

Corporate Governance

By Professor Cameron A. Batmanghlich (PhD)

Lecture Three

Stakeholder Theory; Conflict Resolution

Learning Outcomes

- **Understanding** What Stakeholder Theory is

3.1

Stakeholder Theory: A Viable Alternative?

The company's responsibility

Whereas the ownership perspective, rooted in property law, provides a natural basis for the primacy of shareholder rights, the view of the corporation as a bundle of contracts permits a different view of the fiduciary obligations of corporate managers.

The company's responsibility

The stakeholder framework does not rely on a single overriding management objective for all decisions. As such it provides no rival to the traditional aim of “maximizing shareholder wealth.” To the contrary, a stakeholder approach rejects the very idea of maximizing a single-objective function as a useful way of thinking about management strategy. Rather, stakeholder management is a never ending task of balancing and integrating multiple relationships and multiple objectives.

The company's responsibility

The rejection of a single criterion for making corporate decisions is problematic.

Directors occasionally face situations in which it is impossible to advance the interests of one set of stakeholders and simultaneously protect those of others.

Class Activity – Group discussion

Whose interests should they pursue when there is an irreconcilable conflict? Consider the decision whether or not to close down an obsolete plant.

Consider the decision whether or not to close down an obsolete plant. The closing will harm the plant's workers and the local community but will benefit shareholders, creditors, employees working at a more modern plant to which the work previously performed at the old plant is transferred, and communities around the modern plant. Without a single guiding decision criterion, how should the board decide?

Stakeholder Theory flawed?

Bainbridge (1994) argues:

Ultimately, the stakeholder model is flawed because of its failure to account adequately for what he calls “managerial sin.” The absence of a single decision-making criterion allows management to freely pursue its own self-interest by playing shareholders off against non-shareholders.

Stakeholder Theory flawed?

When management's interests coincide with those of shareholders, management can justify its decision by saying that shareholder interests prevailed in this instance, and vice versa.

The plant closing exercise is a good example:

Stakeholder Theory flawed?

Shareholders and some non-shareholder constituents benefit if the plant is closed, but other non-shareholder constituents lose. If management's compensation is tied to firm size, we can expect it to resist any downsizing of the firm. The plant likely will stay open, with the decision being justified by the impact of a closing on the plant's workers and the local community. In contrast, if management's compensation is linked to firm profitability, the plant will likely close, with the decision being justified by management's concern for the firm's shareholders, creditors, and other constituencies that benefit from the closure decision.

3.2

Resolving the Conflict: Toward Enlightened Value Maximization?

Enlightened Value Maximization

The inherent conflict between the doctrine of shareholder value maximization and the objectives of stakeholder theory can be resolved by melding together “enlightened” versions of these two philosophies:

Enlightened Value Maximization

Enlightened value maximization recognizes that communication with and motivation of an organization's managers, employees, and partners is extremely difficult.

Enlightened Value Maximization

What this means in practice is:

That if we simply tell all participants in an organization that its sole purpose is to maximize value, we will not get maximum value for the organization.

Enlightened Value Maximization

“Enlightened” stakeholder theory simply as stakeholder theory with the specification that maximizing the firm’s total long-term market value is the right objective function.

The words “long-term” are key here.

Enlightened Value Maximization

Enlightened stakeholder theorists can see that although stockholders are not some special constituency that ranks above all others, long-term stock value is an important determinant (along with the value of debt and other instruments) of total long-term firm value.

Enlightened Value Maximization

They would recognize that value creation gives management a way to assess the tradeoffs that must be made among competing constituencies, and that it allows for principled decision making independent of the personal preferences of managers and directors.

Next Week's Lecture:

The Board of Directors: Role and Composition

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THANK YOU!