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

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The concept of a stakeholder is one of the more prominent contributions of recent business ethics. Since the introduction of this concept by R. Edward Freemen in *Strategic Management: A Stakeholder Approach* (1984), a concern for the interests of all stakeholder groups has become a widely recognized feature, if not the defining feature, of ethical management.

Although the stakeholder concept has been developed in various ways (Donaldson and Preston, 1995; Jones and Wicks, 1999), it has been expressed most often in the moral prescription that managers, in making decisions, ought to consider the interests of all stakeholders. The list of stakeholders is commonly taken to include employees, customers, suppliers, and the community, as well as shareholders and other investors.[1] This obligation to serve all stakeholder interests, which is often called "stakeholder management (Post, Preston, and Sachs, 2002; Bowie, 2004), is generally contrasted with the standard form of corporate governance, in which shareholder interests are primary. This latter view—which might be called "stockholder management"—is regarded by advocates of stakeholder management as morally unjustified.[2] To focus attention on only one

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[1]On the problem of identifying stakeholders, see Mitchell, Agle, and Wood, 1997.

[2]Donaldson and Preston, for example, reject what they call "The management serving the shareholders" model because it violates the principle that the "interest of all stakeholders are of intrinsic value," which is to say that each group "merits consideration for its own sake" (Donaldson and Preston, 1995: 67).

stakeholder, they allege, is to ignore other important groups whose interests a business organization ought to serve.

Advocates of stakeholder management get one point right: the modern for-profit corporation should serve the interests of all stakeholder groups. On this point, however, there is no conflict with the argument for the current system of corporate governance. Where stakeholder management goes wrong is in failing to recognize that a business organization in which managers act in the interest of the shareholders can also be one that, at the same time, benefits all stakeholder groups. This failure is due to a second mistake on the part of those who advocate stakeholder management. It is the simple fallacy of passing from the true premise that corporations ought to serve the interests of every stakeholder group to the false conclusion that this is a task for management. Stakeholder management assumes that management decision making is the main means by which the benefits of corporate wealth creation are distributed among stakeholders, but these benefits can also be obtained by groups interacting with a corporation in other ways, most notably through the market. Insofar as the market is able to provide the desired benefits to the various stakeholder groups, they have no need for management to explicitly consider their interests in making decisions.

At bottom, the dispute between stockholder and stakeholder management revolves around the question of how best to enable each stakeholder group or corporate constituency to benefit from the wealth-creating activity of business.[3] Stakeholder management goes wrong by (1) failing to appreciate the extent to which the prevailing system of corporate governance, marked by shareholder primacy, serves the interests of all stakeholders, and (2) assuming that all stakeholder interests are best served by making this the task of management rather than using other means. Stakeholder management is right, however, to

[3]This point is developed more fully in Boatright, 2002a.

stress the moral requirement that every stakeholder group benefit from corporate activity and to make managers aware of their responsibility to create wealth for the benefit of everyone.

Two Forms of Stakeholder Management

It is important at the outset to distinguish two forms of stakeholder management. The main point of difference is whether stakeholder management is incompatible with and an alternative to the prevailing form of corporate governance, or whether it is a managerial guide that can be followed within corporations as they are currently legally structured.

First, it is a simple fact that a corporation has stakeholders in the sense of "groups who can affect, or who are affected by, the activities of the firm" (Freeman, 1984). And any successful corporation must manage its relations with all stakeholder groups, if for no other reason than to benefit the shareholders. To manage stakeholder relations is not necessarily to serve each group's interest (although this might be the effect), but to consider their interests sufficiently to gain their cooperation. The manager's role is not merely to coordinate the contribution of the various stakeholders, but to inspire them to put forth their best efforts in a joint effort to create valuable products and services. Any firm that neglects its stakeholders or, worse, alienates them is doomed to failure.

Second, managers also have obligations to treat each stakeholder group in accord with accepted ethical standards. These obligations include not only those that are owed to everyone, such as honesty and respect, but also the obligations to abide by agreements or contracts made with a firm. In most countries, basic moral obligations concerning the treatment of employees, customers, and other parties as well as agreements and contracts are codified in laws that constitute the legal framework of business. Treating all stakeholders ethically is a requirement of any form of business organization, although differences may exist about what ethics requires.

This version of stakeholder management, which is roughly what Donaldson and Preston (1995) call instrumental, does not constitute a system of corporate governance. Another form of stakeholder management, however, goes beyond the necessity of managing stakeholder relations and the obligations that are owed to stakeholder groups to the question of how stakeholder interests ought to be considered. Indeed, most advocates of stakeholder management hold that stakeholder interests should be central to the operation of a corporation in much the same way that shareholder interests dominate in the conventional shareholder-controlled firm (Freeman and Reed, 1983). In general, they contend that in making key decisions, managers ought to consider all interests—those of shareholders and non-shareholders alike—and balance them in some way (Evan and Freeman, 1993).[4]

This form of stakeholder management, which corresponds more or less to Donaldson and Preston's normative stakeholder theory, does have implications for corporate governance. More specifically, the prevailing system of corporate governance may be expressed in three related propositions: (1) that shareholders ought to have control; (2) that managers have a fiduciary duty to serve shareholder interests alone; and (3) that the objective of the firm ought to be the maximization of shareholder wealth. The main theses of stakeholder management can then be stated by modifying each of these propositions as follows: (1) all stakeholders have a right to participate in 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.

The issues in these two sets of propositions—who has control or the right to make decisions, who is the beneficiary of management's fiduciary duty, and whose interests ought to be the objective of a

[4]For a criticism of the possibility of balancing, see Marcoux, 2000.

firm—are at heart of corporate governance. Consequently, stockholder management and this form of stakeholder management constitute two competing models of how corporations ought to be governed. Stakeholder management goes wrong when it is developed as an alternative system of corporate governance. As a prescription for corporate governance, stakeholder management not only is inferior to the prevailing system but involves several crucial mistakes. Stakeholder management as a guide for managers, on the other hand, contains much that is helpful to managers and constitutes a valuable corrective to some common misunderstandings of the argument for stockholder management.

An Economic Approach to Corporate Governance

The prevailing stockholder model of corporate governance is founded on an economic approach that conceives a firm as a nexus of contracts between a legal entity called the firm and its various constituencies, which include employees, customers, suppliers, investors, and other groups (Coase, 1937; Alchian and Demsetz, 1972; Williamson, 1975, 1984; Jensen and Meckling, 1976). This approach begins with the assumptions that in a market, all individuals with economic assets—such as employees with skills, suppliers with raw materials, customers and investors with money, and so on—would trade with each other in order to obtain a greater return, and that the greatest return will often be obtained by combining individual assets in joint production. That is, individuals will frequently realize a greater economic return by cooperating with others in productive activity than by participating in a market alone.

The Purpose of a Firm

In a seminal article "The Theory of the Firm" (Coase, 1937), Ronald Coase noted that cooperative productive activity could take place entirely in a market. So, he asked, why do firms exist? The answer lies in the costs that would be incurred by individuals in coordinating joint or cooperative production in a market. The transaction costs of making and enforcing all the contractual agreements that would be required are substantial. These costs could be reduced by creating firms in which hierarchical authority relations replace the market as the means for coordinating joint productive activity. Thus, for Coase, markets and hierarchies constitute two fundamentally different means for conducting productive activity. The former operates by exchange, the latter by direct control.[5]

As individuals contribute their assets to joint production, they will voluntarily form firms because doing so brings a greater return insofar as conducting business in a firm rather than a market reduces costs. That is, the transaction costs of organizing productive activity entirely in a market can be reduced by bringing some of this activity into a hierarchical organization, and this reduction in costs will enable each participant to realize a greater return on the assets that are contributed to joint production. Because of this greater return, individuals with assets would voluntarily agree to contribute their assets to production in a firm.

On this theory, then, the purpose of a firm is to enable individuals with economic assets to realize the full benefits of joint production.[6] Every stakeholder group benefits from production in a

[5]Alchian and Demsetz (1972) argue that control in a firm does not differ "in the slightest degree from ordinary market contracting between any two people." For example, an employer has no more control over an employee than it has over its customers, who can "fire" the firm by ceasing to do business with it. What distinguishes a firm for Alchian and Demsetz is that it stands at the center of all the contractual agreements by which the various parties engage in joint production.

[6]The term "purpose" is used here in the sense of the function served by organizing economic activity in firms. Like a market, a firm can be said to have no purpose of its own but to be an organizational form that allows individuals to carry out what purposes or goals they have. Thus, a firm enables workers to earn a wage, customers to obtain goods, and investors to gain a return. In addition, a

firm. Employees, suppliers, and investors gain by the opportunity to contribute their assets—labor, materials, and capital respectively—in a lower-cost form of production that brings a corresponding higher return. Customers benefit by being able to purchase abundant, low-priced goods, and society as a whole is enriched by the wealth creation firms make possible. Although some of these benefits can be obtained in a market, there is an additional gain or return from deploying assets in a hierarchical form of production. It is this additional gain that a firm provides, and realizing this gain constitutes the reason why it is formed.

A firm serves the interests of all participants in much the way a market does. A market is a device that enables everyone to advance their interests by making mutually advantageous trades. Similarly, a firm enables those with assets to engage in joint production and thereby realize a greater gain than they could make alone in a market. Although market outcomes benefit everyone, no one has the task of ensuring these outcomes. So, too, in a firm. Managers, for the most part, are economic actors like employees, customers, and other stakeholders. Their particular role is to provide managerial or decision-making skills. In so doing, they act like other market participants, making agreements and keeping their word, in a cooperative productive activity that benefits everyone.

The Role of Governance

A firm requires many inputs. Economists classify these as land, labor, and capital, although they also recognize the need for managerial

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corporation is generally formed to carry on some economic activity, such as making automobiles, which may also be said to be its purpose. Different groups may participate in a firm, as in a market, for different ends, and they may or may not share an interest in the activity for which a firm is organized. That is, a person may work for the Ford Motor Company merely to earn a wage and not share the purpose of the firm to make cars.

expertise to coordinate these inputs. Traditional stakeholder groups interact with a business organization or firm as input providers—employees providing labor, suppliers providing raw materials, and so on. Each input brings a return such as employees' wages, suppliers' payments, and investors' interest and dividends. It is necessary in a firm for each input provider to secure their return, that is, to employ some means for ensuring that wages are paid, supplier payments are made, and so on. Generally, this security can be obtained by contracts or legal rules that obligate a firm to provide the return due to each corporate constituency.

Governance can be understood as the contractual agreements and legal rules that secure each input provider's claim for the return due on that input provider's contribution to the productive activity of a firm (Williamson, 1985). Accordingly, every asset contributed to joint production will be accompanied by a governance structure of some kind, which may vary depending on the features of the asset provided. That is, the governance structure for securing employees' wages and other benefits may be different from those protecting suppliers, and similarly for other input providers.[7]

When the protection for each group's input can be provided by fully specified contracts or precise legal rules, the governance structure is relatively uncomplicated. Customers, for example, are adequately protected, for the most part, by sales contracts, warranties, and the like. The market also provides some protection. Thus, customers are protected by the opportunity to switch from one seller to another. The greatest problems of governance occur for firm-specific assets, which are assets that cannot easily be removed from production. When assets are firm specific, the providers become "locked in."

For example, employees, who ordinarily assume little risk when they can easily move from one firm to another, are at greater risk when

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[7]For an account of this concept of governance applied to employees, see Boatright, 2004.

they develop skills that are of value only to their current employer. When their skills are firm specific, a move to another firm usually results in lower pay. Similarly, a supplier who invests in special equipment to manufacture goods used by only one customer is providing a firm-specific asset. In both cases, the input provider becomes "locked in" and thus has a greater need for protection than, say, customers.

Developing governance structures to protect input providers is also more complicated when contracts and legal rules cannot be developed easily due to complexity and uncertainty. Contracts and legal rules provide protection only when the situations likely to be encountered can be anticipated and the ways of proceeding in each situation can be specified. When planning is difficult because of the complexity and uncertainty of the situations that might arise, other means must be found to protect stakeholder interests.

Despite the three problems of lock-in, complexity, and uncertainty, governance structures for the assets of each input provider are relatively easy to provide for each stakeholder group except one, namely shareholders, the providers of equity capital.

Shareholder Governance

Although shareholders are commonly called the owners of a corporation, this sense of ownership is different from its ordinary use. Shareholders do not "own" General Motors in the same way that a person owns a car or a house (Schrader, 1996). Rather, shareholders have a certain bundle of rights that includes the right of control and the right to the profits of a firm (Hansmann, 1996). To ask why shareholders should have these rights and thus be the owners of a firm makes no sense. The shareholders are, by definition, whatever group has the rights to control and to receive the profits of an enterprise. The more relevant question is why, in most corporations, this group is equity capital providers and not, say, employees or customers or, indeed, all stakeholders.[8]

Part of the answer to this question is also a matter of definition. Equity capital is money provided to a firm in return for a claim on profits—or, more precisely, for a claim on residual revenues, which are the revenues that remain after all debts and other legal obligations are paid. Just as customers buy a company's products, equity capital providers "buy" the future profits of a firm; or, alternatively, in order to raise capital, a company "sells" its future profits to investors. In addition, since future profits are risky, investors not only provide capital but also assume much of the risk of a firm. The willingness of shareholders to bear this residual risk—which is the risk that results from having a claim on residual revenues rather a fixed claim—benefits all other input providers. As long as a firm is solvent—which is to say that it can pay all its fixed obligations, such as employee wages, suppliers' payments, and so on—then the claims of these groups are secure.

The remaining question, then, is why equity capital providers, who in effect "buy" the future profits of a firm and "sell" their risk bearing services, should also have control and thus the right to have the firm run in their interest. The answer is very simple: control is the most suitable protection for their firm-specific asset. If their return on the asset they provide, namely capital, is the residual earnings or profit of a firm, then this return is very insecure unless they can ensure that the firm is operated for maximum profit. By contrast, the right of control is of little value to other input providers or stakeholder groups because their return is secure as long as a firm is solvent, not maximally profitable. In addition, the return on the firm-specific contribution of other, non-shareholder groups is better protected by other means.

That equity capital provides control is in the best interests of the other stakeholder groups. First, everyone benefits when business

[8]A fuller account of the argument developed in this section is given in Boatright, 2002b.

organizations are maximally profitable because of the greater wealth creation. If firms were controlled by groups whose interests are served only by firms that are solvent, not maximally profitable, then they would create less wealth. Second, every non-shareholder group benefits when shareholders assume much of the risk of an enterprise because their return is all the more secure. Shareholders are willing to assume this risk—in return for some compensation, of course—because they are better able to diversify their risks among a large number of companies. Employees, by contrast, are very undiversified inasmuch as their fortunes depend wholly upon the employing firm. Third, without the right of control, equity capital providers would require a greater return to compensate for the increased risk to their investment. This in turn would drive up the price of capital, thus increasing the cost of production for everyone.

Firms can be owned by groups other than equity capital providers (Hansmann, 1996). Some corporations are employee-owned, and others are owned by customers or suppliers (these are usually called cooperatives). Mutual insurance companies are owned by the policy holders. These forms of ownership are not common, however, because of their relative inefficiency. It is only under certain economic conditions that they would be preferred by the corporate constituencies involved.

The bottom line is that equity capital providers are usually (but not always) the shareholders of a firm, the group with control, because control rights are the best means for protecting their particular firm-specific asset. Each group has the opportunity to seek the best protections or safeguards for their own interests, which is to say the return on the firm-specific assets that they provide to a firm. Usually, non-shareholder groups are better served by safeguards other than control, which is left to shareholders. This outcome is not only efficient but also morally justified because it best serves the interest of all stakeholder groups and results from voluntary agreements or contracts made by all the relevant groups.

Comparing Stockholder and Stakeholder Management

On one point, stockholder and stakeholder management are in agreement: the purpose of the firm is to enable each corporate constituency or stakeholder group to obtain the maximum benefit from their involvement. The economic approach to the firm expresses this purpose in terms of realizing the full benefits of engaging in joint production. Although the advocates of stakeholder management speak in general terms of having each group's interest taken into account and balanced one against the other, they must surely recognize that all benefits result from the wealth-creating economic activity and that stakeholders can receive no more benefits than this activity creates. In short, wealth must be created before it can be distributed.

However, two questions remain. One question is how best to protect or serve each stakeholder group's interests. On the economic approach, what each group is due is a return on the assets that they provide for joint production, and each asset is accompanied by a governance structure that protects this return. The distribution of the benefits or wealth that firms create is largely determined by the market, and the main concern of governance is to ensure that group receives what the market allots. There are many means for securing each group's return, one of which is reliance on management's decision making powers. In the prevailing system of corporate governance, this means is utilized by giving shareholders control, making them the beneficiaries of management's fiduciary duty, and setting shareholder wealth as the objective of the firm. The question, then, is whether the means of relying on management's decision making would also best serve the interest of non-shareholder groups or whether they are better served by other means.

The second question is what are the interests of each group that ought to be protected or served? Stakeholder management advocates might contend that even if the market return due to each group is adequately protected by other means, they are sometimes due more, and that these additional, non-market benefits can be best provided by management. This position is a challenge to the use of the market to determine how the benefits of economic activity are to be distributed. Instead of using the market alone to make this determination, stakeholder management would make this a task of management.

Protecting Stakeholder Interests

The first question is largely an empirical one about how best to protect the interest of each corporate constituency or stakeholder group (Maitland, 1994; Boatright, 2002a). One way to answer this question is by conducting a thought experiment. Suppose that stakeholder management were practiced by a great many firms or even all firms in an economy. In such a system of corporate governance, all groups would share control of a firm; managers would have a fiduciary duty to act in the interests of all groups; and the objective of the firm would be to maximize the return to every group. The resulting economy would be a model of stakeholder management.

Now, add one more condition: that each group is free to opt out of such a system of governance and choose other means for protecting their interests. That is, they would have the opportunity to forgo the protection of management acting in their interests and to seek different contracts with a firm or different legal rules for protecting their interests. This could be achieved by allowing new firms to spring up that would offer different employment opportunities for workers, different purchasing opportunities for customers, different investment opportunities for investors, and so on. Governments could also experiment with different legal rules that promise to provide better protection.

Although opinions may different on the system of corporate governance that might emerge from this thought experiment, there is good reason to believe that each group would prefer stockholder management.

First, management decision making is a weaker form of protection than legally enforceable contracts or legal rules. When such contracts and rules are available, they are more likely to be preferred than a reliance on management's fiduciary duty. Shareholders are forced to rely on the protection of a fiduciary duty because of the problems of uncertainty and complexity that prevent them from utilizing fully-specified contracts or precise legal rules. Fiduciary duty should be viewed, accordingly, not as a special privilege that shareholders enjoy but as an imperfect substitute when more effective means for protecting a group's interests are not available (Macey, 1991; Marens and Wicks, 1999).

Second, corporate decision making is more efficient and effective when management has a single, clearly-defined objective (Jensen, 2002), and shareholder wealth maximization provides not only a workable decision guide but one that, if pursued, increases the total wealth creation of the firm. This, in turn, enables each group to obtain a greater share. That is, each group can get a larger piece of pie if the pie itself is larger. Thus, employees who seek greater job security or expanded benefits—which advocates of stakeholder management would support—are more likely to get these goods if the employing company is prospering. A similar argument can be developed for customers, suppliers, investors, and every other stakeholder group. The benefits of a single objective would be compromised if other groups sought, like shareholders, to protect themselves with claims on management's attention.

If the disagreement between stockholder and stakeholder management is an empirical one about the most effective means for protecting or serving the interests of each stakeholder group, then a definitive resolution is not easy. What the argument for stockholder management shows, however, is that reliance on management decision making, as stakeholder management proposes, is but one means and that many other means are available. Therefore, from the premise that corporate activity should benefit all stakeholder groups, it does not follow that ensuring this outcome is a task for management. It is an outcome that should be achieved by some means, but the alternative of contractual agreements and legal rules, which do not involve management decision making, may secure this end more effectively.

To conclude immediately that it is management's task to ensure that all stakeholders benefit would be to commit a rather elementary mistake in reasoning that might be called the stakeholder fallacy. Just because every stakeholder group ought to benefit from participation in a firm, it does not follow that the task of ensuring this outcome belongs to management—or, indeed, to any persons. This fallacy can be avoided by adding a second premise that gives reasons for believing that management decision making is a better means for protecting all stakeholder interests than the other means that might be employed. The argument for stockholder management gives good reasons for believing that this is not true—that non-shareholder interests are usually better protected or served by various contractual agreements and legal rules rather than a reliance on management decision making. So far, advocates of stakeholder management have not presented a compelling case to the contrary.

Securing Fairness for Stakeholders

The second question about the interests that ought to be protected or served assumes that some stakeholders are due more than a secure return on the assets that they contribute to joint production. Stakeholder management advocates might contend that the prevailing system unduly favors one group, names shareholders, and that more of the wealth created by firms ought to flow to other groups, such as employees, customers, and the community, even if this introduces some inefficiency and hence less wealth creation. In other words, stockholder management may be efficient, critics complain, but it is not fair. This is a charge to take seriously, and it is recognized in economics as the familiar equity-efficiency trade-off.

Without question, there are many ways in which stakeholders could be treated unfairly, and such unfair treatment might increase efficiency or it might merely benefit one stakeholder group at the expense of another. It is morally required that any economic system ensure basic fairness and, where necessary, make a morally defensible trade-off between fairness (or equity) and efficiency. Indeed, the law already contains extensive legal protection for stakeholders with regard to fairness and other ethical concerns. As previously noted, managers have an obligation to treat all stakeholders in accord with accepted ethical standards, which include considerations of fairness. A case can be made for stakeholder management, then, only if these ethical and legal obligations are inadequate to ensure the fair treatment of all stakeholders. Just as corporations should protect and serve the interests of all stakeholders, they should also treat all stakeholders fairly. The question, as before, is how best to do this. Is this a task for management or should it be handled in some other way?

Three points should be observed. One is that there is no reason to believe that contractual agreements and legal rules are any less adequate to ensure fairness than they are to secure each group's rightful return. Just as reliance on management's decision making to protect each group's return on its assets is generally inferior to other, more effective means, so, too, is it inferior for ensuring that the wealth created by firms is fairly distributed. In short, there are better ways than stakeholder management to ensure fairness.

Second, a case can be made that ensuring fairness is not a task of management. Aside from the question of efficacy—whether management decision making is an effective means for achieving this—there is a more fundamental question about who or what should determine the distribution of wealth. Broadly speaking, an economy faces two questions: how to produce wealth and how to distribute it. Generally, decisions about production are made in a market where managers, like employees, customers, and other participants, make decisions primarily on the basis of economic considerations. The market also determines how wealth is to be distributed, but the resulting distribution may not be fair or otherwise desirable.[9] When it becomes necessary or advisable to interfere in the operation of a market and alter the distribution of wealth, this task usually falls, and rightly falls, to government. Because the interests involved bear so heavily on people's welfare, decisions about the distribution of wealth that depart from market outcomes should be made, for the most part, through the political process. It is not only unreasonable to expect managers, who have enough responsibility making decisions about how to produce wealth, to handle questions about how it should be distributed, but it is also dangerous in a democracy to allow unelected managers to make such crucial decisions.

Third, it is a mistake to pursue fairness by means of corporate governance. As already noted, governance consists primarily of the contractual agreements and legal rules that protect the assets individuals contribute to production and their return on these assets. Corporate governance—which is the contract that shareholders make with a firm—answers the basic questions of who has control and whose interests should be served by management and made the objective of the firm. Questions about how the wealth created by firms should be distributed are separate from the concerns of governance and are answered by the market and by government. Not only are matters of distribution not central to corporate governance, but changes in corporate governance are rarely effective in altering the distribution of wealth or in achieving other desirable social goals (Maitland, 2001).[10] As Easterbrook and Fischel (1991, 39) observed, there are many difficult

[9]With regard to the criticism that shareholders receive a disproportionate return, it should be noted that their return is the market rate for capital. Thus, the return to shareholders is determined by a market for capital just as wages for workers and prices charged to customers are determined by their respective markets.

[10]That changes in corporate governance can bring about improvements in distributive justice or fairness is the thesis of the progressive law movement. See Mitchell, 1995, for a useful collection of articles.

moral and social questions, but "to view. . . [them] as governance matters "is to miss the point."

Summary

Viewed in terms of an economic approach to the firm, stakeholder management offers managerial decision making as a means for protecting and advancing stakeholder interests. Insofar as it proposes that managers have a fiduciary duty to serve the interests of all stakeholders and that maximizing all stakeholder interests be the objective of the firm, it seeks to extend the means used to safeguard shareholders to benefit all stakeholders. In short, stakeholder management proposes that all stakeholders be treated like shareholders.

The fundamental mistake of stakeholder management is a failure to see that the needs of each stakeholder group, including shareholders, are different and that different means best meet these needs. The protection that shareholders derive from being the beneficiaries of management's fiduciary duty and having their interests be the objective of the firm fit their particular situation as residual claimants with difficult contracting problems, but employees, customers, suppliers, and other investors (such as bondholders, who provide debt rather than equity) are better served by other means, which include contractual agreements and various legal rules.[11] Management decision making is a relatively ineffective means for protecting the interests of non-shareholder stakeholders. In any event, the choice of means for protecting each stakeholder group's interest is mainly an empirical one

[11]It is instructive to observe that bondholders, who also provide capital, are not regarded, like shareholders, as the owners of a firm. The difference is that bondholders' fixed claims for principal and interest payments are secured by legally enforceable contracts, whereas shareholders' residual claims are fulfilled only if the firm is reasonably profitable. Thus, shareholders, but not bondholders, assume residual risk and thus benefit from having control. An exception occurs when a firm is insolvent, in which case bondholders and other creditors take control and become, in effect, the shareholders of a firm in bankruptcy.

about what works best in practice, and the evidence tends to support the prevailing stockholder-centered system of corporate governance.

Finally, insofar as stakeholder management assigns to managers the task of ensuring that the wealth created by a firm is distributed in a fair way that departs from the distribution that results from purely market forces, this task, too, is better done by other means, most notably through the political process. Managers lack both the ability and the legitimacy that are required to fulfill this task, and, in any event, the attempt to address pressing social problems by making changes in corporate governance is ill-conceived. Corporate governance, which is designed to solve specific problems of economic organization, is simply the wrong tool, like using a screwdriver to hammer a nail.

What's Right with Stakeholder Management

Despite this generally negative appraisal of stakeholder management, it is still an important, constructive development in business ethics. Its positive contributions are obscured to some extent by those who present it as an alternative form of corporate governance and thus create a false choice between stakeholder and stockholder management. Stakeholder management can be understood in a way that complements rather than challenges the prevailing system of corporate governance.

First, stakeholder theory rightly insists that the purpose of a firm is to benefit in every corporate constituency or stakeholder group. The prevailing system of corporate governance may obscure this purpose by failing to emphasize that management's fiduciary duty to shareholders and the objective of shareholder wealth maximization are merely means to an end. These benefits result from the agreements that a firm makes with one input provider, namely shareholders. However, a firm also makes agreements or contracts with other constituencies, including employees, customers, suppliers, and other investors, all for mutual advantage. When the assets contributed by these parties are firm-specific, they are accompanied by safeguards that constitute forms of governance. The agreements between these groups and a firm create both moral and legal obligations that are every bit as binding as those owed to shareholders. In addition, each stakeholder group, including managers, has an obligation to treat all others in accord with accepted ethical standards.

Although stockholder and stakeholder management are agreed on the purpose of a firm—to conduct economic activity in ways that benefit everyone—there is disagreement on how this is done. In particular, the stakeholder view makes it a task of management to ensure that this outcome occurs, whereas on the economic approach, mutual benefit is a result of the opportunity each group has to make mutually advantageous agreements. That is, a firm works like a market in creating mutual benefit from the opportunity to trade. Just as a market achieves this result without any person directing it, so, too, does a firm—in theory!

In practice, though, some stakeholders fail to benefit as they should from a firm's activity. This may occur for a variety of reasons including management's willful violation of agreements, market failures, and externalities or third-party effects. For example, a company might fail to make expected contributions to a pension plan, sell a product to consumers with undisclosed defects or operate a polluting factory. In general, it is the responsibility of government to prevent or correct for these possibilities, but managers, especially those at the top of a business organization, might also be held to have some responsibility. Stakeholder management asks managers to recognize that a firm should benefit all stakeholders, to be aware when it fails to do so, and to take some responsibility for correcting the problems that lead to this failure. Just as we all have a responsibility to make sure that markets work as they should to produce a benefit for all, so, too, do we all, including managers, have a responsibility for ensuring the proper functioning of firms.

Second, corporate governance is concerned with how business organizations should be legally structured and controlled. The provisions that management has a fiduciary duty to serve shareholder interests and that shareholder wealth maximization should be the objective of the firm dictate how decisions about major investment decisions and overall strategy should be made. They tell us very little about how managers should actually go about their task of managing a firm so as to create wealth for shareholders or anyone else. Everyone can benefit from the productive activity of a firm only if there is a vision for a creating a valuable product or service as well as a strategy for achieving this vision. As Michael Jensen (2002: 245) observes,

> Value maximizing tells the participants in an organization how they will assess their success in achieving a vision or in implementing a strategy. But value maximizing says nothing about how to create a superior vision or strategy. And value maximizing says nothing to employees or managers about how to find or establish initiatives or ventures that create value. It only tells us how we will measure success in the activity.

Freeman and his colleagues (Freeman, Wicks, and Parmar, 2004: 364) describe stakeholder management as addressing this matter of what managers and other need to do to create wealth. They write,

> Economic value is created by people who voluntarily come together and cooperate to improve everyone's circumstances. Managers must develop relationships, inspire their stakeholders, and create communities where everyone strives to give their best to deliver the value the firm promises.

The first sentence expresses the fundamental principle that firms exist to benefit all those who take part in them, which is shared with the economic approach. The second sentence is concerned with how managers should actually carry out their role. Left unaddressed, though, is who should have control of a firm and in whose interest a firm should be run. If, as the economic approach holds, the answer is the shareholders, then stakeholder management is not only compatible with stockholder management but an essential complement.

Stakeholder management, then, as a guide for managers rather than a form of corporate governance, provides a valuable corrective to managers who fail to appreciate how shareholder primacy benefits all stakeholders and use it as a reason for disregarding other stakeholders. Such managers commit a mistake of their own by confusing how a corporation should be governed with how it should be managed. There is no reason why managers who act in the interests of shareholders and seek maximum shareholder wealth cannot also run firms that provide the greatest benefit for everyone. Indeed, a manager who fails to benefit every stakeholder group is not achieving the full potential of a firm.

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