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The Modern Day Corporation: A Philosophical Analysis of How Corporations Behave and How They Should Behave

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THE MODERN DAY CORPORATION: A PHILOSOPHICAL ANALYSIS OF HOW CORPORATIONS BEHAVE AND HOW THEY SHOULD BEHAVE

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Table of Contents

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Abstract

We seem to hold corporations to an impossible standard. We call for profit maximization, but at the same time want to place strict limits on the methods corporations may use to obtain them. In this thesis, I explore two popular theories of the corporation: stakeholder theory and shareholder theory. I examine the degree to which each theory explains the corporation as it exists today, as defined in the law and through its behavior, but also the theories' normative appeal. I conclude by positing what I find to be the best normative account of the corporation: a theory of how we should structure the corporation in the United States so it is the most morally-defensible.

1. Introduction

Adam Smith warned in 1776 that "joint-stock companies…can…scarce ever fail to do more harm than good."[1] His warning went unheeded.

Joint-stock companies, more commonly known today as corporations, dominate international business. While proprietorships and partnerships together outnumber corporations almost five to one, corporations have earned more than twice the combined profits of proprietorships and partnerships since 2000.[2] In 2009, Walmart alone employed more than two million people.[3] That American GDP increased 43-fold since 1890 is in large part due to the rise of the corporate structure.[4]

As powerful as corporations might be, however, they do not enjoy the simple ownership structures of their smaller counterparts. Proprietorships occur when an individual person opens (but does not incorporate) a business by himself or herself. Partnerships occur when multiple people open (but do not incorporate) a business by themselves and agree to share in the profits.[5] But corporations?

The United States government defines a for-profit corporation as "an independent legal entity owned by shareholders."[6] Corporations have potentially endless life spans and usually shield their owners from liability. When I sue a corporation, I can hope to

[1] Smith, Adam. *The Wealth of Nations*. London: Penguin Books, 1999.
[2] United States. United States Census Bureau. Washington D.C. Number of Tax Returns, Receipts, and Net Income by Type of Business. January 01, 2012. Accessed April 15, 2013. http://www.census.gov/compendia/statab/2012/tables/12s0744.pdf.
[3] "Global 500 2010: Biggest Companies: Employees." CNNMoney. January 01, 2010. Accessed April 28, 2013. http://money.cnn.com/magazines/fortune/global500/2010/performers/companies/biggest.
[4] Blanchard, Oliver. "U.S. GDP Since 1890." Lecture, Macroeconomics, 3E, Upper Saddle River, April 03, 2013. http://www.ucl.ac.uk/~uctpnpa/growth.pdf.
[5] United States. Internal Revenue Service. Washington D.C. Small Business and Self-Employed Tax Center. Accessed April 01, 2013. http://brc.dc.gov/tax/irssummary.asp.
[6] United States. U.S. Small Business Administration. Washington D.C. Choosing Your Business Structure. Accessed April 01, 2013. http://www.sba.gov/content/corporation.

recover what is owned by the corporation itself, but not the personal wealth or belongings of individual shareholders or managers. The limited liability aspect is no coincidence; the legal protections encourage new enterprise because neither entrepreneurs nor investors would necessarily lose their life savings over one failed endeavor. Nicholas Butler Murray, former President of Columbia University, told the New York Chamber of Commerce in 1911 that "the limited liability corporation is the greatest single discovery of modern times [because] it makes possible huge economy in production and trading."[7]

Under federal and state law, the corporation thus becomes a sort of "legal person."[8] The corporation may be taxed, the corporation may sue and be sued, the corporation enjoys freedom of speech protection – and yet the corporation clearly is not a person. Corporations still do not walk, talk, emote, or vote. Society cannot even punish the corporate entity in the abstract, that is, in a way that does not simultaneously punish its shareholders, employees, or other stakeholders. These complications of the corporate structure invite inquiry regarding what a corporation is and also what a corporation should be. To better articulate this account of a 'legal person' is the project of corporate theory.

Corporate theories can feature positive and normative components. Theories might be *positive*, defining what the corporation is and explaining what corporations do. *Normative* theories, meanwhile, assert why corporations should be structured a certain

[7] Price, Sam. "Limited Liability: An Economic and Moral Consideration." The Student Journal of Law. Accessed April 01, 2013. http://www.sjol.co.uk/issue-4/limited-liability-an-economic-and-moral-consideration.

[8] Smith, G., and D. Dyer. "The Rise and Transformation of the American Corporation." In The American Corporation Today, by Carl Kaysen. New York: Oxford University Press, 1996.

way and how corporations <u>should</u> behave.[9] My goal in this paper is to analyze two popular theories of the corporation through these lenses of positivity and normativity, in the process developing what I believe to be the most compelling account of the modern-day corporation in the United States.

[9] Donaldson, Thomas. "The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications." The Academy of Management Review 20, no. 1 (1995): 65-91. Accessed April 01, 2013. http://www.jstor.org/stable/258887.

2. The Fiduciary Theories

A fiduciary duty is a responsibility to act as an agent of another party's interest.[10] Corporate theory derived from notions of fiduciary duty holds that managers must act on behalf of some other group, as a result of either legal or moral obligations. Two branches of fiduciary theory enjoy widespread support: shareholder theory and stakeholder theory. Shareholder theorists argue that managers must act in accordance with the interests of a corporation's shareholders, but stakeholder theorists believe managers must act in accordance with the interests of *everyone* legitimately and substantially affected by the operations of the firm (including employees, customers, and the local community, in addition to the shareholders).[11] Commonly known as "Friedman vs. Freeman" due to the proponents of each theory, the shareholder-stakeholder debate boils down to the degree to which managers should consider non-shareholder interests.[12] Below I explain the arguments in support of each theory.

2.1 Shareholder Theory

Shareholder theorists want to limit the range of stakeholders that factor into corporate decision-making. They argue that the American legal system, which protects free enterprise and private property, turns business managers into "the employees of the owners of the business."[13] Since investors are the owners of corporations, managers become the agents of these shareholders. As agents, managers are responsible for

[10] "Fiduciary Duty." Legal Information Institute, Cornell University Law School. Accessed April 01, 2013. http://www.law.cornell.edu/wex/fiduciary_duty.
[11] Smith, Jeff H. "MIT Sloan Management Review." MIT Sloan Management Review RSS. July 15, 2013. Accessed April 01, 2013. http://sloanreview.mit.edu/article/the-shareholders-vs-stakeholders-debate/.
[12] Ronnegrad, David, and Craig N. Smith. "Shareholder vs. Stakeholders: How Liberal and Libertarian Political Philosophy Frames the Basic Debate on Business Ethics." INSEAD Faculty & Research Working Papers, 2011. Accessed April 1, 2013. http://www.insead.edu/facultyresearch/research/doc.cfm?did=48947.
[13] Friedman, Milton. "The Social Responsibility of Business Is to Increase Its Profits." The New York Times Magazine (New York), September 13, 1970.

furthering shareholder interests, which Milton Friedman assumes generally to be profit maximization.[14]

Friedman, though, adds an important caveat to his description of acceptable corporate behavior. If managers represent shareholder interests, and shareholders seek only profit maximization, shareholder theory would seem to compel managers to singularly pursue profit. To most, this loses normative appeal. We do not want corporations polluting rivers and starving employees in order to boost investment returns. As a result, shareholder theorists specify that managers are constrained by "the basic rules of society…embodied in law and…ethical custom."[15] They preempt objections that shareholder theory encourages law-breaking or immoral behavior by explicitly stating in the theory that managers cannot break the law or engage in customarily-immoral behavior. For Friedman and the shareholder theorists, this qualified shareholder account provides the most persuasive theory of the corporation.[16]

2.1.1 As Positive Theory

Central to shareholder theory is the principal-agent relationship between the shareholders and the management. Managers assume a fiduciary duty to further the shareholder interest of earning returns on their investment, while simultaneously respecting law and ethical custom. Friedman's caveat thus allows corporations to care for the interests of stakeholders – as long as the care can be explained by deference to law, ethical custom, or long run profit maximization. Consequently, the manager that respects stakeholder interest can still be said to practice shareholder management. Even Friedman

[14] Ibid
[15] Ibid
[16] Smith, Jeff H. "MIT Sloan Management Review." MIT Sloan Management Review RSS. July 15, 2013. Accessed April 01, 2013. http://sloanreview.mit.edu/article/the-shareholders-vs-stakeholders-debate/.

admits this makes it difficult to judge “how well he [the shareholder manager] is performing his task.”[17]

The assessment of a corporation’s adherence to shareholder theory must therefore explore the degree of respect afforded to stakeholder interests. Given the spirit of Friedman’s account, I argue that shareholder theory, properly understood, expects from managers very minimal commitments to stakeholders. I must make this assumption about the ethics in Friedman’s account because he does not explain how his understanding of ‘ethical custom’ translates to stakeholder obligations (a problem I address later). However, the tone and context of Friedman’s argument seem most consistent with the view that ethics provide a check against particularly egregious corporate actions rather than a strict standard that every corporate action must meet. For instance, Friedman makes a point to say that firms should not “take seriously” their responsibilities to stakeholders like employees and the environment.[18] In practice, I believe this means corporations can be said to accord with stakeholder theory when they prioritize short run profits over stakeholder interests, as long as they do not knowingly sacrifice long run profits, break laws, or violate very obvious ethical norms in the process.

2.1.1.1 The Actions Corporations Take

Lynn Stout of Cornell University sees a heavy influence of shareholder theory on corporate actions today. She notes how, in the name of profits, “public companies have sold key assets (Kodak's patents), outsourced jobs (Apple), cut back on customer service (Sears) and research and development (Motorola)…and lobbied Congress for corporate

[17] Friedman, Milton. "The Social Responsibility of Business Is to Increase Its Profits." The New York Times Magazine (New York), September 13, 1970.
[18] Ibid

tax loopholes (GE)."[19] For each miscarriage of shareholder management by an Enron or Worldcom, there are multiple cases of legal, sincere attempts by corporations to generate returns for shareholders despite the costs to other stakeholders.

For example, firms frequently move jobs overseas to improve margins. U.S.-based multinational companies reduced their American labor force by 2.9 million in the past decade while increasing overseas employment by 2.4 million.[20] As early as 2004, 80 percent of American firms had discussed outsourcing labor.[21] When profits conflicted with the interests of existing employees, profits won out.

The same logic applied to the environment. According to the UN Principles for Responsible Investment Initiative, the world's 3,000 biggest corporations cause approximately $2.2 trillion in annual damage to the environment. Between six and seven percent of these companies' profits would have been lost if they adopted more environmentally-friendly business practices.[22] Yet the profits were not lost. The corporations chose to protect their margins and chose to pollute – a clear prioritization of shareholder interests over the public interest in environmental health.

2.1.1.2 Shareholder Theory as Managerial Justification

Whether managers actually try to prioritize shareholder interests remains unclear. Most academics feel they do. Academics label shareholder theory "the driving force of

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[19] Stout, Lynn. "'Maximizing Shareholder Value' Is Ill-conceived Concept." Los Angeles Times. September 02, 2012. Accessed April 01, 2013. http://articles.latimes.com/2012/sep/02/opinion/la-oe-stout-stock-prices-20120902.
[20] Lach, Alex. "5 Facts About Overseas Outsourcing." Center for American Progress. July 9, 2012. Accessed April 28, 2013. http://www.americanprogress.org/issues/labor/news/2012/07/09/11898/5-facts-about-overseas-outsourcing/.
[21] Gongloff, Mark. "U.S. Jobs Jumping Ship." CNNMoney. March 13, 2003. Accessed April 1, 2013. http://money.cnn.com/2003/03/13/news/economy/jobs_offshore/.
[22] Jowit, Juliette. "World's Top Firms Cause $2.2tn of Environmental Damage, Report Estimates." The Guardian. February 18, 2010. Accessed April 01, 2013. http://www.guardian.co.uk/environment/2010/feb/18/worlds-top-firms-environmental-damage.

21st century business" and view it as "entrenched" in the Western philosophy of corporate governance.[23,24] A 2007 article in the *Journal of Business Ethics* found these academics might be right: 31 of 34 corporate directors surveyed for the article claimed to have a legal duty to maximize shareholder wealth. The directors admitted they would pollute the environment, fire employees, and threaten the public interest if it would improve profitability (as long as it was legal). [25]

In contrast, most managers claim not to practice shareholder management. Jack Welch, the iconic CEO of General Electric, claimed to speak on behalf of most corporate executives when he told the *Financial Times* that shareholder concerns never factor into his decision-making. "On the face of it," he argued, "shareholder value is the dumbest idea in the world…shareholder value is a result not a strategy…your main constituencies [the interests to which managers attend] are your employees, your customers, and your products."[26] While understanding it is likely a firm will benefit from treating stakeholders well, managers view stakeholders not as instruments for profit but as constituencies inherently deserving of considerate treatment. In fact, only 35 percent of corporations even mention maximization of shareholder value in their mission statements. Less than half mention shareholder value at all.[27]

[23] Jensen, Keld. "To Hell With Shareholder Value." Forbes. March 18, 2013. Accessed April 01, 2013. http://www.forbes.com/sites/keldjensen/2013/03/18/to-hell-with-shareholder-value/.
[24] Lazonick, William, and Mary O'Sullivan. "Maximizing Shareholder Value: A New Ideology for Corporate Governance." Economy and Society 29, no. 1 (2000): 13-35. doi:10.1080/030851400360541.
[25] Heracleous, Loizos, and Luh Luh Lan. "The Myth of Shareholder Capitalism." Harvard Business Review. April 2010. Accessed April 01, 2013. http://hbr.org/2010/04/the-myth-of-shareholder-capitalism/ar/.
[26] "Welch Condemns Share Price Focus." Financial Times. Accessed April 01, 2013. http://www.ft.com/intl/cms/s/0/294ff1f2-0f27-11de-ba10-0000779fd2ac.html.
[27] Loderer, Claudio, Lukas Roth, Urs Waelchli, and Petra Joerg. "Shareholder Value: Principles, Declarations, and Actions." Financial Management 39, no. 1 (2010): 5-32. doi:10.1111/j.1755-053X.2009.01064.x.

2.1.1.3 Shareholder Theory and the Law

The positive shareholder account must also address whether the law requires corporations to practice shareholder management. An understanding of 'what the corporation is' draws heavily from the way we define corporations in our legal code.

According to the American Bar Association, corporate managers have legal fiduciary duties to the corporation and to shareholders.[28] American courts have generally held that the duty to the corporation as a whole does not entail a duty to non-shareholders.[29] While it remains possible that Friedman overlooks that shareholder preferences might require substantial commitments to stakeholders, he is right to argue that the law *requires* managers to act only as agents of the shareholders – not of other stakeholders.

2.1.2 As Normative Theory

Normative shareholder theory draws from three primary arguments. The first appeals to private property rights, applying them to corporations and their owners. The second makes a consequentialist argument that shareholder management yields the best outcomes for society. The third argument claims that only shareholder management avoids illegal and indefensible taxation of shareholders.

2.1.2.1 Shareholder Theory and Property Rights

A free market requires that individuals have the rights to use their property however they please and to reap the rewards of their property's use. Alternatively put, a well-functioning market only exists when the law protects individuals' ability to be both

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[28] "Fiduciary Duties and Potential Liabilities of Directors and Officers of Financially Distressed Corporations." American Bar. Accessed April 01, 2013. http://apps.americanbar.org/buslaw/newsletter/0003/materials/tip3.pdf.
[29] Ibid

controllers and owners of their property. When these conditions are satisfied, the motive of profit drives people toward economically efficient outcomes.[30] Adam Smith promised as much in *A Wealth of Nations*. Self-interested individuals, when they decide how to use their property and enjoy the benefits of its usage, will receive guidance from an invisible hand toward economic efficiency.

In the modern corporation, however, different groups own and control the same property. Shareholders own the firm's wealth and assets, but managers put them to use. Shareholder interest and managerial self-interest might not align, so the invisible hand cannot produce efficient outcomes. Friedman thus sees normative appeal in uniting the property owners and controllers as best as possible. Legally requiring the manager to use the property as the shareholder would – generally to maximize profit – equates the self-interest of the controller with that of the owner. They become one again, as they were in Adam Smith's vision of the free market, and the invisible hand returns. Without agency costs, perfectly implemented shareholder theory will thus produce economically efficient outcomes. To Friedman, the normative appeal of economic efficiency is self-evident.

2.1.2.2 The Consequentialist Argument

Additionally, shareholder theorists argue that shareholder management stimulates economic growth. The corporate structure allows individuals and institutions to pool resources under singular control. With newfound capital, business ventures gain the ability to grow in size, but more importantly, in scale. For instance, the rise of the

[30] Berle, Adolf A., and Gardiner C. Means. The Modern Corporation and Private Property. New York: Macmillan, 1933.

corporate structure in the 19th century coincided with a period of decreasing production costs and increasing profitability in the United States.[31]

When managers maximize this profitability, they can return excess profits to shareholders as dividends or reinvest them to appreciate their stock price. In either case, the shareholder enjoys a high return. A virtuous cycle begins. Cheaper goods make consumption more affordable for individuals, who find themselves holding more investable funds and wanting access to the corporations' massive profits through investment.[32] Corporations receive capital influxes, scale up even further, and produce goods even more cheaply. As Robert Reich put it, large corporations shift power "to consumers and investors…[who enjoy] better and cheaper products, and higher returns."[33]

The shareholder theorists assert that only shareholder management will offer sufficient incentive for investors to capitalize corporations. If firms spend capital for purely social purposes, as many firms do today with corporate social responsibility (CSR) projects, investors' expected returns drop. They respond by investing less, firms accumulate less capital, production becomes more expensive, and so do goods. When firms do not maximize profit, society sees two fundamental tenets of economic growth contract: consumption (as a result of higher prices) and investment (as a result of lower expected returns).

[31] Ibid
[32] Ibid
[33] Reich, Robert B. Supercapitalism: The Transformation of Business, Democracy, and Everyday Life. New York: Vintage Books, 2007.

2.1.2.3 Only Shareholder Managers Can Avoid Illegal Taxation

When a manager spends corporate profits in a way that reduces returns to shareholders, he is spending shareholder money. Friedman finds this analogous to the manager "imposing taxes, on the one hand, and deciding how the tax proceeds are spent, on the other."[34] Such a privately-instituted tax is, to Friedman, indefensible. We establish electoral and judicial institutions for the very purpose of regulating the practice of taxation; managerial taxation of investors lacks the protections of these institutions. For instance, our government's checks and balances separate the functions of levying taxes and deciding how to spend them, while stakeholder management combines them. The stakeholder manager taxes his investors and decides for which cause the tax dollars will be spent. As Friedman concludes, "if they are to impose taxes and make expenditures to foster 'social objectives,' then political machinery must be set up to make the assessment of taxes and to determine through a political process the objectives to be served."[35] Since corporations do not have this political machinery, stakeholder theory should be avoided. Only by maximizing shareholder value for investors will the corporation avoid spending shareholder money and avoid the unjust taxation pitfall. Friedman believes this gives shareholder theory enormous normative appeal.

2.2 Stakeholder Theory

The stakeholders of a firm are individuals or groups that have an interest in the success or failure of that firm. In this paper, I use Edward Freeman's narrow group of stakeholders, which includes the firm's shareholders, suppliers, employees, customers,

[34] Friedman, Milton. "The Social Responsibility of Business Is to Increase Its Profits." The New York Times Magazine (New York), September 13, 1970.
[35] Ibid

management, and its local community, because he finds the narrow account more persuasive.[36]

Each stakeholder might have a different stake in the company, but all have the ability to impact other stakeholders through their stakes. For instance, take the shareholders, employees, and customers of Toyota Corporation. Shareholders have a financial stake, expecting a positive return on their investment in Toyota stock or bonds; employees have a compensatory stake, expecting a livelihood and meaningful employment in exchange for their time, work, and loyalty. Customers have yet another stake, expecting a well-functioning automobile in exchange for their business. Regardless, a failure by *any* stakeholder to fulfill its role in Toyota's operations significantly harms the firm. Without investment from shareholders, the firm lacks the capital to buy production sites or build machinery. Without employees, the firm lacks the ability to put its land or machinery to use. Without customers, the firm lacks the cash flow to satisfy investors and pay employees.

Given the ability for each class of stakeholders to destroy a firm, stakeholder theorists believe the role of the firm manager is to balance the interests of each of these classes – equally. Stakeholder theorists do not "give primacy to one stakeholder group over another…because when relationships [among stakeholders] become unbalanced, the survival of the whole firm is in jeopardy."[37]

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[36] Evan, William, and R. Edward Freeman. "A Stakeholder Theory of the Modern Corporation: Kantian Capitalism." In *An Introduction to Business Ethics*. Chryssides, George D., and John H. Kaler. (Cengage Learning EMEA, 1993), 254-266.
[37] Evan, William, and R. Edward Freeman. "A Stakeholder Theory of the Modern Corporation: Kantian Capitalism." In *An Introduction to Business Ethics*. Chryssides, George D., and John H. Kaler. (Cengage Learning EMEA, 1993), 254-266.

2.2.1 As Positive Theory

For stakeholder theory to enjoy positive persuasiveness, managers today must demonstrate a concern for stakeholder interests that exceeds the obligations of law and ethical custom. This would manifest itself in corporations not only sacrificing profits in the name of other stakeholder interests, but doing so out of genuine consideration for the welfare of their stakeholders.[38] The stakeholder manager cannot prioritize shareholder returns, so he cannot care for stakeholder relationships in the name of long run profit maximization or a sort of reluctant adherence to laws or social norms. Instead, as Friedman himself observed, the stakeholder corporation's actions must stem from a serious sense of responsibility for stakeholder well being.[39]

2.2.1.1 The Actions Corporations Take

The 21st century has seen a rise in CSR projects. By definition, CSR defies profits in the name of other interests. Whether a CEO increases costs to preserve the environment or decreases prices to benefit the consumer, his or her action primarily aims to benefit non-shareholder groups. When a CEO contracts with a more expensive, environmentally-friendly supplier, he or she is said to be practicing CSR; when a CEO offers employees free day care programs, he or she also is said to be practicing CSR. The overlap between CSR and stakeholder theory is obvious, but the Harvard Kennedy School makes a point to mention how CSR exists because companies feel "accountable not only to shareholders but also to stakeholders such as employees, consumers,

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[38] Smith, Jeff H. "MIT Sloan Management Review." MIT Sloan Management Review RSS. July 15, 2013. Accessed April 01, 2013. http://sloanreview.mit.edu/article/the-shareholders-vs-stakeholders-debate/.
[39] Friedman, Milton. "The Social Responsibility of Business Is to Increase Its Profits." The New York Times Magazine (New York), September 13, 1970.

suppliers, local communities, policymakers, and society-at-large."[40] Consequently, stakeholder theory would hold positive appeal if it were the case that corporations widely adopt CSR and do so because of genuine (non-economic) concern for the welfare of all stakeholders.

KPMG found that 95 percent of the world's 250 largest companies claim to practice CSR. Interestingly, the same study found that a company is more likely to implement CSR if it is incorporated.[41] The report concluded that from its philosophical beginnings with Freeman to its large-scale support today, stakeholder-oriented projects have grown from "an optional but nice activity… to [having] become virtually mandatory."[42] Clearly, corporations appear willing to sacrifice short-term profits in order to protect other stakeholder interests through their CSR. If the corporations' justification for the CSR invokes stakeholder philosophy, then stakeholder theory might prove to be quite persuasive as a positive theory of the corporation.

2.2.1.2 Stakeholder Theory as Managerial Justification

Managers do seem to cite stakeholder philosophy as the justification for their CSR and other stakeholder-oriented projects. Their concern for stakeholder welfare appears less rooted in a sense of obligation to law and ethical custom – and especially not a strategy for long run profit maximization – than in a deep philosophical commitment to the welfare of their stakeholders. While Friedman's shareholder theory does not preclude consideration of stakeholder interests, the data implies that managers feel a much more

[40] "Defining Corporate Social Responsibility." Corporate Social Responsibility Initiative. Accessed April 01, 2013. http://www.hks.harvard.edu/m-rcbg/CSRI/init_define.html.
[41] "KPMG International Corporate Responsibility Reporting Survey 2011 ." KPMG. Accessed April 01, 2013. http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/corporate-responsibility/Pages/2011-survey.aspx.
[42] Ibid

robust obligation to stakeholders than a reasonably interpreted shareholder theory can justify.

Thomas Donaldson of the Academy of Management find empirical evidence that corporate executives conceive of stakeholder relationships in a way that accords with stakeholder theory. Studies by Baumhart (1968), Brenner & Molander (1977), and Posner & Schmidt (1984) found that a majority of corporate managers believe it unethical – not just uneconomical – to prioritize the interests of shareholders. Baumhart's study in particular highlighted the popularity of stakeholder management: he estimated that 80 percent of managers favored the stakeholder approach. Clarkson (1991), Halal (1990), and Bartkus & Glassman (2007) all confirmed "significant" ethical concern for stakeholder interests among United States corporations.[43]

Additionally, close to 60 percent of firms cite "ethical considerations" as their reason for adopting CSR – compared with only 32 percent that mention "shareholder value."[44] Jorg, Loderer, and Roth (2004) conducted a similar study and found similar results. They interviewed managers from 313 Swiss firms, finding that 81 percent of firms wanted to maximize *stakeholder* value and more than half wanted to maximize shareholder value only "as long as it did not come at the expense of other stakeholders in the firm."[45]

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[43] Donaldson, Thomas. "The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications." The Academy of Management Review 20, no. 1 (1995): 65-91. Accessed April 01, 2013. http://www.jstor.org/stable/258887.

[44] "KPMG International Corporate Responsibility Reporting Survey 2011 ." KPMG. Accessed April 01, 2013. http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/corporate-responsibility/Pages/2011-survey.aspx.

[45] Joerg, Petra, Claudio F. Loderer, and Lukas Rot. "Shareholder Value Maximization: What Managers Say and What they Do" Social Science Research Network. August 14, 2003. Accessed April 15, 2013.

2.2.1.3 Stakeholder Theory and the Law

Currently, the law does not impose on managers a fiduciary duty to non-shareholders. The law discusses stakeholder rights in terms of permission rather than obligation. More than half of American states have passed statutes that have become known as 'permissible concern' laws. These explicitly permit a corporation's board of directors to consider, in outlining corporate strategies and goals, the interests of "a host of non-shareowner constituencies, including employees, creditors, suppliers, and local communities."[46] Connecticut even requires this consideration.[47] This means that corporate directors, though rarely required to care for stakeholder interests, would not get punished for doing so. Under the doctrine of permissible concern, stakeholder management is thus allowed – but not required – under the law.

Perhaps because corporations legally do not *have to* consider stakeholder interests, the law limits the degree to which corporations can *ignore* stakeholders in decision-making. Managers have legal duties to honor contractual obligations and relevant statutes (like anti-pollution laws); they cannot always use the lack of a fiduciary duty as a legal justification for stakeholder exploitation.[48] For example, congressional legislation such as the Clean Air Act and the National Labor Relations Act force managers to respect the interests of local populations and employees up to legally-defined levels.[49]

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[46] Orts, Eric Wills. Beyond Shareholders: Interpreting Corporate Constituency Statutes. 1992.
[47] Marens, Richard. "Getting Real: Stakeholder Theory, Managerial Practice, and the General Irrelevance of Fiduciary Duties Owed to Shareholders." Business Ethics Quarterly. 1999. Accessed April 01, 2013. http://web.sau.edu/richardsrandyl/business_ethics_filing_cabinet_getting_real_importance_stakeholders.htm.
[48] Ibid
[49] Evan, William, and R. Edward Freeman. "A Stakeholder Theory of the Modern Corporation: Kantian Capitalism." In *An Introduction to Business Ethics*. Chryssides, George D., and John H. Kaler. (Cengage Learning EMEA, 1993), 254-266.

2.2.2 As Normative Theory

Given the relatively weak presence of stakeholder philosophy in American law, stakeholder theorists justify their account mostly in the realm of morality. They believe only stakeholder management is morally-defensible and that the corporation *should* be structured in accordance with stakeholder philosophy. At the core of their normative account lie three appeals: to Kantian ethics (stakeholders must not be treated as a mere means), to individual responsibility (corporations are responsible for their effects on others), and to consequentialism (corporations adhering to stakeholder philosophy produce the best outcomes in society).[50]

2.2.2.1 Kant and the 'Mere Means' Defense

Freeman invokes Kant in claiming that stakeholders must not be treated as a mere means. He argues that each stakeholder in a corporation becomes a stakeholder through voluntary exchanges from which the stakeholder hopes to become better off. When one stakeholder harms another stakeholder in the name of self-interest – without including the latter in the decision-making process – the first uses the second as a mere means, which is morally-indefensible. For example, managers treat employees as a mere means to profit when they arbitrarily decide to lower employee wages. The decision, which affects employee welfare, did not include the employees' participation, and Freeman (and he claims Kant) would find this unjust.

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[50] Greenword, Michelle, and Helen De Cieri. "Stakeholder Theory and the Ethics of Human Resource Management." Monash University Working Papers, 05th ser., no. 47 (July 2005).

2.2.2.2 Corporations Must Be Responsible for Their Actions

The responsibility justification centers on the idea that corporations should take responsibility for their actions. Modern corporations have grown so large and influential in society that they now have an ethical duty to care for those under their control and influence. By definition, the stakeholders are those subjected to corporate control and influence, so the responsibility argument reaches the conclusion that corporations have a duty to care for stakeholder welfare. As Adolf Berle described it, there is "an insistence that power in economic organization shall be subjected to the same tests of public benefit which have been applied…to…power otherwise located [i.e. government]." The test, for Berle and other stakeholder theorists, is "the well-being of those who are subject to the organization, whether workers, investors, or consumers."[51] Alternatively put, in order to hold corporations responsible for their actions – a notion Berle would argue has intrinsic normative appeal – society must require stakeholder management.

2.2.2.3 Stakeholder Theory Produces Better Outcomes for Society

The consequentialist argues simply that society is best off when corporations practice stakeholder management. Typically, stakeholder theory is defended by "the utilitarian stream of consequentialism."[52] Either the best corporate action is the one that maximizes the total utility of all stakeholders, or the one that maximizes the number of stakeholders that receive utility from the action. The consequentialists believe the stakeholder manager will deliver the best outcome in both cases, so they submit stakeholder theory offers the best normative account of the corporation.

[51] Berle, Adolf A., and Gardiner C. Means. The Modern Corporation and Private Property. New York: Macmillan, 1933.
[52] Greenword, Michelle. "The Importance of Stakeholders According to Business Leaders." Business & Society Review. April/May 2001. Accessed April 01, 2013. http://web.sau.edu/RichardsRandyL/business_ethics_filing_cabinet_importance_of_stakeholders.htm.

3. An Analysis of The Fiduciary Theories

I will begin the chapter by presenting the objections to shareholder theory, then move to objections to stakeholder theory. I will conclude by considering arguments that critique fiduciary theories in general.

3.1 Objections to Shareholder Theory

3.1.1 Friedman Misunderstands Ethical Custom

Shareholder theory does not call for unconstrained profit maximization. The Friedman caveat prioritizes law and ethical custom, articulating that managers should maximize profits only after they honor their legal and ethical commitments.

When I presented the shareholder account, I admitted to making an assumption about the scope of ethical custom. I argued that Friedman’s theory, properly understood, tied managers only to minimal ethical commitments, but Ken Goodpaster sees a difference between Friedman’s account, properly understood, and our society’s actual ethical custom, properly understood. In other words, Goodpaster disagrees with Friedman that our ethical custom imposes only minimal obligations on the corporate manager. And when Friedman is forced to account for the full scope of our ethical custom, Goodpaster says, shareholder theory fails to distinguish itself from stakeholder theory in any meaningful way.

Goodpaster asserts that our ethical custom involves obligations to everyone affected by our actions. Whenever we pursue self-interested goals, we must still respect fundamental moral obligations to society during our pursuit – that our project is self-interested does not relieve us of publicly interested duties. Our ethical custom in a sense demands personal stakeholder management, since we must consider during our decision-making process how our actions will impact the interests of others. Goodpaster then posits a Nemo Dat Principle (NDP) that "no one can expect of an agent behavior that is ethically less responsible than what he would expect of himself."[53] The NDP, applied to corporations, holds corporate managers to the same ethical standard of their shareholders.

Taken together, ethical custom and the NDP require corporations to honor moral obligations to stakeholders. Individuals must consider stakeholder interests when deciding upon individual actions, corporations must abide by the same ethical standard as individuals, and so corporations must consider stakeholders when deciding upon corporate actions. Even though non-fiduciary in nature, these stakeholder obligations remain, in Goodpaster's eyes, "equally important."[54] Goodpaster thus concludes that our ethical custom – to which Friedman tethers corporate managers – forces shareholder theory to converge with stakeholder theory. Corporations have equally important moral obligations to consider the interests of non-shareholders in their decision-making process, because our ethical custom requires them to do so.

3.1.2 Does the Legal Fiduciary Duty to Shareholders Obligate Shareholder Management?

Even stakeholder theorists recognize that managers have a fiduciary duty to shareholders that they do not have to other stakeholders. They understand this is simply "a legal reality."[55] But shareholder theorists and stakeholder theorists clash over the significance of the fiduciary duty.

[53] Goodpaster, Kenneth E. "Business Ethics and Stakeholder Analysis." Business Ethics Quarterly, Vol. 1, No. 1 (Jan., 1991): 53-73. Accessed April 17, 2013. http://www.jstor.org/stable/2857592.
[54] Ibid
[55] Ibid

Stakeholder theorists argue that the spirit of the fiduciary duty is to protect shareholders from managerial greed: it is not to assert a primacy for shareholders in the hierarchy of corporate decision-making. In the absence of managerial self-dealing or corruption as issues, they claim, the law does not ask managers to prioritize shareholder interests.[56]

The law itself defines the fiduciary duty to shareholders as involving duties of care and loyalty. The duty of care is an obligation to govern prudently: a promise to manage the corporation with a good faith attempt to pursue the best interests of the corporation as a whole. The duty of loyalty prohibits managers from engaging in improper self-enrichment and self-dealing. The legal text, in both cases, makes no mention of the relationship between shareholders interests and those of other stakeholders. On the other hand, both duties refer to a manager's obligation to earnestly pursue corporate interests, which suggests the stakeholder theorists are correct about the spirit of the fiduciary duty.

The fundamental question is thus whether a public interest, such as the welfare of non-shareholders, can be plausibly understood as an interest of the corporation. Managers have a legal duty to further the interest of the corporation, and if the corporation has an interest in caring for the interests of its stakeholders, (that is separate from the interest in long run profit accumulation) then the law would seem to require stakeholder management. However, whether the corporation has a legitimate interest in safeguarding the welfare of its stakeholders is a normative question, answerable only by moral philosophy. The significance of this objection is that current law does not preclude

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[56] Brudney, Victor. "Contract and Fiduciary Duty in Corporate Law." 38 Boston College Law Review 595 (1997). Accessed April 20, 2013. http://lawdigitalcommons.bc.edu/bclr/vol38/iss4/1/.

stakeholder management if one can persuasively defend stakeholder management as a legitimate interest of the corporation.

3.1.3 Do Shareholders Have Interests Other than Profit Maximization?

Friedman says that managers are the agents of shareholders, responsible for furthering shareholder interests. Then he quickly concludes that shareholder interests, in most cases, are simply to maximize returns under the constraints of law and ethical custom. In emphasizing the centrality of profit in investor decision-making, Friedman takes what Elizabeth Anderson calls a *homo economicus* view of human beings; we are rational, self-interested pursuers of utility maximization. But as Anderson points out, *homo economicus* approaches "ignore the actual causes of human behavior."[57]

Investment data suggests that investors frequently prioritize social concerns over returns. The term socially-responsible investing (SRI) was coined to refer to investors' desire to "promote concepts and ideals that they feel strongly about [through their investments]."[58] SRI has grown more than 22 percent since 2010 and now roughly one out of every nine invested dollars in the United States can be classified as SRI.[59] Investors, from retail to institutional, commit to SRI even though it has "has been generally disappointing in the returns department."[60]

It would thus appear that Friedman overly discounts investors' attention to business ethics. Many investors hold businesses to a much higher standard than mere

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[57] Anderson, Elizabeth. "Beyond Homo Economicus: New Developments in Theories of Social Norms." University of Michigan. Accessed April 01, 2013. http://www-personal.umich.edu/~eandersn/norms.pdf.
[58] Chamberlain, Michael. "Socially Responsible Investing: What You Need To Know." Forbes. April 24, 2013. Accessed April 25, 2013. http://www.forbes.com/sites/feeonlyplanner/2013/04/24/socially-responsible-investing-what-you-need-to-know/?utm_medium=twitter.
[59] Ibid
[60] Levitt, Aaron. "Big Money Is Moving To Socially Responsible Investing." SFGate. April 5, 2013. Accessed April 20, 2013. http://www.sfgate.com/business/investopedia/article/Big-Money-Is-Moving-To-Socially-Responsible-4386804.php.

conformity to the basic rules of society. Friedman might be correct that the law requires corporations to further only shareholder interests, but the advancement of shareholder interests in turn demands far greater consideration for stakeholder interests than Friedman's account, if it is to be meaningfully different from the stakeholder account, can justify.

3.2 Objections to Stakeholder Theory

3.2.1 Who Counts as a Stakeholder?

Freeman himself recognizes there are two definitions of "stakeholder." The narrow definition refers to groups "vital" to the success and survival of the corporation; the wide definition includes any group or individual who *can* affect or be affected by the corporation.[61] Freeman proclaims his easiest step is to defend the narrow account, but I find even that problematic. Groups beyond Freeman's employees, suppliers, etc. satisfy his narrow definition of a stakeholder. The actions of competitors, for instance, prove "vital" to the success of a corporation indeed. If a competitor decides to sell its product for $10 instead of $10,000, it will profoundly alter the success of a corporation. And yet Freeman precludes competitors from stakeholdership. He argues that companies can exist in monopoly settings – without competitors – where the tenets of stakeholder theory still apply. According to Freeman, monopolies still do and should consider the interests of other stakeholders in their decision-making. In other words, he seems to say that competitors do not count as stakeholders because they do not always exist.[62]

[61] Evan, William, and R. Edward Freeman. "A Stakeholder Theory of the Modern Corporation: Kantian Capitalism." In *An Introduction to Business Ethics*. Chryssides, George D., and John H. Kaler. (Cengage Learning EMEA, 1993), 254-266.
[62] Ibid

This is incredibly odd reasoning. Corporations can also exist without other stakeholders that Freeman *does* include in his account. A corporation does not *need* suppliers; it can produce self-sufficiently. A corporation does not *need* a local community*;* it can operate in unpopulated and remote areas. Freeman would probably have to concede this point and admit that one must only care for suppliers and local communities *when they exist.* This, however, would defeat Freeman's original justification for precluding competitors. If local communities do not always exist, but must factor into the stakeholder manager's decision-making when they do, it follows that the stakeholder manager can function in a monopoly setting but still must consider the interests of competitors when competitors exist.

The moment Freeman includes competitors and other "wide-definition" stakeholders into his narrow account, his theory begins to lose both positive and normative persuasiveness. Are corporations today actually factoring in the interests of competitors when making decisions? Probably not, and there is a strong possibility that corporations actually attempt to harm competitors. Should corporations be considering the interests of competitors in their decision-making? Almost definitely not. Especially when we consider other elements of Freeman's stakeholder theory – like how the corporate manager must weigh stakeholder interests equally – it seems even more wrong to require corporations to give the same considerations to the interests of their investors and of their competitors.

3.2.2 Do We Always Treat Others as Mere Means in Business Relationships?

Freeman heavily relies on Kantian ethics to justify managerial obligations to other stakeholders. He finds that "stakeholders have some inalienable rights to participate in decisions that substantially affect their welfare or involve their being used as a means to another's ends."[63] Managers who ignore the interests of legitimate stakeholders use these stakeholders as mere means to corporate profits, meaning managers have an ethical obligation to practice stakeholder theory.

However, Freeman appears to ignore Kant's distinction between means and mere means. To treat someone as a means to your benefit is allowable and morally-defensible; Kant would allow me to work my employee to the bone in the name of corporate profit *as long the employee legitimately consents to the treatment*. To treat someone as a mere means is not morally-defensible, and consent is not enough to disqualify a relationship from being a mere means relationship. When we force others into action, either by lying or coercion, they do not truly consent, and the consent of a mentally ill person similarly cannot be understood as legitimate consent.[64] For instance, I cannot get an employee to sign a contract by promising two years of employment and then fire him the next week to cut costs. I solicited his consent by lying, which would undermine the legitimacy of the consent. But Freeman's point is even larger. He seems to say that *every* means relationship, even those with legitimate consent from both parties, is a mere means relationship. I can never fire *any* employee without including that employee in the decision-making process, or else I treat the employee as a mere means. I disagree.

Elizabeth Anderson points out how business relationships, by definition, are use relationships. I contract with a supplier not to give the supplier a livelihood, but because I need supplies to produce my goods and ultimately to earn profit. I use my supplier as a

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[63] Donaldson, Thomas. "The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications." The Academy of Management Review 20, no. 1 (1995): 65-91. Accessed April 01, 2013. http://www.jstor.org/stable/258887.
[64] "Kant's Ethics: Some Key Ideas." Trinity University. Accessed April 1, 2013. http://www.trinity.edu/cbrown/intro/kant_ethics.html.

means to profit, my employees as a means to profit, and all other stakeholders as a means to profit. And they use my corporation as a means too. My employees view my corporation as a means to a livelihood, my suppliers view my corporation as a means to revenue, and my customers view my corporation as a means to goods and services. As long as stakeholder relationships stem from legitimate consent, and Freeman's description of 'voluntary, mutually-beneficial exchanges' suggests they do, then it would appear that use relationships do not violate Kantian ethics and so his justification for stakeholder management fails. There is an important difference between means and mere means that Freeman overlooks.

3.2.3 What Use is Stakeholder Theory in Practice?

Goodpaster claims that stakeholder theory cannot guide corporate decision-making. It might outline who will be affected by a decision and to what extent, but it does not provide a platform from which a manager can reach a decision. In Goodpaster's words, "to be told that stakeholders are or must be 'taken into account' is…to be told very little."[65]

Freeman tries to alleviate Goodpaster's concern with two principles of stakeholder management. First, corporations must be managed for the benefit of their stakeholders, who in turn deserve a role in a firm's decision-making when decisions affect their stakes. Second, managers must enter into a fiduciary relationship with the

[65] Goodpaster, Kenneth E. "Business Ethics and Stakeholder Analysis." Business Ethics Quarterly, Vol. 1, No. 1 (Jan., 1991): 53-73. Accessed April 17, 2013. http://www.jstor.org/stable/2857592.

corporation as an abstract entity, which also means a fiduciary duty to the long-term interests of each class of stakeholders.[66]

Goodpaster would likely remain unsatisfied. He would ask what it means to have a role in a firm's decision-making process, hoping that Freeman would recognize the infeasibility of requiring firms to call a stakeholder's representative each time a decision affected that stakeholder. Goodpaster would want a practical account of how managers can satisfy their ethical responsibility to include stakeholders in decision-making.

Similarly, Goodpaster would ask Freeman to crystallize his second principle so a manager would know how to honor his fiduciary duty to the corporation as an abstract entity. Would the manager need to maximize total utility, after the utilities of all stakeholders are considered? Or would the best decision maximize the number of stakeholders receiving utility? Freeman does not answer these questions, even in a later paper of his that claimed to outline four levels of "stakeholder responsibility in practice." Goodpaster would find this alarming considered managers are expected to apply stakeholder theory and practice stakeholder management.[67]

3.3 Objections to Both Fiduciary Theories

Fiduciary theories of the corporation hinge on agency. The corporate manager must make decisions on behalf of another group and attempt to further the interests of his principals when making decisions. If managers defy their agential responsibilities – if they neglect the interests of their principals – fiduciary theories of the corporation lose substantial appeal, both as positive and normative accounts. In other words, if we cannot

[66] Evan, William, and R. Edward Freeman. "A Stakeholder Theory of the Modern Corporation: Kantian Capitalism." In *An Introduction to Business Ethics*. Chryssides, George D., and John H Kaler. (Cengage Learning EMEA, 1993), 254-266.
[67] Ibid

trust managers to respect their agential responsibilities, or hold them accountable when they self-deal, it is not clear why we should structure corporations around a concept of agency.

3.3.1 Do Managers Neglect the Interests of their Principals?

Critics of fiduciary corporate theories do not expect managers to prioritize the interests of principals over self-interest. Adam Smith recognized two hundred years ago that "the directors of such [corporations]…being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance…Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."[68] Managers do not own the property they control and Smith predicted that both the stakeholder and shareholder managers would attend first to their own self-interest. Overwhelming evidence of managerial greed supports his view.

Managers frequently further their private interests at the expense of shareholder and stakeholder welfare. For instance, the compensation of chief executive officers (CEOs) is 20 to 40 percent higher when the CEO has a voice in determining his or her own compensation.[69] The result is managerial compensation that almost never reflects levels that accord with shareholder or stakeholder interests. When investors have expanded power to change executive compensation (such as when members of the executive compensation committee own equity in the corporation), they almost always

[68] Smith, Adam. The Wealth of Nations. London: Penguin Books, 1999.
[69] Cyert, Richard M., Sok-Hyon Kang and Praveen Kumar. "Corporate Governace, Takeovers, and Top-Management Compensation: Theory and Evidence." Management Science Vol. 48, No.4 (Apr. 2002): 453-469. Accessed April 18, 2013. http://fisher.osu.edu/~young_53/Cyert-Kang-Kumar.pdf.

respond by lowering executive pay.[70] Even the corporate executives' use of private jets plummets when control of the firm moves from public shareholders to private equity companies, who have more incentive to ensure corporate compensation aligns with the best interest of shareholders.[71]

The managerial greed is not limited to compensation: managers frequently prioritize their personal control of the firm as well. The best examples come from takeover attempts. Managers typically resist takeovers even if acquirers offer shareholders a premium for their ownership stakes.[72] On the other hand, when managers possess 'golden parachute' provisions in their contracts – large and guaranteed payouts in the event of takeovers – their resistance drops noticeably.[73] A study by Duke University even showed that managers accept takeovers more frequently as they approach retirement age, and no longer care as much whether they lose their job or power.[74] The implication is thus clear. Managers frequently prioritize self-interest, whether in the form of personal compensation or power preservation, regardless of the cost to shareholders and other stakeholders.

3.3.2 Is Correction of Agency Problems Impossible in Public Corporations?

Most publicly traded corporations lack a real ability to correct agency problems. In theory, boards of directors oversee the performance of corporate managers; the board retains the power both to select executive officers and to change their pay. Board

[70] Ibid
[71] Edgerton, Jesse. "Agency Problems in Public Firms: Evidence from Corporate Jets in Leveraged Buyouts." Journal of Finance, December 2012.
[72] Bebchuk, Lucian Arye, and Jesse M. Fried. "Executive Compensation as an Agency Problem." Journal of Economic Perspectives 17, no. 3 (April 2003): 71-92. doi:10.1257/089533003769204362.
[73] Agrawal, Anup, and Charles Knoeber. "Managerial Compensation and the Threat of Takeover." Rodney L. White Center for Financial Research, 1994.
[74] Jenter, Dirk, and Katharina Lewellen. "CEO Preferences and Acquisitions." 2011.

governance certainly offers advantages to the corporation, namely in the form of centralized decision-making, but the board can rarely deliver meaningful oversight of managerial behavior because the managers themselves frequently comprise the board.

In 2012, more than half of S&P 500 corporations had the chief executive officer also chair the board of directors. The person overseen and leading the overseeing were thus one and the same for almost 60 percent of corporations.[75] Legally, shareholders can oust directors with a simple majority vote. However, the manager-directors can make it very difficult for common shareholders to accumulate the necessary votes. Board directors have the power to: (1) use corporate funds to finance re-election campaigns; (2) stagger elections so no single election turns over control to a new group; and (3) change the rules of the elections.[76]

Empirical evidence confirms how little power shareholders have over their board of directors. From 1996 to 2005, shareholders ousted incumbent board directors a total of 45 times. For large companies, defined as having a market capitalization of over $200 million, that figure drops to a mere eight instances over the entire decade. For context, it is worth noting that the smallest corporate market capitalization in the S&P 500 is $1.58 *billion.* Two-thirds of all challenges to director re-election failed, a number that pales in comparison to the number of incumbents that won unopposed.[77]

Clearly, managers that sit on their own boards have a diverse toolset they can use to protect their board positions. And when managers control the board of directors, the

[75] "Key Issues: CEO and Board Chair Roles." PwC. Accessed April 28, 2013. http://www.pwc.com/us/en/corporate-governance/board-leadership.jhtml.
[76] Bebchuk, Lucian A. "The Myth of the Shareholder Franchise." Virginia Law Review 93, no. 3 (2007).
[77] Ibid

same people are charged with misbehavior and correcting the misbehavior. The enforcement of managers' agential responsibilities clearly suffers as a consequence

4. My Conclusions

4.1 The Best Positive Theory

My aim in this paper is to arrive at the most compelling theory of the modern day corporation. From a positive perspective, this requires an understanding of what the corporation is and how it is structured. It seems to me that Friedman's shareholder theory provides a very compelling account. While his primary issue is that he does not articulate his notion of 'ethical custom,' the spirit of Friedman's argument suggests that he views the corporation as a profit-maximizer that reluctantly honors imposed legal responsibilities and a minimal, basic set of ethical norms. The way we structure corporations in the law and the way corporations behave both accord very well with this understanding of Friedman's theory.

The law says that corporations assume a fiduciary duty to shareholders and no other stakeholders. While the fiduciary duty does not necessarily require corporations to prioritize shareholder interests – stakeholder theorists are quick to point out how the legal duty seeks only to prohibit managerial self-dealing – the existence of only one fiduciary duty clarifies that managers do not have the same legal commitments to stakeholders that they do to shareholders. The law therefore demands corporations act in one of two ways. Either they act in the manner Friedman's account calls for, caring only for shareholder interests in the context of other laws, or they honor some minimal set of legal commitments to shareholders and then attend to other stakeholders' interests.[78]

Corporate actions indicate that most managers adopt the profit maximization interpretation. From outsourcing to pollution, corporations routinely demonstrate a

[78] The law does not require the other facet of shareholder theory, the commitment to ethical custom

priority for shareholder returns over stakeholder well being. In many cases, managers even go beyond shareholder theory, breaking laws and employing questionable ethics in the pursuit of profit.[79]

Normative appeal aside, corporations just do not practice stakeholder management – even if they think that they do. When GE's Jack Welch argued that managers do not focus on profits, in the same breath he admitted the opposite. He called shareholder value "a result."[80] If managers make robust commitments to stakeholders, but only because they view stakeholders as instruments toward long run profits, the commitment to stakeholders is fully explained (and required) by shareholder theory. As Goodpaster notes, when managers view stakeholders as means to profit "their basic outlook subordinates other stakeholder concerns to those of stockholders."[81] Welch's argument is not a condemnation of shareholder management but of the ways most managers approach shareholder value maximization. He understands that shareholder value is the desired result, but implies it is maximized only when corporations substantially commit to stakeholder welfare.[82] Like Friedman, Welch implores managers to maximize shareholder value; he just emphasizes, more than Friedman, the importance of stakeholder relationships in the process.

Welch's argument, properly understood, sheds light on why firms adopt practices like CSR so frequently. The reason is not stakeholder theory. Rather, corporations know

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[79] Duhigg, Charles. "Clean Water Laws Are Neglected, at a Cost in Suffering." The New York Times. September 12, 2009. Accessed April 24, 2013. http://www.nytimes.com/2009/09/13/us/13water.html?pagewanted=all.
[80] Welch Condemns Share Price Focus." Financial Times. Accessed April 01, 2013. http://www.ft.com/intl/cms/s/0/294ff1f2-0f27-11de-ba10-0000779fd2ac.html.
[81] Goodpaster, Kenneth E. "Business Ethics and Stakeholder Analysis." Business Ethics Quarterly, Vol. 1, No. 1 (Jan., 1991): 53-73 320. Accessed April 17, 2013. http://www.jstor.org/stable/2857592.
[82] Welch Condemns Share Price Focus." Financial Times. Accessed April 01, 2013. http://www.ft.com/intl/cms/s/0/294ff1f2-0f27-11de-ba10-0000779fd2ac.html.

that they need to maintain a positive reputation with consumers and employees in order to maximize profits. To most this is an obvious point, but the fact that Nike's sales dropped $1 *billion* in 1999 – the year after it was accused of exploiting Asian labor – offers empirical proof.[83]

As a result, CSR initiatives prove quite consistent with shareholder theory. CSR improves firms' access to human capital; one study at Stanford University found that MBA graduates "would sacrifice an average of $13,700 in salary to work for a socially responsible company" and another found that 70 percent of North American students would refuse to work at a socially-irresponsible firm. [84,85] CSR also protects the corporations' sales. Consumers expect significant social responsibility from corporations today and try to guide corporate behavior with their purchase decisions.[86] Unsurprisingly, brand reputation is the reason corporations most frequently list for practicing CSR.[87]

Firms clearly prioritize shareholder returns, even if they view stakeholder relationships as more important for profit maximization than Friedman would have predicted. My interpretation of Friedman's theory can thus be said to provide a very persuasive positive theory of the corporation. They seek to maximize returns for shareholders, while honoring (usually) other legal and basic ethical obligations – and are encouraged by our legal code to do so.

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[83] Boje, David. "Athletic Apparel Stories and Stock Reports." College of Business — New Mexico State University. January 14, 2000. Accessed April 01, 2013. http://business.nmsu.edu/~dboje/nikestockstories.html.
[84] Fox, Adrienne. "HR Magazine: Corporate Social Responsibility Pays Off." Society For Human Resource Management. Vol. 52, No. 8. August 2, 2007. Accessed April 20, 2013.
[85] Ibid
[86] McCluskey, Jill J., Catherine A. Durham, and Brady P. Horn. "Consumer Preferences for Socially Responsible Production Attributes Across Food Products." AgEcon Search. Accessed April 01, 2013.
[87] "KPMG International Corporate Responsibility Reporting Survey 2011 ." KPMG. Accessed April 01, 2013.

4.2 The Best Normative Theory

The corporation is a legal construct. It is only as powerful as the laws that a government uses to define it. As a result, I argue that governments should structure these corporations so that the effects of corporate activity will further legitimate functions of the government.

It is beyond the scope of this paper to articulate a comprehensive account of the legitimate aims of a state or to compare the relative merits of different aims. Instead, I take a legitimate aim of the state that I believe the corporate entity can be understood to advance – that of promoting the general welfare of citizens – and develop a corporate structure that best furthers this aim.[88] The fact that my structure furthers a legitimate government aim, I argue, gives my account substantial normative appeal. I therefore define the most compelling normative theory of the corporation as the one that best furthers the state's ability to maximize the welfare of its citizens.

The corporation reduces transaction costs in business and lowers per-unit fixed costs. If we structure a corporation in a way that allows individuals to pool resources under singular control, then the existence of the corporate entity drives down costs of production. More people can consume, businesses earn more profits, and more people get hired. As Friedman put it, the incentive for creating corporations is "the increased product made possible."[89] Ignoring (for now) the other societal effects that corporations might have, we can say the corporate structure that best promotes the general welfare is the one that maximizes the corporation's ability to stimulate economic activity through decreased production costs.

[88] The aim of state was selected from the list espoused in the U.S. Constitution
[89] Friedman, Milton. Capitalism and Freedom. Chicago: University of Chicago Press, 1962.

Corporations decrease costs by increasing scale. Fixed costs spread over more individual units and transaction costs drop when more resources come under centralized control.[90] The two types of resources at the firm's disposal are human and financial capital, so governments have an interest in defining the corporation in a way that facilitates the accumulation of each type of capital.

I will start with financial capital. While debt financing remains important, the unique function of the corporate entity is that it can increase businesses' access to equity capital, or as Berle calls it, "the wealth of innumerable individuals."[91] On my view, the more a theory of the corporation incentivizes individuals to provide capital, the more persuasive it becomes. This requires knowledge of the factors that drive stockholders to invest. According to Milton Friedman, the factor in most cases is profit alone.[92] We invest because we expect a return on our investment and we invest more when we expect a higher return. By providing ownership of profits (stockholdership), limiting risk (reducing liability) and encouraging managers to maximize profits (total shareholder value, not just short term earnings), we can be plausibly understood to have maximized the incentives for investors to provide financial capital to corporations. While investors, through SRI, might reward the most socially-responsible companies and punish the least, it is important to recall that just under 90 percent of investment dollars go not toward SRI but to investments promising the highest expected returns.[93]

[90] Hansman, Henry, and Kenneth Ayotte. "A Nexus of Contracts Theory of Legal Entities." Yale Law School and Northwestern University School of Law. Accessed April 24, 2013. http://faculty.chicagobooth.edu/appliedtheory/archive/workshop/spring2011/Ayotte.pdf.
[91] Berle, Adolf A., and Gardiner C. Means. The Modern Corporation and Private Property. New York: Macmillan, 1933.
[92] Friedman, Milton. "The Social Responsibility of Business Is to Increase Its Profits." The New York Times Magazine (New York), September 13, 1970.
[93] Risk-Adjusted

Meanwhile, firms also need access to human capital so they can put the financial capital to use. Interestingly, employees make decisions whether to work and how much to work very similarly to how investors make investment decisions. Both seem to care first for their compensation – either wages, salary, or returns – before attending to their ethical concerns. For instance, employee motivation is most strongly correlated with compensation, but high-paid employees are willing to sacrifice some compensation for the chance to work at socially-responsible companies.[94,95]

Since general welfare depends on decreased production costs, which in turn results from human and financial capital accumulation, it would thus appear that the best theory of the corporation would impose a dual-fiduciary duty on corporate managers: to the interests of investors and of shareholders. Given the aforementioned preferences of investors and employees, this dual-agent manager will look much like Friedman's corporate manager. He will pursue profits while conforming to law and very basic ethical norms (if we make the reasonable assumption here that employees and investors would not knowingly support illegal activity or grossly unethical behavior).

However, this account so far ignores that other factors contribute to general welfare. Poor environmental health, for instance, would detract from general welfare because citizens might not be able to drink or breathe without assuming enormous health risks. To truly enjoy normative appeal, the corporation must recognize when other claims

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[94] Rynes, Sara L., Barry Gerhart, and Kathleen A. Minette. "The Importance of Pay in Employee Motivation: Discrepancies Between What People Say and What They Do." Tippie College of Business. Accessed April 27, 2013.
http://www.utm.edu/staff/mikem/documents/Payasamotivator.pdf.

[95] Fox, Adrienne. "HR Magazine: Corporate Social Responsibility Pays Off." Society For Human Resource Management. Vol. 52, No. 8. August 2, 2007. Accessed April 20, 2013.

on the general welfare, and even when claims of other legitimate aims of the state, outweigh the public interest in cheaper production of goods.

We can have the corporation handle competing public interests in one of two ways. We could entrust the corporations to determine when other public interests outweigh the public interest provided by having corporations, but the more appealing solution is to let the public itself make this determination. Through elected officials, with the guidance of established political institutions and the oversight of a judiciary system, we can set limits on corporate behavior. In other words, the solution to the problem of competing public interests comes from legislation.

But then the question arises whether we can trust the policymaking process. Here it seems like the answer is no, due to practical and theoretical issues.

The theoretical issue is that corporations are going to be incentivized to change the laws. If they are told to maximize profits, and they know a different set of laws would allow for more profits, they are going to lobby for legislative change.[96] As the seminal Supreme Court case *Citizens United v. FEC* revealed, corporations will spend millions on advertising campaigns for the purpose of electioneering.[97] This consequence threatens the general welfare and also other aims of the state, including the protection of liberty and justice. Corporations' vast resources would allow corporations to dominate public political discourse; their freedom of speech would deny other (real) people the freedom to hear diverse political opinions. Furthermore, corporate political expenditures would

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[96] Citizens United v. Federal Election Commission. 558 S. Ct. 205 (2010) Accessed April 28, 2013. http://www.law.cornell.edu/supct/pdf/08-205P.ZX.
[97] Ibid

subject shareholders to coerced speech if the corporations supported candidates that some shareholders themselves opposed.[98]

The practical issue is that law enforcement lacks the resources to hold corporations accountable to the laws we establish. The New York Times study on pollution demonstrated this perfectly. As a society, we passed the Clean Water Act. We felt that the public interest in clean water outweighed its interest the cheaper consumption provided by corporations, as long as pollution reached levels outlawed by the legislation. When corporations realized they would not be punished for breaking the law – even knowing their actions were against the law – 23,000 of them violated the act. Moreover, the 23,000 were simply those in "significant non-compliance," which was the highest level of non-compliance that the law specified.

As a result, the profit-maximizing firm, bound only by the law, is not yet morally-defensible. It threatens the general will, public liberties, and justice by corrupting the lawmaking process. I thus call for a ban on corporate expenditures toward electioneering efforts. While Friedman might argue that corporate political speech is crucial for protecting economic freedoms of association, I firmly believe that the costs of corporate electioneering – harms to listener autonomy, to the freedom of shareholder speech, and to the general welfare – justify barring these expenditures. But even if barred from changing the laws, the corporation will still resist its legal constraints if the benefits from doing so outweigh the costs of legal punishment or if law enforcement will not be able to punish them at all. Such is the consequence of structuring the corporation as a profit maximizer: laws alone will not lead the corporation to defer to other, more important public interests.

[98] Ibid

Ralph Nader proposed a solution to the practical issue with federal charters. He points out that corporate behemoths can significantly harm society when they ignore public interests, so he believes federal charters should be required for corporations of a certain size (both in terms of annual sales and employees).[99] The charter would not look the same for each corporation, but would enact certain provisions depending on the industry and firm. Some of these provisions might include: (1) limits on the amount a corporation could invest in other corporations; (2) government stock ownership; (3) tiered liability structures that holds management more accountable; and (4) the appointment of a public interest-trustee to serve as part of the daily management structure.[100] Even a milder form of his solution – a reserved seat on boards of directors for a public official – would seem to offer enormous normative appeal for its likely effect of aligning corporate actions with public interests. A report by the United States Department of Justice indicated that both the directorship and the chartering system would "offer…a better solution for [corporate] accountability."[101]

The public charter solution might sound radical, but the theory behind it is not. It would "require corporations to meet certain public obligations in exchange for privileges conferred through incorporation."[102] This is precisely the solution required by my account of the corporation. I held that the most normatively-compelling corporation was the one structured to maximize profits but also to defer to superseding public interests.

[99] Taming the Giant Corporation by Ralph Nader and Mark Green and Joel Seligman
[100] Cray, Charles. "Revisiting Corporate Charters." Accessed April 25, 2013. http://www.corporatepolicy.org/pdf/charters.pdf.
[101] Nader, Ralph, Mark Green and Joe Seligman. Taming the Giant Corporation. New York: Norton, 1976.
[102] Cray, Charles. "Revisiting Corporate Charters." Accessed April 25, 2013. http://www.corporatepolicy.org/pdf/charters.pdf.

Friedman's account does not sufficiently protect public interests, but it appears the public charter would.

Consequently, my inquiry so far produces a corporation managed for the benefit of its shareholders and employees, that would be required to procure federal chartering when it reached a certain size, and that would be barred from expending corporate money toward electioneering.

However, I my theory must be refined. Knowing that my account calls for a dual-fiduciary duty, and knowing also the agency problems associated with them, I wish to adapt my account to control the consequences of managerial self-dealing as best as possible.

Agency problems are inevitable. While efforts to align managerial self-interest with corporate interests do mitigate the issue, corporations cannot reasonably expect managers' self interest always to be the corporation's self-interest.[103] Adam Smith and Milton Friedman provide compelling theoretical accounts explaining why we should always expect self-dealing in corporations.

On the other hand, I submit that the problem of accountability can be fixed. Managers might be less likely to *act* on their self-interest if they are likely to be caught and to be punished. Given that boards of directors supply the oversight of managerial performance, it would seem plausible that banning managers from these boards, or at least removing their voting power, would improve accountability. Managers argue that they deserve a seat on the board because their insight informs the board's decision-making, but I do not see why a well-functioning board would not find other ways to

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[103] Cremers, Martijn, Joost Driessen, Pascal Maenhout, and David Weinbaum. "Does Skin in the Game Matter? Director Incentives and Governance in the Mutual Fund Industry." Accessed April 22, 2013. http://faculty.insead.edu/maenhout/research/PDF/Skin%20in%20the%20game.pdf.

obtain the information that the manager would contribute.[104] If nothing else, the board could consult with the manager when necessary; this information-contribution argument does not seem to justify the manager's permanent seat, much less chairmanship, of the board of directors. So I propose they do not have it.

At last, I arrive at the theory of the corporation that I believe is the most normatively-appealing. Derived from the state's legitimate interest in maximizing the welfare of its citizens, my theory says:

(1) The corporation should be managed for the benefit of its shareholders and its employees;

(2) The corporation must obtain a federal charter when it reaches a sufficient size, the terms of which to be determined by the state so as to best protect the general welfare;

(3) The corporation's managers are not permitted to vote on decisions by the board of directors and are strongly discouraged from serving on the board at all;

(4) The corporation may not expend corporate resources toward electioneering efforts, defined as efforts to support or oppose candidates and/or legislation.

[104] Council on Foundations. "Should CEOs Be in the Board?" Accessed April 27, 2013. http://www.cof.org/files/Documents/Governing_Boards/Board%20Briefs/CEOsOnBoards.pdf.

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