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Why we need a theory of stakeholder governance - and why this is a hard problem

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FROM THE EDITOR

WHY WE NEED A THEORY OF STAKEHOLDER GOVERNANCE—AND WHY THIS IS A HARD PROBLEM

"There is nothing more powerful than an idea whose time has come."

–Victor Hugo, *Les Misérables*

Corporate governance is an important topic for both scholars and practicing managers. To date, most work on this subject has focused on how to resolve potential conflicts of interest between a firm's senior managers and its shareholders in how firms create and distribute economic value. This work, based in agency theory (Alchian & Demsetz, 1972; Jensen & Meckling, 1976), has led to the design of a variety of corporate governance mechanisms that have been widely implemented by many firms around the world (Aguilera & Jackson, 2003; Williamson, 1996). These mechanisms include incentive programs for senior managers—such as CEO compensation in the form of stock and stock options based on firm performance—that act as management "bonding" devices (Jensen & Murphy, 1990), and a variety of disciplinary mechanisms—such as the inclusion of "outsiders" on boards of directors and legally mandated reporting requirements—that increase the ability of shareholders to "monitor" the performance of a firm (Fama & Jensen, 1983).

Work on using governance to resolve possible conflicts between senior managers and shareholders has largely developed separately from governance questions focused on the broader relationships between a firm and its multiple stakeholders (Donaldson & Preston, 1995; Freeman, 1984). This is ironic since some of the earliest work on agency theory conceptualized a firm as "a nexus for a set of contracting relationships among individuals" (Jensen & Meckling, 1976: 310). These individuals, including "individuals" as legal fictions, can be viewed as a firm's stakeholders. However, instead of examining how governance could enable a firm to work with all of its stakeholders in creating and distributing economic value, agency theorists have mostly focused on governing the relationship between managers and only a single stakeholder: shareholders.

An idea whose time has come is that of considering more directly the governance of relations between a firm and its multiple stakeholders and not just with its shareholders. This will necessitate broadening the conceptualization of the value created by a firm beyond simply shareholder return (Barney, 2018; McGahan, 2020), a requirement accentuated by the recent COVID-19 public health crisis (Carney, 2020).

However, on the face of it, the analysis of stakeholder governance seems likely to be a more difficult problem than the governance of manager–shareholder relations. Theories of shareholder governance focus on how economic value is created by and distributed between two groups—shareholders and senior managers—that are relatively homogenous with respect to their (sometimes)-conflicting interests regarding how they would like to see a firm managed (Jensen & Meckling, 1976). Governance mechanisms designed to reconcile these potential conflicts are relatively straightforward to formulate, although not always easy to implement (Baysinger & Butler, 1985; Tihanyi, Graffin, & George, 2014).

Stakeholder governance, however, must deal with much broader relationships between a firm and its multiple stakeholder groups (Freeman, 1984) and the associated creation and distribution of value across them. Conventional corporate finance suggests that, with *perfect* factor markets, a firm that maximizes the wealth of its shareholders as its sole residual claimants will correspondingly maximize the economic value of the firm (Jensen, 2001). However, this is not the case in a world of incomplete contracting and *strategic* factor markets: maximizing shareholder wealth does not necessarily address the conflicting economic interests of shareholders, employees, suppliers, and other stakeholders, and thus does not necessarily maximize the value of the firm (Barney, 1986, 2018; Klein, Mahoney, McGahan, & Pitelis, 2012; Zingales, 2000).

Moreover, while shareholder governance has primarily focused on economic returns, stakeholders can have interests that go well beyond narrow economic concerns (Campbell, Coff, & Kryscynski, 2012; Carney, 2020; McGahan, 2020). Employees, for example, are likely to be concerned about appropriating some of the economic profits their human capital helps to create (Morris, Alvarez, Barney, & Molloy, 2017), but may also have interests in personal health (Michel, 2011), work life quality (Lambert, 2000), internal and external pay equity (Buttner & Lowe, 2017), and employment stability (Failla, Melillo, & Reichstein, 2017). Customers generally want to purchase the highest-quality products at the lowest price possible (Gale & Rosenthal, 1994), but may also have concerns about exploiting child labor in developing countries (Eden, 2003), a firm's impact on global climate change (Wright & Nyberg, 2017), modern slavery (Crane, 2013; Phung & Crane, 2018), and rising economic and social inequality (Amis, Mair, & Munir, 2020; Bapuji, Husted, Lu, & Mir, 2018). The communities within which a firm operates will be interested in the employment opportunities and taxes that can be generated by a firm in their midst, but might also be alarmed by environmental pollution (Howard-Grenville, Buckle, Hoskins, & George, 2014), traffic congestion (Verhoef, 2010), and urban sprawl (Nechyba & Walsh, 2004).

Milton Friedman (1962: 133) maintained that "the one and only obligation of business is to maximize its profits while engaging in open and free competition without deception or fraud." Many scholars have subsequently argued that firms can safely ignore the noneconomic interests of their stakeholders when making business decisions (e.g., Black & Kraakman, 1996). Some have suggested that these noneconomic issues can be better managed through political processes, and are not part of a firm's sphere of operations.[1] However, not only may failing to attend to stakeholder economic interests result in firm value loss (Connelly, Haynes, Tihanyi, Gamache, & Devers, 2016; Cuypers, Koh, & Wang, 2016), there is also increasing evidence that overlooking noneconomic interests of stakeholders often leads to negative financial consequences for firms (Richard, 2000; Shan, Fu, & Zheng, 2017). Focusing on maximizing shareholder wealth, the conventional corporate governance model, is incapable of addressing the conflicting economic interests of a firm's stakeholders, let alone their noneconomic interests.

Developing a theory of stakeholder governance that explains how firms can reconcile the conflicting economic and noneconomic interests of its multiple stakeholders is a hard problem. However, this is the governance problem that senior managers currently face, a reality reaffirmed by the recent announcement by 181 CEOs associated with the Business Roundtable (2019) that they will now focus on addressing broader stakeholder interests instead of just maximizing the wealth of shareholders.

Our brief essay cannot hope to propose a general answer to this stakeholder governance question, but we hope to accomplish two things: first, we want to call attention to the problem, and, second, we would like to suggest some possible approaches to addressing it. In this spirit, here are some, but certainly not all, possible ways to begin to think about a revised theory of stakeholder governance:

- *Stakeholder governance as a bargaining game among stakeholders.* One approach might be to think of stakeholder governance as an outcome of multilateral bargaining among stakeholders that have conflicting economic and noneconomic interests. Bargaining could be simultaneous, such as when the interests of stakeholders are reconciled in a single negotiation (Krishna & Serrano, 1996), or extended over a period of time, as in a series of bilateral negotiations in which stakeholders A and B strike a deal, then stakeholders B and C strike a deal that is consistent with B's deal with A, then stakeholders C and D strike a deal that is consistent with C's deal with B and B's deal with A, and so on (Machlup & Taber, 1960).
- *Stakeholder governance as creating forums where conflicts among stakeholders can be addressed.* Blair and Stout (1999) focused on how firms can create forums within which stakeholder negotiations take place. In this context, they maintained that an independent board of directors could act as trustees of the diverse stakeholders of a corporation. This mediating hierarchy provides a vehicle through which publicly traded corporations can formulate strategies that protect firm-specific investments and increase the joint welfare of a firm's multiple stakeholders (Hoskisson, Gambeta, Green, & Li, 2018; Klein et al., 2012; Wang, He, & Mahoney, 2009).
- *Stakeholder governance through establishing priorities among different stakeholders.* McGahan (2020) has pointed to the need to identify which stakeholders should be of concern to a firm. In making such judgements, firm leaders will also be faced with having to prioritize the interests of some of its stakeholders over others, based on managerial judgment or some guiding principle such as variations in stakeholders' power, legitimacy, or urgency (Mitchell, Agle, & Wood, 1997). For example, firms may choose to give precedence to the interests of stakeholders that provide profit-generating resources over stakeholders that provide generic resources (Barney, 2018). In addition, firms could make these priorities widely known by signaling (Spence, 1974) their willingness to address the interests of some stakeholders over others. These

[1] An assertion contradicted by the political activities of many firms (Barley, 2010; Hillman, Keim, & Schuler, 2004; Sampson, 1973).

actions could address the stakeholder governance problem by attracting stakeholders, including shareholders, who prefer working with a firm with particular (signaled) stakeholder priorities (Mackey, Mackey, & Barney, 2007; Morris et al., 2017). In this setting, managers would focus on addressing the interests of their highest-priority stakeholders while still maintaining a level of satisfaction among lower priority stakeholders such that they continue to engage with the firm (Barney, 2018; Simon, 1952).

- *Stakeholder governance as a process of finding ways to resolve stakeholder conflicts.* Finally, perhaps there is no general theory for resolving conflicting interests among a firm's stakeholders (Barnard, 1938/1968; Follett, Fox, & Urwick, 1940; Miller, 1992; Nickerson & Zenger, 2002). Instead, maybe all that can be developed is a framework for a process by which managers in firms can create ways to resolve these conflicts in their "particular circumstances of time and place" (Hayek, 1945: 521). This process framework would be, at its core, entrepreneurial in nature, as a superior governance outcome may not be known before the process unfolded (Alvarez & Barney, 2007). That some managers might be more skilled at this than others suggests that stakeholder governance could be a source of a firm's competitive advantage (Barney, 1991; Klein et al., 2012).

These are only four possible approaches to thinking about the stakeholder governance problem; they are neither mutually exclusive nor jointly exhaustive. What is apparent is that the need to reconsider how we theorize, teach, and practice stakeholder governance is compelling and pressing. Depending on the outcome, a theory of stakeholder governance could be among the most important theoretical—and deeply practical—contributions to the field of management in the 21st century.

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