Stakeholder Theory and Organizational Ethics

Robert Phillips

Foreword by R. Edward Freeman

An Excerpt From

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by Robert Phillips
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Preface

Indeed, I must disclaim any originality for the views I put forward.

—John Rawls[1]

Though it is difficult to pin down with any precision the provenance of ideas, I believe I can trace the origins of this book to a late-fall day in 1994 under a tree on The Lawn at the University of Virginia—Mr. Jefferson's Academical Village. There are places in the world that simply feel like proper venues for scholarship; in the shadow of The Rotunda is such a place. There was a particular tree against which I would sit and read as I searched for a defensible moral foundation for stakeholder theory. I had come to Virginia's Darden School to study stakeholder theory and my interest in the work of John Rawls rendered it something of a foregone conclusion that the focus of my studies would involve the confluence of these two. In the fall of 1994, I was reading Donaldson and Dunfee's "integrative social contracts theory" articles and A. John Simmons's *Moral Principles and Political Obligations.* I took (still take) Donaldson and Dunfee's writings as exemplars for research in organizational ethics, but Simmons's critique of tacit consent and the social contract methodology is a powerful one—I was stuck. In another example of the great good fortune that has attended my studies, the Simmons book also contained an extended treatment of Rawls's principle of fair play. It was an epiphany. Here, under a tree on The Lawn I had found a locus for integrating those features that I believed necessary to a robust theory of organizational ethics. That day and the subsequent nine years have culminated in this book.

This book attempts to combine stakeholder theory and the moral and political theory of John Rawls into a single theory of organizational ethics. This task is both obvious and daunting for much the same reason: These theories can plausibly claim paradigmatic dominance in their respective fields. No approach to the examination of organizational ethics can claim a greater share of scholarly and popular attention than stakeholder theory over the past twenty years. No moral or political theory can claim greater twentieth-century influence than Rawls's *A Theory of Justice* and subsequent elaboration. I was stunned to hear Rawls's name uttered on television's *The West Wing* in February 2003. Think about the last time you heard the name of a contemporary political philosopher uttered on a top-ten network television program and you will have some idea of Rawls's influence.

A moment of reader guidance is perhaps called for here as the style of this book varies from chapter to chapter. The majority of the book can be understood by anyone familiar with the stakeholder concept while some of the material is quite dense and fairly technical. Understanding the technical and esoteric parts is not always necessary to understanding the remainder of the book, though leaps of faith may occasionally be required without such familiarity. The book is organized rather like a mountain—it is most accessible on the sides and is highest (in terms of the level of abstraction) in the middle. Chapters 1 and 2 should be palatable to academics and practitioners alike. An intuitive sense of the basic idea of a stakeholder and some of the attendant problems that can arise in the practice of stakeholder management are all that are required to appreciate these chapters. The same can be said of

Chapters 6 through 8. Chapters 6 and 7, about stakeholder legitimacy and the natural environment as a stakeholder, require slightly greater familiarity with the stakeholder debates, but are still well within the grasp of a reader who is not well versed in the academic literature. Chapters 3 through 5, on the need for an ethics of organizations, the main points of contention in the academic stakeholder literature, and the defense of the principle of stakeholder fairness, will be of most benefit to those already familiar with more academic treatments of business ethics and stakeholder theory—though Chapter 4 may also provide a good point of entry into the scholarly debates that currently swirl if one is interested in an overview of the state of the art in stakeholder theory. It is not necessary to climb to the summit of a mountain to appreciate it. One can see the entire mountain without going over the pinnacle and there is often practical value in doing so. But from my experience, there is also a certain satisfaction in attacking the summit. The perspective on the landscape below is far superior and the views from the base are given greater context and meaning.

For any project of such duration, one is bound to compile debts. Good fortune has brought me into contact with so much encouragement and assistance that my debts are still greater. Foremost among my academic debts are those I owe to Ed Freeman and Pat Werhane. Their contributions to my ideas on business, ethics, organizations, food, wine, leadership, writing, and myriad other subjects cannot be overstated. Whatever the merits of this book, they can claim the largest part of the credit. More than this, these two have provided a constant source of both personal and professional support. They are role models and friends.

I would also like to thank the many people who have seen fit to read and comment on earlier drafts of all or part of this work. In addition to providing a part of the original inspiration, A. John Simmons consented to participate on my disser-

tation committee and provided many useful comments on the ideas herein. Maureen Bezold, George Brenkert, Marty Calkins, the late Max Clarkson, Tom Donaldson, Tom Dunfee, Heather Elms, Paul Glezen, Douglas Hammer, Ed Hartman, Barry Johansen, Michael Johnson-Cramer, Tom Jones, Andrea Markowitz, Eric Orts, Lee Preston, Tara Radin, Joel Reichart, Richard Rorty, John Rowan, Tim Rowley, Gordon Sollars, Alan Strudler, Ann Svendsen, Harry Van Buren, Andy Wicks, and Don Yates have all commented on the ideas at least once and in most cases several times during the process. Joshua Margolis has been the most consistent source of criticism, stimulation, and encouragement on this book throughout the process—his efforts on behalf of the material contained here are unsurpassed and deserve special recognition. The book would doubtless be far better had I been able to address all of the concerns these insightful individuals suggested. Any remaining shortcomings in the book are despite rather than because of their input. This responsibility is my own.

There is no better place in the world to study organizational ethics than the University of Virginia, The Darden School, and the Olsson Center for Applied Ethics. I am grateful for their support. Similarly, I would like to thank the students, faculty, and administration of the University of San Diego for their support of the study and practice of ethics in all areas of life.

I would also like to thank the staff at Berrett-Koehler Publishers and especially Steve Piersanti and Jeevan Sivasubramaniam. The company is an exemplar of the stakeholder approach advocated herein. Working with them has improved both the form and the content of the book and I am proud of my association with them.

Finally and above all I want to thank my family. Hoyte Smith, Robert Pinkerton, and Eric Phillips have taught me in various ways the value of hard work, education, and intellectual achievement. Myrtle Smith, Una Mullis, and Amelia Phillips have reinforced these virtues with an infusion of complete and unconditional love. And before he was even a person, the idea of Smith Phillips provided motivation when nothing else could. This book is dedicated to him.

Robert Phillips
San Diego, California
8 March 2003

CHAPTER 1

Stakeholder Theory and Organizational Dogma

Business organizations are among the most powerful social entities on earth. They are the grand social institutions of our time, perhaps the sole remaining effective social institutions, expected not only to fuel free-market economies, but also to carry burdens once thought the province of government and religion (e.g., health care, child care, protection of privacy, education). Business organizations control vast resources, cross national borders, and affect every human life. Their pervasive impact on human lives rivals that of history's most powerful czars, kings, and emperors.

Looking at the old cities of Europe gives one an idea of the movement of social power across time. The oldest of the large, elaborate buildings are religious in nature (e.g., churches and cathedrals). The second oldest of the large, elaborate buildings are governmental. The newest of the large, elaborate buildings are corporate headquarters and facilities.[a] To note this is to note the transfer of power through history. The church and its leaders were arguably the most powerful institution for thousands of

[a]This point was made by Roger W. Sant, CEO of AES Corporation, during a speech on the social responsibility of business.

years. Then, as the liberal notions of the Enlightenment began to replace church orthodoxy, government began to emerge as, again arguably, the most powerful institution on earth. Today, a case can be made that business firms are beginning to emerge as the most powerful institutions in the world.

Philosophy has generally kept pace with the historical transitions of power as described. Scholasticism preceded the giants of secular moral and political philosophy. Now, as power is transferred to business institutions and other private organizations, so must our theories recognize this transition in power and begin to look more closely, explicitly, and reflectively at the morality of economic interactions and the organizations where these transactions take place.

Business organizations are even taking on larger, more complicated roles in society. As they enter new arenas such as health care and education, where tough choices and trade-offs among multiple goods are commonplace, friction between economic objectives and other worthy aims is likely to increase. Elements of business and organizational ethics are interwoven within bioethics—the latter perhaps also a contender for the title of most important area of applied ethics.

If ethics is to become an integral part of business conduct, it must be knit into organizational life. Our theories must thus begin with a consideration of organizations. Just as scholars have previously attempted to philosophically analyze (and justify) the power wielded by the state and its agents, it is essential that at least a portion of our attention be turned to a philosophical analysis of the power wielded by managers in organizations.

Political and moral theory seeks a comprehensive explanation of ethical duties between moral agents. This level of abstraction is typically comprehensive and universal; that is, the classics of moral and political philosophy generally refer to all persons in all times and places. This book attempts to provide a general explanation of the creation and existence of moral obligations within organizations and among stakeholders.[b] As such, it is but one brick (although an important one) in the emerging edifice of stakeholder theory.

Stakeholder Theory

Organizations have constituencies. Furthermore, organizations are dependent upon these constituency groups for their success. This much is uncontroversial. Refer to these constituencies as stakeholders, however, and the disagreements appear ceaseless. Who are these stakeholders? How should they be managed? Is there a legal duty to attend to stakeholders or is such a duty instead legally prohibited due to the shareholder wealth maximization imperative? Should the law require stakeholders on boards of directors? For whose benefit ought the organization be managed? Should stakeholder principles be extended to the entire world in pursuit of a stakeholder society?

The debate only becomes more intense when the questions are couched in moral terms. What does the organization owe its stakeholders? Is there a moral obligation between the organization and its stakeholders? What is the source and justification of this obligation? If the organization in question is a business organization, are there moral duties of any sort or is business either immoral or amoral in nature? The generally beneficial fact that everyone is an ethicist of a sort—having opinions and considered judgments about moral topics—only fuels the considerable fire when stakeholder theory is discussed as a theory of organizational ethics. This book is an attempt to add some light to this heat.

Just as everyone is a sort of ethicist, so too is all activity in organizations, particularly business firms, shot through with

[b]This moral foundation would be analogous to the foundation provided by property rights in the neo-classical economics explanation of business. I will not, however, undertake to contrast the two concepts here except to say that the two are not mutually exclusive of one another. One may affirm property rights (although not to the degree of the neo-classical economist) and still affirm fairness-based obligations.

fodder for moral reasoning (more on this metaphor momentarily). R. Edward Freeman (1994) has identified and described a "separation thesis" at work in discussions of business. Academics and practitioners alike seem to operate with an underlying assumption that business is business and ethics is ethics, but the two have little if anything to do with one another. Professor Freeman argues that this is the greatest obstacle to moral decision making in organizations today.

It would have been easier five years ago to argue that accounting and finance are amoral. That is, they are neither moral nor immoral, but are instead not the sort of concepts to which application of moral ideas is appropriate. These fields of study and practice are merely tools for making decisions and are no more moral or immoral than a pen. Recent events have proven, however, clearly moral connotations to the use of these tools, just as with the use of pens. Anyone making the argument that the use of the tools of accounting and finance are amoral today would likely meet with stunned incredulity in light of recent events.

A still deeper variation of this argument, however, is even more dangerous. The assertion that the purpose of business activity is to maximize the wealth of the business's owners—shareholders in the case of corporations—has near religious status. It is the dogma of business and is taken for granted like the air we breathe. I examine this claim at some length in later chapters. For now, it is sufficient to point out that the prescription to maximize shareholder wealth is itself a moral claim rendered using the language of moral reasoning. The utilitarian variation says that individuals working toward their own self-interest will actually benefit society as a whole. Even when extended from individuals to organizations, the rationale for maximizing owner wealth lies in the benefits that accrue to society: "A rising tide lifts all boats" is a moral argument.

In addition to the utilitarian argument is the property rights argument, which says that because the shareholders own the firm, managers bear an obligation to act consistently with shareholders' wishes, assumed to be wealth maximization. Again, talk of property *rights* is moral reasoning. So, when Professor John Dienhart is asked how long ethics has been a topic of study in schools of business, his stock response is, "As long as there have been schools of business."[c] Merely assuming a moral stance without reflection does not make it any less a moral argument. One issue that arises from the uncritical acceptance of the shareholder wealth maximization model as the moral foundation of business activity is that responses to immoral behavior in such contexts also take this foundation for granted. Few of the fixes that have been suggested to avoid the problems that have recently plagued U.S. firms have directly addressed the shortcomings of this model.

An analogy to an idea in a Darwin Awards message is perhaps apt. A man is out hunting and upon trying to start his old truck to leave he realizes that he has blown a fuse. His idea for a replacement is a .22 caliber shell that is near to hand. The shell promptly fires off, wounding the man as he sits in the driver's seat. I rather doubt the truth of the story, but it strikes me that many of the solutions proposed to repair organizational ethics are akin to trying a different size shell. The problem is more fundamental than whether the shell is a .22 or a .25. We should not be surprised that, until this more fundamental problem is addressed, firms will continue shooting themselves in the foot, or worse.[d]

This book suggests that organizations in the early twenty-first century are confronted with a unique set of moral issues requiring moral theory explicitly tailored to this set of issues and that stakeholder theory is a strong candidate of such a theory of organizational ethics. This book will argue that an amended principle

[c]Personal correspondence, February 2003.

[d]To qualify as a Darwin Award winner, our protagonist necessarily had to have shot himself is an area rather more sensitive than the foot.

of fair play—the principle of stakeholder fairness—provides a defensible source of moral obligations among stakeholders that has been heretofore missing in the literature on stakeholder theory. The remainder of this chapter will be devoted to a broad summary description of what is to follow.

Chapter 2: The Limits of Stakeholder Theory

Much of the power of stakeholder theory may be attributed to its conceptual breadth. The term carries myriad connotations and thereby evokes praise or scorn from scholars and practitioners of multiple academic disciplines and backgrounds. Such breadth of interpretation, though one of stakeholder theory's greatest strengths, is also one of its most prominent theoretical liabilities. Much of the power of stakeholder theory is a direct result of the fact that, when used unreflectively, its managerial prescriptions and implications are nearly limitless. In the hands of advocates and critics alike, stakeholder theory can be used as a basis for nearly any position that one wishes to defend or attack. Wide conceptual breadth allows critics to dress up the theory as they will in the process of attempting to lay it low. In some cases, overzealous advocates may tend to make the critic's job easier as well. Chapter 2 elaborates a number of interpretations, critical and friendly, of stakeholder theory that do not represent the theory described in the current project. After a brief discussion of the nature of stakeholder criticism, I will argue for what stakeholder theory is NOT. With this brief summary as our roadmap, we may now proceed to describe and defend the concepts of organizational ethics in general and stakeholder theory in particular.

Chapter 3: Why *Organizational* Ethics?

Organizational ethics scholarship has historically consisted of attempts to directly translate the classics of moral and political theory into the context of the organization. Hence, the gamut includes utilitarian business ethics, Kantian business ethics, Aristotelian business ethics, and social contractarian business ethics. Many of these translations have been provocative, interesting, coherent, and insightful; however, many of the distinct qualities of organizations and the nuances of the moral problems that arise in organizational contexts are inadequately appreciated. Both moral and political philosophy are too broad and general to account for the obligations that arise in the myriad organizations (business and otherwise) of less than nation-state size and power. This being the case, the need arises for a normative account of organizational morality that, while grounded in the moral and political theories of the past, is tailored specifically for the organizational level of abstraction. Chapter 3 attempts to point out problems that may arise with the more or less direct translation of moral and political philosophical concepts and methodologies.

Having suggested reasons why moral and political philosophy may be inadequate in organizational contexts, Chapter 3 goes on to suggest features that would characterize an ethics of organizations including substantive aims and conceptual independence. With the need for specific theory at the organizational level established, I argue that stakeholder theory is a good candidate. To prepare the foundation for a defense of stakeholder theory, Chapter 4 is an extended discussion of the current status of stakeholder theory as a scholarly topic.

Chapter 4: Stakeholder Theory and Its Critics

Prior to any attempt to elaborate a new stakeholder theory, it is important to have a thorough understanding of past and current thinking about the concept. Chapter 4 attempts to survey the recent work in the field relevant to the topic at hand. Among the most important and widely cited papers in the area are those that suggest a variety of distinctions and taxonomies among stakeholders and stakeholder research (e.g., Donaldson & Preston; Mitchell, Agle, & Wood; and Jones & Wicks). These taxonomies and their role in the development of stakeholder theory are briefly analyzed.

From here the discussion moves to the topic of fiduciary duties and agency relationships. Critics charge that stakeholder theory, particularly the prescription that managers do otherwise than maximize shareholder wealth, violates legal and moral duties. Far from being morally superior to the status quo, critics charge that stakeholder theory advocates the violation of strong moral duties. Goodpaster's (1991) explication of the "stakeholder paradox" exemplifies this critique. He argues:

> It seems essential, yet in some ways illegitimate, to orient corporate decisions by ethical values that go beyond strategic stakeholder considerations to multi-fiduciary ones.[2]

Such arguments rely heavily on the notions of the agency and fiduciary duties of managers to share owners. Based on agency considerations, the relationships between managers and shareholders are held to be "special" and ethically different from other stakeholder relationships. The extent to which these relationships are, in fact, "special" is examined.

Chapter 4 ends with a summation of the problems with extant stakeholder research to be addressed in the remainder of the book. Among these problems are the lack of a normative justificatory framework and uncertainty regarding stakeholder identity and legitimacy. That is, much of the current thinking on stakeholder theory omits discussion of the normative, moral justification for obligations to stakeholders. In addition to the reasons provided above regarding business dogma, failure to address the normative foundation creates the problem of stakeholder identity. Though some have addressed this issue, it remains problematic that much of the extant thinking on stakeholder theory is unable to distinguish those who are from those who are not legitimate stakeholders: If everyone is a stakeholder, then the term is empty and adds no value.

The absence of a normative framework and the problem of stakeholder identity are among the theoretical shortcomings addressed by the principle of stakeholder fairness. The principle of stakeholder fairness—and its predecessor, the principle of fair play—are examined and explicated in Chapter 5.

Chapter 5: A Principle of Stakeholder Fairness

Chapter 5 provides an answer to, why managers should care about stakeholders. Beyond the financial reasons (and the moral rationale that underlies profitability) are other moral obligations that arise in organizational contexts. This chapter defends the principle of stakeholder fairness, which states that when people are engaged in a cooperative effort and the benefits of this cooperative scheme are accepted, obligations are created on the part of the group accepting the benefit. These obligations are elaborated, defended, and compared with other forms of obligation generation such as actual and implied consent.

The principle of stakeholder fairness only provides for the existence of obligations among stakeholders; the content of the obligations must be filled out within the particular contexts of organizational interaction. In other words, that there are obligations and who the parties to these obligations are is determined using the principle of stakeholder fairness. The content of these obligations (i.e., what the parties are obligated to do or refrain from doing) is established by the norms of the particular organization and its stakeholders. The proper test of the legitimacy of such norms is in the discussion of them among all of the parties to the norm. This discourse test for establishing the content of obligations of fairness is elaborated and examined. Chapter 5 concludes with a discussion of a decision made by Cadbury's as an example of communicative stakeholder management.

Chapter 6: Stakeholder Legitimacy

Among the problems with much of the stakeholder literature to date is the inability of previous theories to delimit those groups that are and those groups that are not legitimate stakeholders. It is argued that this is due to an insufficient understanding of the notion of legitimacy in stakeholder theory. Chapter 6 begins, therefore, by defending a multifaceted conception of legitimacy. It is argued that legitimacy in stakeholder theory can be separated into normative and derivative varieties. Normative legitimacy is created by the principle of stakeholder fairness and the obligations that arise there from. Derivative legitimacy is derived from these prior moral obligations and gets its force from the ability of certain groups to affect the well-being of the organization and its normative stakeholders. The vital category of non-stakeholder is also preserved. This distinction creates a conception of stakeholder legitimacy that is more consistent (both within the domain of stakeholder research and with stakeholder theory's disciplines of origin), is able to broadly suggest a moral and logical hierarchy for stakeholder groups, and keeps the moral aspects of the theory in view for decision makers.

Chapter 7: Stakeholder Identity

Facilitated by this new understanding of legitimacy in stakeholder theory, itself grounded in the principle of stakeholder fairness, we are now able to address the problem of stakeholder identity. That is, which constituency groups are normative, derivative, and non-stakeholders and why? By way of example, this new conception of legitimacy is applied to the media and competitors. It is then argued at greater length that neither the natural environment nor social activists are normatively legitimate stakeholders on a fairness-based account. The primary reason for this is the organization has accepted no benefits from these entities nor have these entities voluntarily contributed to the organizational cooperative scheme. The stuff of reciprocity is absent.

It is also argued, however, that these entities may be accounted for, both from within and external to the fairness-based stakeholder theory presented here. It is argued that stakeholder theory may account for these entities in at least two ways. If the activists are able to significantly affect the well-being of the organization and its normative stakeholders in either a positive or negative manner, then they may be considered derivative stakeholders meriting managerial attention. Also, if there is an interest in the activists' causes (or a vital interest in the natural environment even absent any activist representation) among legitimate stakeholders (e.g., the local community), then these groups may be considered as stakeholder proxies and achieve similar derivative status. In the case of social activists, similarities exist between this instrumental approach and the moral theory of civil disobedience. This relation between "stakeholder proxies" and civil disobedience is explored.

Finally, it is important in this context to recall that stakeholder theory is far from exhaustive of moral theory. A vast array of moral duties, rights, responsibilities, and obligations exist apart from stakeholder obligations. Therefore, an organization is precluded from taking actions vis-à-vis the natural environment or social activists apart from the stakeholder status of these entities. For example, the organization may have a duty to not unnecessarily harm the environment based on the moral considerability due non-human entities.

Chapter 8: Stakeholder Theory in Practice

Having completed the defense of stakeholder theory, the final chapter looks more explicitly at the implications of the theory for the practice of administration in organizations. How can this new version of stakeholder theory help address the most common challenges leveled against it from a practical perspective? How does it help manage for stakeholders? Chapter 8 will take the form of answering a series of interrelated questions that would naturally arise for a manager wishing to employ the theory.

1. In light of business dogma, why should I manage for stakeholders?
2. Knowing why I should manage for stakeholders, how do I know who the stakeholders are?
3. Knowing who the stakeholders are, how should I go about determining what they want?
4. Knowing what my stakeholders want but being limited in resources, how do I prioritize among all of these groups?
5. Are the rules of business truly different from other endeavors? If so, how?

Chapter 8 also suggests other resources for the reader in search of further practical advice as well as a number of challenges and questions to the theory that remain unanswered.

this material has been excerpted from

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