What’s Wrong—and What’s Right—with Stakeholder Management

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What Is Stakeholder Management?
- Corporations ought to be operated so as to serve the interests of all stakeholders (employees, customers, suppliers, investors, community, etc.)
- Is this an (incompatible) alternative to prevailing system of corporate governance with shareholder primacy (“stockholder management”)?

Two Forms of SM
- Instrumental Stakeholder Management
  - Corporations have stakeholders who must be managed in some way.
  - Corporations (managers) have some obligations to stakeholders
- Normative Stakeholder Management
  - Corporations (managers) have an obligation to (a) consider all stakeholder interests and (b) balance them in some way.

Is SM a Rival Model?
- ISM is compatible with current system of corporate governance.
- Whether NSM is compatible depends on interpretation, especially with regard to:
  - Control: Who has a right to participate in decision making?
  - Fiduciary Duties: Who is a beneficiary?
  - Corporate Objective: Whose interests ought to be maximized?
Where Does SM Go Wrong?
- Insofar as NSM offers an alternative model of corporate governance, it
  - Fails to appreciate how the prevailing system serves all stakeholders.
  - Incorrectly ascribes the role of serving stakeholder interests to management.
- These mistakes are about
  - The function of corporate governance
  - Wealth creation and wealth distribution

A Contractual Theory of the Firm
- The firm is a nexus of contracts involving all input providers.
- Its purpose is to realize the benefits of joint production.
- Every input (asset) is provided in order to gain some return.
- Governance is the set of contracts and legal rules that protect the return on an input (asset).

The Shareholders’ Contract
- Every asset contributed to production is accompanied by a governance structure.
- For most input providers, this structure consists of fully specified contracts and legal rules.
- Shareholders’ return cannot easily be protected because of lock-in, complexity, and uncertainty.

Justifying Shareholder Primacy
- Shareholders provide an input (capital) in return for residual earnings (profit).
- Thus, they “buy” the future profits by “selling” equity capital and risk-bearing services.
- The elements of corporate governance (control, fiduciary duty, and the corporate objective) serve to protect this return.
Benefits of Shareholder Primacy

- It provides an incentive to keep the firm solvent
  - which protects the return of other groups.
- Residual risk-bearing also insures the return of other groups.
- It provides an incentive to achieve a maximal return
  - Which produces greater wealth for society.

Comparing the Two Models

- The choice of models involves two issues:
  - How best to protect each group’s return
    - Which is an empirical matter (what works best).
  - What each group should receive as a return
    - Which is a normative matter (what is fair).
- And two different means:
  - The market
  - Management decision making.

What Works Best

- Most groups would prefer contracts and legal rules to managerial discretion.
- Fiduciary duties are a second-best form of protection.
  - They are a form of judicial gap-filling.
  - They have greater value when exclusive.
- A single objective is more efficient than multiple objectives.

The Stakeholder Fallacy

- It is a fallacy to argue
  - Corporations ought to benefit everyone.
  - Therefore, this is a job for management.
- Missing premise: Management decision making is the best means for protecting each group’s interest. -- False!
- What are the alternatives?
  - Markets
  - Government
### What’s Fair?
- Fairness in the distribution of the wealth created by corporations is an issue, but
  - Fairness can generally be better secured by contracts and legal rules.
  - Securing fairness is not a task for managers.
    - Producing wealth and distributing it are different functions, the latter better done by government.
  - Fairness cannot easily be achieved by changes in corporate governance.

### What’s Right with SM?
- The purpose of a firm (like a market) is to benefit everyone.
  - By joint production in a market, rather than by managerial decision making.
  - To create wealth, managers must attend to stakeholders.
    - Shareholder primacy gives little guidance for how a firm should be managed.
    - How a firm should be governed and how managed are two different matters.

### The End