Enlightened Shareholder Theory: 
whose interests should be served by the supporters of 
Corporate Governance?

Eric PICHET, Professor, BEM-Bordeaux Management School  
E-mail: eric.pichet@bem.edu - Tel.: +33.(0)6.08.57.87.71

ABSTRACT

This paper questions the feasibility of Corporate Governance (CG) and a company’s Board Members (CG’s most obvious agents) being able to serve two masters at once: shareholders; and the many different agents inhabiting the labyrinth of the stakeholder universe. Following on from this is the question of which of these stakeholders deserve special treatment from companies. After analysing this conundrum, absurdist reasoning will be used to demonstrate the theoretical impossibility of a dual legitimacy that would undermine the very factors explaining the success of modern developed societies. An alternative ‘Enlightened shareholder theory’ will be proposed, inspired by JENSEN’s ‘Enlightened stakeholder theory’ (2001). After demonstrating that a company’s interest is not necessarily synonymous with the interests of its shareholders, a proposition will be made that Board Members should always highlight social interests. The paper’s conclusion will identify the consequences of the new theoretical framework for the definition of CG; Board Members’ missions; and the composition of a Board of Directors.

KEY WORDS
Company performance, corporate governance, principles of corporate governance, shareholder value, Board Members, Board of Directors, value creation, Enlightened stakeholder theory, Enlightened shareholder theory.

INTRODUCTION

There is a broad academic and professional consensus in developed societies that the finality of the corporate sphere is to create value. The heroic figure of the entrepreneur, idealised from
RICARDO to SCHUMPETER, was further extolled throughout the 20th century, notably by DRUCKER and CHANDLER. Just as much admiration has been expressed for the construct of large companies, comprised of actors driven by the ‘invisible hand’ and ultimately (and inexorably) generating widespread prosperity. What distinguishes a firm from a village fete, a family, a government or a game is the objective of long-term value creation that it pursues by selling goods and services and trying to maximise profits (even if incidentally but unavoidably it fulfils many other functions, like collecting taxes\(^1\) or sustaining charities).

At the same time, between the partisans of a shareholder approach and the supporters of a stakeholder vision, there has been much debate about the finality of Corporate Governance (CG) or ‘the management of management’ in the justifiably famous words of PEREZ\(^2\) referring to actors’ efforts to optimise corporate leadership. Without going as far back as Adam SMITH (1776), stakeholder arguments are tied to ideas once formulated by A. BERLE and G. MEANS (1932). The question then becomes whether CG should satisfy a company’s shareholders alone or else all of its stakeholders.

The shareholder approach provides a brief but clearcut response - a company serves its owners i.e. its shareholders. This vision has given birth to various definitions of CG, like the one formulated by A. SCHLEIFER and R.W. VISHNY - ‘Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment’\(^3\) - or by FAMA, for whom shareholder maximisation is the sole criterion for assessing the performance of a listed company\(^4\). In this Friedman-like approach, what counts is formal legality.

The stakeholder approach – or approaches, since there are several – developed in opposition to the shareholder orientation and was born out of criticisms of the limitations of a shareholder vision considered too restrictive by some.

---

\(^1\) In France, for example, company-collected VAT is the leading source of revenues for the State, amounting to €150 billion annually, or nearly 50% of the total tax intake.

\(^2\) PEREZ Roland, La Gouvernance de l’entreprise, Paris : Editions La Découverte, 2003 (collection ‘Repères’), page 23.

\(^3\) SCHLEIFER, A. et VISHNY, R. W. (1997), A survey of corporate governance, The Journal of Finance, Vol LII, n°2, June 1997, page 737.

\(^4\) FAMA, E. F. (1980), Agency problems and the theory of the firm, Journal of Political Economy, 88, 2, 295.
In a stakeholder theoretical framework, CG constitutes ‘the central mechanism governing the function of the modern capitalist system, via the relationships between the managers of large listed companies and all parties concerned by the operations of these companies. First and foremost this means their shareholders but also their employees, suppliers, creditors and more broadly the different categories of agents or institutions affected by their decisions’.\(^5\)

CG also refers to the ‘institutional and behavioural mechanism governing relations between the executives of a company – and more broadly, an organisation – and the parties concerned by its future, led by those who hold ‘legitimate claims’ to it’\(^6\). This approach emphasizes the principle of the legitimate interests of partners over the legality of shareholders’ interests.\(^7\)

The paper’s first section will analyse the difficulty – or impossibility – of finding a satisfactory definition for the stakeholder concept, thus the ontological fragility of stakeholder theories based on such a definition. It will then go on to use absurdist reasoning to demonstrate the impossibility of pure stakeholder theory while indicating the limitations of pure shareholder theory. Part III will suggest an ‘Enlightened shareholder theory’ distinguishing the interests of a company from those of its shareholders. From this new theoretical vision will be derived a few consequences for the definition of CG, as well as other, more practical consequences for governance protagonists such Board Members. The implications for the composition of a Board of Directors, which is the cornerstone of all governance, will also be analysed.

I. STAKEHOLDERS: A HIGHLY VARIABLE DEFINITION

‘Definitions are very free...since nothing is more allowed than the right to give whatever name one chooses to an object that one has clearly chosen’

PASCAL, 1657, De l’esprit géométrique.

The stakeholder approach is rooted in the obvious existence of strong and complex interdependencies between companies and particular groups like customers, investors,

---

5 PEREZ R. (2003), La Gouvernance de l’entreprise, Paris : La Découverte (collection ‘Repères’), p. 3.
6 PEREZ R. (2003), La Gouvernance de l’entreprise, Paris : La Découverte (collection ‘Repères’), p. 22.
7 The border between legality and legitimacy is not as hermetic as this presentation might indicate. Moreover, legislation, which in the developed world has been almost exclusively favorable to shareholders, is not written in stone vitam aeternam. For instance, 38 US states have recognised in law the interests of stakeholders (above and beyond their status as shareholders). For further details on this topic, see HANKS J. L. (1994), From the Hustings: the role of states with takeover control laws, Mergers & Acquisitions, 29, 2.
suppliers or employees. These dependency relationships cannot be described in simple terms but imply, for example, a number of network and feedback effects.

In actual fact, it is the complexity of these relationships and the heterogeneity of their foundations that make the stakeholder construct so ambiguous. Hence the temptation for CG specialists, like THOMPSON, WARTICK and SMITH, to find refuge in extremely vague formulations that define stakeholders as “groups in relationships with an organization”\(^8\). As for theorists who take more straightforward positions, they usually come up with very different characterisations, as noted by WINDSOR\(^9\).

The first appearance of the stakeholder construct seems to be an internal memorandum by Stanford Research Institute in 1963\(^10\). At first, the term mixed up shareholders, employees, customers, suppliers, lenders and society in the broader sense of this term\(^11\).

I.1 A STRICT DEFINITION: VOLUNTARY PARTNERS

Tenants of a strict definition have subordinated the effect of acting in the capacity of a stakeholder to the existence of voluntary relationships with a firm, insofar as the legitimacy of stakeholders is based on the willingness to take risks rooted in contracts, exchange and law\(^12\).

This latter notion is central to most definitions, notably the one preferred by CLARKSON: ‘Voluntary stakeholders bear some form of risk as a result of having invested some form of capital, human or financial, something of value, in a firm. Involuntary stakeholders are placed at risk as a result of a firm’s activist. But without the element of risk, there is no stake’\(^13\).

\(^8\) THOMPSON, J.-K., WARTICK, S. L. and SMITH, H. L. (1991), Integrating corporate social performance and stakeholder management: implications for a research agenda in small business, Research in corporate social performance and policy, 12, page 209.

\(^9\) WINDSOR, D. (1992), Stakeholder management in multinational enterprises, BRENNER, S.N. & WADDOCK, S.A., Proceedings of the 3rd annual meeting of the International Association for Business and Society (Leuven, Belgium), 121-128.

\(^10\) See on this topic DONALDSON, J. (1992), Business Ethics: a European casebook, Academic Press Limited, pages 53-54: “the expression appears to have been originated by Robert K. MERTON in the 1950’s.”

\(^11\) FREEMAN, R.E. (1984), Strategic planning: a stakeholder approach, Boston: Pitman Publishing, p. 32.

\(^12\) See notably AGLE, B. R, MITCHELL, R. K. and WOOD, D. J (1997), Toward a theory of stakeholder identification and salience: defining the principle of who and what really counts, Academy of Management review, 22, 4, 862.

\(^13\) CLARKSON, M.B.E. (1994), A risk model of stakeholder theory, Proceedings of the 2nd Toronto Conference on stakeholder Theory, 5 (University of Toronto’s Centre for Corporate Social Performance & Ethics).
However, there are other criteria in addition to the assumption of risk. For instance, SAVAGE, NIX WHITEHEAD and BLAIR state that two attributes that are indispensable for identifying stakeholders: a legitimate claim; and the ability to influence a firm— to which AGLE et al responded that influence over a firm and legitimacy must be necessary attributes in any models used to identify stakeholders.

I.2 DEFINITIONS THAT CAN BE EXTENDED AD INFINITUM

Whereas partisans of a strict definition of stakeholders view volunteering as a necessary precondition, for MITCHELL et al or STARIK, it suffices that there is a potential relationship: ‘Those who are or might be influenced by, or are or potentially are influencers of, some organization’. This goes beyond the definition of FREEMAN for whom stakeholders are ‘groups without whose support the organization would cease to exist.’

CLARKSON has even used the expression of involuntary stakeholders to describe those who are subjected, against their own will, to risks generated by the firm. Similarly, ALKHAFAJI defines stakeholders as ‘groups to whom the corporation is responsible’.

These expressions constitute a clear displacement of definitional criteria compared to the narrower stakeholder conception, since they all infer a direct and deliberate relationship with a firm’s interests, be it in regards to the firm’s survival or the impact of its actions. Like

---

14 BLAIR, J.D, NIX, T.W., SAVAGE, G.T. and WHITEHEAD, C. J. (1991), Strategies for assessing and managing organizational stakeholders, *Academy of Management Executive*, 5, 61-75.
15 ‘Power and legitimacy are necessarily core attributes of a comprehensive stakeholder identification model’, AGLE, B.R., MITCHELL, R.K, WOOD, D. J, Toward a theory of stakeholder identification and salience: defining the principle of who and what really counts, *Academy of Management Review*, 22,4, page 863.
16 RING, P. S. (1994), Fragile and resilient trust and their roles in cooperative inter-organizational relationships, PASQUERO, J. & COLLINS, D., *Proceedings of the 5th Annual Meeting of the International Association for Business and Society*, San Diego, 107-113.
17 STARIK, M. (1998), Reflections on stakeholder theory, *Business & society*, 3382-131 (and Toronto Conference Proceedings, 89-95).
18 FREEMAN, R.E. (1984), *Strategic planning: a stakeholder approach*, Boston: Pitma Publishing, p. 31.
19 CLARKSON, M.B.E. (1994), A risk model of stakeholder theory, Proceedings of the 2nd Toronto Conference on stakeholder Theory (University of Toronto’s Centre for corporate social performance & ethics), 5.
20 AL KHAFAJI, A. F. (1989), *A stakeholder approach to corporate governance: Managing in a dynamic environment*, Westport: CT Quorum Books, page 36.
21 Notably BOWIE, Norman. (1988), The moral obligations of multinational corporations, LUPER-FOY S., *Problems of International Justice, Boulder Co. Westview Press*, 97-113; FREEMAN, R.E. and REED, D.L. (1983), Stockholders and stakeholders: a new perspective on corporate governance, *California Management Review*, 25 (2), 93-94; and NÄSI, J. (1995), What is stakeholder thinking? A snapshot of a social theory of the firm, NÄSI, J., *Understanding stakeholder thinking*, Helsinki: LSR-Julkasiut Oy, 19-32.
MITCHELL inter alia, the existence of latent stakeholders is now acknowledged. This is a considerable (and almost infinite) expansion of the term’s potential connotations.

The more radical supporters of the stakeholder approach have no qualms about asserting the ‘legitimate claims’ that (almost) everyone has on companies. This makes it particularly difficult to come up with a precise definition or structured typology for stakeholders. The benchmark text for the stakeholder approach is the study undertaken by FREEMAN\textsuperscript{22} in 1984 describing partners (stakeholders) as ‘Any group or individual who can affect or is affected by the achievement of the organization’s objectives’\textsuperscript{23}. This new definition, which would have a bright future, was a radical change since it broadened the scope of stakeholders from those whose situation is stake when the firm acts to those who have a stake in the firm. Basically, it transformed everyone into a stakeholder, and as STERNBERG maliciously noted, it included ‘Everyone, everything, everywhere’\textsuperscript{24}: Terrorists and Competitors\textsuperscript{25}, Vegetation and nameless sea creatures\textsuperscript{26} and generations yet unborn\textsuperscript{27}. Unquestionably, this goes a little bit far.

At the end of this brief literature review, it is clear that whereas the shareholder conception of CG is relatively monolithic and generally sees shareholders as a homogeneous class\textsuperscript{28}, the stakeholder approach is much more nebulous. A distinction can be made between primary and secondary partners, those with proprietary interests and/or an equity stake (actors who have voluntarily chosen to be involved) and those with an interest in less tangible assets, like contractors, resource suppliers, risks takers or anyone who influences an organisation.

\textbf{1.3 AN UNCERTAIN TYPOLOGY}

The full array of a company’s stakeholders can be depicted by concentric circles representing everyone gravitating in its close or distant orbit, from key shareholders to customers, employees, suppliers, local communities, national or international society as a whole (i.e. to

\begin{thebibliography}{99}
\bibitem{22} FREEMAN, R.E. (1984), Strategic planning: a stakeholder approach, Boston: Pitma Publishing.
\bibitem{23} FREEMAN, R.E. (1984), Strategic planning: a stakeholder approach, Boston: Pitma Publishing, p. 46.
\bibitem{24} STERNBERG, E. (1997), The Defects of Stakeholder Theory, Corporate Governance : An International review : Jan 1997, Vol.5 Issue 1, page 4.
\bibitem{25} FREEMAN, R.E. (1984), Strategic planning: a stakeholder approach, Boston: Pitma Publishing, p. 52.
\bibitem{26} According to STERNBERG, this means maritime creatures threatened by a company’s ocean activities.
\bibitem{27} The UK’s Cooperative Bank explicitly includes past and future generations in its list of stakeholders, \textit{cf}. KELLAWAY L., Stakeholders step up for the generation shuffle, \textit{Financial Times}, 17 March 1997, p. 16.
\bibitem{28} Which is not the case, as demonstrated in many studies on the divergent interests of small, large, long-term and other shareholders, one example being questions about shareholders’ equal rights when some are awarded a double vote to ensure their loyalty.
\end{thebibliography}
members worldwidem thus theoretically to the planet’s 6.5 billion inhabitants), future generations and, slightly more utopically, biodiversity.29

The different categories of stakeholders could also be classified into three main groups, in addition to shareholders. In a utilitarian vision, direct stakeholders’ corporate decisions affect the well-being of - in decreasing order - employees whose jobs are at risks, followed by the company’s business partners (i.e. suppliers, retailers, bankers and other creditors). Then come the indirect stakeholders, led by local communities, environmentalists and beneficiaries of socially responsible investments. Lastly come the more distant stakeholders, like future generations or biodiversity.

29 See ‘The co-operative bank’ in LASZLO C. (2003), The sustainable company: how to create lasting value through social and environmental performance, Island Press, chap. 8.
| All stakeholders |  |
|---|---|
| Shareholders | Shareholders |
| Direct stakeholders | Employees |
| | Suppliers, customers, bankers, other creditors |
| Indirect stakeholders | Local communities |
| Distant stakeholders | Future generations |
| | Biodiversity |

There is no use denying the superficial and fragile nature of these inevitably schematic attempts at rationalisation. Occasional shifts in the borders of stakeholder categories further complicate analysis, as if there were any need. Customers, for example, are often lumped in with a category of services (like management consulting) that are rendered by the co-producers of services sold by providers. Nor is any stakeholder subgroup monolithic. For example, the different banks with a direct or indirect interest in companies - like a firm’s advisory bank, the bank that lends it funds or the bank that manages its lead shareholders’ private wealth – do not all have the same interests. Indeed, these can even be antagonistic, as when a bank advises a party seeking to acquire a company through a hostile takeover.

This is why stakeholder identification has become an almost insurmountable obstacle for CG researchers, and why efforts at synthesizing these various elements have encountered so many contradictions. Not only are there a multitude of stakeholders (almost too many to be counted), but also each category pursues divergent and even antagonistic interests. The main weakness of the stakeholder approach to CG is the difficulty of building solid governance on such fragile foundations.

**II. OVERCOMING THE APORIA OF A STAKEHOLDER APPROACH AND THE CONSTRAINTS OF PURE SHAREHOLDER THEORY**

‘You don’t need to understand something to moralise about it.’

*Gilles DELEUZE, 21 December 1980 Lecture on Spinoza.*

The popularity of the stakeholder approach is easy to understand since every citizen is a stakeholder (using the broad definition of this term) in one or several firms. Of course,
politicians have been aware of this popularity, since citizens vote, even if companies do not\textsuperscript{30}. The whole trend has been reinforced by the wave of Corporate Social Responsibility and Sustainable Development, phenomena confused all too easily in people’s minds\textsuperscript{31}.

The absurdist approach reveals a few prohibitive obstacles to stakeholder theory’s further development. Imagine that it is possible to construct a CG theory based on stakeholder interests\textsuperscript{32} once the aforementioned obstacles have been overcome (via contortions, it is true, that can be very hard to accept). At this stage, two objections would arise, with both being equally apt to destroy CG theory.

\section*{II.1 The Impossible Arbitration of Different Stakeholder Interests}

The tragic consequences of certain dramatic situations that have accentuated social upheavals and brought about emergency legislation exemplify this conundrum. There is no doubt that stakeholders face residual risk, as witnessed by the METALEUROP affair in France or the terrible events at BHOPAL in India\textsuperscript{33}. The legal environment must define rules for protecting stakeholders, and it is naturally up to lawmakers to assume their responsibilities\textsuperscript{34}. The real question is whether firms should go further than they have been asked to and add the protection of stakeholder interests to the mission they fulfil.

\textsuperscript{30} For example, at a meeting at Charleville-Mézières (Northern France) during the 2007 presidential elections, Segolène ROYAL was quoted in \textit{Le Monde} as calling for ‘a fair economic order’ in which all companies would be ‘accountable’ for their actions. Similarly, the EADS delegate of France’s FO labour union, J.-F. KNEPPER, reacted to employees receiving a 2.5\% wage hike and €500 bonus at a time when shareholders were voting their annual dividend – a series of events that culminated in May 2007 strike - with ‘stupefaction that these kinds of decisions are being made even as we are being told that company is having problems’. F. HOLLANDE of the French Socialist Party called this a ‘provocation’ in \textit{Les Echos} (7 May 2007, p. 21). These two examples do not represent the whole of the French political spectrum, with right-wingers also expressing similar indignation.

\textsuperscript{31} A significant paradox is that firms are generally deprived of the rights usually associated with the kind of stake they have in governments and policies, i.e. they are affected by governmental decisions but cannot vote. All they can do is hope that the general climate is as business friendly as possible, since the harmonious development of the economy is naturally in the interest of a country and its government, which is accountable to citizens for things like purchasing power and jobs. Like taxpayers, firms also pay taxes without receiving any direct recompense.

\textsuperscript{32} This intimates of course that the problems in defining such stakeholders have been resolved once and for all, which as been shown is anything but true.

\textsuperscript{33} A toxic cloud following a 3 December 1984 explosion at the UNION CARBIDE chemicals plant in Bhopal (India) caused the death of ca. 10,000 persons and injured a further 200,000. India first claimed $2.6 billion from the firm before settling in 1989 for $470 million to facilitate inwards investment from American sources.

\textsuperscript{34} As FRIEDMAN wrote, ‘The existence of a free market does not of course eliminate the need for government. On the contrary, government is essential both as a forum for determining the ‘rules of the game’ and as an umpire to interpret and enforce the rules decided on.’ FRIEDMAN M. (1962), Capitalism and Freedom, Chapter I.
But what are ‘stakeholder interests’? This notion promises to be just as hard to define as the stakeholder concept itself. Asides from an ironic comment by JENSEN about the interests of terrorists and blackmailers\textsuperscript{35}, which groups’ interests should firms take into consideration? Insurmountable problems arise very quickly at this level. For instance, which employees should be viewed as stakeholders - permanent staff members, people on short-term contracts, temps, interns, potential recruits and/or pensioners? How far can this go? What about when people belong to several stakeholder categories at once, i.e. they can be both customers and employees, raising questions about the breakdown between these two roles. Even more complicated is figuring out who is supposed to speak on future generations’ behalf.

The difficulties in defining the interests of a category of stakeholders are compounded ad infinitum when extended to the interests of multiple sub-groups. Much in the same way that stakeholders are not a homogeneous category, neither are subgroups of stakeholders. Take employees, for example: some want to earn more; others want to work less. Moreover, different stakeholders can have conflicting interests, for instance, with higher wages for employees implying higher prices for customers. Even within a given group, wage hikes for some might mean that fewer new recruits will be hired and even that current employees will have to be fired. The question is important since — as shown by the example of TOTAL and its Toulouse plant, built against the will of local residents — the interests of indirect stakeholders are sometimes distinct from those of direct stakeholders, not to mention shareholders.

The big question, then, is which criteria should determine the necessary arbitrages between different categories making conflicting demands? How can priorities be ascertained when each interest group claims that it is the most legitimate and seeks to maximise its advantages by capturing entrepreneurial rents? The only possible answer is that in the stakeholder conception of CG, the advantages gained by some parties are matched by the disadvantages besetting others. In turn, this raises questions about how this might happen.

\textbf{II.2 STAKEHOLDER THEORIES LEAD TO AN EXCESSIVE REINFORCEMENT OF EXECUTIVE POWER, WRONGS SHAREHOLDERS AND UNDERMINES CORPORATE PERFORMANCE}

\textsuperscript{35} JENSEN, M. (2001), Value Maximization: Stakeholder Theory and the Corporate Objective Function, \textit{Journal of applied corporate finance}, 14, 3, Fall 2001, page 9.
The stakeholder approach tends to make CG meaningless when based on the defence of the firm. This is due to the fact that the spirit of this paradigm – balancing benefits for all partners – excludes any objective that might benefit one group of stakeholders in particular. Instead of just maximising shareholder value in the long run, customers must also receive greater value, employees further advantages, the homeless better housing and all poverty eliminated. Paying attention to stakeholders does not mean being accountable to them - being accountable to everyone means being accountable to no one.

Far from constituting a good method of governance, stakeholder theories are counter to the aims of CG and undermine its disciplinary mission by increasing executives’ power excessively. Indeed, the argument that all stakeholders’ interests must receive consideration means that executives and employees – stakeholders themselves – must incorporate their own interests as well. This can generate a serious conflict of interests, as witnessed in overly generous stock options schemes or the exorbitant advantages that executives and their own stakeholders sometimes accrue.

This temptation will be all the stronger if loyalty towards the company itself is no longer required from executives all employees - as is the case in the shareholder vision - but starts to blur due to a lack of clearly identified beneficiaries. Board Members and executives would then be left without clearly defined objectives and could present themselves - behind the cover of an ostensible desire to protect stakeholders’ interests - as defenders of stakeholders versus shareholders, trying thereby to create or expand room to manoeuvre for themselves. Ultimately, stakeholder theory could lead to a dictatorship of executives (as surely as Marxist theory seeking a dictatorship of the proletariat led to the nomenklatura). In short, CG’s stakeholder approach tends to destroy the very basis of CG.

Lastly, the stakeholder approach undermines ownership rights, the basis of mixed stock corporations. It denies a firm’s owners the right to dispose freely of their goods, by adding to current law a number of stipulations for which no one was asking, much in the same way as it

---

36 STERNBERG E. (1998-2001), The stakeholder concept: a mistaken doctrine, University of Leeds Centre for business and professional ethics. P. 16

37 A poignant example of the excesses of a stakeholder orientation is the story of the executive who used to fly his dog around in a company airplane, or the way ENRON’s executives used to pay enormous sums to charities that had little to do with the company’s activity.
largely neglects the obligations that Board Members (agents) have towards shareholders. To a certain extent, this stakeholder model seems like a belated avatar of Marxist thinking seeking to undermine the very principles of capitalism. This is in line with the analysis of 1976 Nobel Prize winner Milton FRIEDMAN, in a still topical essay published in 1962: ‘Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible. This is a fundamentally subversive doctrine. If businessmen do have a social responsibility other than making maximum profits for stockholders, how are they to know what it is? Can self-selected private individuals decide what the social interest is?’

II.3 The limitations of purely shareholder-based legitimacy

If stakeholder theories are not credible, what missions should Board Members fulfil? Their role is circumscribed by the mandates that shareholders delegate to them, thus it is to shareholders that they are supposed to be accountable. But being appointed by shareholders does not necessarily mean being accountable to them alone or even to them as a priority. What would happen if the interests of the company and its owners were no longer aligned, and if shareholders started to act contrary to a company’s interests? Board Members would likely suffer from a conflict of interests, or worse, from a Cornelian conflict of loyalties.

What is the first duty of a Board Member, and towards whom does s/he owe this duty? In certain instances, the answer appears obvious, like when a large shareholder tries to appropriate an organisational rent to everyone else’s detriment. But what if one shareholder suddenly goes crazy or is overtaken by Machiavellian desires, sabotaging a firm to defend the interests of a rival company? Should CG protect the company against the shareholder who decreed this action or else – to perpetuate the theoretical fiction - protect the shareholder

38 FRIEDMAN M. (1962), *Capitalism and Freedom*. FRIEDMAN liked writing in the curt and aggressive style that characterised the Chicago School. He felt that a company is ‘instrument between the hands of its shareholders’ so that ‘in a free economy, there is one and only one social responsibility of business–to use it resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.’
39 Note that this person is the representative of all of the firm’s shareholders, and that it is up to him/her to verify that the company’s decisions do not benefit some shareholders to the detriment of others.
40 An analogy with official auditors springs to mind. They are appointed by a company to an oversight function where they control and validate its accounts. The same applies to Hedge Funds whose Board Members are named for their accounting or sectorial competencies but who must then defend the sole interests of the fund, which in this instance happen to be strictly aligned, at least in the short term, with the interests of shareholders.
41 This hypothesis is not only theoretical. A 2006 example was when the ACAS pension fund suicidally requested such high returns from SYNODY S that it ended up asphyxiating the company.
against him/herself? All of which explains why Board Members must ensure that no conflicts of interest exist between their different mandates.

Outside of these extreme cases, a frequent point of discord between shareholders and guarantors of a company’s interests resides in the timeframe used to assess performance. People holding shares in a listed company tend to focus on short-term financial results, whereas a well governed company seeking long-term success and truly sustainable development will aim to satisfy customers, increase employee responsibility and empowerment and create stable, trust-based supplier relations, all with a view towards generating value for the firm in the long run.

The general interest of a firm is not always equal to the sum of shareholders’ (sometimes incoherent) personal interests. This means that the social interest of a company is distinct from the interest of its shareholders, even if in practice - *grosso modo*, it could be said – such interests are very often identical. A firm is not a toy for shareholders to play with.

### III Enlightened Shareholder Theory and its Practical Implications for CG

‘The hard thing for a honest man is not to do his duty but to know it.’

*Louis de Bonald, 1796, Considérations sur la Révolution française.*

As key figures in CG, Board Members have amongst other duties what might be called a duty of loyalty towards shareholders. The shareholder conception of CG is not so simple where a company’s superior interest is at stake. Its stakeholder aspect also offers a few lessons about the best ways of improving a firm’s performance.

#### III.1 Enlightened Shareholder Theory

Stakeholder theories may be a dead end, but it is clear that when a company adopts a radical strategy geared solely towards the defence of its shareholders’ interests, by so doing it is

---

42 Remember the excellent definition of LITTRE, for whom ‘loyalty means obeying the laws of honour and integrity’.
likely to wrong many stakeholders. In turn, this can be damaging to the firm. Thus, it is the firm’s clearcut interest – and this alone - that forces firms to think about their stakeholders.

In the shareholder perspective, the goal of CG is to focus on the company, thus on stakeholders only to the extent that this is required by law and by concerns for the firm’s reputation, credibility and image. Therefore, the question is at what point this concern for certain stakeholders is a good thing for a firm’s image – and inversely, when does it become detrimental to shareholders and advantageous not to the firm but to other stakeholders, notably senior executives.

The stakeholder vision of CG is not systematically incompatible with shareholder interests. Analysis of the different stakeholder doctrines can even be useful to the construction of a shareholder-based theory integrating certain interesting element derived from stakeholder theories.

There are at least two merits to this stakeholder construct. The first is a common sense observation that people will be much more involved in a process if they consider that they have a financial or other stake in it. This is an issue of motivation for both employees and executives. The second merit of the stakeholder concept is to recall the complexity of the world, to understand that the relationships of an organisation as sophisticated as a company are more than mere head-to-head confrontations with its shareholders. In effect, a firm that totally ignores its customers or critics is in danger. It is obvious that for a firm, protecting its image is a win-win situation. As several studies have demonstrated, maximising shareholder wealth does not contradict the satisfaction of other partners.

The Enlightened shareholder theory being proposed here is based on the work that JENSEN did in ‘Value Maximization, Stakeholder Theory and the Corporate Objective Function.’ This

---

43 It is useful to re-read JENSEN on this point. ‘We cannot maximize the long-term market value of an organization if we ignore or mistreat any important constituency. We cannot create value without good relations with customers, employees, financial backers, suppliers, regulators and communities.’ JENSEN, Michael. (2001), Value Maximization: Stakeholder Theory and the Corporate Objective Function, Journal of applied corporate finance, Fall, 201, page 16.

44 The most important issues may not even be financial. See FREUD and MASLOW.

45 For example, FREEDMAN, R.E . and PATTEN, D. (2004), Evidence on the pernicious effect of financial report bizarre environmental disclosure, Accounting Forum, 28, 1; or CORMIER, D., MAGNAN, M. and MORARD, B. (1993), The impact of corporate pollution on market valuation: some empirical evidence, Ecological Economics, 8, 2.
study criticises stakeholder theories because they offer no criteria for choosing – and measuring the choice - of different stakeholders. It considers that firms cannot maximise value if they ignore stakeholders’ interests. Lastly, it offers an ‘Enlightened Value Maximization’ or ‘Enlightened stakeholder theory’ that uses most of the structure of stakeholder theory but accepts the maximisation of the firm’s long-term value as the criterion for choosing between different stakeholders.

The approach on offer here is the opposite of JENSEN’s much loved ‘Enlightened stakeholder theory’, which is based on stakeholders and therefore fragile for the aforementioned reasons. This is replaced with an ‘Enlightened shareholder theory’ based on shareholder reasoning but integrating useful elements from stakeholder theories as well as more recent contributions from cognitive theory. A good image would be to say that Enlightened shareholder theory has been doubly enlightened by stakeholder theory and by cognitive and behavioural theory.

It is therefore a good idea to broaden the initial theoretical framework. Starting with a basic disciplinary vision that is strongly geared towards shareholders, the new goal is to integrate cognitive contributions. This should help to achieve a synthesis: something that WINTER

---

46 ‘In order to maximize value, corporate managers must not only satisfy, but enlist the support of, all corporate stakeholders – customers, employees, managers, suppliers, local communities’, JENSEN, M. (2001), Value Maximization: Stakeholder Theory and the Corporate Objective Function, Journal of applied corporate finance, 14, 3, page 9.

47 ‘Enlightened value maximization is identical to what I call Enlightened stakeholder theory ... (It) uses much of the structure of stakeholder theory but accepts maximization of the long run value of the firm as the criterion for making the requisite tradeoffs among its stakeholders. Enlightened value maximization, while focusing attention on meeting the demands of all important corporate constituencies, specifies long-term value maximization as the firm’s objective’, JENSEN, Michael. (2001), Value Maximization: Stakeholder Theory and the Corporate Objective Function, Journal of applied corporate finance, Fall, 2001, page 9.

48 Critical readers will have correctly discovered similarities between our approach to JENSEN’s Enlightened stakeholder theory and the attitude adopted by MARX, who decided to reverse the order of priorities found in Hegelian theory (which he considered upside down) to get it to work.

49 It is not possible within the framework of the present paper to go more deeply into the contributions of cognitive theories. For summary of the latest thinking, it is useful to read CHARREAUX, G. (2004), Les Théories de la gouvernance: de la gouvernance des entreprises à la gouvernance des systèmes nationaux, Cahier du FARGO, 1040101, 14; CHARREAUX & WITZ, Discipline ou compétence? L’apport des perspectives cognitive et comportementale à la compréhension des mécanismes de gouvernance, Revue Française de gouvernance d’entreprise, 1er semestre 2007, n°1, pages 211-216.

50 In Le Monde dated 8 January 2000 (before the dot.com bubble burst), a management expert as wise as Peter DRUCKER said that ‘1985 was a year of revolution for companies in the United States, with shareholder value becoming the criterion of choice. This was both necessary and healthy. Indeed, it was exceedingly healthy for the American economy in the short run. However, a balance must be found between the short and long term.’

51 Firms exist because they are more efficient than the market at coordinating collective learning processes, FOSS, N. J. (1996), Firms, incomplete contracts and organizational learning, Human systems management, 15, 1, 17-26.
FOSS considers improbable due to the questionable compatibility of disciplinary and cognitive theories; but that CHARREAU moustrongly welcomes.

III.2 THE LONG-TERM INTEREST OF THE FIRM AS THE ULTIMATE GOAL OF CG

Even if shareholders’ short-term interest can differ from a firm’s interest, in the long run it seems obvious that the two will converge. It is the notion of legal trust that best defines actors’ responsibilities. In France, a 24 July 1966 law on commercial companies stresses an institutional approach where the firm bears a social interest distinct from shareholders’ interests. This framework offers great legal security, but it is too restrictive and runs contrary to the imperatives of competitiveness.

Thus, according to the VIENOT I report, the idea behind governance is to discover in ‘the sole interest of the company concerned – viewed as the superior interest of a legal entity – the existence of an autonomous economic agent, pursuing its own goals, ones distinct from the goals of shareholders, employees, creditors, suppliers and customers but corresponding to their joint general interest. The purpose is to ensure the prosperity and continuity of the company’. It is specifically this objective that a Board of Directors – obliged under France’s Commercial Code to ensure the social interests of the company – is supposed to promote by ensuring that it does not remain a moot point and/or pure legal fiction.

These pious statements of intent must not hide the concrete and very real difficulties contained in the notion of a company’s social interests, which can be difficult to circumscribe. Questions pertaining to measurements and standards of corporate performance are a topic of heated debate. *Grosso modo* and where listed companies are concerned, the preferred benchmark has been long-term share performance (capital gains and dividends).

III.3 A FEW PRACTICAL IMPLICATIONS OF ENLIGHTENED SHAREHOLDER THEORY

52 For further details on these still unproductive attempts at a synthesis, see: WINTER S.G. (1993), On Coase, competence and the corporation, WILLIAMSON O.E. and WINTER S.G., *The nature of the firm*, Oxford: Blackwell, 179-195; FOSS, N. J. (1996), Capabilities and the theory of the firm, *Revue d’économie industrielle*, 77, 7-28; or FOSS K. and FOSS N. J. (2000), The knowledge-based approach and organisational economics: how much do they really differ? And how does it matters?, FOSS N.J. and MAHNKE V., *Competence, governance and entrepreneurship*, Oxford University Press, 55-79.

53 MEDEF-AFEP (1995), *Rapport VIENOT I*, page 8. Note that the first French code, published in 1995, expressed a marginal position in good practice guidelines, one that stressed shareholder interests or did not distinguish between them and social interests.
Enlightened shareholder theory leads to a new definition for CG. The classical definition of the CADBURY report – CG involves ‘the implementation of a system by means of which companies are directed and controlled’ – can now be replaced with the idea of a ‘system comprised of all of the internal mechanisms enabling shareholders to be informed of the proper functioning of their company, controlling it through their AGMs and by the powers they delegate to the Board of Directors, while ensuring corporate strategy in compliance with existing laws in the long-term interest of the firm.’

In this new theoretical framework, the first obligation of Board Members becomes clear - at all times and places, they must defend the firm’s long-term social interests. This notion clarifies the duties of Board Members but also gives them a great deal of room to manoeuvres. Even with a well-defined objective, CG offer Board Members margin for interpretation and a central role not only in this disciplinary sphere but also and above all in the field of strategy.

Another practical consequence concerns the composition of the Board of Directors, which must be chosen very carefully. Not only must the Board be competent in accountancy and company law and have perfect knowledge of a firm’s organisation, operations and sector, it also has to be able to assess the risks of a firm’s activity, for itself and for its stakeholders. What is new is the knowledge that a Board needs about corporate culture. The new theory - and the definition of CG that derives from it - has practical consequences, including the need for Board Members to be aware of cultural or behavioural biases. This theory affects the prescriptions that determine a Board’s composition, since to defend a firm’s long-term interests, the Board will require different kinds of expertises and must be capable of integrating and understanding a company’s culture.

**CONCLUSION**

---

54 Practices like Board of Directors meetings outside of the presence of executives, can for example reduce biases like submission to authority. With regards to these biases, read HIRIGOYEN, Biais comportementaux et mécanismes régulateurs dans la succession de l’entreprise familiale, *Revue française de Gouvernance d’entreprise*, 1st semestre 2007, n°1, pages 67-93.
At the end of this paper, the main problem of governance and its finality appear clearly to relate to the legitimacy of actors and more particularly to the role of Board Members, who are the key actors in governance matters. For whom do Board Members work? To whom should they be accountable? Above all, who are the ultimate beneficiaries of their governance? It has been shown that stakeholders are not the main targets at this level. Shareholders do benefit at times, but not always. In reality, it is the long-term interest of the firm that must be the aim of CG and the constant concern of Board Members. This is the finality of the *Enlightened shareholder theory* whose foundations the present paper has attempted to outline.

**REFERENCES**

AGLE, Bradley. R. MITCHELL, Ronald K. et WOOD, Donna. J. (1997), Toward a theory of stakeholder identification and salience: defining the principle of who and what really counts, *Academy of Management review*, 22, 4, 862.

AL KHAFAJI, A. F. (1989), *A stakeholder approach to corporate governance: Managing in a dynamic environment*, Westport: CT Quorum Books.

BLAIR, J. D., NIX, T. W, SAVAGE, G. T. et WHITEHEAD, C. J. (1991), Strategies for assessing and managing organizational stakeholders, *Academy of Management Executive*, 5, 61-75.

BOWIE, N. (1988), The moral obligations of multinational corporations, in LUPER-FOY S., Problems of international justice, *Boulder Co. Westview Press*, 97-113.
CHARREAX, G. (2004), Les Théories de la gouvernance : de la gouvernance des entreprises à la gouvernance des systèmes nationaux, Cahier du FARGO, 1040101, 14.

CHARREAX, G, WIRTZ, P. Discipline ou compétence ? L’apport des perspectives cognitive et comportementale à la compréhension des mécanismes de gouvernance, Revue française de gouvernance d’entreprise, 1er semestre 2007, n°1, pages 211-215

CLARKSON, M.B.E. (1994), A risk model of stakeholder theory, Proceedings of the 2nd Toronto Conference on stakeholder Theory (University of Toronto’s Centre for corporate social performance & ethics), 5.

CORMIER, D., MAGNAN, M. et MORARD, B. (1993), The impact of corporate pollution on market valuation: some empirical evidence, Ecological Economics, 8, 2.

DAILY, C.M. et DALTON, D.R. (2003), Introduction to special topic, Academy of management, 28-9, 371-382.

DONALDSON, J. (1992), Business Ethics: a European casebook, Academic Press Limited.

FAMA, E. F. (1980), Agency problems and the theory of the firm, Journal of Political Economy, 88, 2, 295.

FOSS, N. J. (1996), Firms, incomplete contracts and organizational learning. Human systems management, 15, 1, 17-26.
FOSS, N. J. (1996), Capabilities and the theory of the firm, Revue d’économie industrielle, 77, 7-28.

FOSS, K. et FOSS, N. J. (2000), The knowledge-based approach and organisational economics: how much do they really differ? And how does it matters?, in FOSS, N. J. et MAHNKE, V., Competence, governance and entrepreneurship, Oxford University Press, 55-79.

FREEDMAN, M. et PATTEN, D. (2004), Evidence on the pernicious effect of financial report bizarre environmental disclosure, Accounting Forum, 28, 1.

FREEMAN, R.E. (1984), Strategic planning: a stakeholder approach, Boston: Pitma Publishing.

FREEMAN, R.E. et REED, D.L. (1983), Stockholders and stakeholders: a new perspective on corporate governance, California Management Review, 25 (2), 93-94.

FRIEDMAN, M. (1962), Capitalisme et liberté (traduction française LAFFONT R., 1971).

HANKS, J. L. (1994), From the Hustings: the role of states with takeover control laws, Mergers & Acquisitions, 29, 2.

JENSEN, M. (2001), Value Maximization, Stakeholder Theory and The corporate Objective Function, Journal of applied corporate finance, 14, 3, Fall 2001.
HIRIGOYEN, G, Biais comportementaux et mécanismes régulateurs dans la succession de l’entreprise familiale, *Revue française de gouvernance d’entreprise*, 1er semestre 2007, n°1, pages 67-92.

KELLAWAY, L., Stakeholders step up for the generation shuffle, *Financial Times* du 17 mars 1997, p. 16.

LASZLO, C. (2003), *The sustainable company: how to create lasting value through social and environmental performance*, Island Press.

*Les Echos* (7 mai 2007), p. 21.

MEDEF-AFEP, (1995), *Rapport VIENOT I*.

NÄSI, J. (1995), What is stakeholder thinking? A snapshot of a social theory of the firm, in NÄSI, J., *Understanding stakeholder thinking*, Helsinki: LSR-Julkasit Oy, 19-32.

PEREZ, R. (2003), *La Gouvernance de l’entreprise*, Paris : La Découverte (collection « Repères »).

RING, P. S. (1994), Fragile and resilient trust and their roles in cooperative inter-organizational relationships, in PASQUERO, J. & COLLINS, D., *Proceedings of the 5th Annual Meeting of the International Association for Business and Society*, San Diego, 107-113.

SCHLEIFER, A. et VISHNY, R. W. (1995), A survey of corporate governance, *The Journal of Finance*, Vol, LII, n°2, June 1997, pages 737-785.
STARIK, M. (1998), Reflections on stakeholder theory, *Business & society*, 3382-131 (et Toronto Conference Proceedings, 89-95).

STERNBERG, E. (1997), The Defects of Stakeholder Theory, *Corporate Governance : An International review* ; Jan 1997, Vol.5 Issue 1, page 3, 8 pages.

THOMPSON, J.-K., WARTICK, S.L. et SMITH, H.L. (1991), Integrating corporate social performance and stakeholder management: implications for a research agenda in small business, *Research in corporate social performance and policy*, 12, 204-230.

WINDSOR, D. (1992), Stakeholder management in multinational enterprises, *in BRENNER, S.N. & WADDOCK, S.A.*, Proceedings of the 3rd Annual meeting of the International Association for Business and Society (Leuven, Belgique), 121-128.

WINTER, S.G. (1993), On Coase, competence and the corporation, *in WILLIAMSON, O.E. et WINTER, S.G.*, *The nature of the firm*, Oxford: Blackwell, 179-195.