Stakeholders versus stockholders and financial ethics: Ethics to whom?
Dufrene, Uric;Wong, Alan
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Stakeholders Versus Stockholders and Financial Ethics: Ethics to Whom?

by Uric Dufrene, Assistant Professor of Finance, Indiana University Southeast, School of Business and Economics, 4201 Grant Line Road, New Albany, IN 47150,
and
Alan Wong, Associate Professor of Finance, Indiana University Southeast, School of Business and Economics, 4201 Grant Line Road, New Albany, IN 47150

> "... my contention that if corporations are to work for excellence in all respects, they must make sure they are not destroyed by one of these junk-bond, bust-up raiders... The hostile takeover is at the least the terrorist bomb of American industry, not fatal to the whole world but exploding individual corporations apparently at random, turning America's corporate scene into an extended Beirut where long-term investments and commitments are unwise and, in general, not undertaken. So we shall have little excellence, little competitiveness, much ado about finance and its yuppies..."
>
> Lisa Newton

Corporate finance is under attack. Commentators mention that corporate managers have enriched themselves and shareholders, and in the process have failed to consider the interests of all stakeholders (Hennessy, 1989, Alkhafaji, 1989, Newton, 1989, Dunfee, 1989, Steidlmeier, 1989, Jones and Hunt, 1991). They cite the active corporate control market that produced hostile takeovers, leveraged buyouts, and corporate restructuring activity, all presumably causing a reduction in social welfare. This view is now beginning to permeate itself into the financial education debate. For example, Hawley (1991) suggests that financial educators are abdicating their responsibility of helping prepare corporate managers to recognize and deal with business ethics-social responsibility effectively. Hawley proposes that the shareholder wealth maximization model for corporate management rationalizes the commission of unethical or socially irresponsible actions. Because of this ongoing criticism being levied against the practice of corporate finance, financial educators are now moving to incorporate ethics in the finance curricula. Although this move may be welcomed, we suggest that financial educators proceed with caution.

An example of the usual treatment of ethics in finance is offered by Eugene Brigham. Brigham (1992) defines business ethics as "a company's attitude and conduct toward its employees, customers, community, and stockholders". According to Brigham, a firm's commitment to business ethics can be judged by how a firm treats each of these parties in a fair and ethical manner. However, as this article demonstrates, fairness to one group can often impose hardships or unwarranted sacrifices on another, and can therefore be perceived as "unethical" by the disafffected. Despite these conflicts, we suggest that the financial educator must continue to assume that the primary goal of management is the maximization of shareholder's wealth.

The goal of this essay is to show that maximizing shareholder wealth is not consistent with what observers depict as "unethical managerial behavior", or an abdication of social responsibility by professional finance practitioners. Since finance theory is founded upon

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the premise that the primary goal of management is the maximization of shareholder wealth, the absence of a clear relationship between such maximization and "ethical behavior" may help explain the minor presence of ethics in the finance curricula. However, as this article suggests, the exclusion of ethics in the traditional corporate finance textbook (Hawley, 1991) is not a signal of ethical neglect by financial educators and practitioners. In fact, the shareholder wealth model is entirely consistent with ethical behavior, and is therefore optimal for society.

The Stakeholder Protection Argument

Ethicists and policy makers stress the necessity for the protection of the firm's stakeholders (Hanly, 1992). Freeman (1984) defines a stakeholder as "any individual or group who can affect or is affected by the achievement of the organization's objectives." These stakeholder theorists seek reform by changing the traditional stockholder view of the firm to a stakeholder perspective. Carroll (1979) suggests that corporations are social institutions that have responsibilities beyond the fiduciary responsibility to shareholders. This reasoning justifies the enactment of legislation promoting stakeholder protection, and corporate management is encouraged to conform to behavioral standards that ensure adequate protection of stakeholder groups: shareholders, bondholders, employees, suppliers, government, etc.

A recent study by Wang and Dewhirst (1992) suggests that the stakeholder view of the firm is not without support. These researchers find that boards of directors have high stakeholder orientations. An example of this stakeholder protection is offered through Hanly (1992) who concludes that workers and communities have suffered as a result of the corporate restructuring wave of the eighties. Based on his stakeholder protection argument, Hanly indicates that the closing of a factory in a given community should be avoided because of the harm inflicted on the various stakeholder groups. Apparently, Hanly fails to recognize the costs imposed on society at large by continuing to operate inefficient plants, or allowing incompetent management teams to be shielded from an active managerial labor market.

This article points out some of the weaknesses of the stakeholder protection argument. The stakeholder argument expects businesses to commit to an ethic of the common good for the larger community of different stakeholders rather than maximizing stakeholder's wealth. Unfortunately, this argument often leads to sending confusing signals to corporations. Corporations that try to meet one stakeholder group's expectations may end up being criticized for failing to meet the other stakeholder group's expectations, which are sometimes contradictory. The argument winds up creating a moral schizophrenia for corporate managers. A business that is chartered to do one thing best is very much limited to do well all things simultaneously (Kirkpatrick, 1993).

Another weakness of the stakeholder theory is the "boundedness" of its moral rationality. One cannot see with an excellent vision the moral truth of the economic impact of a managerial decision on *each* stakeholder group. Given today's business complexity, one finds it extremely difficult to comprehend and absorb all details that are ethically relevant. The morality of a takeover is a case in point. Trying to determine what stakeholder group might be affected by the takeover is difficult enough not to mention

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trying to understand relevant immediate and future economic aspects associated with the takeover (Donaldson, 1993).

Perhaps the principal difference between the stakeholder and shareholder view of the firm is the former emphasizes social performance, while the latter stresses financial performance. Ethical behavior as defined by one stakeholder group, may be inconsistent with another group's *objectives*, and therefore viewed as "unethical" or unfair by the disaffected stakeholder group. However, we believe that superior financial performance is compatible with optimal "social performance" and is therefore beneficial to society at large.[1]

Maximization of Shareholder's Wealth Through Restructuring

One of the most criticized corporate activities by stakeholder theorists and ethicists is the various forms of corporate restructuring: mergers, sell-offs, spin-offs, and leveraged buyouts. Recent corporate restructuring activities have, on average, increased shareholders' wealth (Jensen and Ruback (1983), DeAngelo, DeAngelo, and Rice (1982), Muscarella and Vetsuypens (1990), Linn and Rozeff (1984), Hite and Owers (1983)). Research shows that these higher stock prices are attributed to efficiency gains, and consequently society benefits because of lower operating costs, and new technologies and products. Higher stock prices are realized as a result of transferring the firm's "hidden values" or under-utilized assets to more profitable uses after restructuring.

Although there may be decreased employment at the restructured firm in question, macro-employment improves as assets are transferred to their higher valued uses.[2] Restructuring might impose short-term transitory costs on some stakeholder groups in some cases, and these costs are usually more apparent than the dispersed benefits. These visible short- term transitory costs are often responsible for the criticisms of the shareholder wealth maximization model and the corresponding "unethical behavior" categorization. This argument is somewhat analogous to what economists refer to as the concentrated benefits of government programs and the dispersed costs to the taxpayers (Stigler, 1971). For example, long-standing government subsidies are difficult to eliminate because the benefits are concentrated in a few hands, but the costs are shared by all taxpayers. The contrary can be applied to corporate restructuring; benefits are widely dispersed, and the costs are usually concentrated. Thus, the benefits are often overlooked, but the costs are often made known by politicians, regulators, and the media.

The impact of a higher stock price on the cost of capital can be shown with the use of the traditional Discounted Cash Flow Model. The classical Gordon Growth Model stipulates that the intrinsic value of a firm's stock is a function of expected cash flows as measured by the firm's expected dividend, D_1, the growth rate, g, and the required rate of return on equity k_s.

$$\hat{p}_0 = \frac{D_1}{k_s - g} \qquad (1)$$

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Invoking the equilibrium assumption that the expected rate of return is equal to the required rate of return for the security, we can solve for k_s.

$$k_s = \frac{D_1}{P_0} + g \quad (2)$$

As the price of a firm's stock increases, the cost of a firm's equity, as measured by k_s, decreases. The lower cost of equity decreases the firm's cost of capital, and therefore allows the firm to accept projects that were previously unacceptable.

This marginal investment creates wealth and subsequently results in an increase in consumer welfare, a benefit to the entire economy and to the "population of stakeholders". For example, the active corporate control market and the high number of corporate restructuring observed during the eighties were associated with the creation of over 18 million new jobs (Kim, 1993). Admittedly, jobs in some communities were lost as a result of plant closures, and assets being transferred to their higher-valued uses. But society at large benefited because of management's fiduciary obligation to the *shareholder*. Moreover these gains are not short-term, or the result of a myopic market. Combined with the theory and evidence on market efficiency, research indicates that stock price changes in response to corporate restructuring events reflect the long-term best interests of the firm (Woolridge, 1993) and consequently, its stakeholders.

Is the Shareholder Wealth Maximization Model Unethical?

Critics of the stockholder wealth maximization model often use fairness as a moral issue. Management should look after the best interests of all stakeholder groups equally rather than maximize one group's interests over the other (ie. the interests of shareholders over other stakeholders). Ethicists and stakeholder advocates suggest that maximizing the wealth of shareholders implies that management may be using other stakeholders to simply enrich shareholders (Evan & Freeman, 1988). Unfortunately, this view does not present a complete picture of how a business organization operates.

The maximization of shareholders' wealth does not imply that the creation of this wealth is at the expense of other groups. In fact, it provides the best framework to serve the needs of other stakeholder groups. If management is required to maximize the wealth of multiple principals with conflicting interests, this may lead to chaos and inefficiency. Furthermore, this framework might lead to a lack of management accountability and potentially a greater concentration of management power because there is no one group with homogenous interests that management must exclusively serve. Management will also be forced to play the role of arbitrators, and consequently distracted from the important role of directing the operations of the business. Hence, from an organizational perspective, the stockholder wealth maximization model is the most efficient. It ensures that management can direct its energies to one goal, the maximization of shareholder wealth. Since stockholders are residual claimants of the firm, maximizing stockholders' wealth is consistent with maximizing the wealth of the stakeholder over the long-term.

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Stockholders are People Too!

Shareholders are not a group of elites that are unique from other stakeholders. In fact, many of the firm's shareholders are also members of the other stakeholder groups. Shareholders are different only in terms of the functions they perform: capital providers and residual risk takers. Shareholders' wealth maximization should be viewed as a mechanism to help reduce their risk exposure, given the structure of compensation and other factors that increase the riskiness of their claims. For example, shareholders, the initial providers of the firm's capital, only receive the "residual income" after all other immediate stakeholder groups have been fully compensated. Furthermore, shareholders' claims to assets in the event of reorganization or liquidation is inferior to other stakeholder groups. In terms of the absolute priority doctrine, shareholders are the last on the priority of claims. In addition to insuring that the organization has sufficient funds to compensate other stakeholder groups as contractually agreed upon, the maximization of shareholders' wealth also insures that shareholders are adequately compensated commensurate with the risk undertaken. Thus, the concept of wealth maximization should be seen as a protective mechanism for shareholders and stakeholders alike, not as a license to exploit other stakeholders. In light of the risks shareholders are exposed to because of their residual claim status, it is only equitable that management maximize shareholders' wealth so long as there is no violation of any contracts with other stakeholder groups.

In an intense global competitive environment, not many corporations can serve two or more "masters" equally and be able to maintain their competitive focus. Those who attempt to serve multiple "principals" on an equal basis may jeopardize the survival of the whole organization. Thus, it is *socially irresponsible* to demand that a corporation serve all stakeholders with different sets of self-interests on an equal basis.

Shareholder Wealth Maximization is Efficient and Socially Optimal

The efficiency gains of the eighties and the higher stock prices accompanying these gains occurred because of the active corporate control and managerial labor markets of the 1980s (for a discussion on corporate control and managerial labor markets, see Jensen and Meckling, 1976, Fama, 1978, Jensen and Ruback, 1983, and Jarrell, Brickley, and Netter, 1988). These gains were created despite years of condemnation directed at the "separation of ownership from control" aspect of the corporation by some economists (Berle and Meons, 1932) and public interest groups. With the relaxation of anti-trust enforcement by the Reagan administration, active free market forces reduced inefficiencies associated with the "separation of ownership from control" aspect of the corporation and consequently placed corporate America in a more aggressive position in today's competitive global environment. As a result of the operative corporate control and managerial labor markets, management has become more sensitive to the needs of its shareholders, the market, and society. Therefore, criticizing the corporation because of the "separation of ownership from control" problem has lost some of its merit.

The irony of this outcome is that these same market forces (mergers and acquisitions, leveraged buyouts, use of leverage, and other forms of corporate restructuring) that have mitigated many of the extravagances and inefficiencies of the public corporation are now

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under attack by observers as being costly to society, imposed by ravenous management teams and "unethical" corporate raiders. If these restructuring transactions achieve a more efficient allocation of scarce resources, reduce levels of operating inefficiencies, and lowers the cost of capital, then these criticisms levied against corporate America are not justified.

The opponents to these various forms of corporate restructuring are quick to point out that the gains to shareholders represent a redistribution of wealth from other stakeholder groups. Because of these potential redistributions of wealth, stakeholder theorists view these corporate events as "unethical" behavior (Hanly 1982), and short-sighted actions by management designed to temporarily increase the price of the stock, while imposing financial and social costs on the other stakeholder groups. However, to this date, little evidence supports the wealth redistribution hypothesis. Even if wealth redistributions do occur, then economists and public policy makers should only be concerned if any losses exceed gains.

The accusations directed against corporate restructuring activity can be traced to stakeholder theory, where its advocates call for managerial decisions that balance the interests of all stakeholders. While this may even be desirable from a hypothetical standpoint, the functioning of the active corporate control and managerial labor markets prohibit the implementation of all stakeholder concerns, even if we could identify all of the firm's stakeholder groups (a difficult task by itself). Strict adherence to this stakeholder view during the restructuring wave of the eighties would have limited job creation, shielded inefficient companies from the active and welfare-enhancing free markets, and made America less competitive with its global counterparts. In short, the stakeholder model of the firm is a recipe for gross inefficiencies.

Ethics and the Finance Curricula

Hence, the avoidance of ethics in the finance classroom parallels the dilemma that managers face in maximizing the wealth of the shareholder. The absence of an explicit treatment of ethics in the classroom should not be construed to mean that the finance profession is void of ethical and moral values. The maximization of shareholder's wealth implicitly assumes a behavior that is consistent with enhancing *societal* welfare. It assumes that managerial actions which increase shareholder's wealth, also benefit society as a whole, and therefore should be viewed as "ethical".

Conclusion

The maximization of shareholder wealth requires difficult decisions that may inflict costs on other stakeholder groups, but advance society at large. Analogous to the shareholder wealth maximization model is a physician having to perform a new surgical technique: possibly painful and risky, but necessary to make the patient well and for society to benefit from medical breakthroughs.

Usually, there is no clash of self interests between various stakeholders when the firm is doing well economically. It is often during financial distress when difficult decisions have to be made that lead to a clash of interests. During such times, the first group to suffer

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are the stockholders in terms of adverse reaction of the firm's stock price, not to mention a possible reduction or elimination of dividend payments. Thus it is ethical, and not unethical for other stakeholders to share in the losses as long as no contracts are violated. For this reason, the maximization of shareholder wealth is inconsistent with the stakeholder theory concept of "ethical managerial behavior". Compelling managers to act on behalf of all stakeholders on an equal basis, and characterizing this behavior as "ethical" undermines the fiduciary obligation that managers have to shareholders.

As long as shareholders continue to be providers of capital and have effective control over managerial hiring and firing, managers have no choice but to comply with shareholders' view of ethical behavior - maximization of *their* wealth. At the same time, finance educators should feel reassured that the maximization of shareholder wealth is consistent with enhancing the overall welfare of society. It is not an abdication of their educational responsibility to effectively deal with business ethics.

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Endnotes

1. Friedman (1970) advocates that the social responsibility of business is to maximize profits. Our article emphasizes maximization of shareholder wealth, and the consistency of this model with social responsibility in an educational context.

2. See the Kim (1993) citation below.

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