Creating an Ethical Business: Lessons from Stakeholder Theory

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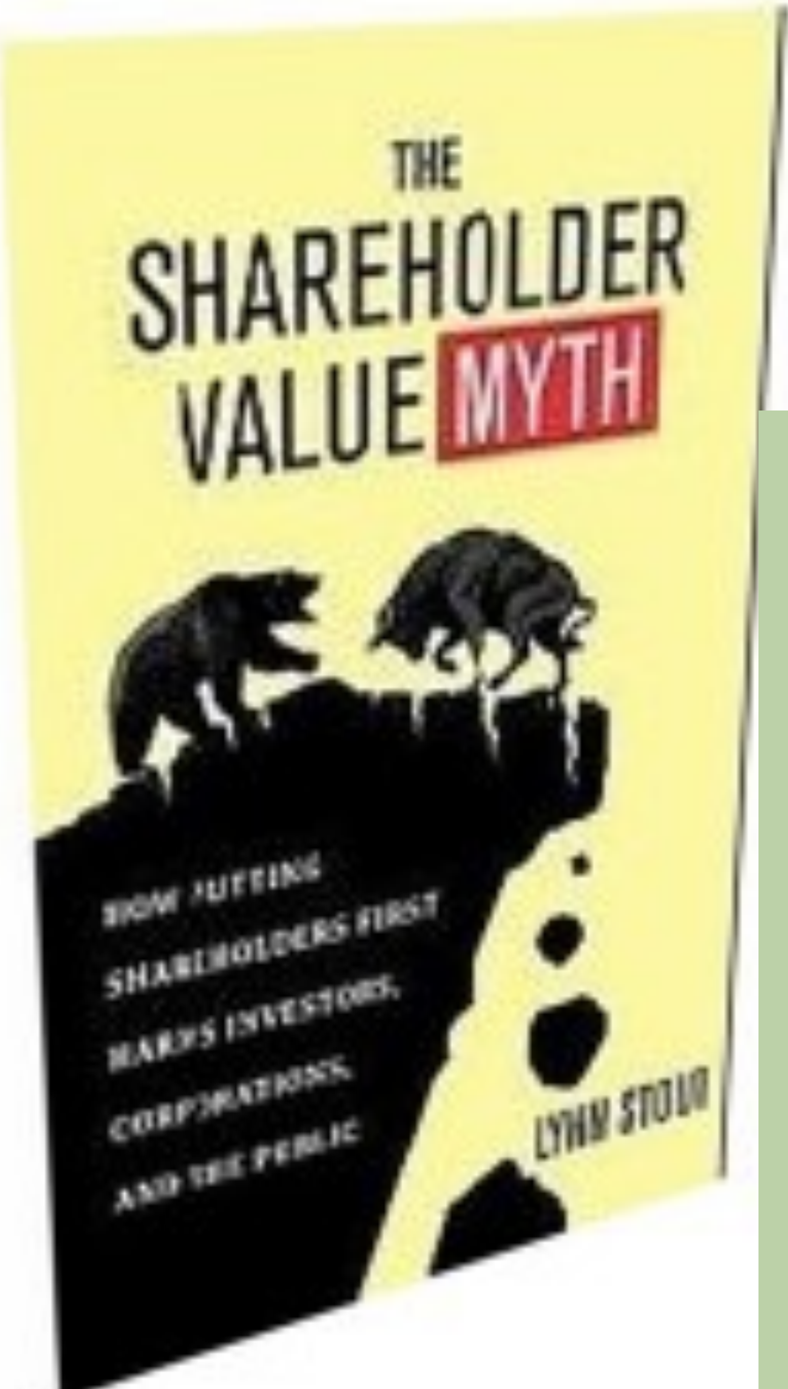
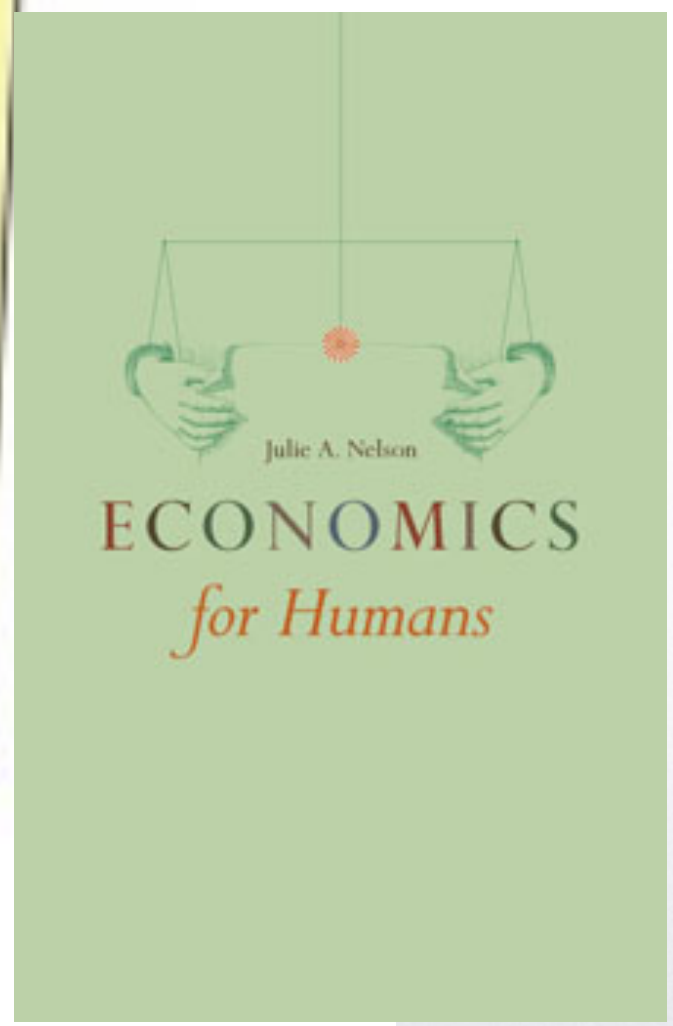
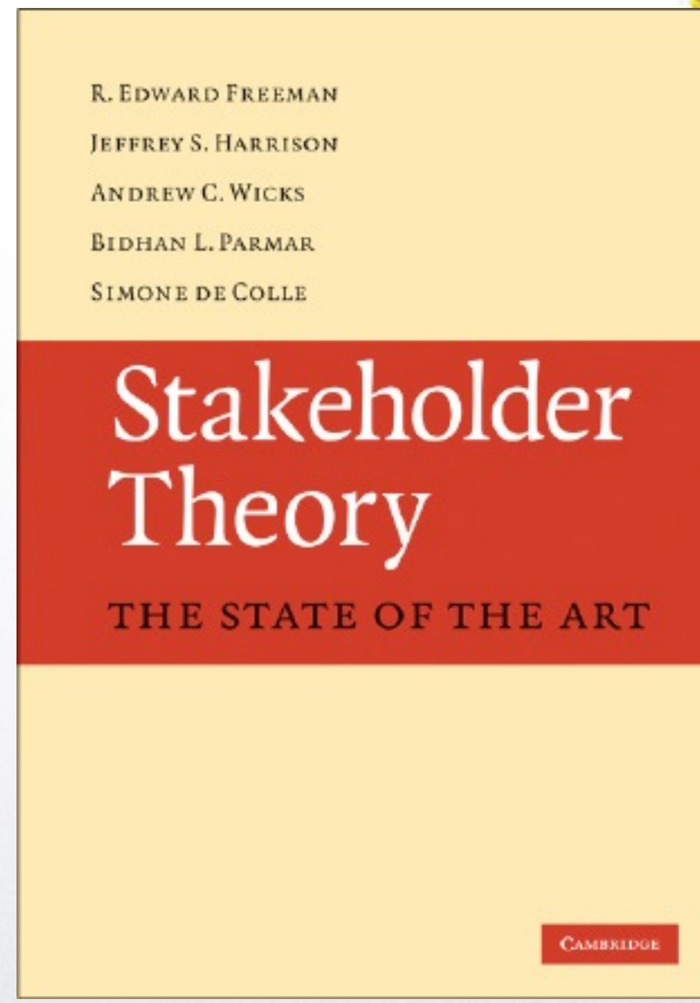
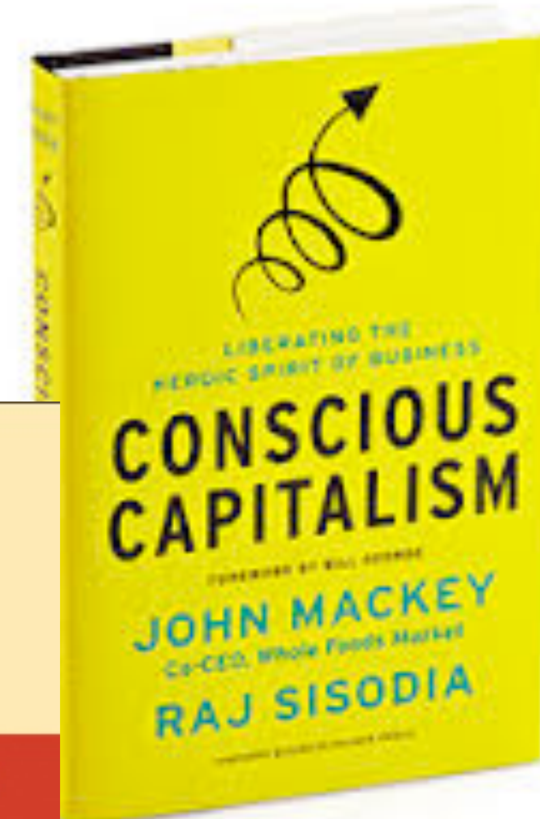
References


THE
SHAREHOLDER
VALUE MYTH
HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC
LYNN STOUT


Julie A. Nelson
ECONOMICS
for Humans


R. EDWARD FREEMAN
JEFFREY S. HARRISON
ANDREW C. WICKS
BIDHAN L. PARMAR
SIMONE DE COLLE
Stakeholder Theory
THE STATE OF THE ART
CAMBRIDGE


LIBERATING THE HEROIC SPIRIT OF BUSINESS
CONSCIOUS CAPITALISM
JOHN MACKEY
Co-CEO, Whole Foods Market
RAJ SISODIA

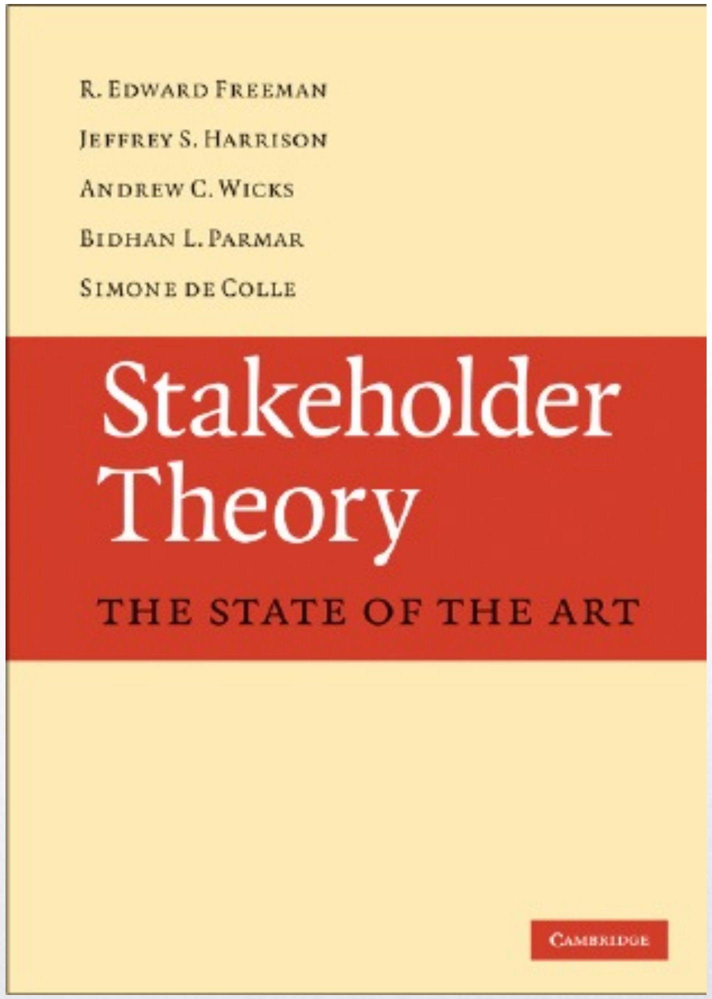
Creating an Ethical Business - Outline

1. The Economist's perspective: Julie Nelson (2006)
   - The Economics as a Machine ***metaphor***
2. The Corporate Law perspective: Lynn Stout (2012)
   - The Shareholder Value ***myth***
3. Reflections from a Stakeholder Theory perspective
   - What is the purpose of the corporation? What is Capitalism?
   - Points in common with Stakeholder Theory

- Open questions: The role of Business Schools
- Conclusion

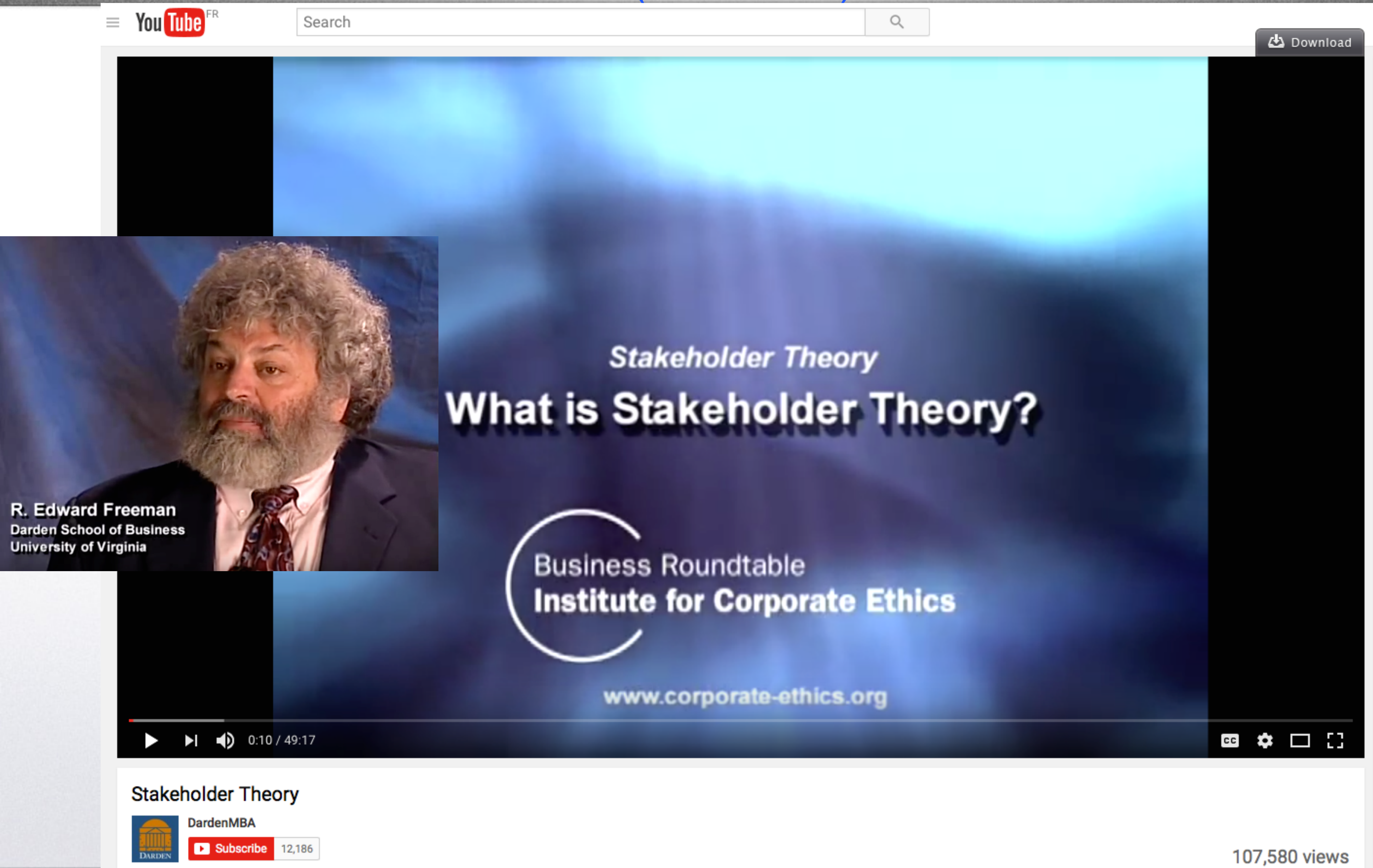
Preamble: What is Capitalism in a Stakeholder Theory perspective?

- *Capitalism is* ***a system of social cooperation and value creation*** *(Freeman et al., 2010, p. 15)*



Ed Freeman: What is Stakeholder Theory?

(3 min video)



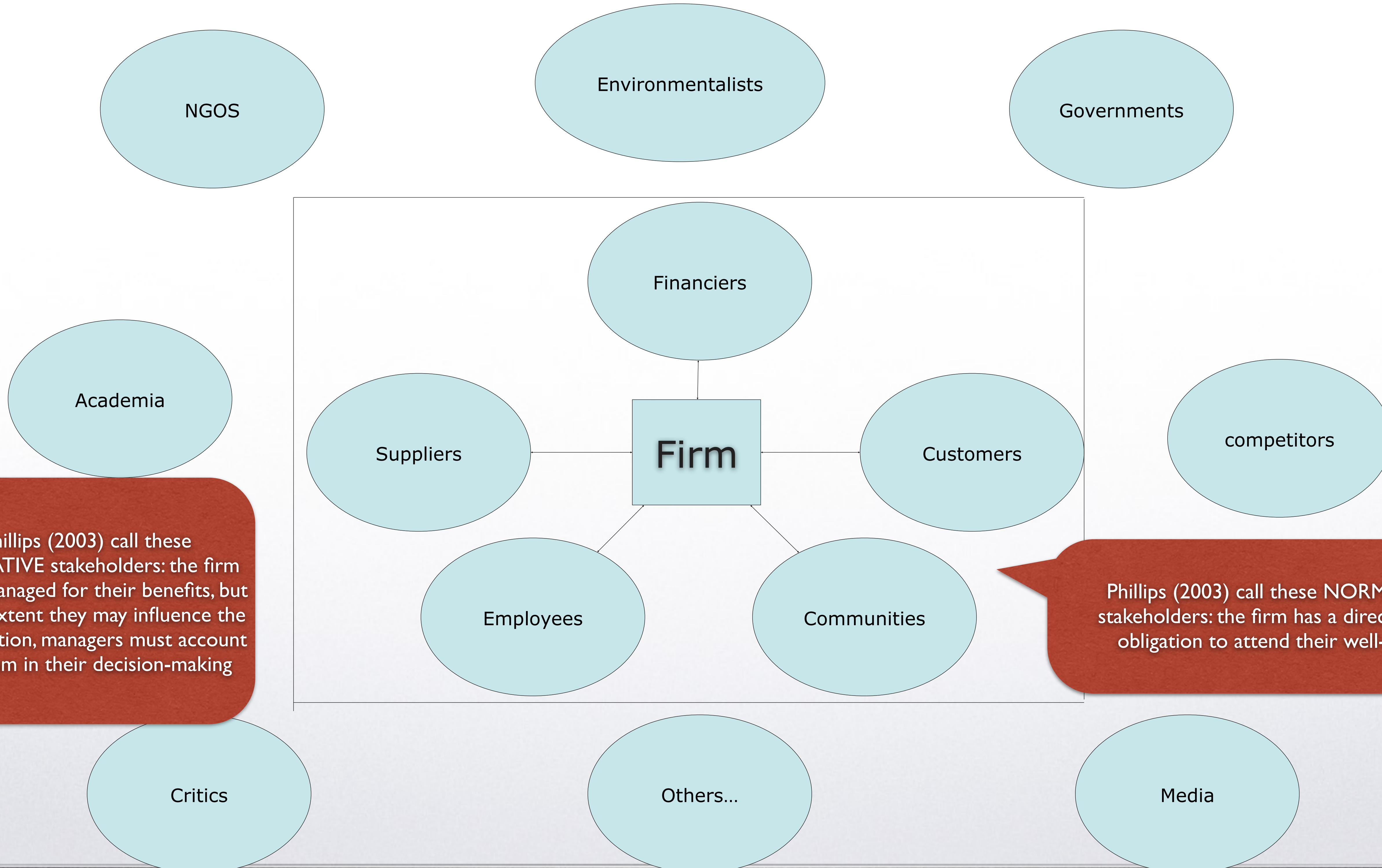
https://www.youtube.com/watch?v=bIRUaLcvPe8

Ed Freeman & Stakeholder Theory

Definition of stakeholder

"**In a narrow sense, the stakeholders are all those identifiable groups or individuals on which the organisation depends for its survival, sometimes referred to as <u>primary stakeholders</u>:** stockholders, employees, customers, suppliers and communities.

On a broader level, however, a stakeholder is any identifiable groups or individual w<u>ho can affect or is affected</u> by organisational performance in terms of its products, policies and work processes. In this sense, public interests groups, protest groups, local communities, government agencies, trade associations, competitors, unions, and the press **are organisational stakeholders".**
(R.E. Freeman,1984: Strategic Management - A Stakeholder Approach)



Phillips (2003) call these DERIVATIVE stakeholders: the firm is not managed for their benefits, but to the extent they may influence the organisation, managers must account for them in their decision-making

Phillips (2003) call these NORMATIVE stakeholders: the firm has a direct moral obligation to attend their well-being

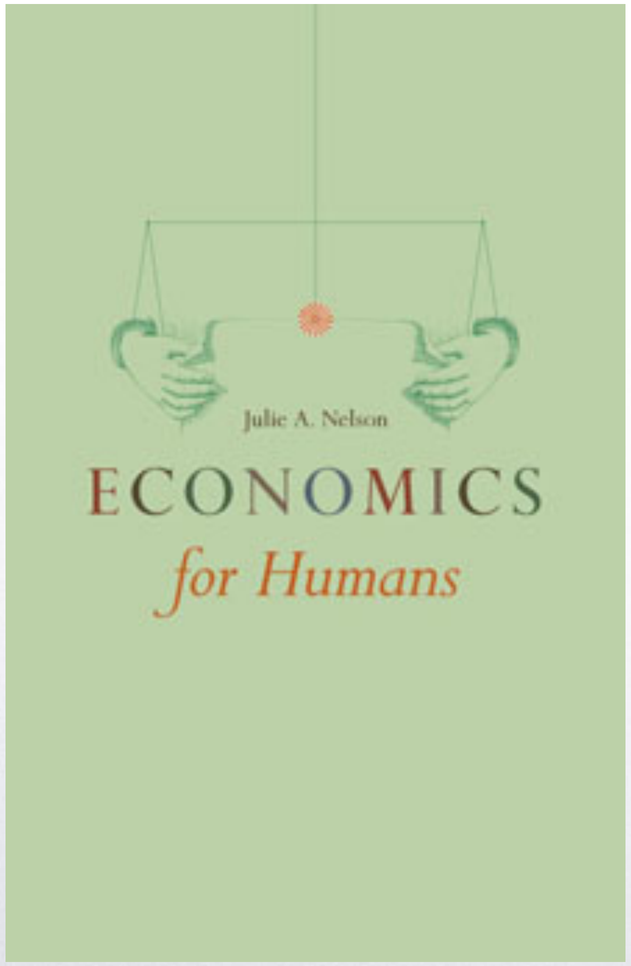
(Source: R.E. Freeman,1984: Strategic Management - A Stakeholder Approach)

What is the purpose of the corporation?
(aka Ending the "Friedman vs Freeman" debate

- The primary responsibility of the executive is **to create as much value as possible for stakeholders.**
- Trying ***to maximize profits is counterproductive*** because it takes attention away from the fundamental drivers of value: stakeholder relationships.
- If **tradeoffs** have to be made, as often happens in the real world, then the executive must figure out how to make them and immediately begin improving the tradeoffs **for all sides**.
- Stakeholder theory focuses on ***how*** this can be done…

(Source: R E Freeman, A. Wicks, J. Harrison, B. Parmar and S. de Colle (2010), *Stakeholder Theory. The State of The Art,* Cambridge University Press.

1. The perspective of the Economist: Julie Nelson (2006)



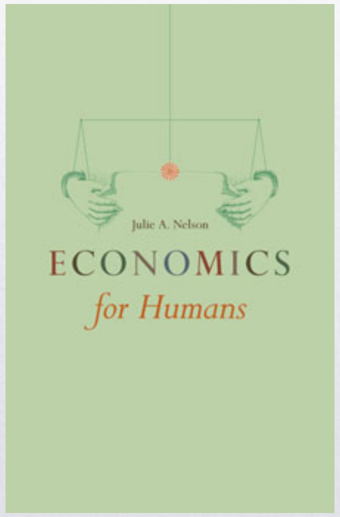
Julie Nelson is Department Chair and Professor of Economics, College of Liberal Arts, University of Massachusetts Boston

"The fact that an organisation is run as a "for profit" in no way requires, either by law or economic "mechanism", that it must have profit as its *sole* goal"
(Nelson, 2006: 114)

The Problem:
The *Economy-as-a-machine* metaphor

" The capitalist economy can usefully be viewed as a machine whose primary product is economic growth"

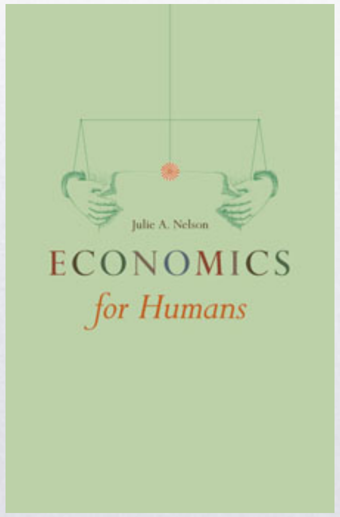
- People are driven by *self-interest*
- Good outcomes arise *automatically* ("invisible hand")
- Markets are *impersonal*
- *Amoral* laws & *inexorable forces*



What if the Economy is not a Machine?

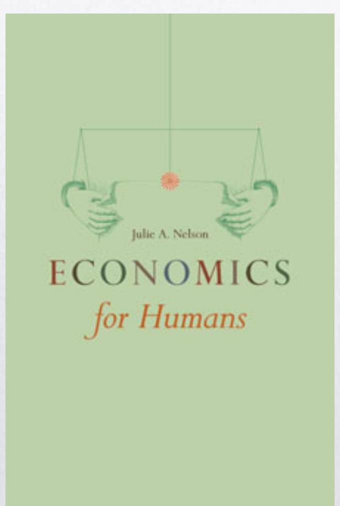
- “The idea that economic systems are inanimate machines operating according to amoral laws is a ***belief***, not a fact”

- “This belief has ***harmful effects***—for life on the planet, for human society, and for you in particular” (Nelson, 2006: 4)



A damaging metaphor

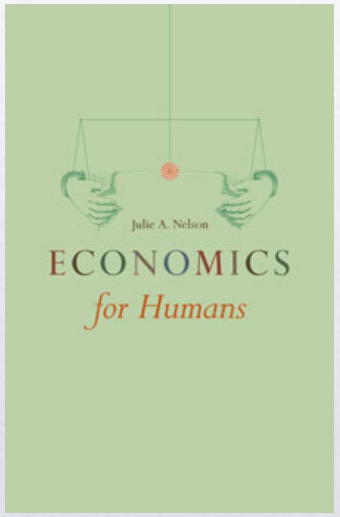
- *Naive and irresponsible* **probusiness policies**
  - probusiness advocates do not think corporations *should* include social responsibility in their purpose
- *Naive and impractical* **antimarket alternatives**
  - antimarket critics do not think that corporation *could* ever be socially responsible



- *It is the machine metaphor that tells us that ethics is irrelevant to economics and that "economic value" are limited to self-interest*
- *Dialogue is blocked, paradoxically, because both groups assume the economy-as-a-machine metaphor*

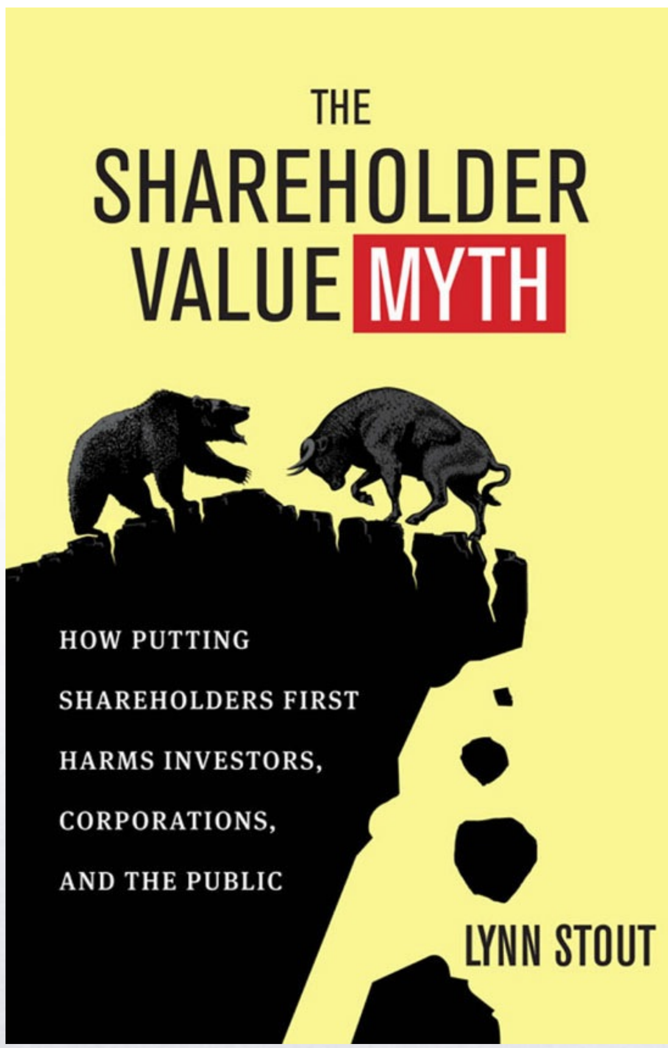
An alternative metaphor: The Beating Heart

- A *living*, vital organ for the ***body***
- *Moving flows* of lifeblood throughout the body (like the economy is made by the circulation of goods and services)
- A living entity, can be *healthy* and strong, or become weak, *clogged* and degenerate (e.g. unhealthy concentrations of goods and services may pose a risk of heart failure)
- *Adapts* and coevolves with ***culture*** and ***institutions***
- The centre of ***love*** (economy of care)
- A symbol of ***courage*** (we are not clogs in a machine…)



- **"Economy of care" and "business ethics" are not *options*, but requirements**

2. The Corporate Law perspective: Lynn Stout (2012)



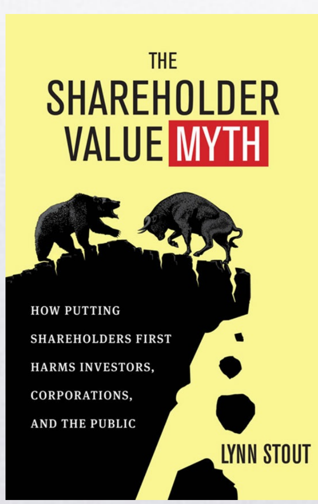
Lynn Stout is Distinguished Professor of Corporate & Business Law, Cornell University Law School

"'Maximize shareholder value' is an incoherent and counterproductive business objective"
(Stout, 2012: vi.)

ow Shareholder Primacy Gets Corporate Law Wrong: The flaws of the Principal-Agent model

The Principal-Agent Model

1. Shareholders ***own*** corporations
2. Shareholders are the ***residual claimants***
3. Shareholders are ***Principals*** who hire directors and executives to act as their ***Agents***

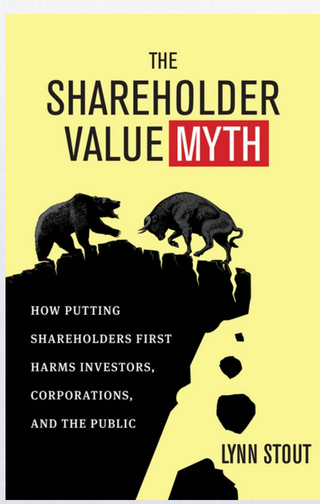


1. **Corporations <u>own themselves</u>** (independent, legal entities)
2. **Shareholders are <u>not the (only) residual claimant</u>** (the Board decides)
3. **Executives own a <u>fiduciary duty to the corporation</u>—not to shareholders** (the board exist prior to the 'principals')

L. Stout (2012)

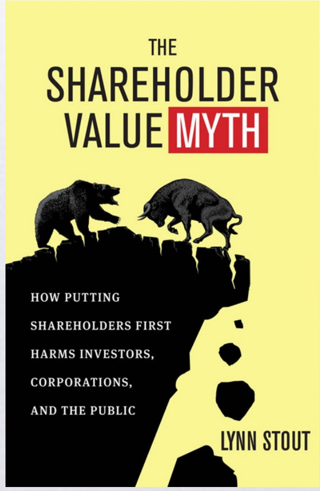
maging effects of Shareholder Value thinki

- ““***Shareholder value thinking*** *causes corporate managers to focus* ***myopically*** *on short-term at the expenses of long-term performance; discourages investments and innovation; harms employees, customers, communities; and causes companies to indulge in reckless, sociopathic and socially irresponsible behaviours.* ***It threatens the welfare*** *of* ***consumers****,* ***employees****,* ***communities*** ***<u>and investors alike</u>***”



Conclusion: Wee need a new paradigm

- ***Maximizing shareholder value is not a managerial obligation: it is a managerial choice***
- ***Corporations are real - the shareholders of the P/A model are fictional (homogeneous, short-termist, self-interested and less prosocial)***
- ***Shareholder primacy can hurt shareholders themselves, both individually in the short-term and collectively in the long-term***



. Reflections from a Stakeholder Theory perspectiv

Points in common with ST	Julie Nelson	Lynn Stout
The motivation complexity: Critique of the 'homo economics" model from both the economist and the corporate law perspective	***"people care, money is not the only motivation "***	***"most people are not psychopaths [...] Most Shareholders are not psychopaths,***
The Separation Fallacy: Both Nelson and Stout see a common problem in today's view of business—what Freeman (1994) calls "the Separation Fallacy"	***"bringing body and soul together"***	***"Shareholders value different things [...]"***
The need of a new narrative: Nelson and Stout agree that the *language* we use matter to shape our understanding *and* our actions—therefore metaphors, beliefs, ideologies, myths can **be useful or harmful…**	***"the 'machine' metaphor has encouraged the development of irresponsible probusiness policies,***	***"We need a new paradigm [...] Shareholder value thinking is based on wishful thinking, not reality"***
The need to understand (and measure) **Stakeholder Value**, not just *profit*	***"The central question is not profit itself, but how to measure value"***	***"We don't need a single metric"***

Open questions

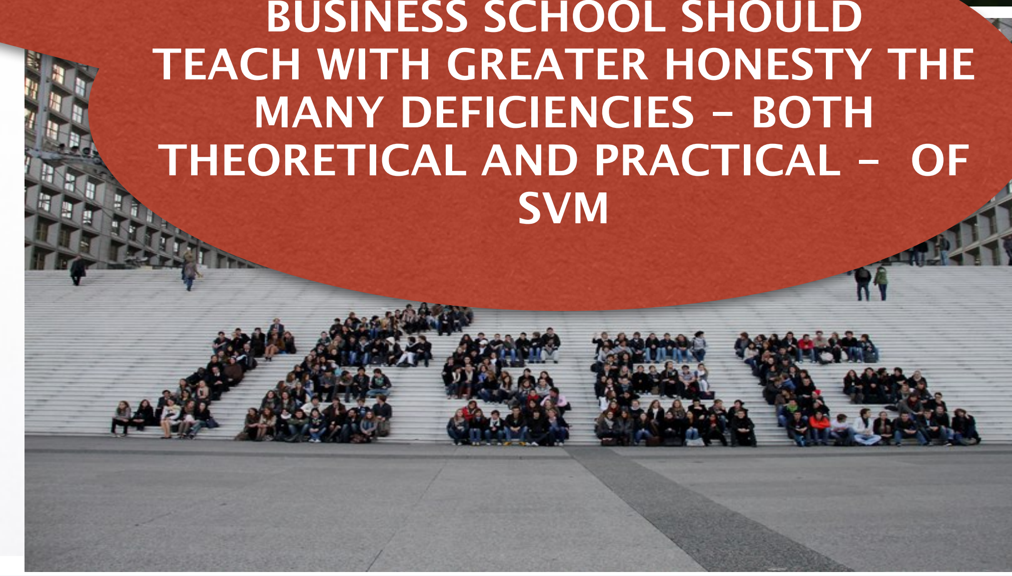
- Do you see further common points/implications between Nelson & Stout and Stakeholder Theory?
- What can we do (more) to promote these ideas within business schools professors, business schools students, policy makers, corporate managers & entrepreneurs?
- Do we need to reform Governance/legal structures, or simply change the way we talk/study corporations? (Or both?)
- When will we not hear anymore something like this…?

Are Business Schools to blame for the economic crisis?

How Business Schools Lost Their Way

N. Craig Smith and Luk Van Wassenhove
January 11, 2010 — 6:19 PM CET

Business schools have been blamed for the economic crisis. The ... nts are said to be responsible for wreaking the havoc in the financial markets we are all now s... and business schools are chastised for not training them better, not least in failing to instill a clear sense of right and wrong. Are they to blame? To the extent that MBA graduates have been closely associated with many of the spectacular failures of financial institutions witnessed over the last 18 months, they may justifiably be criticized for the mispricing of risk in relation to specific financial products and an underestimation of systemic risk more generally. They may also be criticized for failing adequately to question the assumptions of the financial models being used and, with hindsight at least, for following the crowd and gambling that they could continue to dance,



BUSINESS SCHOOL SHOULD TEACH WITH GREATER HONESTY THE MANY DEFICIENCIES – BOTH THEORETICAL AND PRACTICAL – OF SVM

[It would be a mistake to say that business schools are directly to blame, even when their graduates were closely involved; there are more basic drivers. But business schools have played a role indirectly, due fundamentally to their adherence to and perpetuation of an ideology that has contributed significantly to the crisis, albeit unintentionally. That is the ideology of Shareholder Value Maximization (SVM). In most business schools, SVM is the leitmotif of finance teaching and implicit throughout the rest of the curriculum.

Conclusion

- What can we do (more) to promote these ideas within business schools professors, business schools students, policy makers, corporate managers & entrepreneurs?
- Do we need to reform Governance/legal structures, or simply change the way we talk about and study corporations? (Or both?)
- When will we not hear anymore something like this…?

“All what I did was in the interest of ENRON’s SHAREHOLDERS…”

Thank You.

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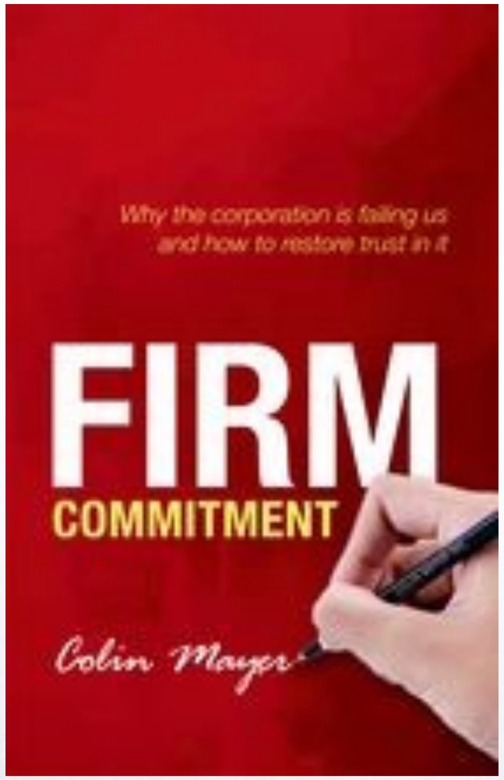
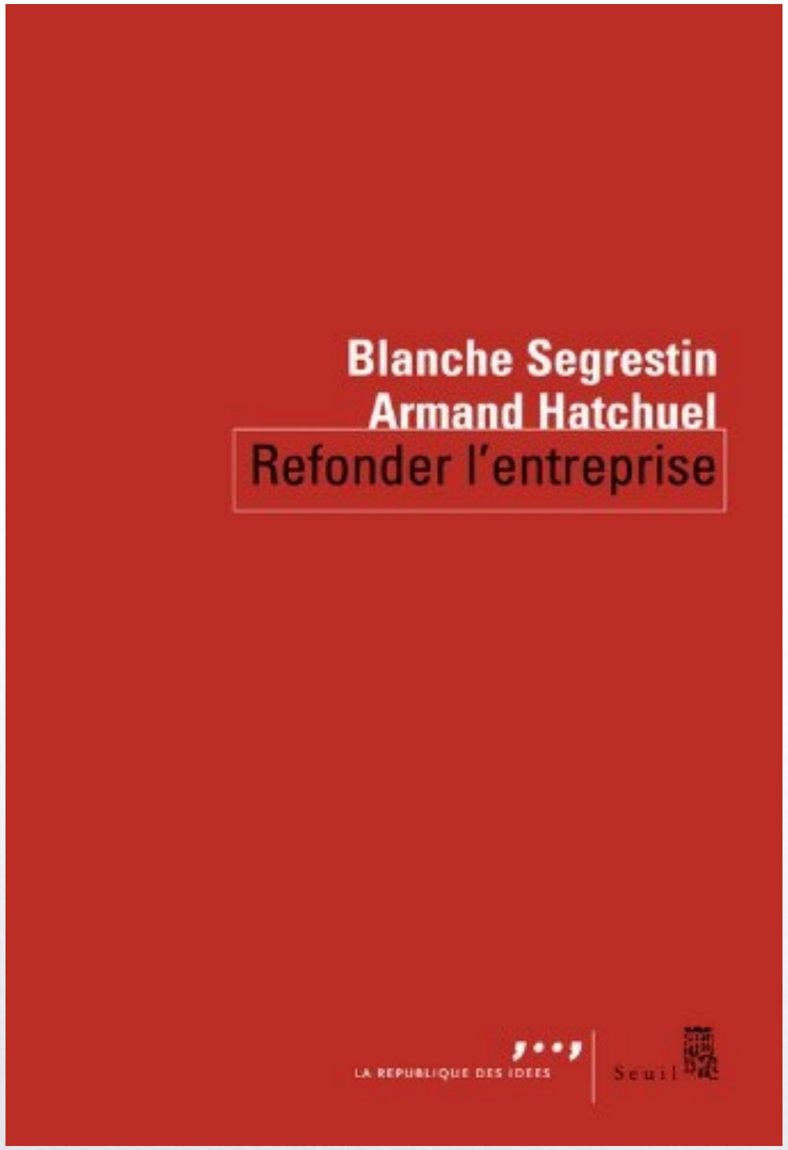
Other Voices



Colin Mayer (2013)

- HOW THE CORPORATION IS FAILING US:
- …our **misconception** about the role and nature of the corporation, both in the ***conventional*** (transaction costs; nexus of contracts etc.) and in the ***unconventional paradigm*** (CSR, Stakeholder theory).
- the firm as a mechanism to provide **commitments** to stakeholders to deliver its purpose
- Barclays and Lehman's were families with strong ethical values….the principles of the founders have been reduced to the **single value** of maximising shareholder earnings.
- *Infusing* ***ethics*** *in enterprise, establishing firm commitment […] is critical to to economic* ***efficiency*** *as well as social welfare, because the moral corporation is an economically efficient corporation (p.11).*

Other Voices



Blanche Segrestin, 2014

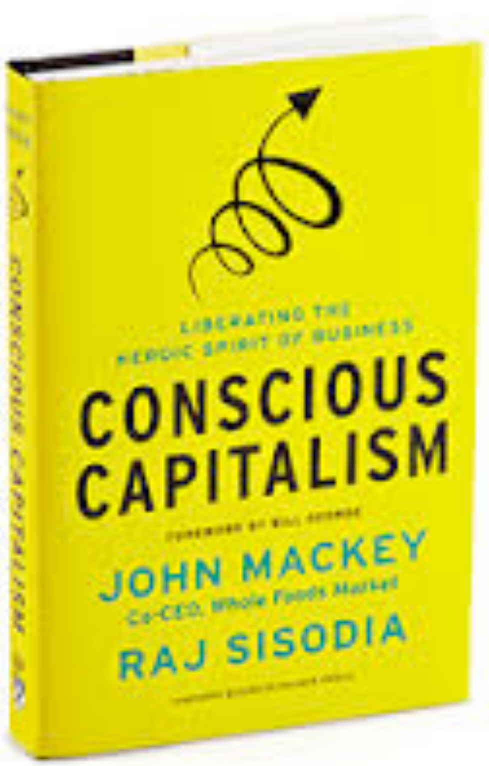
- PURPOSE-DRIVEN CORPORATION
- New forms emerging of Profit-with-purpose corporations:
  - *Flexible Purpose Corporation (FPC)*
  - *Benefit Corporation (Hiller, 2013)*

Is any business applying the

view (and actually being

John Mackey
Founder and CEO of Whole Foods
Co-author of *Conscious Capitalism, 2013*

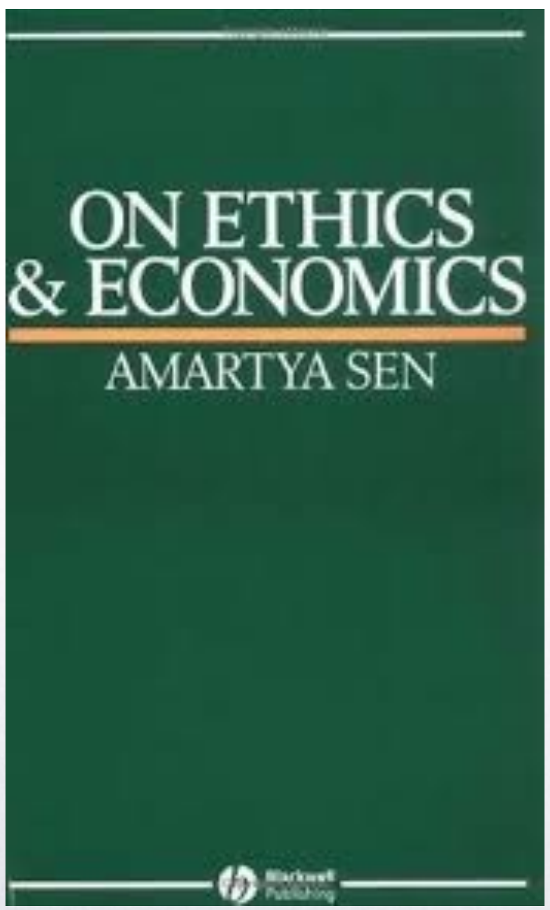
*I'm a businessman and a **free market** libertarian, but I believe that the enlightened corporation should try to create value for all of its constituencies*



*At Whole Foods, we **measure** our success by how much **value** we can create for all six of our most important **stakeholders**: customers, team members (employees), investors, vendors, communities, and the environment.*

*[**Milton Friedman**'s] argument is **not wrong** so much as it is **too narrow**.*

Amartya Sen on the "Separation Fallacy" (1987)



Amartya Sen is Thomas W. Lamont University Professor, and Professor of Economics and Philosophy, at Harvard University.

He won the Nobel Prize in Economic Sciences (1998)

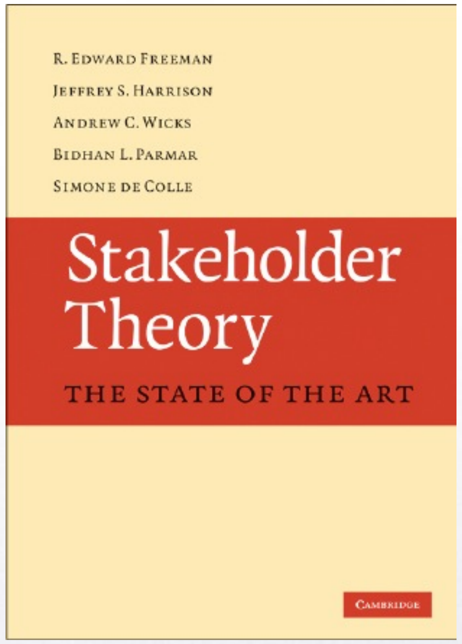
I would argue that the nature of modern economics has been substantially impoverished by the distance that has growth between economics and ethics"

(Sen, On Ethics and Economics, 1987: 7)

…economics can be made more productive by paying greater and more explicit attention to the ethical considerations that shape human behaviour and judgment" (1987: 9)

The Separation Fallacy

- ***It is useful to believe that sentences like, "x is a business decision" have no ethical content, or any implicit ethical point of view.*** *(Freeman, 1994)*



Source: R. E. Freeman, A. Wicks, J. Harrison, B. Parmar and S. de Colle, **Stakeholder Theory: The State of The Art**, Cambridge University Press, 2010.

- Example: if a company hires a person….