society (primarily legislation); 5) The debate between shareholder theory and stakeholder theory is essentially a debate between exogenous vs. exogenous constraints or a debate between liberalism vs. libertarianism.

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 supported by the structure of corporate law. Rawls' Justice as Fairness is particularly appropriate given the rise to prominence of social contract theory in business ethics and the profound 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 norm of corporate governance to the SPN. Contrary to what one might first assume, but in keeping with Rawls' egalitarianism, 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 arbiter among economic systems is pareto efficiency which benefits all citizens. Based on the (qualified) 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.

Although our Rawlsian analysis endorses the SPN we also maintain that it would not be unfettered. In Justice as Fairness the basic structure would impose exogenous constraints on that primacy mainly through legislation that aims to regulate corporate behavior in line with Rawls' two principles of justice. Our analysis further shows that the issue of how corporate behavior should be constrained cuts to the heart of the basic debate between shareholder theory and stakeholder theory. Shareholder theory advocates exogenous constraints while stakeholder theory advocates endogenous constraints, and the justifications for these differences essentially reduce to a debate between political liberalism vs. libertarianism.

There are however 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 recognition of 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 supportive of the SPN, this is not an unqualified endorsement of shareholder theory, at least as advanced by prime SPN exponents such as Friedman (2001), who furthermore advocate unfettered free market competition. While we offer a qualified endorsement of the SPN as a corporate norm of governance, consistent with Friedman, we find support for the SPN in Rawls' theory so long as there are the 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, but given that no countries in the real world have ideal Rawlsian societies it is not possible to fully endorse the pursuit of shareholder interest within constraints if the postulated system of fair constraints is incomplete.

Evidence of the inadequacy of exogenous constraints can for example be found to the extent that the 2008 financial crisis is attributable to regulatory failure. Areas of suggested regulatory reform so far include capping bankers' bonuses, increasing bank capital requirements, and changing the rules that govern international financial institutions (Financial Times, 2009b). The main implication of this analysis for CSR is that criticism of 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

[1] The American Law Institute's (1994: 55) *Principles of Corporate Governance* also provide 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.

[2] 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.

[3] 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.

[4] 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.

[5] Since Freeman (1984) introduced stakeholder theory it has come to mean many things to many people, making it difficult to speak of generically. However, as Freeman is undoubtedly the "father" of stakeholder theory, we use his writings to represent the core of the theory and thus the normative (rather than the instrumental) interpretation (Boatright 2002; Donaldson and Preston, 1995). Freeman's views have changed over the years; in particular, the position that management should balance stakeholder interests (1984) has evolved into a form of multiple stakeholder value creation (Freeman et al., 2007). However, neither position speaks directly to stakeholder equality. Indeed, most treatments of stakeholder theory do not discuss stakeholder equality, yet this is an unavoidable consequence of removing the primacy of one stakeholder group (that has sole voting rights). The SEN is the logical counter norm to the SPN once one realizes how voting rights dictate primary consideration by management.

[6] 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 are 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 (2002) 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.

[7] One way of distinguishing between the instrumental and normative interpretations of stakeholder theory is to say that as a managerial (instrumental) 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 corporation, thus including constituencies whose interests should matter in a non-financial sense to the corporation.

[8] 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 this 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 is 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 arguably the default becomes shareholder primacy.

[9] A potential argument against assigning control rights to shareholders of public corporations relates to the liquidity of such shares (Aglietta & Rebérioux, 2005). Shareholders can enter and exit a position almost instantly which suggests that they should not have influence over corporate operations in order to avoid short-term strategies at the expense of the long-term. This argument is sound, but it is also largely a description of the status-quo. Shareholders do not have operational control. They only vote annually for the board of directors. This incentivises management to stay focused on creating a residual, while appropriate incentive schemes for management should ensure that the goal is to create a long-term residual. Arguably a consequence of this is that shareholders should have limited control rights over management remuneration in order to avoid short-term incentive packages.

[10] Justice as Fairness is not a moral theory that asks people (or managers) to be impartial in their treatment of other people (or stakeholders); rather it is a political theory that asks the basic institutions of society to follow the two impartial principles of justice in their treatment of all citizens (irrespective of what stakeholder group they belong to). Citizens do not fall into discrete stakeholder groups; each individual citizen can belong to any number of stakeholder groups depending on their numerous relationships with corporations throughout society. As a political theory Justice as Fairness covers the concerns of all stakeholders by virtue of their status as citizens. (Furthermore, on an empirical note, the SPN directly benefits most citizens in many developed countries as they are part of voluntary or compulsory pension schemes that invest in the stock market.)

[11] 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.

[12] 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).

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