THE SOCIAL RESPONSIBILITY OF CORPORATIONS AND HOW TO MAKE IT WORK FOR YOU

by John Hasnas[*]

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Are you looking for a promising new vocation? Tired of the humdrum routine of life as an investment banker, corporate attorney, or electrical engineer? Want to get in at the ground level on a field with unlimited growth potential? Then you should consider a career as a business ethicist.

Wait a minute. A *business ethicist?* Aren't they the butt of all those jokes? You know, "I looked up the word oxymoron in the dictionary and it said 'see business ethics.'" Or "One undergraduate says to another undergraduate, 'I just signed up for Business Ethics 101.' The other responds, 'It must be a short course.'"

Well, after years of having to listen to that line about business ethics being a contradiction in terms, business ethicists are finally laughing all the way to the bank. For the business ethics business is booming. Since 1990, there have been approximately 100 substantial corporate contracts for outside ethics consultants each year, with about 25 to 30 major companies spending more than $50,000 and five spending more than $1 million. Ethicists can make from $25,000 to $150,000 a pop performing ethical audits of corporations and from $1,500 to $4,500 a day running ethics training programs. As Timothy C. Mazur, a veteran ethics consultant, has expressed it, "Our market has just exploded. All of a sudden huge companies need ethics training fast." Before too long, he adds, he and his fellow ethics consultants "will be driving BMW's instead of Honda Preludes."[1]

What accounts for this rash of corporate interest in ethics? Have hard-boiled, practical-minded executives suddenly seen the light? Has the Age of Aquarius finally dawned? Or is there a

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[1]Rorie Sherman, *Ethicists: Gurus of the 90's*, NAT'L L. J., Jan. 24, 1994, at 1, 30-31. This article is also the source of the financial data contained in this paragraph.

more mundane explanation? To suggest that the latter may be the case, let me tell you a story. I'll call it "A Brief History of the Social Responsibility of Corporations."

Before beginning, I should say a word about what this phrase means. To claim that corporations have social responsibilities is to claim that corporations have moral obligations to expend funds for socially beneficial purposes even when such expenditures have not been authorized by the stockholders and are not in the financial interest of the business. Thus, in telling a story about the social responsibility of corporations, I am not discussing either cases in which the stockholders have specifically authorized the expenditure of funds for social purposes, e.g., non-profit corporations such as the Red Cross or the Nature Conservancy and for-profit corporations in which the stockholders vote for "socially conscious" investing, or those in which such expenditures are made in the belief that they will increase the firm's profitability, e.g., through the creation of customer goodwill. Rather, I am discussing the claim that corporations are obligated to make such expenditures when neither is the case.

THE STOCKHOLDER THEORY OF CORPORATE RESPONSIBILITY

Once upon a time, it was believed that corporations had no social responsibilities. This was because corporations were viewed as arrangements by which one group of people, the stockholders, advanced capital to another group, the corporate managers, to be used to realize certain specified ends. Under this view, the managers were "agents" of the stockholders. They were empowered to manage the money advanced by the stockholders, but were bound by their agency relationship to do so exclusively for the purposes delineated by their stockholder principals. The existence of this fiduciary relationship implied that managers could not have an obligation to spend corporate funds in ways that had not been specifically authorized by the stockholders regardless of the social benefits that could accrue from doing so. Of course, both the stockholders and the managers were free to spend their personal funds on such projects, but when the managers were functioning in their corporate capacity, they had a duty not to divert corporate funds away from the purposes expressly authorized by the stockholders, which were usually

limited to maximizing the return on investment. Therefore, there could be, as Milton Friedman has expressed it, "one and only one social responsibility of business--to use its resources and engage in activities designed to increase its profits so long as it . . . engages in open and free competition, without deception or fraud."[2]

This view, known as the stockholder theory of corporate responsibility, was supported by a very simple moral argument. The stockholders advanced their money on the condition that it be used in accordance with their wishes. If corporate managers accepted the money on this condition and then proceeded to spend it to accomplish social goals not authorized by the stockholders, they would be spending other people's money without their consent, which is wrong.

THE STAKEHOLDER THEORY TO THE RESCUE

As you may imagine, this was not a very popular theory in academic circles. If corporations had no social responsibilities, what would there be for business ethics professors and consultants to do? This was clearly an intolerable situation which demanded a remedy. Fortunately, one was at hand in the form of the "stakeholder theory."

The stakeholder theory was originally a theory of *management*. It held that effective corporate management required "simultaneous attention to the legitimate interests of all appropriate stakeholders."[3] A stakeholder is anyone who has "a stake in or claim on the firm," and has been defined to include "those groups who are vital to the survival and success of the corporation,"[4] i.e., its stockholders, customers, employees, suppliers, management, and the local community. Thus, the stakeholder theory, as originally conceived, contended that a corporation's financial success could best be achieved by giving the interests of all stakeholders equal

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[2]MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962).

[3]Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, Implications*, ACADEMY OF MANAGEMENT REVIEW (forthcoming).

[4]*See* William M. Evan & R. Edward Freeman, *A Stakeholder Theory of the Modern Corporation: Kantian Capitalism, in* ETHICAL THEORY AND BUSINESS 97, 100 (Tom L. Beauchamp & Norman E. Bowie eds., 3d ed. 1988).

consideration and adopting corporate policies which produce the optimal balance among them.

As a management theory, the stakeholder approach implies no social responsibilities for corporations. It simply describes a method for improving corporate performance. However, if it could be converted from a management theory to an ethical theory, if an argument could be found that showed that corporate managers have a moral obligation to act in the interest of stakeholders other than the stockholders even when this would not financially benefit the firm, then it would become a true theory of corporate social responsibility. This is precisely what happened.

STAKING A CLAIM TO AUTONOMY

The argument that the stakeholder theory embodied the ethical obligations of managers was based upon Kant's principle of respect for persons. This fundamental ethical principle holds that every human being is entitled to be treated not merely as a means to the achievement of the ends of others, but as a being valuable in his or her own right, as an end in himself or herself. But to respect someone as an end is to recognize that he or she is an autonomous moral agent with free will and desires of his or her own. Thus, the principle of respect for persons requires respect for individual autonomy.

The stakeholder theorists applied this to the world of business by claiming that corporations are bound to respect this principle as much as anyone else. Thus, corporations may not treat their stakeholders merely as means to corporate ends, but must recognize that as moral agents, all stakeholders are entitled "to agree to and hence participate (or choose not to participate) in the decisions to be used as such,"[5] and, therefore, that they are entitled to "participate in determining the future direction of the firm in which they have a stake."[6] But, because it is impossible to consult with all of a firm's stakeholders on every corporate decision, this participation must be indirect. Therefore, the firm's management has an obligation to "represent" the stakeholders' interests by giving each equal consideration and managing the

[5] *Id.*

[6] *Id.* at 97.

corporation so as to achieve an optimal balance among them. As a result, corporate management has a fiduciary relationship not only to the stockholders, but to all the stakeholders, and may often be required to sacrifice the stockholders' interests to those of other stakeholders.

This argument was just what the doctor ordered. It not only derived corporate social obligations from the libertarian principle of respect for persons, but these obligations were so amorphous (What does it mean to "keep the relationships among stakeholders in balance,"[7] anyway?) as to guarantee the need for countless academic articles to explain precisely what they required. In fact, its only drawback was that it was clearly unsound.

PULLING UP STAKES

There is nothing wrong with the claim that corporations are morally bound to respect the autonomy of their stakeholders, but this implies neither that stakeholders are entitled to a say in corporate decision-making nor that the corporation must be managed in their interest. The fact that the stakeholders must agree to be "used" by the corporation implies only that no stakeholder may be forced to deal with the corporation without his or her consent. Although this certainly means that corporations are morally obligated to honor the contracts they enter into with their customers, employees, suppliers, and managers and to live up to any representations they freely make to the local community, it does not mean that these stakeholder groups are entitled to more than they freely bargained for.

Employees, suppliers, and customers negotiate for and autonomously accept wage and benefit packages, purchasing arrangements, and sales contracts, respectively. If managers were to break the agreement they have with the stockholders to maximize return on investment in order to provide one or more of these groups with benefits in excess of those they freely accepted, they would not be respecting the autonomy of these groups, but violating that of the stockholders. Thus, far from being entailed by the principle of respect for persons, the stakeholder theory requires its violation.

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[7] *Id.* at 103.

A FALLACY WHOSE TIME HAS COME

The fact that the stakeholder theory violates its own fundamental premise has never been much of a hindrance to its acceptance, for it was a fallacy whose time had come. For the last two decades, it has simply been ideologically unacceptable to argue that corporations could be ethically bound to "selfishly" pursue profit or that it is wrong to force those wealthy enough to purchase stock to expend funds to benefit downtrodden workers, local communities, or society in general. The stakeholder concept was so popular that in the late '70's and early '80's several corporations voluntarily amended their charters to permit managers to base their business decisions on their effects on groups other than the stockholders. This was followed by the advent of corporate "constituency" statutes which permitted (and sometimes required) corporate managers to consider the interests of employees, customers, suppliers, and communities in making business decisions. Although originally adopted as anti-takeover, rather than ethics, measures (the statutes allowed corporate management to escape its fiduciary duty to stockholders to accept generous buy-out offers by declaring that doing so would not be in the interests of one or more of the other stakeholder groups), these statutes have, to date, enacted the stakeholder theory into law in twenty-nine states.[8]

A HAPPY ENDING

The triumph of the stakeholder theory had a profound impact on the way corporations were viewed. The widespread acceptance of the idea that corporations had ethical obligations to serve the interests of the wider society made it possible to ascribe moral characteristics to corporations themselves, rather than merely to the individuals who comprise them. Corporations which met their obligations were described as having a good corporate character or being good corporate citizens; those that did not, as socially negligent. It now made sense to speak in terms of corporate culpability.

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[8]For a useful discussion of these statutes, *see* Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 (1992).

This had a major impact on the Federal Sentencing Guidelines for Corporations which were designed to revise and regularize the fines that could be assessed to corporations convicted of violating federal law. The Guidelines, which took effect in 1991, drastically increase these fines above previous levels, but allow for significant reductions for corporations that have demonstrated "good citizenship" as determined by a "culpability score." To receive a favorable culpability score, a corporation has to have an "effective" program to discourage illegal behavior by the firm's employees; i.e., an ethics training program.[9] The financial difference this can make is so great that one expert has stated that it would be professional malpractice for corporate counsel to fail to recommend such a program.[10]

Now, when we consider that it is ethicists who supply these programs, we may be led to suspect that it is the adoption of the Federal Guidelines that is primarily responsible for the current influx of ethics consultants to BMW showrooms. This may explain why the Guidelines are sometimes referred to as the Business Ethicist Full Employment Act. Unfortunately, it also suggests that the surge of corporate interest in ethics may not herald the Age of Aquarius after all, but is just one more example of businesses looking to their financial interest. However, like all stories that begin with "Once upon a time," this one has a happy ending. For after years of suffering cruel jokes as the ugly ducklings of the academic community, business ethicists have finally blossomed into the swans of the corporate world.

And they lived happily ever after.

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[9]For a useful discussion of the Guidelines, *see* Ilene H. Nagel & Winthrope M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts about Their Future*, 71 WASH. L. Q. 205 (1993).

[10]*See* Michele Galen, *Keeping the Long Arm of the Law at Arm's Length*, BUS. WK., Apr. 22, 1991, at 104 (quoting Professor John C. Coffee of Columbia University Law School).