CORPORATIONS AND CORPORATE GOVERNANCE

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A RETURN TO FIRST PRINCIPLES

Samuel Gregg

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Foreword

Over the past ten years, the language of business life has become increasingly replete with phrases such as 'corporate social responsibility', 'business ethics', 'ethical investment', and 'the triple bottom line'. They are regularly articulated by politicians, journalists, business leaders, welfare lobbyists, as well as the heads of other community organisations.

In this monograph, Samuel Gregg indicates that, from the standpoint of good corporate governance, these ideas reflect a general effort to change decisively the manner in which corporations operate and the ends that they serve. Far from celebrating this development, Gregg suggests that it may do much damage to the capacity of corporations to deliver shareholder value, and, perhaps more significantly, encourage corporate leaders to involve their organisations in activities that corporations are simply not designed to perform.

For these reasons, Gregg revisits the entire idea of corporate governance, and contends that any sound theory of corporate governance has to be based upon premise that every organisation has a particular reason to exist: a *telos*. Once one recognises that a corporation has purposes which are *different* to those of a charity, a church, a social welfare lobby group, or a sports club, then the limits on the corporation's ability to assume other responsibilities becomes clearer. As part of its self-identified mission, for example, a church may articulate, from time to time, various principles that it believes are necessary for the moral underpinnings of a free market economy. But few would regard it as reasonable for a church to take on the role played by government in such an economy. This would strike many as an example of institutional dysfunctionalism—of a church betraying its *telos*.

But the problems with what is commonly referred to as 'stakeholder' theory as well as expressions such as 'corporate social responsibility' and 'ethical investment' go beyond this particular issue. When subject to closer examination, it becomes apparent that they are characterised by profound moral and philosophical incoherence. To this extent, Gregg maintains, they actually serve to distract people from serious reflection upon the moral life within corporations. In this sense, they are counterproductive.

When it comes to developing a sound moral ecology within corporations, Gregg suggests that there is no substitute for abiding by long-established conventions, observance of the rule of law, and an enhancing of understanding of the basic rules of moral reasoning among people working in corporations. While this is a somewhat humbler (and far less politicised) path that many propositions advanced by some stakeholder theorists, Gregg maintains that it is a way that takes the moral life more seriously, precisely because it focuses upon the only earthly moral agent there is: the human person.

Many of Gregg's ideas in this monograph will challenge much of the thinking about corporate governance and the moral life that presently prevails within much of the academy as well as a proportion of the business community. Interestingly, however, Gregg concludes with a challenge to corporate leaders (rather than the proponents of corporate social responsibility and stakeholderism), urging them to

heighten their degree of engagement with the world of ideas. In Gregg's view, the business community tend to find itself forced to adopt defensive positions when debate about questions such as the purpose of corporate governance emerge. All too often, some corporate leaders are slow to enter the fray and consequently find themselves attempting to explain their case on an intellectual terrain that has already been marked out by others, some of whom appear instinctively hostile to business *per se*. According to Gregg, attention to shifts in the world of ideas—however erroneous or desirable such ideas might be—will increasingly become part of the art of corporate governance. For ideas do have consequences, not least for shareholder value and the ability of corporations to operate in a favourable environment.

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About the Author

Samuel Gregg is a moral philosopher who has written and spoken extensively on questions of ethics in public policy, ethics in business, as well as Catholic social teaching. He has an MA in political philosophy from the University of Melbourne, and a Doctor of Philosophy degree in moral philosophy from the University of Oxford which he attended as a Commonwealth Scholar. He is the author of several books, monographs and articles, which study questions ranging from moral philosophy to issues of ethics and economics. In 2000, Gregg was awarded the Friedrich von Hayek Fellowship by the Mont Pelerin Society. He is presently Director of the Center of Economic Personalism at the Acton Institute in Grand Rapids, Michigan, a member of the Faculty of the John Paul II Pontifical Institute (Melbourne Campus) within the Pontifical Lateran University, and an Adjunct Scholar at the Centre for Independent Studies in Sydney.

1

Introduction

In the past three decades, most Western societies have undergone a number of difficult transitions following their embrace of economic reform. Broad changes have also occurred in the functioning of modern corporations, not least because of the information revolution.

But this does not mean that corporations are likely to disappear. Some have been 'downsized'. Others, however, have emerged to transcend the boundaries of nation-states. Francis Fukuyama notes, for example, that 'Even within the communications industry, fiber optic transmission favours a single, giant long-distance company, and it is no accident that by 1995 AT&T had grown back to the size it was in 1984, when 85 percent of the firm was divested into local telephone companies' (1995: 24-5; Davidow and Malone 1992). Certainly, information technology will assist small firms in doing large tasks better. But it will not eliminate the need for scale, any more than the computer's advent has not reduced the amount of time worked by people.

While there may be some dispute about whether corporations will increase or diminish in number, few would question that, for a variety of reasons, corporations do not enjoy a good reputation—especially if they are transnational in nature. Our everyday language is full of expressions such as 'corporate greed', 'astronomical compensation packages', and 'obscene salary levels'. Invariably, they are used with reference to major corporations rather than small-to-medium size businesses.

Corporations are also regularly portrayed as enjoying excessive power. Many corporations are indeed often powerful organisations; but so too are many trade unions, political parties, churches, and welfare lobbies. Furthermore, even if it is true that corporations are powerful organisations, it is a mistake to presume that all business corporations work together to achieve the same common end. While their 'bottom line' is usually the same, the fact that they exist in different industries, dissimilar countries, and operate in a variety of political systems (not to mention compete against each other) means that their interests often diverge significantly. Moreover, there is little evidence that multinational corporations have surpassed the nation-state in terms of political and economic power. The percentage of GDP controlled by the state in most Western countries far exceeds that of even the largest corporations. Additionally, the state also continues to be the only wielder of the most overt form of power: legitimate coercion.

Even many critics of corporations agree with this analysis. John Gray, for instance, maintains that '[T]he growth and power of multinational corporations is enormous and unprecedented' (1998: 62), yet concedes that the very same corporations 'are often weak and amorphous organisations' (1998: 63).

Whatever the facts, it remains that corporations are likely to find themselves subject to continuing criticism of the kind outlined above. Directors and executives of corporations will also find their ability to deliver shareholder value under scrutiny from an increasing number of sources. Apart from traditional watchdogs such as regulatory agencies and banks, fund managers and institutional investors

will closely monitor corporations and seek to influence their performance, be it by employing the increasing shareholder voting power or publicising the results of their increasingly sophisticated computer-driven analyses.

Corporations are also likely to encounter another set of demands from a variety of quite different sectors. These reflect a desire on the part of many for business corporations to change their *modus operandi* and make certain objectives as fundamental to the corporation's purpose as the objective of delivering value to the owners of corporations—the shareholders. One such demand is that corporations be more 'socially responsible'. The implication is that corporations have been less than socially responsible in the past or have somehow lost sight of their 'wider obligations'. Companies that deal with products that are finite and potentially hazardous are especially bound to find themselves under increased pressure from some non-government organisations who seek to bring their influence to bear through the mediums of the press and political action.

At an even broader level, there is an increasingly widespread insistence that corporations behave more 'ethically'. It is a paradox that this call for ethical behaviour has emerged at a point of history where most Western moral discourse is riddled with relativism and when more than one commentator would argue that public understanding of the nature of ethics has never been more confused (MacIntyre 1998: 210-70; Rabkin 2000: 24-26).

Our purpose

In light of these pressures, we may expect ongoing and often intense discussion concerning the manner in which corporations are 'governed' as well as the substance of their central objectives. But corporations have other reasons for reflecting seriously upon the meaning of corporate governance. One is self-interest. According to a 1998 survey of 374 institutional investors in Australia, France, Britain, and the United States (then holding approximately 65 per cent of the world's then $23,400 billion shareholdings), 71 per cent had refrained from investing in companies because of their reputation for poor corporate governance (Russell Reynolds Associates 1998, 0171/457-2345).

The primary objective of this short book is to outline a theory of the nature and ends of corporate governance. In doing so, it seeks to provide shareholders, directors and managers with a conceptual apparatus that enables them to assess the legitimacy of demands made upon them. To this end, we begin by outlining some of the basic concepts applicable to any discussion of corporate governance, and investing them with concrete definitions. This framework is then used to:

- highlight the essential incoherence of what are often called stakeholder theories of corporate governance; and

- identify false and real problems confronting corporate governance.

We then turn to analysing the moral dimension of corporate activity, and reflect upon the problems associated with concepts such as 'corporate social responsibility' and 'ethical investment'. Having established that these ideas actually tend to

obscure clear thinking about morality within corporations, we illustrate that sound morality in corporations is more likely to prevail if closer attention is given to observance of the rule of law and everyday social conventions, but most importantly facilitating a greater understanding within corporations of the nature of ethics.

Central to the approach adopted throughout this book is the Aristotelian notion that *institutions should be primarily understood in terms of their purpose*: i.e., the *telos* that constitutes their fundamental aim. Business corporations, for example, are not the same type of association as, for example, a sports club. The relationship between the key players in a corporation—that is, the shareholders, the directors, and the managers—is primarily a relationship of collaboration and co-ordination mediated in part through contractual arrangements. Shareholders want to maximise their wealth, and managers want to earn a living. In order to attain their own objective, each agrees to help the other to attain his particular objective. The condition of such assistance is that it is *reciprocal*. Shareholders will pay managers and directors if and only if managers make money, and managers will only make money if they are paid out of the earnings of the corporation that is, in the final analysis, owned by the shareholders. The performance of these contracts between shareholders on one hand, and managers and directors on the other thus becomes a common interest, but all in the service of different sets of persons attaining their own objectives.

Aristotle classed all such relationships as *relationships of utility*. Naturally, it is possible, even likely, that the lines of division will not be as clear cut. Some managers, for example, will go beyond a friendship of utility with some shareholders and directors and vice-versa. Nonetheless, contractual relationships remain at the heart of the corporation's organisational culture.

This is a quite different form of relationship to what John Finnis (after Aristotle) calls *relationships of play* (1980: 140). In the final analysis, the central feature of relationships within a sports club, for example, is the mutual enjoyment of the same activity for its own sake, and perhaps even the relationship of friendship in the full sense, i.e., when people collaborate with one another because they are concerned with the all-rounding flourishing of one another (Finnis 1980: 141).

None of this is to suggest that the relevant individuals who make up a business corporation should refrain, in principle, from looking beyond the end of fulfilling their contractual relationships. It is merely to illustrate that business corporations are not athletic associations or even social welfare organisations, and that a horse-riding group does not primarily exist to realise a profit. It is this question of *purpose* that is at the heart of any clear understanding of what constitutes good corporate governance.

2

A Search for Conceptual Clarity

Many once assumed that business corporations had a clear objective: the maximisation of profit. This presumption was first thrown into question by Adolph Berle and Gardner Means (1932). They insisted that the divorce of ownership from control invariably resulted in questions about whether this was the goal actually pursued by most corporations. Did, they asked, the emergence of a managerial group that controlled the day-to-day and even longer term strategy of corporations mean that their objectives would invariably diverge from that of profit maximisation? This debate was fuelled by sociologists and behavioural psychologists (Cyert and March 1963) who claimed that corporations consisted of shifting coalitions, and that the subsequent behaviour of corporations depended on the nature of the dominant coalition.

Many of these propositions were based on the assumption that ownership of corporations is hopelessly divided among thousands of small shareholdings. It is true that thousands of shareholders jointly own the typical large corporation. But several studies illustrate that not every shareholder owns an insignificant number of shares. Describing the ownership of the large corporation as 'extremely diffuse' is not always accurate. Ownership is significantly more dispersed in British and U.S. corporations than in Japanese, European and South African corporations. At an even broader level, Demsetz observes that

> In the typical situation of even the very large corporation a few shareholders own a relatively large fraction of the firm's equity . . . For U.S. corporations as large as the Fortune 500, the fraction of equity owned by the five largest shareholders is about one-fourth. In Japan and several important European countries, this fraction is much larger. The average large corporation, then, is one in which a small number of shareholders have well focussed interests because they own non-trivial blocs of votes. For the smaller corporation, ownership is even more concentrated. (1997: 43)

This ownership pattern suggests that professional management need not be as independent of shareholders as presupposed by the separation of control thesis. This is important to bear in mind insofar as it indicates that shareholders may be in a position to ensure that business corporations remain directed to their formal—and presumably primary—objective: the maximisation of shareholder value. This, in the end, is the purpose of corporate governance, and it is reflected in the nature and history of the business corporation.

What is a corporation?

History and Economics

On a surface level, business corporations vary so much in form and structure that they initially appear difficult to define. In the United States, publicly-listed business corporations constitute barely 1 percent of all business organisations. Yet in 1997, they produced more than half of the United States' economic output (Novak 1997: 4).

Publicly listed corporations range from collections of stores, manufacturers of aircraft, large energy conglomerates such as Shell and Mobil, to new technology organisations such as Microsoft. But Shell is not organised in precisely the same way as McDonald Douglas. Nor is Pfizer structured in the same manner as Mobil.

One common feature of all corporations, however, is that they meet the criteria of what the English conservative philosopher Michael Oakeshott called 'enterprise associations' (1975). Enterprise associations, according to Oakeshott, differ from what he described as 'civic associations'. The latter seek to realise something larger than a *particular* end, interest or good. Generally, they attempt to provide a framework in which the pursuit of particular ends becomes possible. The church is one such organisation; the state is another.

Corporations, by contrast, are clearly enterprise associations. They emerge to realise very specific purposes, many of which reflect the need to satisfy ongoing human requirements (such as our need for food). These enterprise associations are purposive and instrumental. Their executive dimension is thus invariably stronger than that of most civic associations.

The origins of business corporations as enterprise associations are complex. The laws governing corporations may be traced back to the religious orders, monasteries, towns and universities that gradually emerged in the Christian West. These legally constituted associations possessed varying degrees of independence from royal, ecclesiastical and aristocratic power. Such institutions were constituted so as to endure beyond the lifetime of their founding generation. Significantly, their activities often had a strong economic dimension. Michael Novak remarks that

> Among historians, it is no longer unusual to suggest that the Benedictine (and other) monasteries sweeping north into Europe from Italy and east from Ireland, gradually beginning to sell their wines, cheeses, brandies, and breads from region to region, were the West's first transnational corporations. [These] introduced to many formerly nomadic peoples what was, for its time, scientific agriculture, thus enabling entire regions to advance beyond subsistence living. From the surplus thus accumulated, libraries and schools, music halls and commissions for painting grew; civilisation took root. Arts and sciences such as botany, metallurgy, and architecture were nourished; and industries such as mining and engineering were furthered. (1996: 6).

As the centuries passed, discoveries such as double-entry book-keeping, mutual insurance societies, patents, copyright, and the stock association began to contribute to the emergence of business corporations as they are understood today. Observing what the Austrian philosopher and economist Friedrich von Hayek aptly describes as an evolutionary process (1960: 56-62), the Japanese sociologist Kazua Noda states:

> The corporate form itself developed in the early Middle Ages with the growth and codification of civil and canon law . . . the first corporations were towns, universities, and ecclesiastical orders. They differed from partnerships in that the organization existed independently of any particular membership; but they were not, like modern business corporations, the 'property' of their participants. . . . By the 15th century, the courts of England had agreed to the principle of 'limited liability': 'If something is owed to the group, it is not owed to the individuals nor do the individuals owe what the group owes.' . . . As applied later to stockholders in business corporations [this principle] served to encourage investment because the most that an individual could lose in the event of the firm's failure would be the actual amount he originally paid for his shares. (1977: 183)

By the sixteenth century, Holland and England had promoted legal conventions that permitted the placing of ownership in large groups that extended beyond family (Novak and Cooper 1981; Barry 1993). These included joint stock companies, limited liability partnerships, and joint proprietorship.

Progress was nonetheless slow. In Adam Smith's time, the business enterprise was invariably a small single-owner arrangement. As late as 1820, there were not more than 56 business organisations in France that employed as many as twenty persons (Gide 1924: 171-2). There is, however, little question that the emergence of the joint stock company did permit businesses to grow in ways beyond the family unit, especially by permitting the amalgamation of the resources of a large group of unrelated investors.

As a family firm grows, its increasing scale makes it difficult for one family to operate. Injections of non-family capital, especially by institutional investors, means that its influence over the firm begins to diminish. At some point, every successful family business faces a choice: to give up control and become passive shareholders, or to try to retain control (which may mean accepting that the business will not grow beyond a certain size). If they choose the former path, then the family business may well find itself becoming a corporation, with professional managers taking over much of the operation. This has lead some observers, such as Galbraith, to claim that 'It matters less and less and eventually not at all who ultimately owns the corporation, or where it is owned, for the owners are without power' (1978: 90). Whatever the accuracy of Galbraith's observation, it is clear that the enterprise begins to take on a life of its own, with a formal organisational structure usurping any ad hoc arrangements. The increasing load of information, for example, necessitates employing more middle managers (Williamson 1971).

In both Britain and the United States, these developments were given solid grounding in the common law (Hessen 1979), so much so that by 1800, the United States 'had more corporations, and more explicitly business corporations, than all of continental Europe put together' (Handlin 1981: 2). This formal legal recognition facilitated the development of a framework of corporate law that encouraged business stability and peaceful conflict resolution.

There was, nevertheless, a certain economic logic to the corporation's emergence. In 1938, the Nobel Prize winner Ronald Coase underlined the ability of large scale business operations to reduce what are often called 'transaction costs'. If every

carpenter, tradesman, or bricklayer freely contracts with other individuals, for example, it increases costs for firms: that is, the cost of the negotiating process, linking buyers and sellers, and arriving at arrangements in the form of contracts (Posner 1992: 391-427). If, however, all the relevant people are gathered together in one organisation, it eliminates the need for cumbersome and costly individual transactions. This produces large efficiency gains for the firm. To this extent, there is surely much truth to Oliver Williamson's statement that 'The modern corporation is mainly to be understood as the product of a series of organizational innovations that have had the purpose and effect of economizing on transaction costs' (1981: 1537).

Presuming that such firms remain successful and profitable, they continue to expand until the costs of large size begin to surpass whatever savings have occurred through expansion and economies of scale. The problem then emerges that as corporations grow larger, it becomes more difficult for managers to know what is happening in the organisation (Alchian and Demsetz 1972: 777-795). The larger the firm and the more complex its composition, the more severe become the problems of controlling the interdependencies among its parts. This severity can become so great that the advantages of 'centralised contracting' within the corporation become overshadowed by the inability of senior managers to attend appropriately to important matters. Many corporations consequently choose to decentralise their institutional arrangements, and in some cases, develop subsidiary firms, each with its own central contracting facilities (Demsetz 1995: 34). We thus see the development of the multidivisional corporation which simultaneously combines the reduced transaction costs that flow from integration, with decentralised organisational arrangements and mulitprofit divisional centres (Williamson 1970: 175).

Corporations and the law

While corporations have a distinct history and economic character, they are also characterised by specific legal characteristics. The most important legal feature is that they are artificial persons. To cite the classic definition of Chief Justice Marshall:

> A corporation is an artificial being, invisible, intangible and existing only in contemplation of law. Being the mere creation of law, it possess only those properties which the charter of its creation confers upon it, either expressly or as incidental to its existence. (*Dartmouth College v. Woodward* 1819)

Unlike partnerships and sole proprietorships, corporations are capable of enjoying a perpetual legal existence. They have assets and liabilities that are distinct from that of their shareholder owners.

But while they enjoy a separate legal existence, one should remember that the corporation remains the subject of its *shareholders* insofar as they are the *property* of their shareholders in aggregate. Hence, the shareholders can terminate the corporation, or allow it to be acquired by, or merged into, another corporation. This makes it clear that the ultimate responsibility of a corporation's board of

directors and management is to the shareholders. It is to shareholders that they owe what is called a 'fiduciary duty'.

Corporations are now created on a regular basis, and for whatever purposes that are chosen by the owners (subject, of course, to what is permitted by law). These purposes may be found in the corporation's constitution, articles of association, or whatever document through which an incorporated body chooses to identify its formal purpose.

The official purposes of corporations will obviously vary and some may be couched in extremely broad terms. Nonetheless, they are important insofar as the formal purposes establish a basis for accountability. A corporation which has, for instance, a non-profit dimension built into its constitution may be legitimately criticised by its shareholders if it appears to be making the pursuit of profit its primary activity. Although a corporation's official purpose often means that it needs to engage in secondary or ancillary activities, these may never be allowed to undermine or supplant its official purpose.

In summary, business corporations may be described as enterprise associations that depend upon a market for investors willing to invest a portion of their savings or borrowings in it. The corporation takes on burdens shared by its individual members, and the owners of the enterprise so created are entitled to the residual profits. Corporations are legally incorporated as a legal person and governed according to by-laws by a duly-appointed board of directors of business corporations. The official purpose of business corporations is to provide services and products of a distinct type (or in a distinct way) in the expectation of earning profits for its investors. They have a care for the investments entrusted to them. Corporate governance involves ensuring that corporations realise this end within the constraints of law and morality.

Understanding corporate governance

Adolph Berle and Gardner Means were correct when they identified the maintenance of a link between ownership and management as a primary problem of modern corporations (1932). The increasing dissociation between the two opened up the possibility of a divergence of interest between owners and professional managers. Corporate governance is, in part, directed at preventing such disjunctions from occurring. This is no guarantee, of course, that good corporate governance will result in good business performance. Indeed, it is possible for companies to have poor corporate governance, and yet be economically prosperous (though, ultimately, the costs associated with poor corporate governance will grow exponentially). In the final analysis, businesses compete against each other, which means that some will be successful and others will not. The situation would not change, even if every single corporation or business had perfect corporate governance structures and cultures.

Unfortunately, the term 'corporate governance' is often employed in a misleading manner. Some use the phrase to describe 'the creation of a healthy economy through the development of business operations that operate for the long term and compete successfully in the world economy' (Lipton and Rosenblum 1991: 197).

The pursuit of this form of knowledge, however, properly belongs to the fields of economics, political economy or even business studies.

Instead, corporate governance is designed to prevent situations emerging whereby boards of directors and managers lose sight of their responsibility to pursue the purposes of corporations as designated by their owners. It follows that corporate governance is best understood in the terms used by the English philosopher, Elaine Sternberg. She defines corporate governance as

> ways of ensuring that corporate actions, assets and agents are directed to achieving the corporate objectives established by the corporation's shareholders. (1998: 20)

The most obvious objection to such a definition is what some may view as its narrowness. Certainly, there is much that this understanding of corporate governance does exclude. But precision in discussing corporate governance with regard to business corporations is essential. It provides the necessary grounds for a *disciplined* exploration of the many dimensions of corporate activity and allows one to detect when corporate governance is being subverted.

It undermines, for example, the notion that good corporate governance necessarily involves integrating the pursuit of certain ends such as 'community well being' or 'environmental stability' into the official purposes of a business corporation, if the integration of such ends is contrary to the expressed desire of shareholders. Indeed, our definition suggests that it would be *immoral* (given that it would represent a betrayal of the trust that shareholders place in directors) for a business corporation to place other objectives on the same level as the end of maximising shareholder wealth without consulting and obtaining the consent of shareholders.

Another advantage of Sternberg's definition is that it highlights the fact that corporate governance involves three elements. These are:

- principals;
- agents;
- and outcomes.

One group of people (corporate directors) is accountable to a second group (the corporate owners) for the achievement of a designated outcome (the corporate objective). Thus, in business corporations, directors are properly accountable to shareholders for maximising shareholder value. This illustrates that directors' accountability to shareholders is not in any way opposed to the directors' responsibility for maximising shareholder value. The two are in fact indivisible.

Shareholders: The owners

While shareholders in corporations may be individuals, institutional investors, banks, or other corporations, their common denominator is that they are suppliers

of risk capital. In this sense, Jensen and Meckling are correct to state that shareholders essentially contract to be residual claimants to the income and assets of a company. They receive income only after other inputs of production have been compensated. In most cases, their main concern is 'that they receive the highest possible return, either in the form of income or in accretion of their share values, that is possible for the risk class of their investment' (1976: 6).

In any event, shareholders are correctly understood as partners in contract with a firm of which they acquire some ownership by way of the market. This contract entitles shareholders to a return on their investment if profits are made. For this reason, courts in America have been reluctant to uphold the legality of the actions of corporations that have been manifestly proved not to have stockholder interests as their object (*Dodge* v. *Ford* 1919; *A.P. Smith Manufacturing Co.* v. *Barlow* 1953).

A shareholder may be an owner for a short time frame or over a long period of time. They are often scattered throughout the stock market, with large portions of the shares of any major corporation increasingly being held by managed funds, superannuation schemes, as well as other institutional investors who act as proxies for millions of individuals. According to one observer of the shifting pattern of corporate ownership in the United States:

> In 1965, individual holdings constituted 84 percent of corporate stock, institutional holdings 16 percent. By 1990, the individual fraction had declined to 54 percent, and the institutional fraction had risen to 46 percent. A closer look at the 1,000 publicly traded companies with highest market value during the 1980s and 1990s reveals much the same trend. Between 1985 and 1994 . . . the institutional share rose by more than a point a year, topping the 50 percent threshold in 1990 and reaching 57 percent by 1994. (Useem 1996: 25)

These individual owners are thus effectively rationally ignorant (i.e., poorly informed and willingly uninvolved) of the practices and prospects of any one individual corporation. Nonetheless they have a significant stake, albeit at several removes, in the prosperity of the corporation. This underlines the onerous responsibilities that are assumed by directors and managers.

Directors and executives: The stewards

The spread of ownership of corporations only reinforces the wisdom of corporate governance being exercised primarily through boards of directors. This separation of ownership from control has occurred for many reasons, but the most important is that people have learnt over time that corporations produce greater shareholder value when they are managed by professionals. In most cases, '[s]hareholders vote for the Board of Directors which hires the officers of a company who act as operating managers under the direction of this governing council' (Mannion 1996: 9). Their fundamental responsibility is to represent the shareholders and direct the corporation to achieve the purposes established by the shareholders. Their first loyalty must therefore be to the corporate purpose—not the employees, managers, or even customers. The New York Supreme Court summarised the situation

succinctly when it stated in 1868 that 'directors have a fiduciary obligation only to the stockholders in their dealings with or on behalf of the corporation' (*Carpenter* v. *Danforth*).

The role of directors is therefore best described as that of good stewards. Judging from selection procedures, directors are often appointed because they have influential contacts or specific business experience. While these are important, they are often only incidentally related to the required *moral* qualities. For directors do not serve to micro-manage executives' activity. Instead, directors must be able to identify the key issues confronting the corporation. They must be able to ask the questions necessary to safeguard the owners' interests and obtain, evaluate, and act on the answers. Their responsibilities are to ensure that the corporation remains loyal to its corporate purpose, to exercise prudential judgement, and to demonstrate moral courage in carrying out these functions. The last two qualities are among those that Thomas Aquinas (*Summa Theologiae* II-II, q.47, a.2; III *Sent.* d34, q.1a, 2c), following Aristotle (*Ethics* vi.5; iii.6), listed among the cardinal virtues, with prudence or practical reasonableness (*rationis bonum*) being identified by the former as the progenitor of *all* moral virtues (ST, q.61, a.2c; cf. Finnis 1998: 56-131).

Sound judgement in the context of the work of corporate directors involves knowing what constitutes achievement of the corporate goal and what good and law-abiding means may be used to achieve it. This necessarily involves directors in:

- making key decisions that allow the corporation to achieve shareholder objectives;

- monitoring, overseeing and, if necessary, correcting, executive performance;

- appointing senior executives and auditors;

- establishing internal control systems that ensure that corporate actions not taken directly by the board are both legal and directed to achieving the corporation's objectives; and

- determining executive remuneration.

In this light, the differences between the role of director and executive become clear. While the primary fiduciary duty of both directors and executives is to shareholders (Mannion 1996: 35), executives serve to *execute* the strategy and decisions of the board of directors. In practice, many boards have one or more directors who also have an executive management role in the corporation. This is one area that generates much discussion about the operations of boards of directors. In strict conceptual terms, however, the distinction between the responsibilities of individuals who manage the corporation, and their responsibilities as members of the board is clear.

Given that senior executives are appointed by the board of directors, their responsibility is to the Board of Directors. All, however, have a responsibility to the shareholders. They have their capital invested in the actual operations of the

corporation whereas possible or future investors do not have any capital invested in the present operations. Actual shareholders have put their property at risk and thus enjoy certain privileges. Future or possible shareholders do not have any capital at risk and consequently do not enjoy such privileges.

Many, however, would disagree with this description of the relationship between shareholders, directors, and executives, not to mention the description of the end and nature of corporate governance outlined above. Prominent among these are proponents of various versions of what are popularly known as 'stakeholder' theories of corporate governance. Given the extent to which these have permeated corporate and academic thinking about business life, such theories deserve close attention.

3

Against Stakeholderism

> There are other things to notice about a company, things just as important as profits. The time is . . . five years from now. The place is a company's general meeting. The Chairman rises to his feet: 'Fellow shareholders, fellow stakeholders, fellow customers, fellow employees, suppliers, and fellow members of the human race'. (Day 1994: 1)

Given that the central concern of ethics is with the morality of freely willed human acts, one would imagine that much of the focus upon the moral life within corporations would be on issues of honesty, promise-keeping, and other essential moral supports for the functioning of corporations, not to mention society as a whole. This, however, is not the case. Alexei Marcoux observes that the attention of many studying 'business ethics' is upon developing what are commonly known as stakeholder theories of the firm (2000:1).

The term 'stakeholder' first appeared with reference to business in a 1963 internal memorandum at the Stanford Research Institute. It was used to describe 'those groups without whose support the organisation would cease to exist' (Edward 1984: 31-2). Since then we have witnessed the emergence of entire stakeholder doctrines which have become central to much management and business ethics theory since the 1960s. It has received some endorsement by business groups in Britain (CBICA Committee 1973; cf Cadbury 1995: 146). In the United States, stakeholder interests have been recognised by law in 38 states (Hanks 1994).

The conceptual use of 'stakeholder' has changed significantly since 1963. Edward Freeman, for instance, claims that '[a] stakeholder in an organization is (by definition) any group or individual who can affect or is affected by the achievement of the organisation's objectives' (1984: 46).

This definition appears to expand the coverage of 'stakeholders' from shareholders, employees, suppliers, and customers (i.e., those without whom a corporation cannot survive) to *anyone* who can be recognised as having 'a stake' in a corporation. In light of the increasing globalisation of the life of corporations and the internationalisation of trade, those 'affected' by a transnational business organisation include an infinite number of people and institutions, both in the present and in the future. We should not therefore be surprised to find an American businessman arguing that

> Every citizen is a stakeholder in business whether he or she holds a share of stock or not, is employed in business or not, or buys the products and services of business or not. Just to live in American society today makes everyone a stakeholder in business. (Liebig 1990: 217)

As a word, 'stakeholder' reflects an unsubtle play on the word 'stockholder'—the implication being that it confers an entitlement not dissimilar to that of ownership.

But what does it mean to take account of the interest of stakeholders? Damian Grace and Stephen Cohen suggest that

> The simple answer is that it is to calculate the impact of an action or practice on the stakeholders, and to figure into the overall calculation the effect of the practice or action on the stakeholders. Usually this is seen as a matter of calculating the utility or disutility of a proposed practice for the stakeholders, recognising that various stakeholders . . . have different stakes in the possible outcomes of some activity. (1995: 72)

Other commentators have gone so far as to suggest that 'directors may in fact be in breach of their fiduciary responsibilities if they are not taking care of key relationships, including community interests' (Tunzelmann 1996: 65).

Stakes and stakeholders

Cursory reflection upon stakeholder theory soon indicates that it is characterised by significant problems of logic. This becomes apparent when one considers how corporations are formed. It is possible, for example, for society, a group, or an individual to be interested in the activity of corporations *per se*. It is difficult, however, to extrapolate a general social interest into a *specific* interest in a *particular* business. It follows that attempts to identify the moral claims of often self-identified stakeholders in, for example, Microsoft or Mobil is likely to be a confusing and inconclusive exercise.

It is also the case that unreflective use of the stakeholder concept *within* a corporation can lead them to believe that they have moral responsibilities to any number of 'interested' parties, simply because the latter have taken an interest in the corporation's activities. Corporations should be aware that an 'interest', even if legitimate, is not necessarily a stake. Too often, claims to be a 'stakeholder' are asserted rather than demonstrated propositions. Even people affected by a corporation's activities do not necessarily have a stake in them. Simply being offended by a practice, for example, is hardly sufficient to make an individual, group, or even society qualify as a stakeholder.

Moreover, even if it is possible to identify an individual or a group as a stakeholder in a corporation's activity, this does not in itself point to an ethically correct analysis of the issue at hand (Goodpaster 1991). Nor does a corporation's decision about a possible practice which may or may not advantage or disadvantage a particular individual or group necessarily mandate consultation with that individual or group. Sometimes the options available for choice are such that there is no need to consult 'stakeholders'.

Part of the problem is that when it comes to stakeholders, there is no ordering principle equivalent to the price mechanism which is used by directors and managers when determining which decisions best realise shareholder value. It is impossible to aggregate the 'utilities' and 'disutilities' referred to by Grace and Cohen into a single measure or criterion. Taken to its logical conclusion, stakeholderism would turn board rooms into something resembling parliamentary assemblies, with each of them becoming battlegrounds for warring groups. It is not

a co-incidence that many stakeholder theorists refer to such groups as 'constituencies'.

An incoherent ethical basis

At this point, the essential incoherence of stakeholder theory begins to become apparent. How is it possible for any one person or board of directors to assess what is the right thing to do when they are obliged to think about the consequences of certain actions for everyone? Corporations would have to negotiate with any 'constituency' that could validate—according to some undefined criterion—their claim to stakeholdership. Were each valid stakeholder-claim deemed to confer an entitlement, directors and managers would acquire a duty to each stakeholder group. Since stakeholder theory cannot prioritise the conflicting claims of different stakeholder groups, there is a strong likelihood that directors and managers would eventually accede to those who are the loudest or who can muster the greatest political strength. This may be described as many things, but it is *not* an ethically sound way of resolving disputes.

It is, in fact, intellectually impossible to 'balance' stakeholder interests. Stakeholder theory offers no guidance as to how and which individuals and groups should be selected. It cannot provide any real basis for coordinating and settling the rivalries of the potentially endless number of stakeholders. To take the case of a plant-relocation: which stakeholder group should be given priority? Does each have an equal right to be heard? Which is most relevant to the situation? Is it those in employment who will have their life disturbed by the move, or those whose employment prospects will be damaged if the plant does not move?

The consequentialist error

The inability of stakeholder theories to provide non-arbitrary answers to such questions reflects the fact that, in moral-philosophical terms, they rely upon the premises of what is widely known as consequentialism. It is important to assess the intellectual foundations and assumptions upon which stakeholder theories tend to rely. These theories do not exist in a type of intellectual vacuum. Consciously or otherwise, they draw upon a range of moral-philosophical claims, many of which are themselves flawed. It follows that if consequentist ways of moral reasoning are flawed, then stakeholder theories may be regarded as being erroneous in their very roots.

The word 'consequentialism' is normally used to refer to a moral outlook which evaluates actions or behaviour according to the *consequences* of that behaviour. According to consequentialists, the master principle of good moral acts is to direct the chooser to act in ways that are most likely to produce the best net proportion of good to bad consequences, overall and in the long run.

The actions of individuals and groups do have consequences, and it would be morally negligent not to think about their effects. But consideration of consequences is *not* sufficient for judging the moral goodness or evil of a concrete choice. In simple terms, the 'weighing' of the foreseeable goods and evils that

proceed from an action is not an adequate method for determining whether such an action is morally good or bad.

As a general strategy of moral reasoning, consequentialism is, strictly speaking, *irrational*. Consequentialists (McCormick 1978: 86-94; McKim and Simpson 1988: 349) claim that

- one should always choose the act that, so far as one can see, will yield the greatest net good on the whole and in the long run ('act-utilitarianism'); or
- one should always choose according to a principle or rule, the adoption of which will yield the greatest net good on the whole and in the long run ('rule-utilitarianism').

The essential problem with these propositions is that the injunction to 'maximise' good is *senseless* (Finnis, Boyle and Grisez 1990). It presumes that the realisations of human good (and evil) are commensurable in a way that makes possible an intelligent weighing or measuring of 'value' (Grisez 1978: 21; Raz 1985/86: 117-34; Muller 1977: 115-32). Consequentialist reasoning thus relies upon the assumption that we can measure moral goods according to some single, well-defined goal or function (a dominant end).

We know, however, that when people act, they do *not* have a single common factor in mind. There is therefore no measuring basis against which we can somehow 'weigh' the significance of various goods. But equally erroneous is the implicit consequentialist assumption that each and every human desire has the same *prima facie* entitlement to consideration when the 'measuring' occurs. What reason, for example, can be found for treating the desire of someone who wishes to keep people ignorant as a wish that is entitled to just as much satisfaction as the desire of someone who loves knowledge and wants others to share in knowledge?

In light of these problems, one should not be surprised that consequentialism is essentially characterised by arbitrariness. It provides, for example, no reason for preferring altruism to egoism. Jeremy Bentham, the founder of utilitarianism, equivocated and oscillated for sixty years about whether his utilitarianism sought to maximise his own happiness or the happiness of 'everybody'. As Finnis remarks: 'A genuinely consequentialist assessment of alternative possibilities could never end, and could begin anywhere' (1980: 117). This suggests that it should never begin at all.

Once one understands stakeholder theory's deep reliance upon consequentialist thinking, the sooner one grasps stakeholder theory's essentially irrational premises. A corporation that sought to incorporate stakeholder theory into mechanisms and processes of corporate governance would soon find itself attempting to engage in the intellectually impossible task of measuring and weighing all the certain and possible good and evil effects of an action upon a potentially infinite number of stakeholders. How, one must ask, could an absolute obligation for directors to embark upon any such action resulting from such debatable calculations be justified?

The reality of limited knowledge

A similar insight into stakeholderism's inadequacy as an ethical theory of corporate governance emerges from economics. As noted, consequentialism claims to draw the criteria of the moral good of an action solely from a calculation of foreseeable consequences derived from a given choice. But as Jesus Huerta de Soto notes, the evolution of economic theory illustrates that it is impossible to obtain the necessary information regarding the benefits and costs arising from each human action. Being innately creative creatures, human being are continually discovering new ends and means, thus giving rise to a flow of new information or knowledge (Soto 1999: 150-1). This particular insight, Soto notes elsewhere, makes it impossible to predict specific future consequences of human actions and/or political decisions adopted at any given moment (1998).

Moreover, as societies grow more complex, so too do the limits to what any one person, or group of persons (such as a board of directors) can know about the totality of things, events and consequences (Hayek 1937: 33-54). Awareness of this phenomenon led Friedrich von Hayek to conclude that

> the limitations of [man's] conscious knowledge and therefore the range of ignorance have constantly increased. . . . The more men know, the smaller the share of all that knowledge becomes that any one mind can absorb. The more civilised we become, the more relatively ignorant must each individual be of the facts on which the workings of his civilization depends. (1960: 26).

Another economist of the Austrian school, Ludwig von Mises points out that only a mind of perfect foresight would be able to discern precisely how the future unfolds (Mises 1966: 105). Acting humans, however, have only an imperfect knowledge. They cannot possibly know everything. This introduces an inescapable element of uncertainty into the process of thought and choice that precedes and accompanies every human act.

None of this is to suggest that decisions are never made without any knowledge. Nor would it be correct to suppose that decisions are so inherently complex that rational analyses by directors and executives of corporations can make no contribution. It simply means that it is *impossible* to expect even the most able board of directors to know the entire range of stakeholders potentially affected by any one action of their corporation. To ask them to undertake such a task is therefore irrational.

A social contract?

Partly as an attempt to avoid the ethical morass into which consequentialism quickly leads its practitioners, some stakeholder theories promote the idea that corporations effectively enter into a form of 'social contract' with stakeholders (indeed, entire societies) because they use society's resources and have been granted special privileges to do so by society, such as perpetual life, limited liability for debt and tort actions. Corporations therefore apparently owe something to society in return for these advantages—in short, there is a kind of moral licence which corporations must constantly earn (Barry 1999: 4). This hypothetical contract

between society and the corporation is invoked to claim that it is not enough for corporations to provide jobs, consumer items, and services. They must contribute in other areas as well.

Perhaps the most significant problem with the social contract arguments advanced by some stakeholder theorists is that they speak of the community as if it were a single agent with a distinct set of preferences. This is simply fallacious. Society consists of a variety of subgroups, many of which have quite different agendas.

A second problem is the assumption that corporations would not exist without legal privileges. In most cases, formal permissions are required to establish or operate corporations. But when such formal permissions are given, not only privileges but also formal expectations are explicitly stipulated (Barry 2000). Typically, designated undertakings are submitted to designated civic authorities, and are usually accompanied by the payment of designated fees. Many of the obligations involved are specific to the corporation. Noone, for example, pays corporate taxes except corporations. This is the payment for their privileges.

More generally, while it is true that members of society give an implicit agreement that such corporations may operate in their society, this does not make corporations accountable to society. While corporations must and certainly do take different groups into account (not least by abiding by rule of law), they are, strictly speaking, answerable to those groups only insofar as the law or specific contractual arrangements have made them so (Sternberg 1995: 41-2).

While members of society can certainly cease to cooperate with corporations or even protest against their activities, they enjoy no general or legal authority to hold them to account. Here corporations would do well to reflect that if they voluntarily embrace the notion of being accountable to stakeholders, they may be making the corporation liable to claims against it from innumerable potential sources. This, presumably, would actually discourage people from investing in businesses that voluntarily assume such questionable liabilities.

Undermining corporate accountability

There is also much to suggest that stakeholder theory actually undermines corporate governance. It may even be said to be bound to do so. If good corporate governance is about maximising shareholder value, then stakeholder theory is bound to distract directors and managers from achieving this end.

Stakeholder theory compromises the duty that agents (i.e., directors and executives) owe to principals (the shareholders). Whenever one entrusts one's assets or affairs to another, an agent-principal relationship is established. It arises in respect of corporate managers and directors, as well as civil servants, lawyers, accountants, financial planners etc, in other contexts.

In formal terms, then, the corporation remains accountable only to its shareholders, those to whom the corporation makes itself accountable by way of legitimate contracts, and, like everyone else, the law. But stakeholder theory confuses, distorts, and ultimately destroys any real lines of accountability. Stakeholder theory renders the central agent-principal relationship within the corporation unworkable insofar as it subordinates the agent's particular duty to

their principals to the 'duties' that directors and managers owe to other groups. Most stakeholder theories insist, for example, that corporations should in some way be accountable to their stakeholders. The difficulty is that this argument proceeds from the undeniable fact that organisations are affected by and affect certain factors, to the conclusion that organisations should be accountable to them. This is, of course, a *non sequitur*. Organisations may be affected by the weather or affect inflation; but in logical terms, they cannot be accountable to them.

Stakeholderism thus disrupts the moral relationship between owners and employees. It also endangers contractual relationships in the sense that no contractual relationship would be secure if they were constantly being revised in light of the need to make political-like stakeholder decisions.

This has not, however, prevented some stakeholder theorists from arguing in favour of legislation to force corporations to become more accountable to their respective alleged stakeholders. George Goyder, for example, has called for a law that forces the corporation 'to act as a responsible member of the community of which it is a member and one that can be called to account where there is gross failure to act justly. It means legislating for the responsible company' (1994: 186). Precisely what, however, constitutes 'acting justly' over and above acting lawfully is left undefined.

Yet if stakeholder theory is indeed as wanting as outlined above, then it would seem somewhat dubious to enshrine any variant of stakeholderism in law. Another good reason for not doing so is the inevitable increase in state power over civil society that would ensue. Hayek observes, for example, that

> once the management of a big enterprise is regarded as not only entitled but obliged to consider in its decisions whatever is regarded as the public or social interest, or to support good causes and generally to act for the public benefit, it gains indeed an uncontrollable power—a power which could not long be left in the hands of private managers but would inevitably be made the subject of increased public control. (1979: 82)

Given the potentially limitless scope that stakeholder theory gives for people to be called—or to identify themselves as—stakeholders in any one or every corporation, it would seem that giving the state responsibility for reinforcing corporations' responsibilities to a multitude of stakeholders is a recipe for a dramatic expansion of state power. Most countries already have laws and regulations that specify employment practices, health and safety requirements, consumer protection, planning restrictions etc. Many of these are indeed necessary. Stakeholder theory nonetheless gives governments many opportunities to increase regulation, or for political groups to use regulation to advance and institutionalise their particular agendas within the functioning of corporations.

Directors and managers of business corporations have to make a myriad of decisions every day. Each decision, however, is governed by the organisation's fundamental purpose: to maximise shareholder value for the owner. But in a stakeholder world, a corporation could easily become accountable to almost anyone or everyone: as is well known, an organisation that is accountable to all easily becomes accountable to noone. In such cases, it would become difficult to

detect all but the most inappropriate behaviour on the part of directors and managers in the stakeholder world, as most self-serving behaviour could be justified by linking it to the interests of some stakeholding group.

Corroding ownership

Closely associated with stakeholderism's capacity to blur clear lines of accountability is its subtle undermining of private ownership. Property, derived from the Latin *proprietas*, means (in the juridical-ethical sense of the word) the dominion that a person may exercise over a certain object possessed. It expresses the possibility of controlling the object as one desires, subject to the provisions of the rule of law. The object may be physical in nature, though much property is increasingly of an intellectual or immaterial kind. Property rights are not, of course, absolute. The fact that some limitations apply does not, however, amount to an argument for imposing others. The abolition of slavery, for example, does not justify confiscation of land.

Stakeholder theory undermines private property insofar as some stakeholder theorists posit that the assets utilised by corporations should be used for the balanced benefits of all stakeholders. Two prominent stakeholder theorists, for example, claim that 'The reason for paying returns to owners is not that they own the firm, but that their support is necessary for the survival of the firm, and that they have a legitimate claim on the firm' (Evan and Freeman 1993: 56). They proceed to argue that the way to balance shareholder claims against stakeholder demands is to appoint a 'metaphysical director' who would make 'impartial' judgements between claims advanced by various shareholders and stakeholders and determine what constitutes 'a balanced benefit' for all.

Immediately, one observes that the 'dominion' that shareholders enjoy over the corporation is arbitrarily diluted in this stakeholder scenario. A concept that is, at least ostensibly, concerned with producing a situation of fairness, actually disadvantages those who have chosen to undertake risks that others have not. The interests of equity investors are reduced to only one among the many interests that have to be considered and served. If the corporation makes a loss, the shareholders make a loss. If, however, the corporation makes a profit, the adoption of a stakeholder approach would make it possible that shareholders would *still* make a loss if other interests were deemed to be more weighty and important. To this extent, stakeholder theory may actually undermine the process of issuing shares as a means of financing the corporation's growth and new entrepreneurial ventures. For why would potential shareholders invest, if they knew that their interests would be subordinated again and again to those who had made no financial investment?

Here there is also a danger that stakeholder theory could seriously disrupt the meaning of signals generated by the market upon which economic growth, stable employment, and the liquidity of the financial market depend. Equity holdings, returns to equity and appreciation (or depreciation) in the market price typically serve as signals for financial health, and hence as mechanisms for pricing debt capital. Widespread or legally mandatory adoption of stakeholder theory could undermine well-established, stable and efficient market norms for pricing capital in favour of a regime whereby capital becomes more costly for firms to acquire

because investment (whether in the form of liquidity or debt) becomes an inherently riskier proposition. The need to appease stakeholders, especially in financial terms, means that lenders would have less expectation of receiving an adequate return on their investment. Stakeholderism is thus likely to produce poorer, static, risk-adverse corporations and hence a poorer, static, risk-adverse economy. If this is true, then stakeholder theory may actually serve purposes that are *contrary* to the interests of the very stakeholders that it purports to help.

A 'limited' stakeholderism?

If stakeholder theory is as intellectually incoherent and problematic as illustrated above, does the term 'stakeholder' have any use at all? If being attentive to stakeholders simply means that corporations must take into account a wide variety of interests when pursuing the corporate purpose, then stakeholder interest simply describes something that we have long known.

In this limited sense, the idea of 'stakeholders' serves as a convenient collective noun for the groups and individuals that corporations have always had to take into account when pursuing their official purposes. Though a corporation's responsibilities to stakeholders are limited to those created by law and specific agreements, a business cannot afford to ignore those external concerns that might affect its ability to generate long-term owner value. Company boards and management cannot afford to take the view and the imperative of maximising profit is so demanding that they can ignore the criticisms generated by various interest groups. This does not, however, mean that the interests of stakeholders should be given the same consideration as shareholders, or accepting that corporations are somehow accountable to stakeholders. Nor does it follow that fundamental change in the underlying legal framework of corporations is required.

Rather, the notion of stakeholder may serve as a conceptual aid to strategic management. It may help corporations to think about long-term considerations, and to develop stable investment environments. It reminds corporations that it may, for example, be counterproductive in the long term for business to ride roughshod over others when making decisions or to treat their workers poorly. Issues such as environmental impact of economic activity, regional development and employment are legitimate issues to discuss not just in the wider community, but in the board room as well.

But if this is so, then the concept of stakeholder adds little to our fount of moral wisdom. Oversight, collective consultation, information gathering, and some awareness of the wider implications of one's actions will always be needed for the simple reason that no one person or group can know everything. We are all partial and fallible. Executives who are concerned about achieving the corporate objective will endeavour to have as many dispersed agents of practical wisdom and sources of knowledge as possible. But the purpose of such safeguards is not to engage in forging a political consensus as those involved in democratic governments are obliged to do. Instead, the objective is to help directors and executives to do their job properly and achieve the corporate purpose.

In terms of such strategic considerations, it may be contended that engaging in stakeholder-like strategies may assist corporations in protecting shareholder profit

and value from incursions by self-identified stakeholders—no matter how ill-informed or unreasonable the claims made by pressuring groups. A form of appeasement may therefore, as David Henderson notes, be the right strategy (2000). Although the separation between ownership and control cannot in the long run make it possible for managers to sacrifice the profit of owners to the interests of such 'stakeholders', it is entirely possible that such activity may contribute to the corporate objective (not least as a way of avoiding government regulation) in the long term.

A significant difficulty with this strategy is what some regard as some corporations' tendency to accept in a relatively uncritical manner the validity of the views and opinions of stakeholders, as well as an associated failure to engage such groups in debate about whether the latter's views and opinions are mistaken, based on faulty evidence, or downright wrong (Henderson 2000). In such instances, corporations seeking to appease particular groups by promoting particular causes may actually be engaged in socially *irresponsible* behaviour.

Not every claim made by environmentalists, for example, is true. Left-liberal environmental authors such as Gregg Easterbrook have underlined the striking number of environmental predictions that have proved over the years to be false. Easterbrook, for example, notes that the overwhelming majority of forests in Europe and America have *not* been destroyed by pollution. Fossil fuels have *not* been exhausted. Growing populations have *not* caused worldwide food shortages. Nor have wildlife species been made extinct on a massive scale (Easterbrook 1995; Budiansky 1996). In 1972, for example, the Club of Rome asserted that humanity's existence was threatened because of the imminent depletion of resources. Yet not only does the empirical evidence illustrate that *all* the significant resources that the Club of Rome identified as eventually running out have actually increased, but the Club of Rome itself eventually disowned its 1972 statements (Simon & Kahn 1984: 104). There is now more oil, natural gas, and coal available in the world than there was twenty years ago (Hodel 1997: 1-4).

These facts suggest that a new challenge for corporate governance in the future will be to point out that the facts concerning issues such as the environment often differ from what is claimed by self-identified stakeholders. This public defence role of directors and managers will not, however, be confined to engaging with and often refuting ideas advanced by those enunciating stakeholder theories. It will increasingly concern matters that feature prominently in public discussion of corporate activity, such as executive pay and director accountability, and identifying which are genuine problems for corporate governance and which are not.

4

False and Real Problems

While it may be described as a movement characterised by significant flaws of logic, stakeholderism's emergence illustrates that boards of directors as well as executives must have some consciousness of the direction and character of public policy debates. But warding off and/or exposing the unreasonableness of some demands made by various groups is just one contemporary difficulty that faces modern corporations. The possible consequences of differences between the interests of the corporation's owners and the concerns of directors and professional managers has had a long history in economic discussion. In his *Wealth of Nations*, for example, Adam Smith raised doubts about the ability of joint stock companies to serve their owners:

> The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot be well expected, that they should watch over it with the same vigilance with which the partners in a private co-partnery frequently watch over their own. Like stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. . . . They have, accordingly, very seldom succeeded without an exclusive privilege; and frequently have not succeeded with one. ([1976] 1776: 741).

Indeed, Smith stated elsewhere that

> The only trades which it seems possible for a joint stock company to carry on successfully, without an exclusive privilege, are those, of which all operations are capable of being reduced to what is called a Routine or to such a uniformity of method as admits of little or no variation ([1976] 1776: 756).

Smith's focus upon the problem of *control* is central to much contemporary thought about corporate governance. It underpins questions such as compensation paid to senior executives and the efficacy of hostile takeovers. But once one remembers the nature and purpose of corporations, close study suggests that it is questionable whether some of these issues are in fact problems at all.

Excessive pay?

Perhaps the most regular charge levelled at corporations is that directors and executives receive excessive remuneration. Strangely enough, we seem not to be so disturbed by the high incomes of some athletes and entertainers. We seldom 'grudge the very high earnings of the boxer or torero, the football idol or the

cinema star, or the jazz king' (Hayek 1976: 77). One executive salary of $5 million, we often hear, could be used to pay 100 people $50,000 each. How can any one executive or director be worth so much? Surely, it is held, such salaries cannot reflect good corporate governance insofar as they must detract from shareholder returns.

The issue is not an easy one. Good managers are not plentiful. Corporations therefore regularly head-hunt each other. A good executive can make a difference to companies worth millions of dollars. A high bid for an executive's services may therefore be easily worth the cost. Conversely, a bad decision by an executive or a board of directors can cost shareholders a significant amount of income, not to mention contribute to job losses. To this extent, one may say that generous compensation schemes are basic self-protection measures for corporations attempting to retain talented directors and executives.

One criterion that determines whether or not director and executive salaries are 'excessive' is surely whether or not they are merited. If they reflect real contributions to achieving the corporate objective, then they are deserved.

Here it is important to remember that there is nothing necessarily immoral about large pay differentials. Properly understood, the remuneration accorded to directors and executives is payment for services rendered. What determines the worth of those services to a corporation, and accordingly how much it should pay for them, is the contribution that these services make to achieving the corporate purpose. This in turn depends upon the quality of the employee's actual performance and the firm's specific circumstances. To pay a lazy, unproductive executive a salary of $100,000 is not just inefficient, but morally wrong. But to award a $1,000,000 salary to an executive who has added 200 times that amount to the value of the corporation may actually be *inadequate*. It may even be said that the riskier the situation for the executive (in the sense that his career, reputation, and future income become exposed to a high chance of failure), the higher the compensation package that is merited.

Widening differentials of payment within a corporation may also reflect an expanding variance in the contributions made by different employees in achieving the corporate objective. In some instances, pay rises for senior executives may even be compatible with redundancies elsewhere. When, for instance, certain functions become redundant and senior and middle executives assume more responsibility, it may be right to pay executive staff more while shedding those staff who no longer have a role to play. By the same token, it may be wrong to increase the remuneration of the business executive of companies whose value is declining. In these cases, insufficient reference is being made to the corporate objective by those responsible for determining remuneration. The proper criticism therefore concerns not 'excessive' executive salaries, but rather a system that makes the determination of all corporate remuneration insufficiently responsive to achievement of the corporate purpose.

What should matter, from the standpoint of morality, is not so much the precise amount that any one executive or director is paid. Rather, the primary issues are by whom they are paid, using what methods, according to what criteria, and for what publicly defensible reasons. It follows that attempts must be made to ensure the neutrality and detachment of those deciding compensation levels. The economist

Irwin Stelzer has noted that 'the chore of explaining and defending executive compensation is being made more difficult than need be by some corporate governance practices in need of reexamination' (1996: 1). Stelzer has in mind those instances where executive compensation is set by boards who largely consist of CEOs of other firms.

Exacerbating the difficulties of determining whether or not the remuneration of directors and executives is the perennial problem of establishing the extent to which their actions do affect shareholder value. Scholars studying this issue have tended to investigate the association between changes in firm equity value and changes in CEO compensation (Lewellen 1971; Jensen and Murphy 1990; Murdoch 1991). They generally find that

- executive compensation is not, on average, very sensitive to firm performance;
- sensitivity of executive compensation varies considerably across corporations; and
- sensitivity is industry specific but also correlates with firm-specific risk.

Not surprisingly, there is widespread disagreement among scholars about whether or not it is valid to take changes in stock price as the sole arbiter of executive productivity. It has been argued, for example, that 'Stock options provide a direct link between executive expected utility and shareholder wealth. Assuming that executives understand how their actions affect share prices, option holdings provide incentives for executives to take actions that increase share price, and to avoid actions that decrease share prices' (Hall and Murphy 2000: 211). Some literature suggests that stock options also provide incentives to encourage risk taking, to avoid dividends and to favour repurchases over dividends (Murphy 1999: 2485-2563). 'Through bonuses, options, or long term contracts, shareholders can motivate the CEO to maximize firm wealth' (Bertrand and Mullainathan 2000: 203).

Unfortunately, *none* of these analyses manages to illustrate how one determines the precise contribution of all members of a corporation to realising the corporate purpose. Given that the productivity of everyone in corporations is to a certain extent interdependent, we should be wary about making any strict translations between one person's activity inside a corporation and the corporation's success in realising its objectives.

It would therefore be impractical and error-prone for an executive compensation board to review non-trivial changes in equity value in order to determine what fraction of the change was wrought by senior executive performance, and what was not. How, for example, can one assess the relative impacts of executive performance and external events upon equity value? The executives of a large oil company usually can bring about only a small change in equity value. The outbreak of war, however, may bring about large changes.

All such factors make executive compensation packages very difficult to determine and underline why, in the end, such decisions are often wisely left to the market. To compensate executives with stock options ties compensation to the performance of the firm regardless of whether performance results from executive

decisions or external events. (Interestingly, this way of aligning directors' interests with those of shareholders is routinely rejected by groups ostensibly defending shareholders' interests [Institutional Shareholders Committee 1993]). Straight salary compensation may, on the other hand, remove potential incentives for executives to enhance further equity value.

Takeovers: a predatory action?

Almost as controversial in any discussion of corporate governance is the issue of corporate takeovers. Early empirical investigations of this subject began with the study of the effects of mergers on stock prices (Mandelker 1974; Dodd and Ruback 1977; Bradley 1980). As the number of corporate takeovers began to accelerate in the 1980s, some commentators argued that it would have detrimental affects upon economic development. The management theorist Peter Drucker, for example, contended that

> Almost every week these last few years there has been a report of another 'hostile takeover bid', another stock market manoeuvre to take over, merge, or split up an existing publicly-held company against determined opposition by the company's board of directors and management . . . The new wave of hostile takeovers has already profoundly altered the contours and landmarks of the American economy. It has become the dominant force—some would say *the* dominant force—in the behaviour and actions of American management, and, almost certainly, a major factor in the erosion of American competitive and technological leadership. (1986: 3)

Given the U.S. economy's good performance since the 1980s as well as the United States' continuing leading edge in technological development, it would seem that Drucker's 'almost certainly' has yet to eventuate. It should, moreover, be remembered that upheaval in the economic order is actually a constant. The fact of upheaval is not in itself a reason to be wary of takeovers.

Takeovers nevertheless continue to be viewed in some quarters as inherently disruptive to communities, job stability, customers and suppliers. Stakeholder theorists figure prominently in this regard. Some (Shliefer and Summers 1988) claim that takeovers illicitly transfer wealth to shareholders by virtue of an implicit violation of contract with particular 'stakeholders' who have been led to believe that certain forms of behaviour will lead to them being rewarded in particular ways. Reliable employees, for example, expect some job security, while regular customers become accustomed to some flexibility with credit.

For such a claim to be true with regard to a takeover, such an action would have to have three components:

- the agreements entered into by the 'target' corporation would have to be legitimate arrangements;
- these arrangements would have to be wrongly transgressed; and

- a violation of trust would have to be a necessary feature of the takeover.

Nor should it be forgotten in any consideration of these matters that business corporations do *not*, for example, exist to create jobs or to establish a guaranteed source of contracts to their suppliers. Not only does this mean that people should not 'expect' regular contracts from corporations; it also means that corporations should not encourage inappropriate expectations on the part of those with whom they have regular dealings.

Another objection to takeovers is the manner in which they allegedly result in a corporation's resources being diverted from productive investment to 'unproductive' activities. Takeovers are widely regarded as resulting in money, energy and time being diverted so as to pursue or repel takeover bids, instead of being invested in managing the corporation properly.

Any response to this common argument must note the importance of grasping the precise reason why any one takeover is undertaken. If a corporation, for example, decided to undertake a takeover of another firm simply because its directors and management were 'bored'—which has occurred (Burrough and Helyar 1990)—this would be wrong as it would indicate that the directors and executives do not have the corporation's official purpose in mind when devoting time, finance and energy to such an enterprise.

Each takeover bid must be examined on its merits. Some bids *are* in the best interests of all concerned. A bidding corporation may, for example, be managed more effectively than its takeover target. A successful takeover may well result in the latter being forced to improve its ways.

It also needs to be remembered that takeovers are *not* labelled 'hostile' because they threaten the interests of shareholders, or because they will damage the corporation being taken over. A takeover is described as 'hostile' simply because the board of the corporation being targeted have decided to resist. Their decision to resist may be based upon a desire to provoke a higher share-price (and thus obtain a better result for shareholders). In other cases, their defence may simply be motivated by the desire of directors and managers to protect their jobs.

So why do takeovers receive a negative press? Part of the reason is that it is often held that a 'bidding' corporation (X) does not have the interests of the 'prey' corporation (Y) at heart.

This criticism seems, however, unfounded, once one considers the purpose of any one business corporation. In the final analysis, the interests of X corporation are the maximisation of X's shareholder value. It would therefore be *unreasonable* to expect that X corporation to have Y corporation's interests at its heart, as X's corporate purpose is to increase the wealth of X's shareholders. But once X takes over Y, maximising Y corporation's long-term value as part of the new combined enterprise is central to X's legitimate business.

In one sense, then, takeovers may be legitimately regarded as the *ultimate corporate governance mechanism*. In Stelzer's words, takeovers are one way of rectifying those situations whereby directors and managers of the corporation are not adequately serving the interests of the shareholders (1997: 28).

This much becomes clear when one reflects upon what happens during takeovers. Put simply, a takeover occurs when one company or corporation acquires another

by buying shares. As it is the purpose of the directors to represent the shareholders, it is often the case that those who have acquired a very large or majority shareholding will expect a change in directors and sometimes senior management.

Even the prospect of a takeover can serve to improve corporate governance. Presuming that a corporation's poor performance may convince shareholders to sell their shares to others who want to change the composition of boards and management, incumbent directors and managers may decide to work harder to secure their shareholders' interests.

But perhaps the most significant empirical evidence of the contribution of takeovers to good corporate governance is the fact that they tend to result in increased shareholder value. Investors holding shares in either acquiring or acquired companies before the takeover announcement will find that, on average, their share value has increased after the takeover (Bradley, Desai and Kim 1983; Jensen and Ruback 1983; Dodd and Officer 1986; Jarrell et al. 1986; Bishop et al. 1987). Studies of corporate takeovers in the United States during the 1980s illustrate that shareholders of target companies benefit considerably from a takeover of their firm (Jarrell, Brickley and Netter 1988). It is often the case that those selling shares to those bidding for control ultimately receive a price higher than the market would otherwise allow. A 'white knight', for example, may appear to protect the corporation from an external bidder. Other potential purchasers, alerted to the possibilities embodied within the target corporation, may also decide to bid. The resulting competition leads to higher share prices. Thus, even if the target corporation's shareholders decide to sell out, they can gain substantially.

This evidence is supplemented by the fact that the introduction of anti-takeover legislation tends to *undermine* shareholder value. One study of anti-takeover regulations in the United States, for example, estimated that such laws had cost shareholders of the affected firms more than $6 billion in 1990 alone (Karpoff and Malatesta 1990: 1). The enactment of anti-takeover regulations in the state of Pennsylvania resulted in the share prices of companies which remained incorporated in Pennsylvania dropping by 4 per cent (Nesbitt 1990; Jensen 1988; cf. Jarrell 1983).

Few people would object to a takeover that removes poorly performing directors and executives. But what about those cases where a takeover is directed at ousting a management team and/or board of directors that is maintaining shareholder value?

The objection that a takeover is being directed at a management team that is maintaining value is not a reason to oppose such a takeover on moral grounds. The purpose of business corporations, we recall, is to *maximise* shareholder value—not simply maintain their value. A takeover that results in a replacement of management teams need not imply that the previous managers were incompetent. It may simply mean that there was a *better* group of managers available.

Takeovers may, of course, precipitate opportunities for immoral acts. The stakes can become so high that people start to believe that the end justifies the means, and thereby engage in activities that are unquestionably wrong. But however wrong activities such as fraud and lying are, the possibility that they may occur does not in itself make takeovers immoral. Other methods of transferring control from one person to another, such as general elections, are just as susceptible to being

corrupted by immoral behaviour. Yet noone would suggest that the possibility of electoral fraud de-legitimates in principle the mechanism of elections.

This political analogy raises the question of how the interests of smaller shareholders should be protected during takeovers. In most takeovers, the will of large shareholders usually prevails over smaller shareholders, with the latter being relatively powerless to stop developments of which they do not approve. Sound political democracies usually have mechanisms to protect those who find themselves in a minority. Should small shareholders in corporations enjoy similar protections?

A crucial principle of political democracy is one-person-one-vote. The corresponding principle in a corporation is one share-one vote. Thus the equality that exists in corporate elections is not the equality in dignity of human persons. Rather it is the equality of fungible capital. Votes are, in short, attached to shares—not individuals.

Perhaps the best means for protecting the interests of small shareholders is to insist that the provisions of corporate law as well as internal corporation rules requiring due process are rigorously followed. American laws, for example, afford the protection of due process to smaller and minority shareholders by insisting that dividend payouts be the same, requiring majority approval of mergers, allowing derivative law suits, and insisting upon standard accounting methods (Demsetz 1997: 56; Marsh 1990; Stainer 1991).

Small shareholders do, however, need to remember that, in many respects, the very possibility of increasing the value of their stock is dependent upon the fact that they have pooled their investment with that of wealthier individual and institutional investors. It is the wealth of the latter that compounds the earning potential of small shareholders who are, in a sense, 'hitching a ride' on the capital of larger shareholders. To this extent, they are gaining access to potential earnings that they would not otherwise enjoy. Ultimately, of course, smaller shareholders can express their dissatisfaction with larger shareholders' wishes by selling their shares and investing elsewhere. They may even make a profit in doing so.

Directors and accountability

Though it is relatively easy to underline the problems with arguments that criticise 'excessive' salary packages and 'disruptive' takeovers, concerns about the accountability of directors and managers to shareholders are not so easily dismissed. Monk and Minnow, for example, maintain that 'Corporations determine far more than any other institution the air we breathe, the quality of the water we drink, even where we live. Yet they are not accountable to anyone' (1991: x).

Such statements are an exaggeration. In the end, corporations are accountable to their owners. Large shareholders can, for example, wield a significant influence over the corporation's activities, not least by influencing the composition of the board or by deciding to sell their stock.

There is, however, some evidence to suggest that the accountability of directors and managers to the shareholders has been weakened in more recent years. It appears to have been undermined by:

- the decline of the *ultra vires* doctrine (under which shareholders could sue managers for embarking on projects contrary to the corporate purpose);

- the emergence of corporate 'constituency statements' (which permit managers to consider and appeal to a broader range of interests in determining how and whether to fend off a take-over bid, thereby hampering the smooth operation of the market for corporate control);

- the expansive interpretation of the business judgement rule (which shields some managerial actions from substantive judicial review) by courts in the United States;

- procedures that govern annual general meetings (AGMs) and corporate elections. AGMs in Britain, for example, have been described as 'an expensive waste of time and money' (DTI 1996: 5), while some have referred to American corporate elections as 'procedurally much more akin to the elections held by the Communist Party of North Korea than those held in Western democracies' (Epstein 1986: 13). Part of the difficulty is that the agenda of AGMs is set by directors and not shareholders. While it is reasonable that those charged with the corporation's direction should list the major issues for discussion and voting at AGMs, this significantly limits shareholder power. By combining conceptually different points into the same resolution, for example, directors can limit shareholder options for shaping major decisions;

- the limits on the subject matter permitted for shareholder resolutions at AGMs. In the United States, such resolutions cannot deal with 'the conduct of ordinary business operations' (SEC Reg.240.14a-8) of the company. Nor, in many instances, are such resolutions binding on the board, even when passed unanimously (Monks and Minnow 1991: 260). It follows that the only way that shareholders can dispute a director's remuneration is by opposing his appointment to the board. This severely limits shareholder options when it comes to affecting the corporation's direction; and

- the diminishing means that shareholders have at their disposal if they wish to remove directors. In Britain, for example, significant numbers of boards of directors do not require re-election at all (Lewis 1996:1). Legal sanctions against directors are expensive and of limited usefulness, especially in the United States where state legislation severely limits directors' liability, even for gross negligence. Certainly, directors require a high degree of protection from liability, otherwise the number of qualified people willing and able to serve as directors would diminish. Nonetheless, many directors in the United States are indemnified against errors at shareholders' expense, even when courts have found directors to have been in breach of their duty (Monks and Minnow 1991: Chp 3).

Each of these factors is complicated by the fact that some directors of corporations are often also its executives. Their interests as executives may often be different

from those of the shareholders that they are supposed to represent as directors. An executive director may have a vested interest, due to internal management politics or a desire to enhance their career prospects, in protecting what may be, from the standpoint of shareholder value, an unsatisfactory status quo.

Most corporations strive to minimise such difficulties by having a large number of non-executive directors (who often make up the majority of the board) who, by definition, are detached from the interests of management. But non-executive directors are not immune from conflicts of interest. A non-executive director of X corporation may well be an executive of Y corporation, and thus protective of interests that *all* managements have in common.

Unintended consequences

However they are resolved, corporations should be wary of the potential for concerns about accountability to be counterproductive. Directors do need to be in a position to take necessary risks. Excessive disincentives to take prudential risks can be created in the name of corporate governance, thereby undermining the capacity of directors and managers to realise their official objective. One Australian CEO has even stated that ‘there is little soundly based empirical evidence which indicates that “best practice” corporate governance delivers “best practice” outcomes for shareholders over the long run’ (Wallis 2000: 5).

If corporate governance is mistaken for the imposition of rigid specifications that focus upon limiting executive remuneration or setting (and/or limiting) the numbers of executive and non-executive directors on boards, there is no reason to suppose that these requirements will automatically help to realise shareholder value or prevent inappropriate behaviour. There is, for example, a tendency to promote check-list type of measurements—such as mandating how many independent directors are on the board or who attends the most board meetings—when it comes to determining the success or failure of corporate governance (Charkan 1994; Russell Reynolds Associates 1998). Their worth is, however, questionable insofar as such measurements provide only limited insight into the relative effectiveness of directors and managers. They cannot tell us which directors have been prudential risk-takers and which tend to advocate reckless policies. Nor can they distinguish between those who are inclined to ramble during meetings as opposed to those who keep their counsel to the point.

Rigid adherents to such requirements can also have negative unforeseen consequences. As noted, the responsibility of boards is to represent shareholders. Most directors are not therefore involved in the management of the corporation, and are often generalists rather than specialists in any one area. The emergence of new technology companies, however, makes it clear that intellectual/human capital is becoming an increasingly important force in determining whether or not corporations will achieve their corporate purpose. While they may not have as many (if any) shares, is it sensible to exclude those who possess such human capital from boards of directors? Would it be wise for a computer company, for example, to exclude a Bill Gates from the board on the basis that he is employed by the corporation and/or has only a small shareholding? The rapid pace of technological development may make such objections seem less and less plausible. Yet there is a

danger that a certain rigidity of concern about keeping directors as much above the fray as possible may blind some corporations to the need to think about how such developments will affect their governance. Discussing a similar issue, Wallis notes that such phenomena may actually necessitate

> more executive directors and more directors who have had industry experience or involvements, notwithstanding that such directors have shareholding or advisory relationships with the company. . . . Conflict issues will arise, but in most instances of conflict around the board table the core issue is not the existence of conflict *per se*, but how it is handled. (2000: 7)

Knowledge and a corporate governance market

Given the range of issues outlined above, the challenges facing those responsible for good corporate governance are formidable. Undoubtedly, ways will be found and procedures devised for bringing onto the boards of corporations, people who can inject the necessary expert knowledge while simultaneously maintaining the board's necessary degree of independence from the corporation's day-to-day affairs.

But perhaps the most significant force that will ensure that the corporate governance of business corporations is not unduly distracted from realising their official objective will be the rise in share-ownership within much of the population of developed nations. Though this may increase the demands upon business to adopt stakeholder-like approaches to management, it will undoubtedly increase the pressure exercised by individual and institutional shareholders for corporate performance that delivers shareholder value. The unprecedented competition for shareholder investment among corporations, the growth in sophisticated financial information and analysis (be it through television, the internet, or written material), the growing transparency of investment flows, as well as the institutional power wielded by professional independent analysts representing large shareholders will only add to this pressure. Here there may be opportunities for market forces to be brought to bear upon corporations in ways that effectively create a 'market for good corporate governance'.

The suitability of this approach was endorsed by the OECD as long ago as 1988. 'A market for governance arrangements should be permitted', it argued, 'so that those arrangements that can attract investors and other resource contributors—and support competitive corporations—flourish (OECD 1988: para 54).

The evidence that such a market can have good results is underlined by the experience of the California Public Employees Retirement Systems (CalPERS). CalPERS has an institutional investor arm that assesses companies' performance. The underperforming corporations that it has highlighted have routinely proceeded to outperform the Standard & Poors's 500 index. According to a 1992 report (*The Economist*, 10th August 1996, 57), CalPERS's strategy of identifying and publicising underperformance cost it approximately $500,000, but helped to generate profits of $137 million over the S&P average in the corporations whose performance was found wanting. This result was confirmed in 1994, when targeted companies that trailed market averages by 66 per cent for the five years prior to CalPERS's

intervention, outperformed the S&P index by 52.5 percent over the following five years (Nesbitt 1994: 75-80).

The value of publicising underperformers has been further corroborated. Ninety six companies that were put on the US Council of Institutional Investors' focus list went on to outperform the S&P 500 by 11.6 per cent in the year after they were targeted, and generated an estimated total dollar gain of $39.7 billion (Opler and Sokobin 1995). In this light, one should hardly be surprised that a 1996 survey illustrated that two-thirds of investors were willing to pay an average 16 per cent premium for companies that had 'good corporate governance' (Felton, Hudnut and Heeckeren 1996).

If this finding is indeed accurate, then it may create further opportunities for improving corporate governance, not least by encouraging corporations to engage in a careful analysis of their official corporate purpose. Corporations could significantly distinguish themselves in the competition for investment funds by identifying their corporate objectives more precisely. Rather than limiting themselves to 'maximising shareholder value', a corporation could state that its purpose is to realise profits, over a certain time period, for shareholders willing to invest at a certain level for a set period. Many corporations have already begun marketing themselves in such a way, and building such specifics into their corporate purpose. Corporations would be able to compete for shareholders by illustrating the extent to which performance measurement actually reflected fulfilment of the corporate objectives.

But while these options for improving corporate governance are worthy of consideration, they are only of marginal significance for the *ethical* dimension of corporate activity. This is an area in which corporations increasingly find themselves under scrutiny. Phrases such as 'ethical investment' and 'corporate social responsibility' increasingly fill the Academy as well as public discourse; they are widely regarded as ways of improving and enhancing the moral dimension of corporate activity.

Before corporations rush to embrace such ideas, they would do well to pause. Careful study of these propositions soon indicates that they often have more to do with politics—and politics of a distinctive kind—rather than ethics properly understood. Such theories are, in many respects, a distraction from serious reflection upon the moral conditions upon which corporations have often unconsciously hitherto relied and which, in many respects, are in urgent need of rebuilding.

5

Corporations and the Moral Life

> The bourgeoisie, during its rule of scarce one hundred years, has created more massive and more colossal productive forces than have all preceding generations together. Subjection of Nature's forces to man, machinery, application of chemistry to industry and agriculture, steam-navigation, railways, electric telegraphs, clearing of whole continents for cultivation, canalisation of rivers, while populations conjured out of the ground—what earlier century had even a presentiment that such productive forces slumbered? (Marx and Engels [1848] 1948: 13-14)

As corporations move into the twenty-first century, their environment will continue to change at a rapid pace. Complicating matters will be the increasing number of 'ethical' demands made on corporations. Terms such as 'ethical investment' or 'corporate social responsibility' are already used with much frequency in public discourse. This has in turn spawned an unprecedented debate about ethics and corporate life.

By definition, the moral life is not excluded from either the boardroom or the management of corporations. By its very nature, the moral life touches upon every freely-willed choice between good and evil. Like everyone else, people working within corporations find themselves having to make such choices every day. These choices can range from how much information should be given to shareholders to resisting the temptation to engage in fraud, no matter how small or large the scale. Sometimes the choices are not as clear as this. People working in corporations thus require a thorough grounding in how to think their way through moral dilemmas.

Unfortunately, serious reflection on the moral life within corporations is being circumvented by the prevalence of generally superficial approaches to moral questions. Here we examine some of the more prominent of these paths, before outlining some ways of approaching the moral dimension of corporate activity in a manner which is faithful to the nature of ethics properly understood.

The good of corporations

Before considering these matters in detail, it is appropriate to remind ourselves of the real moral, social and material good that is realised by corporations on a daily basis. One such good is their associative dimension.

Corporations are, by nature, voluntary and part-time associations—'at every stage of its growth the corporation is a voluntary association' (Hessen 1979: 73). They make no pretence to be a total community (with the possible exception of certain Japanese firms in the 1960s) (Charkan 1994: 70-118; Drucker 1995: 253-4). They involve communal risk-taking and the pooling of resources. Business corporations are thus *social* enterprises that take people—sometimes unconsciously and even involuntarily—beyond the scope of the family and other smaller groups. The very word 'corporation' suggests 'communal' in the sense of many people acting together.

Business and market relationships are often viewed as having a socially disintegrative effect. It is true that they can undermine established social patterns. But one should not forget Alexis de Tocqueville's observation that modern economic activity tends to draw people out of their familial, ethnic and religious associations, and helps them to mix with people with whom they might not otherwise have associated (1835/1840). While people often work in corporations to satisfy their personal needs, the corporation cannot help but integrate them into broader social interactions. This is not to claim that relationships forged through corporate activity or business interactions are sufficient for human flourishing. Evidently, they are not. It is merely to stress that there is an associative dimension to human life that corporations rely upon and contribute to.

CEOs of large corporations, for example, hardly lead the life of an isolated individual. Much of their time is spent conveying a sense of coordination, *ésprit de corps*, and unity throughout a large organisation. Inevitably, they turn to others for advice, trust some, and inspire many. Corporate management and directors have to work together to determine and implement common strategies. Clearly, corporate life is not for rugged individualists.

Nor are the associative benefits of corporations limited to any one nation at a time. The links that they forge between countries have, in their own way, contributed to dragging Western civilisation out of the morass of militant nationalism that plagued the nineteenth and twentieth centuries. Galbraith has illustrated how banking operations and resource industries facilitated economic internationalisation, followed by oil and then the trading companies that produced an international exchange of goods (1978: 84). Back then, as in the present, the business pioneers of internationalisation were accused of many evils. International bankers, for instance, were regularly portrayed as 'unpatriotic' (a condemnation regularly laced with strong anti-Semitic overtones), while trading companies were associated with colonialism and imperialism (most notably by Lenin).

Foreign corporations inevitably bring with them a foreign culture. Noone would dispute that most corporations have made errors as they penetrate these cultures. The personnel involved are bound to commit some error of discretion or cultural sensitivity. But the cause of such clashes does *not* lie in the fact that corporations are corporations. The fault lies in the fact of difference. Numerous other foreign groups such as non-government organisations have made similar mistakes.

Yet while such problems exist, it is also true that multinational corporations bring with them a certain degree of homogenisation that benefits the developing nations that they enter. While politics and cultures may differ, fundamental rules of investment, business organisation, savings and commercial sales appear assimilable by virtually all cultures.

This is not the only positive benefit that corporations bring to the developing world. While most transnationals have their origin and headquarters in one nation, they do create productive elements in others. A major study of the impact of multinationals upon Latin America between 1957 to 1970, for example, found that corporations do not merely sell their goods in other lands, buy goods from other lands, or trade with other lands. They often build facilities in other countries in order to operate there. While the training of a local labour and management force is

not a strict by-product, this often turns out to be the case. Other contributions of corporations to host nations include:

- the creation of capital facilities;
- the technology transfers inherent in the training of personnel which remain forever in the host country;
- the products manufactured within the nation no longer have to be imported, thus easing balance of payment problems; and
- the wages paid to employees remain in the country, and local citizens begin to invest (Muller 1973: 42).

On a more mundane but equally important level, corporations contribute on an on-going basis to the well-being of entire societies by creating wealth, jobs, material goods and services. Their growth as autonomous organisations also contributes to the growth of that non-state sphere of social activity commonly known as civil society.

Contrary to much contemporary wisdom which persists in limiting civil society to non-government organisations and the voluntary sector, business corporations *are* part of civil society insofar as they too are part of—indeed, essential to—the non-state sector of society. This much has been recognised by philosophers ranging from Smith to Marx (Black 1984). Similarly, their wealth-creating actions help to expand the sources of private capital, wealth and property that, as Pope John XXIII noted ([1961] 1981: para. 108-110), are crucial for the survival of civil and political liberties. By engaging in commercial activity, they also contribute to what the French philosopher Charles-Louis de Montesquieu described as the civilising power of commerce; i.e., it relies upon respect for law; it benefits by peace; it teaches prudence and attention to small losses and small gains; and it diverts attention from grandiose schemes in order to facilitate modest progress ([1748] 1949). In these and other ways, corporations play a role in the creation of moral, material and social goods that extend beyond the monetary returns to their owners.

Corporate 'social responsibility'?

The capacity of corporations to facilitate these goods is, however, not enough for some. 'Social responsibility' is a phrase increasingly used with reference to business. Broadly speaking, it refers to the apparent requirement of business corporations to engage in activities that are made morally compelling by the invocation of criteria such as the needs of others or the interests of society.

These demands go beyond expecting corporations to keep promises and observe elementary rules of morality and justice. Instead, the corporation is often enjoined to restrain its profit-maximising role (i.e., to increase returns to its legal owners, the shareholders) by contributing to society in ways that go beyond what is described above. Not surprisingly, the word stakeholder is used to identify those to whom business organisations are somehow morally responsible.

Leaving aside the problems of incoherence already identified with stakeholder theory, there are just as many difficulties with the notion of corporate social responsibility. Marcoux summarises many of these by pointing out that the image of the corporation presented in the corporate social responsibility literature tends to be 'that of a free rider, unjustly and uncooperatively enriching itself to the detriment of the community' (2000: 10). Such thinking evidently reflects a failure to recognise the moral, material and social goods facilitated by business activity.

Corporate social responsibility is also associated with claims that corporations should be obliged to contribute more in financial terms to the community than just corporate taxes. Certainly, if private owners want to forego income for what they think is a justified cause not forbidden by law, then they are, at least ostensibly, making legitimate use of their money. Privately owned companies can make decisions based partly (or even wholly if so they desire) on their owner's particular political beliefs. It is, after all, their money. Likewise, if a corporation genuinely wants to devote a share of the corporation's gains to worthy causes, or to sacrifice a profitable opportunity in order to contribute to the realisation of another goal, then it is entirely free to do so—*provided that it does so with the approval of shareholders*.

While executives enjoy a high degree of discretion in the management of corporations, this independence is defined, directed and limited by the fact that managers have a strict moral and legal duty to manage in the interest of the owners. Naturally, this does not mean that owners can direct managers to do evil things. But it does remind us that corporations are responsible to shareholders, often widely dispersed, who normally invest so as to receive the highest possible return: they do *not* generally make the investment to secure any one particular ethical goal (unless they have invested through a self-identified 'ethical investment' fund). Indeed, a great deal of equity in many economies is held by superannuation funds which makes the manager's responsibility to maximise profit even more urgent. These institutional investors have their own fiduciary duties to the thousands who have invested their financial future in them. This limits corporations' scope for programmes of 'social responsibility', not least because the retirement income of thousands of people is increasingly dependent on the performance of corporations.

A triple bottom line?

This attention to the 'bottom line' is challenged by some who maintain that corporations should embrace what is popularly known as 'the triple bottom line' if they wish to be socially responsible. While the precise composition of this line tends to differ (depending upon which theorist one consults), John Elkington's definition features heavily in the literature. According to Elkington, the triple bottom line that business must meet is '[that] of sustainable development: economic prosperity, environmental quality, and . . . social justice' (1998: 32).

From the standpoint of good corporate governance, however, the notion of triple bottom line is intellectually unsustainable. Corporations are, of course, designed to pursue economic prosperity (though Elkington does not specify whose economic prosperity he has in mind). But reference to terms like social justice is not at all likely to provide corporations with substantive guidance as to what constitutes

socially responsible behaviour. The very meaning of the term is rigorously disputed by philosophers, jurists and theologians. Some scholars dismiss the entire concept as intellectually incoherent and unworkable (Hayek 1976). Others understand it as referring primarily to one's *personal* responsibility to act justly towards others (Novak 1993). Nor should it be doubted that some thinkers invest the term with specific ideological commitments (usually, though not always, from the political left). Articulating a commitment to 'social justice' is often therefore unhelpful when reflecting upon the moral life within corporations.

There are also difficulties involved in determining what, in many instances, would be precisely the 'socially just' thing for a corporation to do. Some would argue that a corporation's decision to close down a plant is socially unjust insofar as it leads to the unemployment of some people. It is entirely possible, however, that a decision *not* to close one plant may rebound negatively upon those employed by other plants owned by the same corporation.

These and similar dilemmas are encountered by corporations on a daily basis. But neither their discernment nor their resolution are helped by references to 'social justice' or 'corporate social responsibility'. A more coherent approach would be to distinguish between the negative and positive responsibilities of corporations. Negative responsibilities involve following a rule common to many schools of moral philosophy: *do no evil*. This in turn suggests that

> A business is responsible for taking reasonable precautions regarding the influence and effects of its activities and correcting mistakes that are due to its not taking such reasonable precautions. (Soloman 1994: 281)

What constitutes the *positive* responsibilities of corporations beyond making a profit for their owners are more debateable. In any event, it would be far better for such responsibilities to be decided by shareholders rather than managers so that the actual owners can choose whether or not they want their money given to certain causes.

'Ethical' investment

One means by which people can invest their money in ways which will expedite the realisation of various goals is the 'ethical investment fund'. There is much to be commended about an approach that directs the power of the market towards the realisation of non-material objectives. There are, however, varied accounts of their success. As one CEO notes, '[t]he reality has been that there has not been a significant, broad-based willingness to pay for cleaner—but more expensive—goods' (Duncan 2000: 71-2).

Notwithstanding the apparent gap between rhetoric and reality, there are significant philosophical difficulties with the concept of ethical investment. The list of concerns promoted by some ethical investment funds is long and not especially coherent. They include:

- investment in armaments;

- investment in tobacco;
- investment in gambling;
- investment in sexual exploitation of women, most notably pornography;
- investment in any product using animal experimentation;
- investment in inhumane farming;
- investment in the nuclear industry;
- investment in mining;
- investment in countries with oppressive regimes;
- failure to promote equal opportunity or affirmative action programmes;
- failure to match First World employment opportunities in Third World countries;
- failure to recognise trade unions;
- inadequate level of giving to charity;
- inadequate level of community involvement;
- unreadiness to disclose information to ethical investment information groups;
- emission of excessive greenhouse gases. (Anderson 1996: 8)

The moral implication to be drawn from this list is clear: if you do not invest in corporations that match one or more of these criteria, then you are ethical, socially responsible and 'sensitive'. It follows that those who do so are, by implication, morally suspect.

But whether such implications are legitimate is far from obvious. *Who*, for example, is to determine what constitutes 'adequate community involvement'? Similarly, the tendency to distinguish between good and bad products ignores the fact that what matters, from an ethical viewpoint, is the *use* to which people put the product. It is a bizarre ethics that suggests that certain products are in themselves 'ethical' or 'unethical'—after all, only human beings are capable of morality.

Many ethical investment funds, for example, label any investment in arms manufacturing as wrong (Sparkes 1995: 4). But weapons can be used to defend just causes as well as people suffering aggression. It was, after all, through the use of weapons that Nazi Germany was defeated in the Second World War. Similarly, the objection to investment in the nuclear industry *per se* is equally questionable. The opposition is presumably to investment in organisations making nuclear weapons.

Yet much of the nuclear industry is also a pioneer in the area of radiation treatments for medicine. Is investment in this aspect of the nuclear industry to be condemned as well?

The list above also reflects the fact that much of what passes for ethical investment criteria seems to have more to do with fashionable causes than the moral life as a whole. Apart from objections to pornography, it reflects little interest in questions of sexual morality. Nor do the criteria suggest that when making investment decisions, one ought to consider whether the personnel of corporations embody the recognised virtues of temperance, courage, justice and prudence in their corporate-related activity.

In short, a high degree of moral selectivity is apparent in the concerns promoted by some 'ethical investment' funds. In the 1980s, for example, promoters of ethical investment invariably listed South Africa as a country in which it was ethically wrong for corporations to invest (Sparkes 1995: 5). But why, one may ask, did they not also list countries with regimes as oppressive as Cuba, Libya, East Germany, Iraq, Zaire, Zimbabwe, Ethiopia, the Soviet Union, Romania, or Vietnam?

It is also the case that many of the criteria above reflect a narrow view about how to deal with genuine moral problems. Noone would hold that racial discrimination is a good thing. But one does not have to be a racist to object to affirmative action programmes. Many eminent moral thinkers have articulated carefully reasoned arguments to suggest that affirmative action is in fact *unethical*. It is not a question of whether racial discrimination is good or bad. It is rather a question of whether a particular policy like affirmative action also constitutes racial discrimination, or is the best way among a range of possible ways (all of which have drawbacks and disadvantages) to prevent or ameliorate the effects of discrimination. It is therefore highly contentious to imply that a corporation that does not engage in affirmative action is engaging in unethical behaviour.

There is also a real ethical question about the use of animals in testing various products. But should we test such products on humans instead? Or should we let people use the products without testing them at all? Nor is there any question that we all have the duty to oppose tyrannical regimes. The real issue, however, is *how*. Some argue that investments in countries such as Cuba ruled by regimes as oppressive as Fidel Castro's will only further entrench his rule. Others maintain that such investment will lighten the burden for the oppressed, and gradually undermine the regime's control of the Cuban economy. Surely much depends on the nature of the investment, the degree of control exerted by any one corporation over that investment, and the conditions of the country at different points in time. To assume that such complex ethical issues will be resolved simply by refusing to invest in firms that test drugs on animals, or which have holdings in Cuba or Iraq, is simply inadequate.

Then there are the sharp differences of view about the moral status of certain activities that many ethical investment funds implicitly condemn. Perhaps the most prominent is gambling. It is not often understood that there are varying traditions of moral reasoning about gambling within, for instance, the Christian churches. Evangelical Protestantism, for example, tends to rule out gambling *per se* on the basis of Scriptural statements. Catholicism, on the other hand, maintains a different view. According to the *Catechism of the Catholic Church*:

> Games of chance (card games, etc.) or wagers are not in themselves contrary to justice. They become morally unacceptable when they deprive someone of what is necessary to provide for his needs and those of others. The passion for gambling risks becoming an enslavement. Unfair wagers and cheating at games constitute grave matter, unless the damage inflicted is so slight that the one who suffers it cannot reasonably consider it significant. (CCC para.2413)

Reflecting on gambling, Catholic scholars would generally hold much depends on the type of gambling concerned. Betting on prize-fighting is wrong because prize-fighting necessarily involves the intention to inflict harm on the other player. Hence, one should not cooperate in such an activity by betting on the outcome (Farraher 1963: 64-9). They also maintain that one should not take unfair advantage of others when gambling. Lying is never justifiable, and people should be given as much information as possible concerning the risks, the odds of winning or losing. Illegal gambling is also wrong, because of the general presumption that people must make that laws are just and must be obeyed. This presumption is hard to overcome in the case of laws against gambling.

But eminently orthodox Catholic philosophers such as Germain Grisez usually add that gambling *can* be a reasonable activity (1993: 818-20). The morality of the act of gambling, Grisez maintains, is specified by the gambler's intention. Like some investing, gambling is an agreement between two or more parties in which at least one of them puts a sum of money or good at risk with the expectation, contingent on some future event, of either gaining more or losing the stake. Gambling differs from responsible investment insofar as gamblers do not accept a risk of loss as a side-effect of making provision for the future but choose to take a risk for the sake of the gain that they expect if they win.

It can also be argued, again from a Catholic standpoint, that gambling can enhance other rationally justified activities. The excitement of gambling can help, for example, elderly or disabled people to overcome the lethargy with which they are sometimes afflicted. In such cases, gambling may enhance sociability and create an environment for interpersonal interaction. Gambling on a sporting event that one is watching can intensify interest, thereby making one's involvement more gratifying. If that activity constitutes good recreation or 'play'—which some Catholic scholars regard as a *basic moral good* (Finnis 1980: 87)—it can be justified on these grounds, provided that such activity violates no law, involves wagers of modest amounts consistent with one's other responsibilities, and avoids addiction and scandal.

Our purpose here is not to engage in an in-depth analysis of the ethical dimension of gambling. But what this brief outline does illustrate is that it is imprudent for ethical investment funds to label all forms of gambling as wrong.

But an even more questionable action on the part of some ethical investment funds is their listing of 'disclosure of information' to ethical investment organisations or funds as an ethical criterion against which corporations should be assessed (Adams, Carruthers and Hammill 1991: 6). The implied claim that failure to respond to an ethical investment questionnaire is itself unethical, is highly suspect.

There may be many good moral reasons why a corporation may choose not to disclose information. These include a reticence to release information to competitors and pre-existing duties to maintain existing confidences. The targeted respondent may think that the questions are poorly framed, consider the assumptions underlying the questions to be unsubstantiated, or regard the ethical categories employed as having more to do with fashionable causes than any substantive understanding of ethics. In such instances, it may be *un*ethical to respond to such surveys. In any event, it is clearly questionable to label someone as unethical on the basis of their failure to complete an unsolicited form.

'Investing ethically' is evidently not a straightforward matter. The issues involved are often heavily disputed. The danger with ethical investment is that it will focus on particular causes, disregard counter-arguments, or underestimate the complexity of various moral questions. As it currently exists, much that is called ethical investment provides people with a somewhat crude view of the nature of the moral life. This being so, it may actually *subvert* effective moral education. Naturally, if those promoting the pursuit of particular causes through market forces wish to do so, then they are entitled to do so. One may, however, legitimately object to their appropriation of the word 'ethical' to describe the nature of such investment.

The rule of law

If the promotion of notions such as corporate social responsibility are flawed means by which to promote a genuine appreciation of the moral life within the corporation, what are the alternatives? This issue was the subject of much thought by many scholars following World War II, not least because of the extent to which German business had failed to resist the Nazi regime and even—in many cases and to varying extents—participated in that regime's crimes. Galbraith argued, for example, that it was pointless trying to encourage morality within corporations. Instead, he believed that it should be checked by a 'countervailing power' (1952: 26).

The power that Galbraith had in mind was the state. At the beginning of the twentieth-first century, however, we know that there is no necessary connection between state regulation (or even state ownership) and good moral behaviour. State-owned enterprises in Communist countries were notoriously corrupt organisations (Holmes 1997).

It is nonetheless true that law does play a significant role in shaping humans' moral behaviour. This insight was recognised as long ago as Aristotle. In part, it involves people submitting to what is widely known as the rule of law. Most jurists agree that rule of law is evidenced by the following characteristics:

- rules are prospective and not retroactive, and are not in any way impossible to comply with;

- rules are promulgated, and are clear and coherent with one another;

- rules are sufficiently stable to allow people to be guided by their knowledge of the content of the rules;

- the making of decrees and orders applicable to relatively limited situations is guided by rules that are promulgated, clear, stable and relatively general; and

- those people who have the authority to make, administer, and apply the rules in an official capacity are accountable for their compliance with rules applicable to their performance and do actually administer the law consistently and in accordance with its tenor. (Finnis 1980: 270-271)

Some jurists (Raz 1979: 223-5) regard adherence to rule of law as having a deterrent effect upon human behaviour insofar as observance of rule of law tends to discourage individuals or organisations from doing what is illegal (even if they believe certain activities to be morally permissible) and/or otherwise widely accepted as wrong. Others insist that 'the rule of law, in its promulgation, prospectivity, possibility of compliance, clarity, and so forth, is best explainable in part as involving an at least minimal commitment to human dignity and responsibility' (Wright 1996: 63). As the Athenian philosophers and medieval scholastics pointed out, rule of law involves the further 'matter of doing what can be done to see that we are ruled by *reason*' (Finnis 1998: 250). Law, in this sense, is the fruit of the actions of people who act according to reason rather than mere whim or passion.

Adherence to the rule of law should not therefore be underestimated in terms of its effects within corporations. The situation has, however, been complicated by the fact that in many jurisdictions, the notion of corporations being liable for serious criminal offences is beginning to be incorporated into law. The word 'corporation' is usually used in this context as a singular term to describe a non-natural agency whose features enable it to commit actions previously thought to be capable of performance only by natural agents. Intention, for example, is now attributed to corporations.

But while civil law recognises the corporation as a personalised entity, the fact remains that it is *not* a surrogate human being capable of *mens rea*. Thus in most jurisdictions, a criminal prosecution of a corporation can only succeed if it can be shown that particular individuals—the 'controlling minds' of the corporation—were indeed culpable. Judges have therefore looked for evidence of *personal* wrong-doing in cases brought against corporations. In Britain, the Board of Directors of P.&O.—the owners of the *Herald of Free Enterprise* that sank off Zeebrugge—was charged with 'corporate manslaughter' (even though the company had changed hands two weeks before the disaster). The need for a *mens rea* to be established in criminal cases makes the identification of the corporation as an individual almost impossible to sustain, as it is extremely rare for corporations to be corporately bent upon evil ends. Usually, it is individual employees who are responsible for wrongs such as fraud. In the Zeebrugge case, the judge dismissed the manslaughter charge against the P.&O. corporation because he refused to allow the aggregation of individual wrongs to constitute a collective wrong. Put another way, attributing personhood to corporations and then pursuing them for wrongs may actually allow the responsible malefactors to hide behind the corporation. But, as Barry observes

(1993: 352), if this is the case, then one must ask what is the point, in justice, of going further and prosecuting corporations?

Codes of conduct

Though the role of law in facilitating the moral life within corporations is often underestimated, law is not enough by itself. Between government regulation and utter license lies moral responsibility and self-regulation. One option for fostering such an environment is the adoption of codes of conduct.

Such codes reflect the reality that corporations are not natural persons. While they often have distinctive cultures, they do not in themselves possess moral properties such as conscience, reason or free will. Hence, codes of conduct may, like all formal rules, have an educative effect upon those who do possess these characteristics: the directors, managers and employees of the corporation. To this extent, codes of conduct can provide everyone in a corporation with a common reference point. They allow everyone to know what is expected practice, and to plan and act accordingly.

There are, however, several caveats that should be noted. Sir Adrian Cadbury stresses, for example, that corporations should embrace such codes voluntarily, primarily because he believes that statutory codes would specify minimum standards that would tempt some companies to do the bare minimum (1998: 76). Codes of conduct can be used to escape ethical requirements as well as enforce them. By stipulating what may not be done, they can encourage minimal compliance.

We should also remember that codes of conduct can never substitute for people's absorption of basic moral principles such as the principle of never doing evil, even in the pursuit of a good end. It is far better to have each person develop the capacity to engage in sound moral reasoning than to become overly reliant on unthinking adherence to laws and codes of conduct. Such codes and laws have a legitimate, but subsidiary role to play in the moral life. In the end, people working in and for corporations need to absorb, like everyone else, a moral ecology that eschews both emotivism and relativism.

Observing conventions

In a sense, it is incorrect to suggest that corporations require a 'special kind' of ethics, or even an awareness of what some call 'business ethics'. Cadbury underlines a simple but fundamental truth when he states that 'business morality is simply personal morality writ large' (1998: 83).

The development of an appropriate moral ecology that nourishes this morality within individuals depends on two things. The first is the conscious cultivation and protection of various social conventions that contribute to the maintenance of a civilised society. Contemporary economists such as Milton Friedman have stressed the importance of business observing social conventions in addition to the binding obligations of law (Friedman 1970; Barry 1993: 349). The convention of *caveat emptor* is often seen as implying low trustworthiness in economic relationships. In

a limited sense, this is true. But more fundamentally, it could be seen as simply a warning to be prudent, to think through one's decisions carefully before acting.

Another key convention is the practice of reciprocity. This allows people within corporations to coordinate their economic activity and business dealings with a certain degree of predictability. Trust is key to this predictability. In free economies and corporations, a minimum of trust is taken for granted. If we had to rely solely on contracts and legislation, we would spend much time making sure that there was no possibility of people escaping their obligations. We would never offer to do more than we were legally obliged for fear of being used. Many innovative proposals from entrepreneurs would be dismissed because they would require corporations to trust them. We could not even look to arbitration or courts for guidance, as noone would trust arbitrators. Thus it was the case that in Communist societies (where trust was rare outside families and sometimes within them), corruption, bribery and cheating were the rule rather than the exception (Havel 1991: 125-214). As the economist Kenneth Arrow, who is also a member of the Pontifical Academy of Social Sciences, observes:

> trust has a very important pragmatic value . . . Trust is an important lubricant of a social system. It is extremely efficient; it saves a lot of trouble to have a fair degree of reliance on other people's word. Unfortunately, this is not a commodity which can be bought very easily. If you have to buy it, you already have some doubts about what you've bought. Trust and similar values, loyalty and truth-telling, are examples of what the economist would call 'externalities'. They are goods, they are commodities; they have real, practical value; they increase the efficiency of the system . . . But they are not commodities for which trade on the open market is technically possible or even meaningful. (1974: 23)

Evidently, promise-keeping is essential. But what does this mean in practice? When is a promise made? Being a human practice, engaged in and maintained for diverse practical purposes, a promise is constituted if and only if:

- one person (A) communicates to another (B) his intention to undertake an obligation to perform a certain action (or to see to it that certain actions are performed); and

- B accepts this undertaking in the interest of himself, or A, or of some third party (C).

The giving of a promise is thus the making of a 'sign' which signifies the creation of an obligation. Reflecting upon this, David Hume commented:

> the [promising] conventions of men . . . create a new motive . . . After these signs are instituted, whoever uses them is immediately bound by his interest to execute his engagements, and must never expect to be trusted any more, if he refuse to perform what he promised. (Hume [1738-40] 1951: Bk III, Part II, sec.5)

The line of practical reasoning followed by Hume is essentially the following: 'I have made what is conventionally regarded by my fellow human beings as a promise. Given the expectations and attitudes that are part of that convention, I will never again be trusted by fellows if I fail to perform as I promised and they expect. But it is in my own interests to be trusted (i.e., I want/need to be trusted); it is therefore necessary for me to perform'.

Rarely do people reflect upon the reasoning that underlines conventions such as promise-keeping. It is when one does so that their importance to everyday corporate life becomes apparent.

Nonetheless, conventions are not enough in themselves. Just as good conventions that reflect sound reasoning can become absorbed into our moral ecology, so too can conventions characterised by inadequate reasoning. Moreover, despite the prevalence of good conventions in corporate life, it remains that moral wrongs are committed by people working for corporations. There are limits to the effectiveness of conventions when it comes to working one's way through the moral dimensions of highly complex activities. This requires a clearer understanding within corporations of the nature of ethics.

Our current morass

More than one commentator has observed that in recent decades, the word 'ethics' has become a part of everyday and business life to an extent that most moral philosophers would not have thought possible (Lawson 1988). This does not, however, necessarily mean that a clear or accurate understanding of ethics necessarily prevails.

Nor is the pursuit of 'business ethics' likely to be helpful in adding clarity to the situation. The plausible and ordinary moral duties that one expects people working in corporations to recognise, such as honesty and fair dealing, flow from ordinary morality rather that a unique 'business ethics'. When SmithKline&Beecham withdrew the whole of their Panadol product from circulation because a few samples were found to be poisoned, such an action reflected nothing more than the demands of ordinary morality rather than any formal commitment to business ethics.

Clearly, there are moral problems of a certain type (such as fraud) which tend to emerge more regularly in the corporate world. But one of the problems with phrases like 'business ethics' is that they convey a sense that there is something especially morally hazardous about business. In fact, *any* human activity that involves choices between good and evil has its moral hazards. While doing good and avoiding evil in corporate life is often difficult, it is no more difficult than in family life or professions such as medicine and law.

The situation is further complicated by the fact that we also live in a time where 'there is no clearly settled meaning of "ethics" in modern philosophical discussion' (Finnis 1980: 128). Part of the problem is the fragmentation of moral discourse in Western societies highlighted by Alasdair MacIntyre in his seminal book, *After Virtue* (1981). Words like morality, virtue, reason, and free will are widely used without any real appreciation of the classical context of such terms and the manner

in which they relate to each other. Their meaning has been obscured by the establishment of what MacIntyre describes as emotivism as the orthodoxy among not only most Western moral philosophers but public discourse as a whole.

By emotivism, MacIntyre has in mind the idea that there is no such thing as 'good' and that when people use such phrases, 'they are doing no more and no other than expressing their feelings and attitudes, disguising the expression of preference and whim by an interpretation of their own utterance and behaviour which confers upon it an objectivity that it does not in fact possess' (1981: 16-17). Hence, we find philosophers such as John Mackie announcing at the outset of his book on ethics that 'there are no objective values' (1977: 15). The effect has been to turn much of moral philosophy into a type of sociology.

Perhaps the most visible manifestation of this tendency is the 'values-talk' that permeates so much public discourse on ethics. The word 'value' was once used as a verb, meaning 'to esteem'. Now, however, it is primarily a plural noun, denoting beliefs or attitudes. It is very common to hear people speak of 'my values', while others are regarded as having 'their values'.

Values-talk is very democratic, but it fails to facilitate any meaningful discussion about the moral life. In fact, it destroys the very possibility of such a conversation and encourages people to think of ethics as a type of moral smorgasbord. Anyone can assert and espouse values. Both Communist and Fascist regimes, for example, had values in the sense that they were unquestionably committed to not-dissimilar sets of beliefs.

Herein lies the problem of values-talk. It suggests that one value is as good as another. The statement, 'I have values', is one that is often used to indicate a person's belief that he is essentially a good person. Such statements are, however, surely meaningless until one discerns what those 'values' happen to be. Unfortunately, values-talk discourages people from assessing the worth of those beliefs, because it implies that the only important factor is that a person has chosen it. To question the correctness of that choice is judged (in our non-judgemental age!) to be wrong, because it implies that some values are 'not as good' as others or may indeed be positively evil. Discussion of good and evil are integral to any serious discussion of the moral life, but values-talk eschews this in favour of a type of relativistic moral levelling.

This much becomes clear when one contrasts values-talk with the virtue ethics of Aristotle. The Aristotelian tradition holds that the virtues are, by definition, not only limited in number, but transcend time, place and culture in their *truthfulness*. Hence, one cannot hold that the habit of courage is a virtue for one person and not for another. Prudence is a habit that may be acquired by anyone, and is always superior to the vice of foolish decision-making (imprudence). Aristotle also specified that it is *difficult* for people to acquire the virtues. One has to *choose constantly* the same habits of action and *act* accordingly when one is faced with a choice between, for example, courage or cowardice, prudence or foolishness.

On a number of levels, then, the Aristotelian approach to the moral life is very different from that of values-talk's distinctly relativistic tendencies. Moreover, it opens up the possibility of serious reflection about how we do good and avoid evil. This proceeds precisely from the truth-claims made by Aristotle, the very type of

claim that values-talk is incapable of making, save that of claiming that everything is relative.

Rediscovering the moral life

Fortunately, correctives to developments such as emotivism and values-talk have arisen in recent decades, most notably as a consequence of a return by many scholars to classical sources of moral philosophy. A prominent example is the resurgence of natural law theory. Those who have presided over the revival of this school hold that no matter how fragmented the state of Western culture, no matter how different people's heritages, allegiances or commitments, it remains possible for every person who possesses unimpaired reason to discern certain basic moral truths. For while these truths may find particular modes of expression in different cultures and traditions, they 'are nevertheless captured in sound practical judgements that may be formed by any thinking person. They are not deduced, inferred or derived from other practical or theoretical truths, but are, rather, *per se nota* (self-evident)' (George 1989: 254).

This school of thought, for example, maintains that knowledge is in itself good, and that it is *unreasonable* for anyone to deny that knowledge is and ought to be treated as a form of excellence, or to deny that error and ignorance are evils that no reasonable persons should wish for themselves or others. Nor, one could add, is there any reason to be 'impartial' between death and life, health and disease, or trash and art. If this is true, then we can say with confidence that people who treat goods such as life, knowledge, or beauty as being of no account, are being *irrational*.

Ethics is not about 'getting along' with others or picking which values we 'prefer', find 'congenial', or suit our 'lifestyle'. Nor would any serious moral philosopher consider reference to opinion polls or focus groups as sufficient reason to do X and not Y. Rather, ethics involves:

- rational reflection upon what we are;
- using our reason to discern which options available for choice are good and avoid evil; and
- actualising one's choice for the good and/or describing various actions as ones that people ought or ought not to do (Gregg and Harper 1999: 26-9).

As such, ethics directs us towards making *judgements* about the freely-willed actions of oneself and others (even if they are habits that we have acquired because, though habitual, they proceed in each and every case from our choice to act) and describing such actions as good or evil.

Such judgements will emerge, because, as Aristotle reminds us, one only does ethics properly, adequately, and reasonably in order to be able *to act*. Many view ethics as a dry, theoretical exercise, without realising that ethics is intimately concerned with *practical knowledge*. Naturally, there is a contemplative dimension to ethics. But corporations should recognise that ethics is a very practical exercise

because the reason that one searches for moral truth is in order to be able *to do* good and avoid evil. It revolves, to put it another way, around the question of what one ought to do, a question faced by those working in corporations on a regular basis.

The complexity of obligation

While ethics does involve considering what we ought to do, there are several senses in which the phrase 'ought' may be used. It can be employed to describe:

- that which is within our power to do or not to do, which (regardless of what we desire) we have to do (but not because we are forced to); or
- that which it is wrong or shameful not to do.

This only begins to touch the surface of just how much moral knowledge can be gained by reflection upon the word 'ought'. But, some might ask, how is it possible to say that someone 'ought' to do a certain act and ought not to do another, given the extent to which people within corporations (indeed, in society as a whole) disagree about morality in ways that they do not disagree about various empirical facts (such as the earth's revolving around the sun?

The answer is that a science of morality is possible because human beings possess free will and reason. Hence, we do not act purely from instinct. The *choice* of the good is the *subjective* part of morality. Nonetheless, by use of our *reason* we are capable of identifying *objective* standards which tell us whether or not our subjective choices and actions are good or evil.

One moral philosopher who provides corporations with guidance in this area is Immanuel Kant. This prominent 18th century thinker maintained that when we act, we act with an intention, and our intention includes a maxim: that is, a general principle. If, for example, a person intends to give something to charity, there exists in his intention an implicit maxim that he *ought* to give to charity.

The validity of such maxims may be tested against standards of morality which Kant called *categorical imperatives*. He formulated these in a number of ways. The first was 'Act only according to that maxim by which you can at the same time will that it should become a universal law' (Kant [1785] 1990: 38). This is a thought test which involves generalising an action by asking questions such as 'what would it be like if everyone behaved this way?'

If, for example, a corporate executive forms the intention to lie for what he considers to be a good cause, can he universalise the maxim that it is justified to lie in a good cause? The answer is surely 'no', not least because his lying would involve people believing that he tells the truth. Generalising that intention would undermine the very institution of telling the truth.

Likewise, can a person reasonably will that a maxim of not helping others should become a general law? Again, the answer is surely 'no'. People cannot but believe that occasionally they will need help, such as when they are children, sick, or elderly. On those occasions, it is reasonable to want to be helped. A universal law forbidding people from helping each other would be inconsistent with this.

Kant produced a second formulation of the categorical imperative which may be more familiar to many but equally relevant for our purposes. It was 'act so that you treat others, whether in your own person or in that of another, always as an end and never as a means only' ([1785] 1990: 46).

The principle essentially represents Kant's version of the age-old principle articulated by Judaism and Christianity to love your neighbour as yourself. Kant held that it was reasonable to act in this way because it is reasonable to respect your own person and unreasonable not to. This does not mean that corporate executives may not use others as a means to produce profit. They are simply reminded not to treat such people *solely* as a means to an end.

Further reflection on this theme leads us to understand free adherence to such obligations contributes to the development of a moral ecology that allows people to attain both their private purposes as well as those objectives conceived and executed as common enterprises (such as corporations) that advantage the community as well as specific persons. More specifically, fulfilment of obligations by individuals enable the past, present and predictable future to be related in a stable developing order. Finnis summarises the position well:

> it is a truth of wide application that an individual acts most appropriately for the common good, *not* by trying to estimate the needs of the common good 'at large', but by performing his contractual undertakings, and fulfilling his other responsibilities, to ascertained individuals, i.e., to those who have particular rights correlative to his duties. Fulfilling one's obligations in justice, even in the restricted sphere of private contacts, family responsibilities, etc., is necessary if one is to respect and favour the common good, *not* because 'otherwise everyone suffers', or because non-fulfilment would diminish 'overall net good' in some impossible utilitarian computation, or even because it would 'set a bad example' and thus weaken a useful practice, but simply because the common good is the good of individuals, living together and depending on one another in ways that favour the well-being of each. (1980: 302) [Emphasis added]

So what does this mean for corporations? In simple terms, it suggests that one of the most effective ways that corporations—or more precisely, people who work within corporations—can live the moral life and contribute to a sound moral ecology is to do good and avoid evil in their everyday dealings with each other and those outside the corporations. These obligations are crucial, indeed essential, to the functioning of corporations and market economies. Where they do not exist, one either has to resort to the clumsy tool of regulation or helplessly watch as Mafia-like/crony-capitalist arrangements begin to prevail. The political philosopher Raymond Plant notes that 'Truth-telling, promise keeping, fair play, integrity etc., are fundamental moral prerequisites for capitalist economic relations to exist' (1983: 230). Writing from the standpoint of another tradition, John Paul II has insisted again and again that if market and corporate relations are to endure, there must be some degree of moral consensus about our obligations, and such a consensus cannot be contracted because it underpins all contractual relations (1991: para 36).

But some people will find this focus upon fulfilment of such obligations will be disconcerting as it does not provide ready answers to questions such as appropriate salary levels. As illustrated, such matters are complex. There is no easy checklist to follow. But focussing upon the moral choices made by individuals working within corporations avoids the pitfalls associated with the thinking underlying notions such as 'stakeholderism' and 'corporate social responsibility'. It also focuses the responsibility where it belongs: the moral agent that is the individual human person. If ethical problems in business are to be resolved, then those confronting moral dilemmas need to be thoroughly versed with the *practice* and *art* of thinking through the moral dimension of their freely chosen acts. Failure to acquire such skills may only encourage many people to believe that politics is the only appropriate arena for such issues to be discussed, and that the only mechanism for dealing with them is political action.

Moral reasoning is not a matter of Euclidean geometrics. Logic is a necessary guide to moral reasoning, but it is not sufficient. Certainly, there are universal principles upon which any society of persons with mutual duties and expectations of one another must rely. Yet it is entirely possible for a person to be familiar with all the rules of logic for moral reasoning, but still arrive at the wrong answers, precisely because they have not acquired the habit of thinking and acting prudentially.

Developing this habit often involves reflecting upon multifaceted realities and often complicated personalities. This is not a matter of indulging in emotivism, because reason works in ethics just as it does in every other field of human inquiry into the truth. But in ethics, the way of reason is more subtle and delicate than in science; it requires much practice and heightened powers of observation. The use of reason in ethics compliments the use of deductive and inductive logic by drawing upon a multiplicity of experiences so that the moral agent learns to discern minute details that can often prove crucially important in discerning moral responsibility. John Henry Newman referred to this manner of reasoning as the 'illative sense' (1903: 246, 356-7). It is a type of practical knowing, based in part upon evolutionary trial and error methods, during which people weave their way towards not only moral judgement of themselves and others as well as knowledge of the truth in a manner akin to that of a mountain climber seeking to reach the summit.

There will, of course, be those directors, managers, employees and owners of corporations who shirk the responsibility of trying to live the moral life in their business activities. Here we inevitably rely upon the law, social conventions, and other devices to deter them from evil acts. Such deterrence does not always work, and some individuals working in corporations will engage in immoral activity that may or may not be discovered and punished. But to an extent, this is one of the prices of living in a free society, for the alternative is to introduce stringent controls that unduly hamper the initiative and entrepreneurship required in corporations, not to mention undermine the scope for the free choice that is an essential prerequisite for a person's actualisation of moral good. Articulating these and other arguments in the public square will increasingly figure as an important dimension of corporate governance.

6

Conclusion

At the beginning of this work, we noted that a clear understanding of the nature of any organisation requires a grasp of its *telos*. This forces us to recognise that a business should not be expected to behave as a social welfare organisation; nor should a charity be viewed as a business. Any relatively formal association of people that wishes to remain faithful to its objectives should regularly assess whether or not its *telos* is reflected throughout the entire organisation.

Failure to do so can result in a high degree of organisational dysfunctionalism. A church, for example, that speaks exclusively about political and economic issues and says nothing about the transcendental and/or fails to articulate Christianity's often demanding ethical teaching is surely a church that has lost its way.

The same observation may be applied to corporations. For a variety of good reasons (including those of a commercial nature), some corporations may choose to engage in what are, at face-value, non-commercial activities. But once a business corporation loses sight of its corporate objective, or forgets that its primary responsibility is maximisation of shareholder value, then it has effectively betrayed its *telos*.

Institutions that follow such paths have, according to the American psychologist Pat Fagan, fallen prey to what he describes as 'institutional busybodyism'. This 'disease', as Fagan calls it, distorts the relationships between businesses, families, churches and schools as well as the major institutions of government. It takes the form of each institution trying to do the primary work of one of the other organisations. The government is encouraged to perform the tasks of the family, the school, and business. School find themselves doing the work of the family. Churches cease to articulate their spiritual messages and instead attempt to become overtly political actors.

In all of this, we need to remember that each institution has tasks that are specific to it, precisely because they are at the core of its identity. While this does not mean that these institutions should not cooperate, it does mean that each organisation has its own special task to perform, and should be wary of allowing itself to be excessively diverted from these commitments.

A trade union, for example, that becomes totally focussed upon political activity to the extent that it ceases to meet its members' everyday needs will gradually become an explicitly political movement and cease to serve its members' interests, save in an indirect and detached sense. Similarly, one must entertain strong doubts about whether corporations that list objectives such as the environment among their primary objectives will be able to meet their responsibilities to their shareholders. A corporation's commitment to maximising shareholder value is not, of course, a mandate for wanton ecological destruction. It does, however, mean that shareholder value must be the priority for directors, managers and other employees. To do otherwise would be to betray the primary responsibility with which they have been entrusted.

Here one may suggest that corporations need to explain more carefully the seriousness of their obligations to shareholders and why they cannot be taken lightly. This in turn points to a more general need for intellectual engagement on the part of corporations.

As observed, phrases like stakeholders, corporate social responsibility, and ethical investment begin to look decidedly problematic when subject to closer analysis. It is, however, also true that corporations have been slow to point out some of the deficiencies in the arguments of their detractors, as well as to underline the remarkable moral, social and material good that they help to realise.

Managing a corporation is not, of course, a theoretical exercise; it is a very pragmatic endeavour. But if corporate executives lack an appreciation for the long term significance of the effects of ideas, however sound or erroneous such ideas might be, they will be ill-equipped to engage with those who advance criticisms, and to determine when such criticisms are legitimate and when they are not. Unless they keep abreast of such issues, they may well find themselves trapped into arguing their case within frameworks that are not only flawed, but created by those who, for a variety of reasons, wish to curtail and undermine the legitimate work of corporations. To cite Novak:

> many executives are still reacting too late to issues framed and organised by [others] long before. [As a consequence] much too often, their highest aim is damage limitation. In the arena of public opinion and public policy, tigers in competition have appeared before the public as lambs, bleating in appeasement . . . They seem to imagine themselves in a no-win situation; the only question is how much they will lose. (1997: 29)

These are strong words. They do, however, suggest that an increased awareness of what is happening in the world of political and philosophical ideas will surely be integral to successful corporate governance in the future. Executives will need to pay heed to changes in economic conditions, but also to the political and moral settings of the world of ideas. Prudent and courageous in making business judgements, those charged with corporate governance must be willing to try and set the terms for political and economic debates, and summon up the full intellectual case for their position and to shape public opinion early—otherwise, they may find their capacity to maximise shareholder value increasingly and unduly constrained.

In much contemporary literature, for example, business is often portrayed as somehow separate from civil society. Local associations, welfare groups, churches and non-government organisations are widely viewed as part of civil society (as indeed they are), while corporations appear to have been relegated to an unnamed category of their own. Such notions betray an wholly inadequate understanding of the history of the term, which, as numerous scholars recognise, is intimately linked to (though not exclusively associated with) commercial activity (Black 1984). It is no coincidence that the destruction of civil society that was facilitated in command economies was accelerated by the banning of private commercial activity and the collectivisation of private property.

Unfortunately, this understanding of the place of business as an institution vital to the fostering of civil society has been largely lost sight of. Corporations thus find

themselves battling against the lexicon of the age. This makes corporations more prone to finding themselves foisted with stakeholder arrangements by law (such as having 'public interest' directors placed on boards) in the name of demands advanced by parts of a truncated civil society. When such things occur, it amounts to a failure of corporate governance. Dealing with such problems is not a matter of image-making or public relations (though this does have an important role to play. It requires serious intellectual engagement.

The Achilles heel of many modern corporations has been a lack of intellectual self-consciousness. Corporate leaders should not underestimate the size, intelligence and commitment of the many organisations determined to undermine their legitimate autonomy and activities. In an age of instant communication and easy demagoguery, corporate leaders who lack a clear philosophical picture of where they and those critical of corporations' activities stand, leave the shareholder value which they serve to maximise unnecessarily exposed to depreciation. In forthcoming decades, intellectual rigour in the philosophical realm may well be as important as entrepreneurial skills when it comes to practising the art of corporate governance.

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