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Assessing Freeman's Stakeholder Theory

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ABSTRACT. At least since the publication of the monumental *Strategic Management: A Stakeholder Approach* (1984), the "stakeholder theory" originated by R. E. Freeman has engrossed much of the business ethics literature. Subsequently, some advocates have moved a bit too quickly and without proper definition or argument. They have exceeded Freeman's intentions which are more libertarian and free-market than is often thought. This essay focuses on the versions of stakeholder theory directly authored or coauthored by Freeman in an effort to recover (1) Freeman's intentions and (2) the argumentative justification of stakeholder theory. It then argues that Freeman's appeal to legal, economic, and ethical constraints ultimately produce arguments that are invalid. One can thoroughly support legislation constraining corporations or seeking to prevent age discrimination, market monopolies, and externalities and regret the extent that capitalism *is* heir to such shortcomings without it following that (1) business beneficiaries should be changed from stockholders to *stakeholders* and (2) the latter should be given *serious* decision-making power. Further, stakeholder theory neither defines nor battles any obvious opposition. Hence, it is difficult to see what it changes about business management. In short, stakeholder theory either changes too much about business, or nothing important at all (depending on one's interpretation). Efforts to supplant or improve the reigning theory of capitalism will have to do better.

KEY WORDS: R. E. Freeman, Milton Friedman, libertarianism, stakeholder theory, stakeholder management, stockholder theory

Introduction

The articles explaining, extolling, defending, and sometimes critiquing stakeholder theory are too numerous to list. The Rotman School of Management (Toronto) lists at least a couple hundred (Redefining). This essay, on the other hand, highlights the versions given by R. E. Freeman and his various coauthors. To my knowledge, a critique focusing simply on works authored or coauthored by Freeman has not been attempted. James Walsh's wonderful book review essay (2005) critiques stakeholder theory *in general* but does not focus simply on Freeman's contribution to stakeholder theory. Freeman only authors or coauthors one of the three books Walsh discusses. Heath (2006) provides some nice criticisms, but does not delve very deeply into Freeman's writing. Moreover, since these publications, Freeman has offered new arguments or, as it seems, new versions of old arguments.

The relevant literature, for all its value as critique, also seems to miss a few main points that are important to highlight. These include (1) the true nerve of saying that businesses should change the beneficiaries and those with decision-making power to stakeholders rather than just stockholders, (2) the deepest error in Freeman et al.'s argument structure (its invalidity), and (3) the true separation between Freeman et al. and others who may more accurately be described as "libertarian" (such as Nozick or Machan). The literature also does not consider some of the important articles published or republished in the textbook *Business Ethics: A Philosophical Approach* (2008) such as "A Stakeholder Theory of the Corporation" (2002), and "Managing for Stakeholders" (2008). Walsh (2005), for example, was a *book* review, not a *theory* review.

Freeman et al. have *also* come out with a new book: *Managing for Stakeholders: Survival, Reputation, and Success* (2007). Partly I am motivated by this retelling of Freeman's classic story. Partly I am motivated by the preemptive philosophical strike that Freeman published afterward in *Ethical Issues in Business* (2008). It is a familiar structure for Freeman: a practical management text followed by one or more articles published in a Business Ethics textbook.

The promissory note with the implied follow up is also familiar. Freeman et al. write in *Strategic Management; A Stakeholder Approach* (1984) or in *Managing* (2007) that "A full accounting" of academic scholarship will come later, and *Managing* (2007) is written for executives (xii). The books are practical; Freeman leaves the philosophical justification to the subsequent articles. Hence, these articles such as "Stakeholder Theory of the Modern Corporation" (2002) and "Managing for Stakeholders" (2008) will be the main targets of this critique.

Perhaps a word or two is also needed to explain why such a critique is necessary. A critique of stakeholder theory is important first because stakeholder theory is arguably one of the most prominent and well-known theories of business management to ever come out of a philosophical school or way of thinking. The relation between Ethics as a philosophical discipline and business as a human practice is at stake.

Second, it is important to assess whether stakeholder theory is likely to ameliorate any of the problems it addresses. These are ethical problems derived from a highly imperfect world, many complaints of which assail business executives as purported "social responsibilities." Awash in the AIDS crisis, publicly minded governments and political bodies insist, for example, that businesses shoulder their share of the responsibility (Walsh, 2005, p. 426). Publics clamor for better roads, sanitation, education, and employment opportunities, while firms currently labor under a higher, even "third degree" of regulation and scrutiny seemingly unfettered in their greed (Walsh, 2005, p. 426).

Additionally, a business ethicist might ask whether selfishness made the executives at Enron shift their liabilities to dummy corporations with the names of Disney characters; whether arrogance tied employee stock ownership to 401 k plans they could not sell when Enron stock plummeted. Yet, the hungry and unemployed seldom have the time or luxury to sift the fine details. They crave action at nearly any cost. The indigent represent a potentially dangerous world-majority to tap into, yet the affluent deny them at their peril (as in 9/11) or at the risk of conscience (as in Darfur).

This paper takes the position that in the face of worldwide demands, Freeman et al.'s calls to redistribute the wealth offer solace and compassion:

> Stakeholder capabilities include building and supporting communities where employees live and work. The Dayton Hudson Corporation in Minneapolis has been engaged in this capability for many years, contributing to programs for lower-income families as well as the arts in Minnesota (Freeman et al., 2007, p. 68).

Yet these calls mask dangers, some of which are obvious to Freeman some of which are not. It matters *how* one proposes to share the wealth and the burdens. As world famous philosopher and libertarian Robert Nozick has put it:

> We are not in the position of children who have been given portions of pie by someone who now makes last minute adjustments to rectify careless cutting. There is no central distribution, no person or group of persons entitled to control all the resources, jointly or deciding how they are to be doled out (Nozick, 1974, p. 149).

A theory that refocuses decision-making power and the benefits of labor from those who invest money (stockholder) *to* (stakeholders) "any group or individual who can affect or is affected by the achievement of the activities of an organization" (Freeman, 1984, p. 46; Freeman et al., 2007, p. 6) is open to abuse. The price of solace and compassion is too high when it forces the redistribution of wealth from the haves to the have-nots *carelessly*. Redistribution of wealth abuses those who *merit* their earnings. Redistribution harms especially when it offers no end to its manipulations nor a seeming basis or rational for equitable transfer.

Of course, Freeman recognizes the potential for abuse and attempts to lessen it, at least to some extent. Early on, he cleaves strategic issues from issues of social responsibility noting that one "must address real strategic issues and not so-called 'social responsibility' issues" (1984, p. 178; Walsh, 2005, p. 428). One must "narrow down" stakeholder theory's "list of stakeholders. It must leave those out who are too small and too insignificant to worry about to others" (1984, p. 190; Walsh, 2005, p. 428). More recently, Freeman et al. insist that stakeholder theory has "libertarian background conditions" (Friedman and Phillips, 2002, p. 334). One of these conditions is "the belief that the existence of a 'more than minimal night-watchman state'"(referring to Nozick, 1974) such as one that might redistribute wealth cannot be justified (2002, p. 334). In fact, the stakeholder argument

> Says nothing about treating all stakeholders equally, nor does it suggest even remotely that managers should take from one stakeholder group and give to another. Rather the argument recognizes that the stakeholder framework is largely managerial in the sense that Donaldson and Preston have pointed out (Friedman and Phillips, 2002, p. 337, referring to Donaldson and Preston, 1995).

How does this ''stakeholder framework'' in the ''managerial sense'' cohere with Freeman's earlier and best-known theses? How does it cohere with his insistence that ''I can revitalize the concept of managerial capitalism by replacing the notion that managers have a duty to stockholders with the concept that managers bear a fiduciary relationship to stakeholders'' and ''the crux of my argument is that we must reconceptualize the firm around the following question: For whose benefit and at whose expense should the firm be managed'' (Freeman, 2002, p. 39)? I contend that Freeman's later statements are inconsistent with the reasonable and plausible view of stakeholder theory developed in business ethics texts. I take this reasonable or plausible view of stakeholder theory to be the subject of this critique and try to note places where it may not be what Freeman actually meant as evidenced by some of his later papers.

In short, this paper intends to review and reject Freeman et al.'s philosophical attempts to support their theory as well as the theory itself. This essay is highly critical, but it criticizes with the utmost respect to both the problems and the theorists involved. Absent Dr. Freeman, there would be nothing to criticize, and it doubtless takes more effort to construct a proposal than to tear one down. Still it becomes necessary to disagree with stakeholder theory.

It becomes necessary to put into relief two central questions, one that may be called the ''value creation question,'' and a second that may be called ''the question of distributive justice.'' These twin moral imperatives appear to demonstrate that Freeman et al.'s thesis unnecessarily risks important freedoms in the market system.

For example, *Managing for Stakeholders*' dust jacket reports:

> Current ways of thinking about business and stakeholder management usually ask the Value Allocation Question: How should we distribute the burdens and benefits of corporate activities among stakeholders? *Managing for Stakeholders*, however, helps leaders develop a mindset that instead asks the Value Creation Question: How can we create as much value as possible for all of our stakeholders?

The passage (restated in 2007, 4 and elsewhere), attempts to avoid the Rawlsian ''distributive justice'' answer to the ''question of distributive justice,'' but it restates Rawls' answer in different words. Rawls wrote in part that ''inequalities'' (that is, that some people have more and others have less) are only justified to the extent they favor the disadvantaged: Rawls' difference principle [1993, p. 282]. Otherwise, the iron-heel of government is to stamp out inequalities between the have and have-nots that do not serve overall public good. Certainly, says Rawls, such a government cannot allow individuals to be rewarded for goods, gifts, or abilities that are naturally and morally arbitrary. ''Creating value for stakeholders'' likewise implies the moral demand to use one's resources for the good of the less fortunate. Freeman expressly says that he refuses to have his work read in the manner of Rawls' second principle (Freeman and Phillips, 2002, p. 35); however, such a reading is inescapable if stakeholder theory is to mean anything beyond business as usual. Reading positive duties into Freeman's stakeholder theory is necessary and reasonable, yet it clashes with the views of libertarians he wishes to convince.

Freeman is certainly aware of Robert Nozick's arguments (Freeman and Phillips, 2002, p. 335). Nozick has written that one neither should nor really *can* distribute burdens and benefits at all (Nozick, 1974, p. 149). Yet, perhaps Freeman is unaware of another essential libertarian, Ayn Rand, who has noted the immorality built into the attempt furnish to anyone her *values* (Rand, 1964, p. 31). These must be self-discovered not furnished by a corporation or management team (Ladd, 1991, p. 131).

Laissez-faire advocates believe that justice is best left to a minimal set of rules governing an otherwise free market. As Thoreau, Paine, Emerson, and others have observed: ''That government is best which governs least'' (Thoreau, 1966, p. 224; the quotation is variously attributed). But, Freeman's ''value creation'' seems to deny the value of limited government despite Freeman's appeals to voluntary regulation over government regulation (Freeman,

1984, p. 74; Freeman and Phillips, 2002, p. 337) as corporations become in effect a second kind of government. Advocates of limited government see liberty and freedom as inversely proportional to *any kind* of regulation, not just government regulation. Moreover, they contend that the fewest imposed rules from anywhere are a precondition of conscious autonomy. In a ''free-market'' system everyone wants and should want to create individual products of effort (goods or labor) that are either self-sufficient (as in the case of art works), or which are bartered away for the goods needed to pursue happiness (Aristotle, 1985; Huyn, 2001). One's guiding thought in all this is, of course, her own true self-interest which she sees wrapped up, by necessity in a social contract with others (Carrol, 1999; Smith, 2008, p. 167). Such advocates argue that one does not create values for others (they create their own values); one creates specific goods for sale and puts them on the market in the hope that others will snap them up.

Strategically, one advertises a product in such a way as to make it attractive, may even dress it up as ''creating value for stakeholders''; but the true business executive is hardly naive. She has quality standards and integrity independent of what her customers may happen to value. Call the idea that one's duty as a businessperson is to create value for others ''the question of altruism'' as opposed to ''the question of egoism'' (the pursuit of true self-interest).

Simply put, this paper explores the extent to which the question of distributive justice and the question of altruism continue to burden Freeman's stakeholder theory.

What is stakeholder theory? ''Stakeholder theory of the modern corporation.''

Each of Freeman et al.'s articles must be taken singly. Not only does each convey distinct conclusions and arguments, but also their arguments and conclusions sometimes clash or contradict. However, definitions are prior to battles. First, it is necessary to define stakeholder theory. Surprisingly, many of Freeman et al.'s later papers do not define stakeholder theory, although I suppose it might be somewhat trite to keep redefining something that is in common parlance. But what is the common parlance? Many people seem to think they understand stakeholder theory when arguably they do not, though this may well be because the theory keeps shifting and re-manifesting. Nevertheless, I take the best and most fundamental definition of stakeholder theory *for Freeman et al.* to derive from ''Stakeholder Theory of the Modern Corporation'' (2002). This paper first taught me about stakeholder theory and it seems this is where many undergraduates first learn it as well. The article appears, for example, in at least two important Business Ethics textbooks (Beauchamp and Bowie, 2004; Donaldson et al., 2002).

The ''purpose'' of ''Stakeholder Theory of the Modern Corporation'' ''is to pose several challenges'' to the *assumptions* ''within the framework of managerial capitalism'' (2002, p. 38). Primary among these assumptions is the ''primacy of the stockholder.'' A ''prophetic'' quote from Berle and Means sets up the corporation as a modern day Goliath ''grown to tremendous proportions'' (Berle and Means, 1932) that has become ''a method of property tenure and a means of organizing economic life'' (Freeman, 2002, p. 38 quoting Berle and Means). Freeman writes that he does not seek ''the demise of the modern corporation,'' rather he seeks its ''transformation'': ''My thesis is that I can revitalize the concept of managerial capitalism by replacing the notion that managers have a duty to stockholders with the concept that managers bear a fiduciary relationship to stakeholders'' (2002, p. 39). Nevertheless, the short article evinces what Freeman himself (in one section) calls ''The Attack on Managerial Capitalism'' (why attack something that one *only* seeks to transform?).

This ''attack'' on some form of capitalism which has become a trademark of Freeman's work, consists of what Freeman calls a legal and an economic argument. Succeeding these arguments are the usual considerations about how stakeholder theory might affect each of the stakeholders in the corporation – stakeholder such as owners, suppliers, customers, and the local community. Freeman ends by considering the ''Role of Management.'' In this section he argues that stakeholder theory is compatible with several different ''normative cores'' (i.e., theories of ethics) such as fair contracts, feminism, and ecological principles.

What is important here is the definition of stakeholder theory. Freeman defines stakeholder theory here as:

(1) Redistribute benefits to stakeholders, and
(2) Redistribute important decision-making power to stakeholders.

As for (1) *Redistribute benefits to stakeholders*, Freeman writes, ''My thesis is that I can revitalize the concept of managerial capitalism by replacing the notion that managers have a duty to stockholders with the concept that managers bear a fiduciary relationship to stakeholders.'' ''The crux of my argument,'' writes Freeman, ''is that we can reconceptualize the firm around the following question. For whose benefit and at whose expense should the firm be managed'' (p. 39)?

Freeman thinks that firms should benefit and exact costs from *stakeholders*. In this early paper, Freeman provides no way of assessing whether one stakeholder has made a greater contribution than another, but this does not mean that the costs and the benefits are to be divided equally. A later paper clarifies the problem: ''Surely the claims of a customer outweigh in a moral sense the claims of a terrorist group, no matter what effects are brought about by each'' (Dunham et al., 2006, p. 26). Freeman et al. examine ''four different subcategories of community, each of which suggests potentially different discussions of both moral claims and management approaches'' (2006, p. 36). Eventually, Freeman et al. give an answer:

> We hypothesize that a firm ought to interact *with* other communities that it *affects or is affected by*, seeking to understand their perspectives, listen to their preferences, and evaluate the impact of actions on them. Such interaction is best characterized as…*cooperation*…it ought to be *in* closer community with those upon whom it *relies* for support – employees, suppliers and customers. Such interaction requires a deeper commitment than that necessary for the first set of communities. It requires a more active pursuit… – sharing interest, actions, and values. The firm's interaction with these groups must be…*collaboration* (Dunham et al., 2006, p. 38).

Many will find Freeman et al.'s answer unsatisfactory. First, it seems to appeal to self-interest rather than altruism. A firm that takes care of those who can affect it most, rather than those who cannot, seems to be advocating managerial capitalism or business as usual not a revolutionarily new stakeholder theory. Second, one might argue that Freeman et al.'s response really does not answer the question (besides maybe excluding a fiduciary duty to aid terrorist groups). It says that one group of stakeholders should get more than another. It does not answer who gets what *among* the members of the two groups themselves.

As for (2), *Redistribute Important decision-making power to stakeholders*, Freeman defines stakeholder theory as giving each stakeholder an important say and efficacy in making important decisions: ''That is, each of these stakeholder groups has a right not to be treated as a means to some end, and therefore must participate in determining the future direction of the firm in which they have a stake'' (Freeman, 2002, p. 39). They must have real and not simply illusory or token decision-making power. Once again, this need not be equal decision-making power (either equal to the executives or equal among themselves). However, the problem persists: *who* should be given more decision-making power? (Indeed, who is empowered to dole out decision-making power?) Presumably, Freeman et al.'s answer to who gets decision-making power dovetails with the discussion of who benefits quoted above. Those in the collaboration group get more decision-making power than those in the cooperation group. Still, the collaboration/cooperation distinction does not help decide who gets more decision-making power within each group and why.

Next, in ''Stakeholder Theory of the Corporation'' Freeman offers two arguments, or sets of premises, for this theory as defined, one set ''legal,'' the other ''economic.''

Freeman begins the ''legal argument'' by saying that it is ''central to the managerial [capitalism] view that ''management can pursue market transactions with suppliers and customers in an unconstrained manner'' (2002, p. 39). This, of course, is a bit of a straw man, depending on what one means by ''unconstrained.'' It seems impossible to find an advocate of traditional laissez-faire or free-market capitalism who does not believe that firms should be prevented from selling human beings or from forming monopolies. Adam Smith writes of the government's duties to erect institutions that are for

societal benefit rather than individual (Smith, 2000, II.3). This would probably include the regulation of food and drugs. Milton Friedman tells us that

> Anything that prevents prices from expressing freely the conditions of demand or supply interferes with the transmission of accurate information. Private monopoly – control over a particular commodity by one producer or a cartel of producers – is one example. (1980, p. 17)

Freeman's next step involves eliciting some new laws "in this century" that now constrain corporations and "in effect" require "that the claims of customers, suppliers, local communities, and employees be taken into consideration" (Freeman, 2002, pp. 39–40). For example, Freeman cites *privity of contract* in Winterbottom v Wright, *strict liability* in Greenman v. Yuba Power. He also cites the Consumer Product Safety Commission, the National Labor Relations Act, and the Clean Air and Clean Water Acts among others.

In sum: New laws are constraining corporations in a way they once were not: therefore we have to (or should) change the beneficiaries of business from the stockholders to the stakeholders and give the stakeholders serious decision-making power.

Clearly, the conclusion need not follow from the premises. There is no doubt that new laws constrain corporations in a way that they once were not constrained. However, stakeholder theory does not follow. The conclusion that we *should* or in fact *are* changing the beneficiaries and the decision makers from stockholders to stakeholders does not follow from laws preventing violation of the rights of stakeholders.

Let us consider government regulation of the economy for a moment. It is possible to have a maximal state, a minimal state, an ultraminimal state, or no state at all. In *Anarchy, State and Utopia* (1974), a classic of free-market political thought and economics, Robert Nozick tries to show why the minimal state is best. The minimal state is best because it protects the non-violability of persons, particularly from state or individual aggression. Famously, the minimal state protects individual persons through "moral side constraints":

> A specific side constraint upon action toward others expresses the fact that others may not be used in the specific ways the side constraint excludes. Side constraints express the inviolability of others in ways they specify (1974, p. 32).

Winterbottom v Wright, for example, considers a particular kind of "economic externality" – namely, a person who benefits from a contract who was not part of the contract. The Postmaster-General in this case contracted with the plaintiff Winterbottom to *drive* a mail coach. However, the Postmaster contracted with the defendant Wright to *maintain* the coach. These are two different contracts. Meanwhile, the coach fell apart and Winterbottom was injured (Winterbottom v. Wright, 1998).

Winterbottom v. Wright is a strange case for Freeman to use to make his point, since the court ruled that the third party, Winterbottom, had *no* case against the Postmaster's contract with Wright (that is the point of privity of contract). The stakeholder loses out. Yet, imagine counterfactually that some future stakeholder-favoring law actually awarded damages to Winterbottom for his injuries and sought to make him whole again. It still would not follow that Winterbottom *benefits* from the Postmaster's contract with Wright, nor that he has any real decision-making power in it. Civil tort law regulates the relations between aggrieved parties. Under preponderance of evidence a remedy seeks to make a plaintiff "whole" – that is, it gives back to the person what the injury has taken away. Such a remedy does not change beneficiaries nor award any greater "decision-making" power to the plaintiff that she did not already possess as a right.

Similar reasoning shows the invalidity of Freeman's "economic" argument. According to Freeman,

> In its perennial criticism of government regulation, management espouses the [Adam Smith's] "invisible hand" doctrine. It contends that it creates the greatest good for the greatest number, and therefore, government need not intervene. However, we know that externalities, moral hazards and monopoly power exist in fact, whether or not they exist in theory (41).

Freeman gives examples such as the "tragedy of the commons," the "free-rider problem," calling these "moral hazards" when

> the purchaser of a good or service can pass along the cost of that good. There is no incentive to economize

on the part of either the producer or the consumer, and there is excessive use of the resources involved. *The institutionalized practice of third-party payment in health care is a prime example* (41, emphasis mine).

Again, the examples are rather irrelevant when the *target* is the "pure ideological form [of] managerial capitalism" that "espouses the "invisible hand" doctrine. Invisible hand enthusiasts think that *government intervention causes* problems such as the tragedy of the commons, free-riderism, and the moral hazards of third-party payment in health care. They do acknowledge the *lack* of government intervention as the problem. They argue that the problem actually is *too much* government intervention. For such enthusiasts, it seems next to impossible to see how the cure for economic ills could possibly be *increased* regulation in the form of changing the beneficiaries of business and the decision makers to stakeholders. Why would someone think that the kind of increased regulation stakeholder theory proposes (internal or otherwise) would help alleviate economic woes or moral hazards?

Take for example third party payment in health care. Employers who pay for healthcare sometimes have employees who bill unneeded or unnecessary procedures and exams. Alternatively, medical establishments may inflate prices when they know that a big company is paying for them (Singer, 2006).

Freeman contends that "*the institutionalized practice of third-party payment in health care is a prime example*" (41, emphasis mine) of the kind of economic externality and moral hazard stakeholder theory can alleviate. Yet, it is not clear how stakeholder theory even applies to third-party health care at all. I am not sure how Freeman would clarify, but stakeholder theory's most straightforward demand is that HMOs and other health-care management structures should (1) change the beneficiaries from stockholders to stakeholders and (2) give stakeholders serious decision-making power they do not already have.

Two immediate responses arise. First, nonprofits do not have stockholders (unless one metaphorically considers the public to be stockholders), so (1)'s application is dubious. Second, it is not clear *which* stakeholders need more benefiting and how. According to the Cato Institute:

> The high cost of health services regulation is responsible for more than seven million Americans lacking health insurance, or one in six of the average daily uninsured. Moreover, 4,000 more Americans die every year from costs associated with health services regulation (22,000) than from lack of health insurance (18,000). (Conover, 2004)

Conover, a free-market, "invisible-hand" theorist, argues that deregulating health-care would actually benefit many more "stakeholders" than would the regulations demanded by stakeholder theory. In conclusion, stakeholder theory has not shown itself to be viable in alleviating economic ills. We need not accept that freedom in the market produces these economic ills. But, even when we do, it is not clear how stakeholder theory follows or applies to ameliorate them.

Managing for stakeholders

"The purpose" of the essay "Managing for Stakeholders," writes Freeman, "is to outline an emerging view of business…[that holds that] businesses and the executives who manage them, actually do and should create value for customers, suppliers, employees, communities, and financiers (or shareholders)" (2008, p. 39).

In "Stakeholder theory" Freeman argued against "managerial capitalism." In "Managing for Stakeholders" he argues against "the dominant story or model of business that is deeply embedded in our culture" (39). It is "no longer workable." By this Freeman means the dominant story or model is "resistant to change, not consistent with the law, and for the most part, simply ignores matters of ethics." Freeman argues that "managing for stakeholders solves some of the problems of the dominant model." "Managing for stakeholders" creates better consequences (utilitarianism), better respects human rights (Kantian or Lockean deontology), produces better human character (virtue ethics), and is better according to some kind of pragmatist argument. In short Freeman contends that managing for stakeholders trumps the dominant story or model according to most every important theory of ethics.

The first difficulty lies in figuring out how "managing for stakeholders" differs from the

dominant story or model of capitalism. Hence, this difficulty also raises the problem of figuring out exactly what stakeholder theory opposes (this problem persists through nearly all of Freeman's work). Freeman does not help here. Instead of explaining the dominant story or model, Freeman writes that he will explain "how the dominant story came to be told" (40). Telling how a story "came to be told" differs from telling it. It is *not* the same thing as giving or explaining the dominant story or model. Presumably Freeman thinks that what he says about "how the dominant story came to be told,"is true: this *is* how it came to be told. Meanwhile, the whole point is that he thinks the actual dominant story or model is fallacious (false or untrue or at least "unworkable," "resistant to change," "inconsistent with the law," and ignorant of ethics). He means to *change* the dominant story or model to something that is workable, changeable, legal, and ethical. If so, then we do not have the dominant story or model. We have "how it came to be told," which is *history*. One cannot change history; history just is. It is presumably a fact that Alfred Sloan divisionalized General Motors, i.e., adopted the "military and civil service bureaucracy" model for managerial authority. It is a fact that "managerialism, hierarchy, stability, and predictability all evolved together,…to form the most powerful economic system in the history of humanity" (40). So much so that it is a fact that "Joseph Schumpter predicted that it would wipe out the creative force of capitalism, stifling innovation in the drive for predictability and stability."

So far then Freeman has not said anything that we can disagree with or change. Perhaps, we can agree with Freeman that this is how the dominant story or model (whatever it is) *came to be told*. Still, we do not know what the dominant story or model is.

Instead of explaining, Freeman goes right into attacking. Throughout all his works he seems to argue repeatedly for a single point: that stakeholders should replace stockholders. In "Managing for Stakeholders," Freeman says that "During the last 50 years this "Managerial model" has put "shareholders" at the center of the firm as the most important group for managers to worry about…It has become common wisdom to "increase shareholder value" (41). He notes that incentive plans for superior performance are tied to the price of company stocks so that the stock price "has become the standard for measuring company performance." Freeman is correct that executives at Enron, WorldCom, Tyco, and Arthur Anderson lost sight of more accurate measures of company value in an effort to increase stock price. However, it is not clear that "the recent scandals…are in part due to executives trying to increase shareholder value." It is true that these scandals involved artificially inflating stock price. The executives then burst the bubble and then collected before all the hot air ran out. Still, the overwhelming majority of shareholders lost considerable value. Arthur Anderson continues to be sued by Enron shareholders (Corporate Scandals, 2005). Worldcom CEO Bernard Ebbers "was sentenced to 25 years in prison" and has "agreed to pay $5.5 million cash…and other assets worth as much as $40 million to resolve claims filed by WorldCom shareholders who lost billions…when the company collapsed (Corporate Scandals, 2005). Heath (2006) argues that managers "underestimate the potential for moral hazard in the relationship between managers and shareholders…at their peril" (538). Managers at Enron, Parmalat, Tyco, and WorldCom enriched "themselves primarily at the expense of shareholders (Heath, 2006, p. 538).

Hence, if the dominant story or model of managerial capitalism puts shareholders "at the center of the firm as the most important group for managers to worry about," then the dominant model does not seem to condone or justify scandals that harm shareholders.

Freeman suggests that maybe it is not the dominant model but the *conditions for applying* the dominant model which are at fault for such scandals: "Unfortunately, the world has changed so that the stability and predictability required by the shareholder approach can no longer be assured" (41). However, Freeman never clarifies why the dominant story or model requires "stability" or "predictability." Nor does he argue as to why we cannot change the conditions for applying the dominant story or model (say through legislation). In fact, these scandals might simply be listed as crimes (since they broke laws). Criminals pervert many fine principles. Otherwise, Freeman must show that applying the dominant model likely *leads* to scandal. This seems logically false as well as implausible.

Let us move on to Freeman's particular arguments in "Managing for Stakeholders." The first argument

is that the "dominant story or model" is resistant to change. Freeman explains that "the managerial view of business with shareholders at the center…puts shareholders' interests over and above the interests of customers, suppliers, employees, and others, as if these interests must conflict with one another" (41). On this model of hierarchy, "change should occur only when the shareholders are unhappy." Freeman says this model ignores current reality:

> if customers are unhappy, if accounting rules have been compromised, if product quality is bad, if environmental disaster looms, even if competitive forces threaten, the only interesting questions are whether and how these forces for change affect shareholder value.

Freeman seems to imply that the "managerial view" (as he here calls it), fiddles while Rome burns. The managerial view refuses to change its commitment to returning the investment of stockholders.

Once again, one can acknowledge many of the "ifs" (or "antecedents" as is the lingo) without concluding that the managerial view is irresponsibly unchanging. Yes, some customers are unhappy (when will customers ever be completely happy?). Yes, some accounting rules have been compromised; yes, some product quality is bad (and so on). I return to the previous argument. What do these "scandals" have to do with either the letter or the application of the "managerial view"? Freeman does not clearly and causally connect the ills with the view that he thinks is responsible, nor with that view's resistance to change.

In fact, change is not always good. The refusal to change on some things is called "integrity." Companies change product lines, advertising approaches, personnel, market-share, leadership (and so on) frequently or all the time. However, they should have integrity. This means that companies should have sufficient reason before they change their core principles.

Freeman next argues that "The Dominant Model is Not Consistent with the Law." This is a nearly verbatim repeat of the "legal argument" from "Stakeholder Theory" (2002, discussed above). However, an additional point needs to be made about this more recent (2008) construal of the argument: it now seems paradoxical. How can the "dominant" model be *dominant* and inconsistent with the law? It is the dominant view because it is the law. At least one would think that the dominant model of managerial capitalism is in part constituted and constitutive of the law. Milton Friedman, a prominent free-market theorist, argues that business only social responsibility is to follow ethical custom *and law* (2002, p. 33 also referenced by Freeman, 2008, p. 43). Business must follow the rules of the game (2002, p. 38). How then can it be inconsistent with the law?

One can easily multiply examples of business-people breaking laws. One can even find examples of free-market or any other kind of theorists breaking laws. What Freeman must do, but does not do is show where and how "the managerial view" might by itself lead to or even enable law breaking.

Similarly, Freeman argues that "The Dominant Model is Not Consistent with Basic Ethics" (43). But what is "basic ethics?" I rather do not agree that what Freeman comes up with as basic ethics is really *basic* ethics, however agreement is not really essential here. Once again, one can agree with Freeman's basic ethics without his conclusion involving rejection of the dominant model following at all (once more an invalid argument).

First, Freeman notes that many people believe the "separation fallacy." this fallacy says that: business decisions have no ethical content and ethical decisions have no business content or implications for business. Freeman also notes the "Responsibility Principle": "Most people, most of the time, want to, actually do, and should accept responsibility for the affects of their actions on others" (2008, p. 44). With these premises, Freeman provides the following argument. Schematically,

> Basic Ethics principle (1) Business is not separate from ethics
>
> Basic Ethics principle (2) Most people want to accept responsibility for their actions effects on others
>
> The traditional model denies (1) and (2)
>
> – therefore
>
> The traditional model is inconsistent with basic ethics

Looking at this argument's premises, I agree with Freeman that the belief in the separation of business and ethics is absurd. Ethics is the study of theories of

what is good or bad, right or wrong in human conduct. Business is a kind of human conduct. Ethics and business cannot be separated as long as there is always conduct that is good or bad in business. Separating ethics from business would be like separating mathematics from algebra. Algebra can be done badly but that hardly dismisses the rules for doing it. One can even agree that ''Most ethical decisions, or decisions about ethics have some business content or implicit view about business'' (2008, p. 44), though I am not sure I would agree if pressed. As I said before, Freeman never actually provides anything like a complete description of the ''traditional model.'' All he says is that it has something to do with benefiting and deriving decisions from stockholders.

As for the second premise or Basic Ethics principle (2) Most people want to accept responsibility for their actions effects on others, I am not sure this is true. I agree that it would be nice were it true. Freeman then argues that ''the Responsibility Principle is incompatible with the Separation Fallacy.'' This seems correct.

Finally, the conclusion: ''If we want to give up the separation fallacy and adopt the integration thesis,..., then we need a new model for business...[i.e., the] ''stakeholder framework'' (pp. 44–45). This conclusion does not seem to follow at all. Freeman neither clarifies the traditional model nor shows that it denies either ''basic ethics'' principle. Freeman even cites Milton Friedman as giving ''a morally rich answer'' that coheres with both principles:

> He claims that the responsibility of the executive is to make profits subject to law and ethical custom. Depending on how ''law and ethical custom'' is interepreted, the key difference with the stakeholder approach may be that we disagree about how the world works. In order to create value we believe that it is better to focus on integrating business and ethics within a complex set of stakeholder relationships rather than treating ethics as a side constraint on making profits (43–44).

As it turns out, Friedman does not treat ethics as a set of side constraints on making profits because he believes that the business of making profits is *itself* ethical. The problem is that many people associate profit making with some form of self-interest and ethics with some form of altruism (Heath, 2006, pp. 540–541). Those who think Ethics constrains self-interest will hold that business ethics constrains the pursuit of profit. Heath (2006) notes two strategies ethically legitimating the pursuit of profit. The Lockean strategy (espoused in part by Friedman, Nozick, Machan and others) holds that shareholder money is invested property (see also Stieb, 2004). Shareholder rights include an expectation of repayment with interest for money the shareholder has invested. Heath calls the second strategy Paretian apparently after ''Pareto optimality'' which has to do with reallocating goods to find the point where no person can be made better off from further redistribution. This strategy would argue that pursuit of shareholder profit creates the greatest good for the greatest number (utilitarianism) and is argued for by both Heath (2006) and, classically, Adam Smith's invisible hand. A third strategy missed in Heath's list enjoins that the pursuit of profit is inherently ethical and commendable (argued by Rand, 1964 and Chesher and Machan, 1999). The successful pursuit of profit represents many virtues including thrift, industry, hard-work, and intelligence. Thus, it becomes difficult to see why ''the dominant model is not consistent with basic ethics'' (Freeman, 2008, p. 43).

''Stakeholder Theory: a Libertarian defense''

So far this essay has looked at Freeman's ''Stakeholder theory of the corporation'' (2002) and ''Managing for stakeholders'' (2008). ''Stakeholder theory'' argues that the beneficiaries of business should be changed from stockholders to stakeholders, and that stakeholders should be given serious decision-making power. ''Managing'' argues that the ''dominant model'' of managerial capitalism is resistant to change, inconsistent with the law and inconsistent with basic ethics. Both papers offer similar structures and arguments. I have argued that all the arguments presented by Freeman are invalid. One can agree with the truth of the premises without the conclusion following as true.

Stakeholder theory's conclusion is very important. I think there is plenty of reason to believe that stakeholder theory concludes that beneficiaries

should be changed from stockholders to stakeholders and that the stakeholders should be given serious and effective decision-making power on par with executives. This is how it is defined, and what it implies. Stakeholder theory then appears to be an attack on laissez-faire or free-market economics, capitalism itself, or whatever else is the ''dominant view'' or ''managerial capitalism'' (Freeman calls it an ''attack'' on managerial capitalism in 2002, p. 39). Indeed, most textbook editors think this is what Freeman means (Donaldson et al., 2002; Donaldson and Werhane, 2008, p. 13; Heath, 2006, p. 540).

Such editors then usually look for some opposition to Freeman. It is necessary to supply some obvious counterpoint or opposition to Freeman because he does not supply one himself. Milton Friedman appears to fit. Friedman argued at least in part that the only social responsibility of business is to make a profit because (1) they are the employees of stockholders who are the ones with the money, (2) social responsibility makes an end run around the democratic process (decisions affecting a majority should be made by a majority), (3) executives do not have much ability to change things like inflation or hard-core unemployment, little training, and a good chance of being fired if they do so, (4) efforts at ''social responsibility'' are self-contradictory, and so on (Friedman, 2002). Friedman seems to typify ''stockholder theory'' or the pre-eminence of the stockholder as beneficiary and decision maker in business.

The point is redoubled by Heath who says that Friedman's ubiquitous ''The Social Responsibility of Business is to Increase its Profits'' which argues that maximizing profits for shareholders is ''the cornerstone of business ethics,'' only appears in textbooks ''not as the point of departure for further development of the theory, but rather as an example of an instructively mistaken point of view'' (2006, p. 540). But, says Heath, this is a mistake. Friedman's view *can* be a ''point of departure'' for its own consistent ethical theory (which Heath supplies in part).

Likewise, Freeman may not oppose Friedman at all. In fact, Freeman explicitly denies that there need be any disagreement (2008, p. 43), and he embraces many common tenets. Some of these tenets are freedom, liberty, the demand of Rawl's first principle of justice which seeks maximal liberty compatible with like liberty for all, the acceptance of Nozick's critique of Rawls' second principle, negative rights including individual property rights, only voluntary positive obligations, countenance of the minimal state, and personal *not* ''social'' responsibility (Freeman and Phillips, 2002, p. 336).

It gradually becomes clear that Freeman means to at least look like he is not really attacking laissez-faire free-market economics or the ''dominant view'' of ''managerial capitalism''at all. Perhaps these are just misguided. They ask ''the wrong questions'' (Freeman et al., 2007, p. 11). This is the point of Freeman and Phillips' paper ''Stakeholder Theory: A Libertarian Defense'' (2002). In my opinion ''A Libertarian Defense'' bends over backward to make stakeholder theory look compatible with libertarianism; however, it does not succeed.

A libertarian, laissez-faire, Adam Smith, invisible hand theorist (or whatever one might want to call such a theorist) such as Milton Friedman, Tibor Machan, or Ayn Rand might well agree with the first half of ''A Libertarian Defense.'' Freeman and Phillips take great pains to show a great respect for the concepts of personal freedom: ''that it is definitional of humans, or shows us at our best'' (334). They acknowledge that ''one human being has the right not to be interfered with by others'' (at least physically not physically harmed) – hence, a strong system of individual property rights. Freeman and Phillips point out that libertarians disagree with any form of wealth redistribution and anything more than a ''minimal night-watchman state'' (334 referring to Nozick, 1974). All figures involved including Phillips and Freeman appear to acknowledge Rawls' first principle of greatest liberty compatible with like liberty for all and disdain his second which justifies inequalities only if they favor the disadvantaged.

However, a subtle shift begins to occur. One might think that the shift away from agreeing with libertarianism occurs at the beginning of Freeman and Phillips' paper when they seem to set up *only two* options for capitalism. ''Cowboy capitalism'' presumes that individuals are ''nakedly greedy, responsible to others for the effects of their actions only in so far as they are caught doing harm.'' Cowboy capitalism sets up a state ''that pervasively regulates all aspects of value-creation and trade'' (331). Once again, Freeman and Phillips also call cowboy capitalism ''the standard story'' and ''shareholder capitalism.''

And yet again, the heroic alternative ''stakeholder capitalism'' argues that ''individuals have a complex psychology,'' ''they desire to be and are responsible for the effect of their actions on others.'' ''Many are, or certainly ought to be, deeply skeptical of the view that the state looks out for their interests.''

One might want to stop this apparent false dichotomy at the beginning and note that there are all kinds of capitalism. ''Cowboy capitalism'' does not seem to describe anyone's view in particular, nor business as usual or any such thing. However, let us just take ''cowboy capitalism'' as an idealized construction representing what some cynical robber baron might think, and as something everyone including laissez-faire theorists should oppose.

If we do this, then we see that Freedman and Phillips' departure from libertarianism seems to occur when they do not actually acknowledge their agreement with Nozick's critique of Rawls (335). There comes a tricky point where they stop agreeing and simply start describing. Second, there are a few remarkable tale-tell quotes sure to raise a libertarian's suspicions. First, Freeman and Phillips quote Jean Hampton:

> Whereas utilitarianism might be said to allow individuals to be held hostage to the well being of the community; libertarianism might be said to allow the community's well-being to be held hostage to the rights, and in particular the property rights of individuals'' (Hampton, 1997, quoted by Freeman and Phillips, 2002, p. 336).

No libertarian is going to agree that libertarianism holds the community hostage!

Second, a quote from Donaldson and Preston is extremely instructive as to what Freeman and Phillips really think. First Freeman and Phillips say that ''despite the libertarian arguments..., ultimately we have to come to see stakeholder theory as *managerial*'' (2002, p. 339, emphasis mine). A theory is ''managerial'' when it ''does not simply describe existing situations...[but] also recommends attitudes, structures, and practices...'' (2002, p. 339 quoting Donaldson and Preston, 1995, pp. 75–76). Specifically, ''Stakeholder theory does not necessarily presume that managers are the only rightful locus of corporate control and governance.'' This is quite a gem which is apt to be missed in rushing through the paper. Freeman means to say that other people than managers – i.e., stakeholders – should *control* and *manage*? No libertarian will agree that the suppliers, the local community, the employers and so on should control and manage the firm. I do not believe that any manager would or should agree either. It would mean the end of her job.

A couple of pages earlier Freeman and Phillips write:

> Managers..., must take the interests of stakeholders into account, else they might misuse shareholder's property to harm others and violate their right to freedom. This argument says nothing about treating all stakeholders equally. [sic] nor does it suggest, even remotely, that managers should take from one stakeholder group and give to another. Rather, the argument recognizes that the stakeholder framework is largely managerial, in the sense that Donaldson and Preston (1995) have pointed out. (Freeman and Phillips, 2002, p. 337)

Now, how should we interpret this apparent contradiction? Does the ''managerial'' view of the stakeholder framework cede control of managing and controlling the firm to stakeholders? This is what the first recommended quote from Donaldson and Preston seems to conclude. Or, does the recognition that the stakeholder framework is managerial (in the sense of Donaldson and Preston) not ''suggest even remotely that managers should take from one stakeholder group and give to another?'' as the second quote says? Ceding control and management power (and decision-making power and the rest) *is* taking from one stakeholder group and giving to another.

Despite his protestations in ''Stakeholder Theory: A Libertarian Defense'' (2002), I think Freeman's stakeholder theory seeks to cede control and management of the firm. As ''Stakeholder theory of the Corporation'' published the same year (2002) informs us: stakeholder theory seeks to change the beneficiaries to the stakeholders and to give them serious decision-making power. This conclusion is unacceptable in general and not just to libertarians. It is unacceptable because Freeman never seems to provide a valid argument for it (we can accept all his premises without this conclusion following). It is also unacceptable because it denies the property rights of stockholders, denies the fiduciary duty of managers to stockholders, relieves managers of their

duties, and rewards stakeholders (such as suppliers and competitors) who are either marginal or even counter to the firm's actual wealth creation. It takes from those who do the work and gives to those who do not for no other reason than (plausibly) compassion or egalitarianism.

The question of "distributive justice" (taking from the "haves" and giving to the "have nots") pinpoints the problem. Is one to distribute according to need, merit, effort, distribute equally, or some other criterion? I think Freeman more or less assumes *need* decides. For example, in a list of how stakeholder theory is supposed to affect each stakeholder he writes: "When the firm treats the supplier as a valued member of the stakeholder network, rather than simply as a source of materials, the supplier will respond when the firm is in need" (2002, p. 43).

More pressingly,

> The local community grants the firm the right to build facilities…The firm cannot expose the community to unreasonable hazards in the form of pollution, toxic waste, and so on. If for some reason the firm must leave a community it is expected to work with local leaders to make the transition as smooth as possible…When it discovers some danger or runs afoul of new competition, it is expected to inform the local community and to work with the community to overcome any problem. When the firm mismanages its relationship with the local community, it is in the same position as a citizen who commits a crime. It has violated the implicit social contract with the community and should expect to be distrusted and ostracized. It should not be surprised when punitive measures are invoked. (Freeman, 2002, p. 43)

The firm needs the supplier and Freeman commends the supplier for supplying it when it is in need. The community needs the firm, and rather than simply following "the law and ethical custom" according to their perceived best-interests (Friedman, 2002, p. 33), the firm should go beyond these and assist the community according to some vague individual standard of what is reasonable. Presumably, some powerful individuals in the community get to decide whether the firm's pollution *is* reasonable.

This raises a question, as Friedman might put it, on the level of "political principle." Friedman noted with the *Federalist Papers* that the law is slow for a reason (so it does not make mistakes). Hamilton, Jay, and Madison argued that it is better to achieve change through democratic processes where all (potentially) have a say rather than surrender governance to a few powerful interest groups. Yet apparently, for Freeman, the communities need trumps due process.

Further, I do not know what Freeman means when he says not to treat suppliers "simply as a source of materials" (2002, p. 43). How could one treat any person that way? What is Freeman asking us to do: continue to purchase materials from a supplier even when there are better sources? Of course suppliers should be treated civilly, but beyond that I really do not know: "There is no guarantee that any supplier will "respond" to any "need" no matter how well treated. Nor is there any reason to believe that the supplier [or anyone else] has a responsibility to act altruistically."

The "capitalist" or "libertarian" solution to the wealth distribution problem tells individuals to keep their hands off the market ("laissez-faire"). The *market* distributes; we do not. Governments, "to secure the rights of the governed" must enforce some minimal conditions stipulating contracts, preventing monopolies, proscribing the sale of human beings and the like, but the ultimate solution follows the money. One is obliged to the money they accept from stockholders. Stockholders are the primary beneficiaries of corporate effort and dividends. Freeman would like to have *stake*holders benefit (more than they do already), not because they put money into the corporation, but because they have a "stake" in it. However, he seems to have no good answer to the questions: "How much should stakeholders benefit and get to decide?" and "Do they already benefit enough and have enough decision making power?" If the answer to the second question is "yes," then Freeman et al. simply do not have a theory that changes anything.

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