Stockholders and Stakeholders: The Battle for Control of the Corporation

Donna Card Charron

The American corporation is in trouble not only because of various immoral executives, but also because it is a target of sustained attacks. For several decades, corporate revisionists have toiled to transform the corporation from private to public property. Were they to succeed, the tragedy of the commons would slowly sap the corporation of its vitality. My objective in exposing the battle for corporate control is to urge and encourage those committed to the preservation of this highly performing institution to place the issue more prominently on their agenda. To this end, I detail the evolution of the battle and assess the present state of affairs. In so doing, I describe and critique "stakeholder theory," the revisionist's chosen weapon for gaining control of the corporation. Stakeholder theory currently dominates textbooks and syllabi of courses in business management, human resource management, marketing, and public policy. It colors the decisions of many corporate executives. And it controls the thinking in the majority of business ethics centers. Aware of its reach, I adumbrate a strategy for reversing the destructive inroads of stakeholder theory.

The Threatened Corporation

The corporations most endangered in this momentous property dispute are the private, publicly traded ones in which stockholders are owners (principals) and hired corporate officers are managers (agents). Board directors have the duty to oversee the agents. Agents

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and directors have a fiduciary duty of care to protect and increase the investment of owners. Directors have the added duty of loyalty to stockholders. Corporate law gives no detailed discussion of the obligations of directors to employees who are not officers in the company. However, corporate law does emphasize that every employee of the firm has the same fiduciary obligation to the corporation as do the officers.

In the other direction, law grants that corporations may spend corporate earnings on nonbusiness related projects for the benefit of employees, the community or society at large, provided that such expenditures can be expected to advance the corporation's primary goal of making profits for stockholders.

These traditional agreements on the nature of corporate relationships constituting the firm are in serious dispute. Inside and outside the corporation, corporate revisionists are seeking to disestablish the corporation as a privately owned, publicly traded entity. In its place, they seek to ensconce an institution publicly owned and controlled by political decision rather than by the market.

Battle Inside the Corporation

In many of today's corporations, managers are the revisionists. Throughout the cultural revolution of the 1960 and 1970s, managers and stockholders stood together rejecting stakeholder theory. Few corporate observers, other than Adam Smith (1776), would have thought that this solidarity would crumble or that managers would support actions to disenfranchise the stockholder and ultimately weaken the corporate institution itself.

As control of the corporation separated from ownership, the controlling managers found themselves conflicted. As legal agents, they were to maximize profits for their stockholder principals; but, as individually rational agents, many tended to maximize benefits to themselves. In time, they began to divert stockholder wealth to stakeholders through higher compensation packages, more expensive perquisites, comfortable surroundings, and generous charitable contributions.

Market for Corporate Control

It is argued that if managers deviate too far from acting in the interests of stockholders, the market for corporate control will intervene and oust them. The market for corporate control, as explained by law professor Henry Manne in his 1965 article "Mergers and the

Market for Corporate Control," recognizes stockholders' power to replace underperforming managers with a team expected to gain greater wealth for the company. Subscribing to the efficient market theory, Manne assumes that the average stock market price is the best gauge of the value of a company. Inefficient management is revealed in earnings and stock prices lower than those of competitors in the industry. When companies consistently underperform, they risk becoming targets for takeover, through tender offers, proxy fights, or mergers. The stockholders will replace old nonentrepreneurial management with a new entrepreneurial team.

For market players, underperforming companies represent an opportunity for gain.

> The lower the stock price, relative to what it could be with more efficient management, the more attractive the takeover becomes to those who believe that they can be entrepreneurially more creative and manage the company more efficiently. And the potential return from the successful takeover and revitalization of a poorly run company can be enormous [Manne 1965: 113].

If the return can be so enormous, why have takeovers been relatively rare? Stockholders may be losing wealth under nonentrepreneurial managers, but the high cost of entering the market for corporate control sometimes protects managers. The cost of organizing and communicating is greater than the lost wealth. However, if managers go beyond a given threshold in their wealth diversion such that gains would exceed the cost of entry, they are likely to trigger takeover action.

Control by Mergers and Acquisitions

Since the 1980s, academic rhetoric resounded in the marketplace as reality mirrored Manne's theory. Activating the market for corporate control, T. Boone Pickens, Sir James Goldsmith, Carl Ichan, and others painted themselves as saviors of corporate America, banishing nonentrepreneurial managers. Thus, there emerged the internal battle for the American corporation, the battle between stockholders and wealth-diverting managers.

The wealth opportunities enticed short-term arbitrage investors and occasioned the establishment of merger and acquisition departments of investment banking and brokerage firms. Corporate America came under the scrutiny of financial brains. Dissecting financial performance of corporations through meticulous study of annual reports, financial statements, and corporate actions, analysts looked for corporations with nonproductive spending, including

overly generous employee benefits, large community contributions, and many personal prerequisites together with low funding of productive goods and services, including R&D, advertising, and capital equipment. If a liquid capital stash exists, it is all the better. Corporations fitting this description became targets for a corporate takeover. The market for corporate control made a difference in boardrooms. With every takeover, onlooking managers became increasingly aware that they too could be removed if the board judged that new management could make greater profits for the firm.

Subversion of the Market for Corporate Control

One could hardly expect managers to welcome hostile takeovers. They reacted defensively, charging that enemies of the public corporation were perpetrating a "financial rape" of the corporation's assets and an attack on professional managers. They argued that the takeover activists were short-term investors interested only in quick profits and not in the long-term health of the target corporation. They called the activists "raiders" and accused them of acting in their own interest, not in the interest of stockholders. Managers coalesced to portray themselves as the real saviors.

In late 1980s, the Business Roundtable, with the power of 200 chief executive officers of the largest United States corporations, took a leadership role to protect managers from stockholders (see Charron 1985b). Corporate managers formed The Coalition to Stop the Raid on Corporate America, organized in Washington, D.C., to lobby against corporate takeovers. In 1996, Silicon Valley managers formed TechNet, their own self-defense lobby. The word around corporate headquarters was "Vote with management!"

Many boards adopted poison pills, golden parachutes, and two-tiered stock arrangements. They participated in lobbying campaigns that succeeded in passing anti-takeover laws in a number of states. More than 35 states enacted such statutes as profit disgorgement, cash out, fair price, and freeze out: most of which are still on the books. Then, cutting to the quick, Pennsylvania enacted a statute that redefined the fiduciary duty of directors. It permitted directors to base business decisions on the interests of all the stakeholders, not primarily on the interests of stockholding owners. This permission reduced stockholder rights.

Pennsylvania's landmark move began a legal reconsideration of the nature of the firm throughout the land. By these acts, state legislatures empowered stakeholders and disempowered stockholders. Stockholder-rights proponents challenged the revisions in courts.

But, state supreme courts upheld the legality of the anti-stockholder measures: among them was the court of Delaware, home of 300,000 U.S. corporations. In the 1980s, managers subverted the market for corporate control and entrenched themselves.

Attempts at Reassertion of the Market for Corporate Control

To counteract the subversion, T. Boone Pickens, as chairman, and Ralph M. Whitworth, as president, formed the United Shareholders Association (USA), a nonprofit 50l(c)4 organization. Its purpose was to organize advocacy for stockholder rights, "to give shareholders a united voice at the public policy table backed up by a nationwide grassroots network . . . to stir a national debate of shareholder rights and corporate governance . . . to reform the proxy voting rules, giving shareholders a better opportunity to elect accountable boards and to influence major corporate policies" (Whitworth 1993: 2).

USA sought to establish for public corporations a one-stock one-vote standard, confidential corporate elections, independent tabulation of voting, and equal stockholder access to proxy statements. It called for unified minimum standards for state tender offers and for greater distribution of corporate wealth to stockholders. USA gained allies, including the SEC, the stock exchanges, institutional investors, investor research groups, and a few academics and politicians.

USA members took the battle to some of the largest corporations, including ITT, IBM, Occidental Petroleum, Time Warner, Polaroid, and others. In all, USA introduced 158 proposals at 70 companies, winning many resolution fights to reject poison pills, tie executive compensation to stock performance, and eliminate golden parachutes. It promoted the defeat of the Colorado anti-stockholder bill and successfully persuaded 86 Pennsylvania corporations to opt out of the state's anti-stockholder statute. On the national level, USA forced the withdrawal of a Senate anti-stockholder bill by convincing key legislators to add to it pro-stockholder amendments.

USA published research assessing the wealth effects of anti-takeover legislation. On the one hand, studies found that Indiana stockholders who sold their stock during the takeovers of the 1980s together received a net gain of $346 billion. Stockholders who bought such stock gained an estimated $50 billion. On the other hand, in Ohio, anti-stockholder legislation diminished earnings. After the enactment of management entrenchment legislation, the value of Ohio stockholders' shares decreased by 2 percent (Sidak and Woodward 1990).

USA established the "USA Shareholder 1000" that ranked U.S. corporations by their corporate governance performance (see Charron:

1996). It identified 50 corporations to lobby for stockholder-rights reforms. Its Annual Compensation Study created a pay-for-performance measure and encouraged compensation committees to add stock options to the package, with the belief that these purchase privileges would link the interests of the entrepreneurial manager with the wealth interests of stockholders.

Management Entrenchment

USA scored many gains, but the key success eluded it, namely, the goal of establishing stockholder rights in state law and in the boardroom. Protected by entrenchment, managers became increasingly assertive. Acting as their own best financial critics, they disciplined their corporations from within, eliminating unprofitable plants and divisions, exploiting the benefits of new technology, seeking more efficiency, demanding higher performance from their executives, and so on. Managers inspected operations to find new savings and new profit centers. Installing new information technology, they downsized, eliminating middle management and clerical personnel. They outsourced, bought out contracts, retired, and fired. Seeking higher profits, they cooperated in management-initiated mergers and management buyouts. Such activities resulted in high financial performance: profits rose, stock prices climbed, and investment soared. In effect, managers raided their own corporations. In so doing, they unlocked the value of their companies, but they put much of the gain in their own pockets. Management entrenchment gave them the impunity to do so.

It is an understatement to call contemporary compensation packages impressive. But if rewards are tied to stock performance, how can they be criticized? In too many cases, rewards are not tied to stock performance. In cases where they are, managers sometimes found ways to manipulate the stock performance and earnings. Thus, at the opening of the 21st century, many corporate executives scandalously enhanced the financial picture of their firms.

Such duplicity could have been detected if managers had been monitored adequately. It is difficult not to conclude that the managers were directing the directors. They were also compromising the hired professionals: corporate lawyers, accountants, and financial analysts. But even if the professionals were monitoring well, their duties extend only to the legality, proper accountancy, and soundness of financial judgments. Disciplining management is outside of their authority. In sum, the subversion of the market for corporate control corrupted some monitors and emasculated others. Without effective monitors, managers were free to plunder.

Battle Outside the Corporation

The inside battle gave outside revisionists an opportunity to increase their control of the firm. Outside revisionists are social activists and academics in the business schools, social science and humanities departments of many universities. These revisionists think that corporate law reflects an incorrect view of the nature of the firm. To correct the view, they employ theory, specifically, the theory of the firm.

Early Theories of the Firm

R. H. Coase's 1937 article "The Nature of the Firm" provides an economic theory that gives a nonrevisionist description of the firm and a causal explanation of its emergence. On this account, the firm emerges from the economically rational choices of business decisionmakers who seek to escape the transaction costs of the price system. Rather than hiring each laborer with a new contract for each day, a worker is brought into a matrix as an employee under the conditions of a long-term contract. The matrix is what we know as the firm. As Coase (1937: 393) describes it, "a firm consists of the system of relations [contracts] which comes into existence when the direction of resources is dependent on an entrepreneur, [who is] the person or persons who, in a competitive system, takes the place of the price mechanism in the direction of resources." The firm, then, is a closed market where factors are exchanged to maximize profits.

Adolf Berle and Gardiner Means's popular and influential theory of the firm focused on governance. In *The Modern Corporation and Private Property*, Berle and Means noted that ownership and control were thoroughly separated in the corporations of the 1930s. They predicted that the separation would create a "corporate oligarchy with the probability of an era of corporate plundering," with managers dipping into the corporate treasury. Such an eventuality would mark "the explosion of the atom of private property" (Berle and Means 1932: 8).

The corporation that Berle and Means were discussing is the one defined in corporate law that recognizes managers as agents of principals, not as self-interested controllers to operate the corporation for their own gain. The stockholders, through the directors, are to set policy and to vote on the material issues of the firm. As Berle and Means saw it, in surrendering to managers "control and responsibility" for the corporation, stockholders have relinquished their ownership rights. In so doing, they "released the community from the

obligation to protect them to the full extent implied in the doctrine of strict property rights" (1932: 355).

But, for Berle and Means, *out-with-the-stockholders* did not mean *in-with-the-managers*. They predicted a different result—the surrender of the corporation to the political control of society at large.

> Eliminating the sole interest of the passive owner, however, does not necessarily lay a basis for the alternative claim that the new powers should be used in the interest of the controlling groups [the managers]. The latter have not presented, in act or word, an acceptable defense of the proposition that these powers should be so used. No tradition supports that proposition. The control groups have, rather, cleared the way for the claims of a group far wider than either the owners or the controllers. They have placed the community in a position to demand that the modern corporation serve not alone the owners or the controllers but all society [Berle and Means 1932: 355].

The divergence of manager and stockholder interests called for explanation. Armen Alchian's 1965 article, "The Basis of Some Recent Advances in the Theory of Management of the Firm," answered with the utility theory explanation of corporate behavior. Utility theory understands each individual as a rational agent who is expected to act in a manner to maximize his own well-being. With respect to owners and managers, potential for conflict of interests exists in the expected ways. When managers' interests are consistent with maximizing profits, they will also promote the interests of stockholders, who are presumed to prefer a maximum return on their investments. But, on the job, managers sometimes prefer "pretty secretaries, thick rugs, friendly colleagues, leisurely workloads, executive washrooms, larger support staff, relaxed personnel policies involving job security, time off for statesmanlike community activities, gifts of company funds to colleges, out-of town hotel suites, racial and religious discrimination in personnel policy, etc." (Alchian 1965: 34), all of which cost a bit more. The "bit more" comes out of stockholders' potential returns. In these cases, the interests (utilities) of managers and stockholder diverge.

Alchian (1965: 41) assessed that the utility maximization theory of individual behavior would challenge the "conventional, individual private property system," prompting demands for "changes in ownership structures" and "different *types* of corporations." Also, it would involve changes in the perception of corporate obligations. His prophecies were fulfilled with the emergence of the stakeholder theory of the firm.

Stakeholder Theory of the Firm

Corporate revisionists throughout the world have converged to advance the stakeholder theory of the firm. The theory is now in its third stage.

During its first stage, from the 1960s through early 1980s, corporate revisionists set the stakeholder theory agenda. The messages of that period critiqued the idea of corporate profits, rejected stockholder ownership, and advanced the idea of the firm as a "social institution." The first corporate revisionists were the academics in sociology, business ethics, and organizational and managerial "sciences." They developed theories of collective responsibility calling the corporation a moral agent and fit subject for punishment. To them, firms are the productive arm of society, with the obligation of providing society's needs. They spoke of "corporate social responsibility" and required "social audits" to justify the firm's behavior (Charron 1985a: 2–16). They argued that corporations owe their protection to society and, therefore, should "serve public or social purposes."

> Today it is absurd to regard the corporation simply as an enterprise established for the sole purpose of allowing profit making. We the citizens give them special rights, power, and privileges, protection, and benefits on the understanding that their activities will fulfill our purposes. Corporations exist only as they continue to benefit us. . . . Every corporation should be thought of as a social enterprise whose existence and decisions can be justified only insofar as they serve public or social purposes [Dahl 1975: 17].

Moved by these ideas in the early 1970s, business ethics professors embraced stakeholder theory. Their professional presentations and writings chided managers for placing stockholder over stakeholder interests, depicted managers and stockholders as motivated primarily by greed and selfishness, and accused business of perpetuating the master-slave relationship (see Bowie and Freeman 1992: 3–22).

In the second stage of stakeholder theory, from the late 1980s to 2000, outside corporate revisionists increased their ranks by the addition of two groups of allies: several influential theory-of-the-firm economists and self-protecting corporate managers who thought the time propitious to dethrone the stockholder. Corporate managers began to see wisdom in stakeholder theory after understanding the mantra that stockholders are simply one set of stakeholders among many. Such a message was particularly meaningful to corporate managers who were defending themselves against stockholder-rights activists.

As stakeholder theorists and corporate managers solidified their

friendship, they formed a mutual support society. Managers recognized stakeholders as the dominate category and stockholders as only one set of stakeholders. In return, stakeholder theorists softened their criticism of management, silenced their charge that the goal of profits reflects only greed, and cloaked their insistence that the corporation be converted into a social institution. They accepted wealth production as the primary purpose of the corporation. However, stakeholder theorists continued to reject the stockholder as the owner of the firm with rights of control. For them, no stakeholder group is to receive preferential treatment.

Stakeholder theory gained credibility from an influential group of theory-of-the-firm economists. Despite their awareness of the problems of rent seeking and free riding, these economists advanced stakeholder theory by presenting stockholders simply as investors. Marrying the thoughts of Coase and Alchian, the theory-of-the-firm economists treated stockholders as contracting utility maximizing agents but not as owners of the firm. They proposed "agency theories" (not to be confused with agency law) and "contract theories" that removed from stockholders the ownership of control rights entailed by private property.

The economists become metaphysicians when they argue that the firm is not the kind of thing that can be owned. It is but a logical fiction. In reality, the term "firm" refers to a nexus of contracts, not to a substantive thing. "There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and consumers of output" (Jensen and Meckling 1976: 311). This line of thinking moves in the direction of changing the ownership structure, as Alchian had predicted and as several theory-of-the-firm economists urged. These economists give expression to the new idea.

> Instead of thinking of shareholders as joint owners, we can think of them as investors, like bondholders [Alchian and Demsetz 1972: 789].
>
> Dispelling the tenacious notion that the firm is owned by its security holders is important because it is a first step toward understanding that control over a firm's decisions is not necessarily the province of security holders [Fama 1980: 289].
>
> The shareholder as an owner of property rights in the decision-making of the firm is an anachronism at this time. The long-term interests of the corporation are more likely to be vested *de facto*, but not legally, with the managers, workers, suppliers, customers, and the community of the firm [Kaplan 1983: 343].

Such sentiments demonstrate a consensus among prominent scholars to relegate stockholders to the position of investing stakeholders who are but one among many owners of various kinds of inputs to the firm. Inputs to the firm come from employees, customers, suppliers, investors, and the local community. The respective contributions that each is said to bring to the firm are human resources, revenues, goods and materials, and capital. In return for these inputs, the corporation is said to have a responsibility to the members of each contracting group. The corporation's duty is to provide employees with acceptable wages, working conditions, and benefits (day care, career consulting, substance abuse consulting, sick days, and the like); to provide customers with quality goods and necessities at appropriate prices with appropriate warranties; to provide investors with an acceptable return on their investments; and to provide the community with financial support in terms of taxes, gifts, jobs, environmental and natural resource protection, and other public goods.

In stakeholder literature, stockholders are typically introduced as investors. When mentioned as a distinct group, they are said to be owed the firm's "residual" earnings, that is, earnings "net of payments to other inputs" (Alchian and Demsetz 1972: 782).

Managers are to "adjudicate" among the various interests of the participating rational agents. The resulting structure of the firm will be "the equilibrium behavior of a complex contractual system made up of maximizing agents [stakeholders] with diverse and conflicting objectives" (Jensen 1983: 327). This weak organizational structure encourages rent seeking and permits managers to self-deal by rewarding those groups who behave in a manner to enhance the managers' benefits.

Redefining the Corporation

Between 1995 and 2000, corporate revisionists sought to establish the claims of stakeholders. The major vehicle was the international conference, "Redefining the Corporation," funded by the Alfred P. Sloan Foundation. The colloquy assembled more than 100 scholars, representing 15 countries, to focus on "The Corporation and Its Stakeholders." The participants—mostly professors of business ethics, HR business executives, public policy consultants, accountants, and lawyers—convened "to increase the amount and improve the quality of scholarly and managerial attention devoted to consideration and analysis of the nature, purpose, and governance of corporations" (Clarkson 2002).

The colloquy's "Consensus Statement" asserts that the purpose of

business is to create wealth. All participants, "intentionally or consequentially," assist in the wealth creation by bearing burdens and taking risks. Therefore, all participants are stakeholders and should get a "balanced share" of the riches created by the joint endeavor (Clarkson 2002: 1). The statement supports seven principles, known as the "Clarkson Principles" (Jonge 2006), for guiding management in its corporate governance. According to the principles, managers "*should*" do the following:

- Monitor and respond to concerns and interests of all legitimate stakeholders.
- Communicate with stakeholders about their concerns, contributions, and risks.
- Act with sensitivity to each stakeholder group.
- Attempt to achieve a fair distribution of benefits and burdens.
- "Insure" that risks are minimized and harms are compensated.
- Never jeopardize "inalienable human rights" or deceive concerning risks.
- Deal with the conflicts of its self-interest and the interest of stakeholders through public institutions, public reports, incentive systems, and third-party review.

The use of the word "should" shows these principles to be imperatives. However, they are not simply technical recommendations advising managers on what to do in order to be successful. They are categorical imperatives stating moral obligations. Managers who do not observe these mandates are immoral. The "shoulds" form the core of "stakeholder management," the style business educators increasingly prefer for the next generation of corporate managers. Revisionists hope for a stakeholder era without private ownership.

By the end of its second stage, stakeholder theory gained considerable acceptance. Revisionists unified around a mission, a message, and a course of action.

In the contemporary third stage of stakeholder theory, corporate revisionists are launching a campaign to bring the law of the land, the mind of the university, and the spirit of society closer to their way of thinking. The campaign is global, as shown by the extensive "Value-Based Management" website mastered by European corporate consultant Jaap de Jonge. The website promotes the ideas of "Redefining the Corporation," which Jonge (2006) uses to criticize the highly successful and paradigm-altering *financial* strategy known as Value-Based Management (VBM).

Financial VBM is a stockholder-rights management strategy developed in 1986 by Alfred Rappaport, then finance professor at

Northwestern University. It is an intricate and innovative program for stockholder wealth maximization focusing on free cash flows rather than accounting earnings. In VBM, "value" means "financial value." It translates as stockholder wealth. VBM recognizes the importance of stakeholders and agrees that the best method for increasing wealth for stakeholders is to maximize wealth for stockholders. "Shareholder [stockholder] value orientation builds a more attractive company not only for investors, but for employees, customers, and other stakeholders" (Rappaport 1986: 163).

Conflating the stakeholder theory's moral with VBM's technical sense of the term "value," Jonge (2006) proposes a s*takeholder* VBM to replace s*tockholder* VBM. In Jonge's construal the two views are radically incompatible, and stockholder VBM is on the wrong side of every issue. Under stockholder control, the firm is interested only in profits. It uses people as instruments. It is socially irresponsible. It cares only for the wealth and not the health of society. It is selfish and neglects to pursue joint interests and build trust with stakeholders. The charge of stockholder immorality is barely veiled, and it echoes accusations made during the formative years of stakeholder theory. The voice of Lisa Newton returns:

> We might be in agreement that greed is immoral and an unworthy motive for humans, destructive to the character of the citizens and therefore dangerous for the commonwealth; we might agree, therefore, that it should not be encouraged or even sanctioned as a motive for industry. . . . [I]t is morally outrageous that the truly greedy should inherit the earth, its resources, and all the human effort that is needed to transform those resources into marketable goods and services" [Newton 1992: 102].

Few stakeholder theorists understand entrepreneurism and few are able to distinguish it from greed.

Criticism of Stakeholder Theory

Replete with false dichotomies, exaggerations, and baseless claims, stakeholder theory lacks the precision and clarity expected of a good theory. "Stakeholder," the core concept, is indeterminate. Its definition as anyone who "intentionally or consequentially" participates in the corporation by experiencing effects of corporate activity makes all current and future humans participants. This criterion is so broad as to nullify the scope of responsibility. Requiring managers to respond simultaneously to the concerns of members of such a wide population assumes managers have knowledge, control, and power beyond what can be expected or demanded. Managers are finite beings with

human constraints who can achieve only what is possible. Not all ideals are co-possible: nor are all the Clarkson Principles co-achievable.

It is a fact of life that moral values often conflict; and when they do, it is not clear where moral obligation sits. The "shoulds" of the Clarkson Principles propose prima facie ideals shared by persons of sensitivity, but ideals alone do not ground moral obligation. When true moral conflicts emerge, moral agents must resolve the conflict by assessing which moral claim has priority. Jonge tries to make the case that stockholders and stakeholders have conflicting moral values and therefore the conflict must be resolved in the favor of one or another. However, his comparison is specious. Proponents of stockholder and stakeholder models are not concerned with the same questions. As noted, technical imperatives are not necessarily moral imperatives. Clearly understood and unambiguous moral imperatives are constraints on technical imperatives. The stockholder model is dealing with the technical issues of financial and economic value—how to succeed in business and the marketplace, consistent with ethical principles. The stakeholder model is dealing with moral issues as they see them. The conflict that exists between the stockholder and stakeholder perspectives is a conflict between proponents of individual responsibility and proponents of socialized responsibility.

On the scientific side, stakeholder theory is defective in lacking empirical foundation. It is often presented as a rigorous explanation of the nature and operation of the firm on a par with the theories of Coase, Berle and Means, and Alchian. But the theory cannot explain how capital, creativity, and energy come together to bring forth new firms. Stakeholders do not create firms; entrepreneurs do. Yet entrepreneurs are not recognized among the stakeholders of the firm, nor are alternatives suggested.

Stakeholder theory also fails to explain what is required for the survival of a firm, whatever its genesis. Neither the Clarkson Principles nor the principle of balanced distribution gives clear guidance for behavior to sustain the firm: the former being too inclusive, the latter being too vague. Stakeholder theory relies on managers to provide the balanced distribution by adjudicating "among maximizing agents with diverse and conflicting objectives." Such an arrangement governing maximizing agents with conflicting objectives is inherently unstable. It is fraught with power struggles and massive rent seeking. Groups compete as the members of each group have an incentive to expend resources to gain a larger share of corporate wealth. The energy and resources each group invests in the wealth seeking reduces the amount of activity available for wealth production. The damaging effect is magnified by the fact that most of the rent seekers

are members of the middle class, the group that traditionally drives economic expansion by their motivation to improve their lot (Olson 1986: 62). As to be expected, rent seeking will dissipate corporate wealth, resulting in losses for everyone.

Stakeholder theory fails descriptively as well. In its characterization of the input owners, the theory claims that all input owners are commensurable and homogeneous. Members of various stakeholder groups are equal in contracting with the firm to exchange their input for a return. The firm purchases title to the input, transforming it to the property of the firm. However, stockholders do not exchange an input for a return. The title actually travels in the opposite direction. The stockholder receives a certificate of private ownership, establishing a right to returns in perpetuity. The firm is acknowledged as a trustee of the stockholder's private property. The firm is the buyer/owner/beneficiary/consumer of the other inputs. A key difference between stockholders and other stakeholders is that stockholders have a relationship with the firm that the firm cannot terminate unilaterally.

The situation is not resolved by reducing stockholders to investors, for stockholding investors are different from nonowning investors. In general, investors have a priority claim on the assets of the firm, and they are a part of the firm only until their investing instrument matures. At maturity of the instrument, the relationship terminates. But, such is not the case with stockholders. The relationship with stockholders continues for the life of the company or until the stockholder terminates it. Common stockholders are free to dispose of their stock as they see fit, but the firm has no right to dispose of the stockholder as it sees fit. The concept of stakeholder equality is difficult to maintain in the face of these facts.

A recent version of the theory has the additional weakness of unwarranted inferences. In *Redefining the Corporation,* a publication emerging from the colloquy of the same name, James Post, Lee Preston, and Sybille Sachs (2002: 5) argue, "The nature of the corporation should be discovered through observation of its characteristics and behaviors, rather than through abstract legal, economic, or philosophical reasoning." Adopting the "maxim" that "Corporations ARE what they DO" (p. 2), the trio conducted field studies of three firms that were judged to have been managed according to stakeholder theory. The researchers cite observations to justify the rejection of the shareholder theory: "The notion that shareowner interests should dominate those of all other corporate constituents is inconsistent with the observed behavior of successful firms. Therefore, the

conventional shareowner dominant model of the corporation is unrealistic, as well as normatively unacceptable" (p. 11).

Although it is acceptable for a thing to be what it does, what a thing does has no decisive bearing on what a thing should be or what it should do. Taken by themselves, empirical observations have no implications about "shoulds." To justify a movement from what *is* the case to what *should* be the case, the observations need to be embedded in a coherent value system that can withstand criticism.

Corporate revisionists seeking to redefine the corporation misconceive or misrepresent what they are doing. They are not engaged in an empirical enterprise to uncover the underlying nature of the firm. They already know what they want the firm to be. Efforts like those of Post, Preston, and Sachs do not generate scientifically based conclusions. They only generate persuasive definitions, definitions that in fact do not define what things are. Persuasive definitions are value statements presented under the guise of scientifically discovered definitions of the true nature of a thing. To the extent that they are definitions at all, persuasive definitions are stipulative definitions constructed to impose upon others the persuader's values. As such, they are evaluative appeals to induce others to approve of the new order of things championed by the definers. Corporate revisionists, intentionally or unintentionally, claim theoretical superiority to support a campaign to promote the widespread adoption of the stakeholder agenda for the firm.

The battle for control of the corporation is not one of theory but one of practical consequences. Would a firm organized on stakeholder principles surpass an alternative in bringing greater gains for most, while not violating the basic rights of each? Stakeholder theorists say "yes" and provide inadequate evidence. Stockholder theorists say "no" and provide compelling evidence. Transforming the ownership of the firm from stockholders to all the stakeholders would move the firm from the realm of private property to that of common property. Under this arrangement, stakeholders, as well as stockholders, would stand to lose significantly. The logics of private and common properties show why.

The Corporation and Private Property

A corporate economy organized on stakeholder principles would lack the special ownership rights that direct gains from efforts back to owners. Historically, ownership rights, including rights to control and to receive a return on investment, have been the force motivating individuals to assume the risk of forming and sustaining a firm.

Private property ownership rights are the exclusive rights of separate owners to use or transfer their goods, and only their goods, as they judge fit. Rights of private property motivate owners to engage in creative and efficient use of their goods because the exclusivity guarantees the return to the owner not only the costs but also the benefits of development, consumption, and transfer. Productivity is self-rewarding; inefficiency is self-defeating.

In contrast, property held in common has the nature of a public good—that is, a good available for use by any member of a relevant public. Restricting use of a public good is either illegal or excessively costly. Since everyone can use the good, no one person feels responsible for its care. Individuals are disinclined to expend efforts in situations where most benefits are spread among many. In the logic of common property, the benefits of maintenance and production and the costs of individual consumption are socialized among the members of the group. In effect, the benefits and costs fall outside of the control of individual producers or users. In such a situation, individuals have little or no incentive to produce or care for goods. Consequently, such property is typically used inefficiently and unproductively. The result is that common, public property enters a spiral of deterioration known as the tragedy of the commons. In the tragedy, the rational behavior is to free ride on the production of others. Free riding is self-rewarding, and therefore self-reinforcing.

Aristotle was correct. Private ownership of property optimizes benefits for society. It reduces resentment and quarrels and increases care, productivity, generosity, and gratitude (*Politics,* Bk. II.5, 1263a–64). A clearly defined and enforced system of private property rights ensures that actors not only bear the costs but also reap the benefits of their efforts. When legal protections are in place, individuals will act in productive manners, since the benefits of production return to them individually. Such guarantees minimize parasitic behavior of free riders and rent seekers and motivate individuals to productive behavior. Given this logic of private property, the privately owned corporation can be expected to outperform the commonly owned one. The stockholder-based corporation will outperform the stakeholder-based one.

Understanding the logic of property is central in settling the argument between the traditional view of the firm and the contending stakeholder view. In the traditional firm, business law sets rights and privileges for individuals. The logic of private property holds sway in the market. In seeking to redefine the corporation so that stakeholders may control it, corporate revisionists seek to place the corporation

under some form of public control where the logic of the commons holds sway.

That the logic of private property is at work in shareholder-owned firms and the logic of common property in stakeholder-owned firms is well established in the literature. Research from the Harvard Business School and Wharton School of Economics shows that "firms with stronger shareholder rights had higher firm values, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions" than did firms with weaker shareholder rights (Gompers, Ishii, and Metrick 2003).

Stakeholder theory must be rejected on the basis of replicated research confirming the underperformance of commonly held companies, the logic of incentives engendered by privately owned versus publicly owned property, and the massive data of history recording the failure of every secular commune ever attempted, inadequate public support for public television and radio programming, extinction of the buffalo and overharvesting of whales, and even the failure of the Soviet planned economy. It must be rejected, not only as a theory, but also as a model for organizing the firm. It is a structure that is likely to diminish the productivity of the firm and, thereby, likely to destroy it.

Upholding Private Property

Reinforcing the institution of private property is the surest curb on corporate revisionism. The United Shareholders Association took the lead. By creating public awareness of the revisionists' threats to stockholders as private property owners, USA sounded an alarm. The result is that stockholder rights are more strongly enforced today than they had been for decades. Institutional investors, such as TIAA-CREF, CalPERS, and union pension funds, are leading the current discussion of corporate governance. With concentrated ownership in many corporations, institutional investors are careful monitors of management. Their excellent stewardship is acknowledged: judges of the Delaware Court of Chancery "have been putting their faith in the sophistication of institutional investors, the importance of independent directors and the stockholder vote" (*The Economist* 2002: 61).

Sarbanes-Oxley, although vastly regulating, incorporates many valuable reforms to enhance monitoring for stockholders. In adopting changes suggested by the SEC, the New York Stock Exchange, and NASDAQ, Sarbanes-Oxley increases the powers and responsibilities of the boards of directors; requires more independent directors; eliminates some conflict-of-interest practices of directors, officers,

and consultants; strengthens timely disclosure rules; and defines corporate criminal behavior.

However, Sarbanes-Oxley imposes excessive costs, as typical of political solutions of market issues. Also, it engendered significant losses: many foreign companies will no longer list on U.S. exchanges; several public companies have been taken private by owners or private equity firms; undoubtedly, some new corporations will decline to go public. More seriously, under the specter of Sarbanes-Oxley, the price-earnings ratio has declined. These results indicate that the reforms have come at a high price. Time will tell if stockholder-generated efficiencies can restore the high performance of the firm.

Sarbanes-Oxley would not have been needed had the market for corporation control been unhampered. Corporate revisionists entrenched management, and management had its way. It was not just greed that moved the Enrons to "plunder the corporate treasury." They did it because they could. They were well-entrenched by board resolutions and state anti-shareholder statutes. The monitors failed the stockholders because they were co-opted, minimized, or deceived by managers. USA's attempt to protect shareholder rights was derailed by management entrenchment and corporate revisionism.

Conclusion

Like all human institutions, the corporation is flawed and vulnerable, but it is not yet a failed institution. However, "Redefining the Corporation" is a rallying cry, and it makes no idle threat. Stakeholder theory demeans the publicly traded, private corporation, and it engenders activism for radical revision. The media give space and time to the stakeholder message. In the university, stakeholder theory dominates the business school curriculum and the business ethics center agenda. Business organizations such as the Conference Board and the Business Roundtable uphold the stakeholder side. Corporate managers, business ethics professors, management science professors, and others commingle at conferences and consulting sessions. Many corporations fund business ethics centers of the stakeholder persuasion, as does the Business Roundtable itself. From these ranks, academics, politicians, reporters, social activists, and business executives have formed a united attack on stockholder private property rights. As of now, the stakeholder versus stockholder debate is one-sided, with stakeholder theory leading the discussion.

Stakeholder theory has not yet met with adequate criticism. In agreement with Rappaport, VBM consultants proclaim "clear

unanimity with regard to the various stakeholder groups. All agree that the interests of all stakeholder groups are best served when putting the shareholder first" (Ameels, Bruggeman, and Scheipers 2002: 18–73). But VBM consultants are not taking their message to the media, management, or business ethics professors: neither are the institutional investors nor the corporate directors. This needs to change.

In confronting stakeholder theory intellectually, corporate supporters need to address its inadequate theoretical foundations, rent-seeking motives, and ultimately destructive consequences. They need to expose stakeholder theory as a campaign of moral politics to gain control of the corporation. And they need to educate corporate directors in the basics of the theory to protect them from its moralistic claims.

Under no circumstances does rejecting stakeholder theory strip stakeholders of their rights. Morality is a universal constraint on the behavior of individuals without and within all organizations, including the corporation. As human beings and as leaders of corporations, stockholders, directors, and corporate officers are obligated to uphold moral principles and to proscribe force or fraud in their decisionmaking. Corporate leaders address stakeholder rights daily in treating employees well, producing quality goods in different price ranges, paying bills, being good corporate citizens by providing jobs, paying taxes, making charitable gifts that contribute to its well-being, and running their corporations in manners to increase its operating capital and free cash flows.

Stakeholder theory must be properly placed as an instruction to human resource policy. Once stakeholder theory is properly placed, corporate America then must confront itself. To restore confidence in the institution of the firm, management must be disentrenched and the market for corporate control reinstated. Corporations should take it upon themselves to eliminate poison pills, golden parachutes, and excessive compensation packages. Corporate managers should adopt financial VBM practices and join with stockholder-rights organizations to seek repeal of the state and federal laws that permit stakeholder interest to trump stockholder interest. Also to be repealed are cash out, freeze out, fair price, profit disgorgement, and other anti-stockholder legislation. Powerful business forces must join together to reestablish private property rights as the legal grounding of corporate America. Until corporate revisionists are countered, the private, publicly owned corporation is in danger.

The corporate form has been time-tested. Its weaknesses and strengths are increasingly understood. The challenge is to eliminate the weaknesses without sapping the strengths. What the private,

publicly traded corporation has done for the United States and Western civilization, it is doing for the world. We owe it to humanity to come to its aid.

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