Stakeholder Theory of the Modern Corporation

R. Edward Freeman

INTRODUCTION

Corporations have ceased to be merely legal devices through which the private business transactions of individuals may be carried on. Though still much used for this purpose, the corporate form has acquired a larger significance. The corporation has, in fact, become both a method of property tenure and a means of organizing economic life. Grown to tremendous proportions, there may be said to have evolved a "corporate system"—which has attracted to itself a combination of attributes and powers, and has attained a degree of prominence entitling it to be dealt with as a major social institution.¹

Despite these prophetic words of Berle and Means (1932), scholars and managers alike continue to hold sacred the view that managers bear a special relationship to the stockholders in the firm. Since stockholders own shares in the firm, they have certain rights and privileges, which must be granted to them by management, as well as by others. Sanctions, in the form of "the law of corporations," and other protective mechanisms in the form of social custom, accepted management practice, myth, and ritual, are thought to reinforce the assumption of the primacy of the stockholder.

The purpose of this article is to pose several challenges to this assumption, from within the framework of managerial capitalism, and to suggest the bare bones of an alternative theory, a stakeholder theory of the modern cor-

¹ R. Edward Freeman, "Stakeholder Theory of the Modern Corporation." Reprinted by permission of the author.
I do not seek the demise of the modern corporation, either intellectually or in fact. Rather, I seek its transformation. In the words of Neurath, we shall attempt to “rebuild the ship, plank by plank, while it remains afloat.”2

My thesis is that I can revitalize the concept of managerial capitalism by replacing the notion that managers have a duty to stockholders with the concept that managers bear a fiduciary relationship to stakeholders. Stakeholders are those groups who have a stake in or claim on the firm. Specifically I include suppliers, customers, employees, stockholders, and the local community, as well as management in its role as agent for these groups. I argue that the legal, economic, political, and moral challenges to the currently received theory of the firm, as a nexus of contracts among the owners of the factors of production and customers, require us to revise this concept. That is, each of these stakeholder groups has a right not to be treated as a means to some end, and therefore must participate in determining the future direction of the firm in which they have a stake.

The crux of my argument is that we must reconceptualize the firm around the following question: For whose benefit and at whose expense should the firm be managed? I shall set forth such a reconceptualization in the form of a stakeholder theory of the firm. I shall then critically examine the stakeholder view and its implication for the future of the capitalist system.

THE ATTACK ON MANAGERIAL CAPITALISM

The Legal Argument

The basic idea of managerial capitalism is that in return for controlling the firm, management vigorously pursues the interests of stockholders. Central to the managerial view of the firm is the idea that management can pursue market transactions with suppliers and customers in an unconstrained manner.

The law of corporations gives a less clearcut answer to the question: In whose interest and for whose benefit should the modern corporation be governed? While it says that the corporation should be run primarily in the interests of the stockholders in the firm, it says further that the corporation exists “in contemplation of the law” and has personality as a “legal person,” limited liability for its actions, and immortality, since its existence transcends that of its members. Therefore, directors and other officers of the firm have a fiduciary obligation to stockholders in the sense that the “affairs of the corporation” must be conducted in the interest of the stockholders. And stockholders can theoretically bring suit against those directors and managers for doing otherwise. But since the corporation is a legal person, existing in contemplation of the law, managers of the corporation are constrained by law.

Until recently, this was no constraint at all. In this century, however, the law has evolved to effectively constrain the pursuit of stockholder interests at the expense of other claimants on the firm. It has, in effect, required that the claims of customers, suppliers, local communities, and employees be
taken into consideration, though in general they are subordinated to the
claims of stockholders.

For instance, the doctrine of “privity of contract,” as articulated in Wint-
terbottom v. Wright in 1842, has been eroded by recent developments in prod-
ucts liability law. Indeed, Greenman v. Yuba Power gives the manufacturer strict
liability for damage caused by its products, even though the seller has exer-
cised all possible care in the preparation and sale of the product and the
consumer has not bought the product from nor entered into any contractual
arrangement with the manufacturer. Caveat emptor has been replaced, in
large part, with caveat venditor.3 The Consumer Product Safety Commission
has the power to enact product recalls, and in 1980 one U.S. automobile
company recalled more cars than it built. Some industries are required to
provide information to customers about a product’s ingredients, whether or
not the customers want and are willing to pay for this information.4

The same argument is applicable to management’s dealings with em-
ployees. The National Labor Relations Act gave employees the right to
unionize and to bargain in good faith. It set up the National Labor Rela-
tions Board to enforce these rights with management. The Equal Pay Act
of 1963 and Title VII of the Civil Rights Act of 1964 constrain manage-
ment from discrimination in hiring practices; these have been followed
with the Age Discrimination in Employment Act of 1967.5 The emergence
of a body of administrative case law arising from labor-management dis-
putes and the historic settling of discrimination claims with largeemploy-
ers such as AT&T have caused the emergence of a body of practice in the
in corporation that is consistent with the legal guarantee of the rights of the
employees. The law has protected the due process rights of those employ-
es who enter into collective bargaining agreements with management. As
of the present, however, only 30 percent of the labor force are participat-
ing in such agreements; this has prompted one labor law scholar to pro-
pose a statutory law prohibiting dismissals of the 70 percent of the work
force not protected.6

The law has also protected the interests of local communities. The
Clean Air Act and Clean Water Act have constrained management from
“spoiling the commons.” In an historic case, Marsh v. Alabama, the Supreme
Court ruled that a company-owned town was subject to the provisions of the
U.S. Constitution, thereby guaranteeing the rights of local citizens and
negating the “property rights” of the firm. Some states and municipalities
have gone further and passed laws preventing firms from moving plants
or limiting when and how plants can be closed. In sum, there is much cur-
rent legal activity in this area to constrain management’s pursuit of stock-
holders’ interests at the expense of the local communities in which the firm
operates.

I have argued that the result of such changes in the legal system can be
viewed as giving some rights to those groups that have a claim on the firm,
for example, customers, suppliers, employees, local communities, stock-
holders, and management. It raises the question, at the core of a theory
of the firm: In whose interest and for whose benefit should the firm be
managed? The answer proposed by managerial capitalism is clearly “the
stockholders,” but I have argued that the law has been progressively cir-
cumscribing this answer.
The Economic Argument

In its pure ideological form managerial capitalism seeks to maximize the interests of stockholders. In its perennial criticism of government regulation, management espouses the “invisible hand” doctrine. It contends that it creates the greatest good for the greatest number, and therefore government need not intervene. However, we know that externalities, moral hazards, and monopoly power exist in fact, whether or not they exist in theory. Further, some of the legal apparatus mentioned above has evolved to deal with just these issues.

The problem of the “tragedy of the commons” or the free-rider problem pervades the concept of public goods such as water and air. No one has an incentive to incur the cost of clean-up or the cost of nonpollution, since the marginal gain of one firm’s action is small. Every firm reasons this way, and the result is pollution of water and air. Since the industrial revolution, firms have sought to internalize the benefits and externalize the costs of their actions. The cost must be borne by all, through taxation and regulation; hence we have the emergence of the environmental regulations of the 1970s.

Similarly, moral hazards arise when the purchaser of a good or service can pass along the cost of that good. There is no incentive to economize, on the part of either the producer or the consumer, and there is excessive use of the resources involved. The institutionalized practice of third-party payment in health care is a prime example.

Finally, we see the avoidance of competitive behavior on the part of firms, each seeking to monopolize a small portion of the market and not compete with one another. In a number of industries, oligopolies have emerged, and while there is questionable evidence that oligopolies are not the most efficient corporate form in some industries, suffice it to say that the potential for abuse of market power has again led to regulation of managerial activity. In the classic case, AT&T, arguably one of the great technological and managerial achievements of the century, was broken up into eight separate companies to prevent its abuse of monopoly power.

Externalities, moral hazards, and monopoly power have led to more external control on managerial capitalism. There are de facto constraints, due to these economic facts of life, on the ability of management to act in the interests of stockholders.

A STAKEHOLDER THEORY OF THE FIRM

The Stakeholder Concept

Corporations have stakeholders, that is, groups and individuals who benefit from or are harmed by, and whose rights are violated or respected by, corporate actions. The concept of stakeholders is a generalization of the notion of stockholders, who themselves have some special claim on the firm. Just as stockholders have a right to demand certain actions by management, so do other stakeholders have a right to make claims. The exact nature of these claims is a difficult question that I shall address, but the logic is identical to that of the stockholder theory. Stakes require action of a certain sort, and conflicting stakes require methods of resolution.
Freeman and Reed (1983) distinguish two senses of stakeholder. The "narrow definition" includes those groups who are vital to the survival and success of the corporation. The "wide-definition" includes any group or individual who can affect or is affected by the corporation. I shall begin with a modest aim: to articulate a stakeholder theory using the narrow definition.

**Stakeholders in the Modern Corporation**

Figure 1 depicts the stakeholders in a typical large corporation. The stakes of each are reciprocal, since each can affect the other in terms of harms and benefits as well as rights and duties. The stakes of each are not univocal and would vary by particular corporation. I merely set forth some general notions that seem to be common to many large firms.

Owners have financial stake in the corporation in the form of stocks, bonds, and so on, and they expect some kind of financial return from them. Either they have given money directly to the firm, or they have some historical claim made through a series of morally justified exchanges. The firm affects their livelihood or, if a substantial portion of their retirement income is in stocks or bonds, their ability to care for themselves when they can no longer work. Of course, the stakes of owners will differ by type of owner, preferences for money, moral preferences, and so on, as well as by type of firm. The owners of AT&T are quite different from the owners of Ford Motor Company, with stock of the former company being widely dispersed among 3 million stockholders and that of the latter being held by a small family group as well as by a large group of public stockholders.

Employees have their jobs and usually their livelihood at stake; they often have specialized skills for which there is usually no perfectly elastic market. In return for their labor, they expect security, wages, benefits, and meaningful work. In return for their loyalty, the corporation is expected to provide for them and carry them through difficult times. Employees are expected to follow the instructions of management most of the time, to speak favorably about the company, and to be responsible citizens in the local communities in which the company operates. Where they are used as means to an end, they must participate in decisions affecting such use. The evidence that such policies and values as described here lead to productive company-employee relationships is compelling. It is equally compelling to realize that the opportunities for "bad faith" on the part of both management and employees are enormous. "Mock participation" in quality circles,

![Figure 1. A Stakeholder Model of the Corporation.](image-url)
singing the company song, and wearing the company uniform solely to please management all lead to distrust and unproductive work.

Suppliers, interpreted in a stakeholder sense, are vital to the success of the firm, for raw materials will determine the final product's quality and price. In turn the firm is a customer of the supplier and is therefore vital to the success and survival of the supplier. When the firm treats the supplier as a valued member of the stakeholder network, rather than simply as a source of materials, the supplier will respond when the firm is in need. Chrysler traditionally had very close ties to its suppliers, even to the extent that led some to suspect the transfer of illegal payments. And when Chrysler was on the brink of disaster, the suppliers responded with price cuts, accepting late payments, financing, and so on. Supplier and company can rise and fall together. Of course, again, the particular supplier relationships will depend on a number of variables such as the number of suppliers and whether the supplies are finished goods or raw materials.

Customers exchange resources for the products of the firm and in return receive the benefits of the products. Customers provide the lifeblood of the firm in the form of revenue. Given the level of reinvestment of earnings in large corporations, customers indirectly pay for the development of new products and services. Peters and Waterman (1982) have argued that being close to the customer leads to success with other stakeholders and that a distinguishing characteristic of some companies that have performed well is their emphasis on the customer. By paying attention to customers' needs, management automatically addresses the needs of suppliers and owners. Moreover, it seems that the ethic of customer service carries over to the community. Almost without fail the "excellent companies" in Peters and Waterman's study have good reputations in the community. I would argue that Peters and Waterman have found multiple applications of Kant's dictum, "Treat persons as ends unto themselves," and it should come as no surprise that persons respond to such respectful treatment, be they customers, suppliers, owners, employees, or members of the local community. The real surprise is the novelty of the application of Kant's rule in a theory of good management practice.

The local community grants the firm the right to build facilities and, in turn, it benefits from the tax base and economic and social contributions of the firm. In return for the provision of local services, the firm is expected to be a good citizen, as is any person, either "natural or artificial." The firm cannot expose the community to unreasonable hazards in the form of pollution, toxic waste, and so on. If for some reason the firm must leave a community, it is expected to work with local leaders to make the transition as smoothly as possible. Of course, the firm does not have perfect knowledge, but when it discovers some danger or runs afoul of new competition, it is expected to inform the local community and to work with the community to overcome any problem. When the firm mismanages its relationship with the local community, it is in the same position as a citizen who commits a crime. It has violated the implicit social contract with the community and should expect to be distrusted and ostracized. It should not be surprised when punitive measures are invoked.

I have not included "competitors" as stakeholders in the narrow sense, since strictly speaking they are not necessary for the survival and success of
the firm; the stakeholder theory works equally well in monopoly contexts. However, competitors and government would be the first to be included in an extension of this basic theory. It is simply not true that the interests of competitors in an industry are always in conflict. There is no reason why trade associations and other multi-organizational groups cannot band together to solve common problems that have little to do with how to restrain trade. Implementation of stakeholder management principles, in the long run, mitigates the need for industrial policy and an increasing role for government intervention and regulation.

**The Role of Management**

Management plays a special role, for it too has a stake in the modern corporation. On the one hand, management's stake is like that of employees, with some kind of explicit or implicit employment contract. But, on the other hand, management has a duty of safeguarding the welfare of the abstract entity that is the corporation. In short, management, especially top management, must look after the health of the corporation, and this involves balancing the multiple claims of conflicting stakeholders. Owners want higher financial returns, while customers want more money spent on research and development. Employees want higher wages and better benefits, while the local community wants better parks and day-care facilities.

The task of management in today's corporation is akin to that of King Solomon. The stakeholder theory does not give primacy to one stakeholder group over another, though there will surely be times when one group will benefit at the expense of others. In general, however, management must keep the relationships among stakeholders in balance. When these relationships become imbalanced, the survival of the firm is in jeopardy.

When wages are too high and product quality is too low, customers leave, suppliers suffer, and owners sell their stocks and bonds, depressing the stock price and making it difficult to raise new capital at favorable rates. Note, however, that the reason for paying returns to owners is not that they "own" the firm, but that their support is necessary for the survival of the firm, and that they have a legitimate claim on the firm. Similar reasoning applies in turn to each stakeholder group.

A stakeholder theory of the firm must redefine the purpose of the firm. The stockholder theory claims that the purpose of the firm is to maximize the welfare of the stockholders, perhaps subject to some moral or social constraints, either because such maximization leads to the greatest good or because of property rights. The purpose of the firm is quite different in my view.

"The stakeholder theory" can be unpacked into a number of stakeholder theories, each of which has a "normative core," inextricably linked to the way that corporations should be governed and the way that managers should act. So, attempts to more fully define, or more carefully define, a stakeholder theory are misguided. Following Donaldson and Preston, I want to insist that the normative, descriptive, instrumental, and metaphorical (my addition to their framework) uses of 'stakeholder' are tied together in particular political constructions to yield a number of possible "stakeholder theories." "Stakeholder theory" is thus a genre of stories about how we could live. Let me be more specific.
A “normative core” of a theory is a set of sentences that includes among others, sentences like:

(1) Corporations ought to be governed . . .
(2) Managers ought to act to . . .

where we need arguments or further narratives which include business and moral terms to fill in the blanks. This normative core is not always reducible to a fundamental ground like the theory of property, but certain normative cores are consistent with modern understandings of property. Certain elaborations of the theory of private property plus the other institutions of political liberalism give rise to particular normative cores. But there are other institutions, other political conceptions of how society ought to be structured, so that there are different possible normative cores.

So, one normative core of a stakeholder theory might be a feminist standpoint one, rethinking how we would restructure “value-creating activity” along principles of caring and connection. Another would be an ecological (or several ecological) normative cores. Mark Starik has argued that the very idea of a stakeholder theory of the firm ignores certain ecological necessities. Exhibit 1 is suggestive of how these theories could be developed.

In the next section I shall sketch the normative core based on pragmatic liberalism. But, any normative core must address the questions in columns A or B, or explain why these questions may be irrelevant, as in the ecological view. In addition, each “theory,” and I use the word hesitantly, must place the normative core within a more full-fledged account of how we could understand value-creating activity differently (column C). The only way to get on with this task is to see the stakeholder idea as a metaphor. The attempt to prescribe one and only one “normative core” and construct “a stakeholder theory” is at best a disguised attempt to smuggle a normative core past the unsophisticated noses of other unsuspecting academics who are just happy to see the end of the stockholder orthodoxy.

### EXHIBIT 1. A Reasonable Pluralism

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<tr>
<th>A.</th>
<th>Corporations ought to be governed . . .</th>
<th>B.</th>
<th>Managers ought to act . . .</th>
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<td></td>
<td>in accordance with the six principles.</td>
<td></td>
<td>in the interests of stakeholders.</td>
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<td>Doctrine of Fair Contracts</td>
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<tr>
<td>Feminist Standpoint Theory</td>
<td>. . . in accordance with the principles of caring/connection and relationships.</td>
<td>. . . to maintain and care for relationships and networks of stakeholders.</td>
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</tr>
<tr>
<td>Ecological Principles</td>
<td>. . . in accordance with the principle of caring for the earth.</td>
<td>. . . to care for the earth.</td>
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<th>C.</th>
<th>The background disciplines of “value creation” are . . .</th>
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<td>—theories that explain stakeholder behavior</td>
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If we begin with the view that we can understand value-creation activity as a contractual process among those parties affected, and if for simplicity's sake we initially designate those parties as financiers, customers, suppliers, employees, and communities, then we can construct a normative core that reflects the liberal notions of autonomy, solidarity, and fairness as articulated by John Rawls, Richard Rorty, and others. Notice that building these moral notions into the foundations of how we understand value creation and contracting requires that we eschew separating the "business" part of the process from the "ethical" part, and that we start with the presumption of equality among the contractors, rather than the presumption in favor of financier rights.

The normative core for this redesigned contractual theory will capture the liberal idea of fairness if it ensures a basic equality among stakeholders in terms of their moral rights as these are realized in the firm, and if it recognizes that inequalities among stakeholders are justified if they raise the level of the least well-off stakeholder. The liberal ideal of autonomy is captured by the realization that each stakeholder must be free to enter agreements that create value for themselves, and solidarity is realized by the recognition of the mutuality of stakeholder interests.

One way to understand fairness in this context is to claim à la Rawls that a contract is fair if parties to the contract would agree to it in ignorance of their actual stakes. Thus, a contract is like a fair bet, if each party is willing to turn the tables and accept the other side. What would a fair contract among corporate stakeholders look like? If we can articulate this ideal, a sort of corporate constitution, we could then ask whether actual corporations measure up to this standard, and we also begin to design corporate structures which are consistent with this Doctrine of Fair Contracts.

Imagine if you will, representative stakeholders trying to decide on "the rules of the game." Each is rational in a straightforward sense, looking out for its own self-interest. At least ex ante, stakeholders are the relevant parties since they will be materially affected. Stakeholders know how economic activity is organized and could be organized. They know general facts about the way the corporate world works. They know that in the real world there are or could be transaction costs, externalities, and positive costs of contracting. Suppose they are uncertain about what other social institutions exist, but they know the range of those institutions. They do not know if government exists to pick up the tab for any externalities, or if they will exist in the nightwatchman state of libertarian theory. They know success and failure stories of businesses around the world. In short, they are behind a Rawls-like veil of ignorance, and they do not know what stake each will have when the veil is lifted. What groundrules would they choose to guide them?

The first groundrule is "The Principle of Entry and Exit." Any contract that is the corporation must have clearly defined entry, exit, and renegotiation conditions, or at least it must have methods or processes for so defining these conditions. The logic is straightforward: each stakeholder must be able to determine when an agreement exists and has a chance of fulfillment. This is not to imply that contracts cannot contain contingent claims or other methods for resolving uncertainty, but rather that it must contain methods for determining whether or not it is valid.
The second groundrule I shall call “The Principle of Governance,” and it says that the procedure for changing the rules of the game must be agreed upon by unanimous consent. Think about the consequences of a majority of stakeholders systematically “selling out” a minority. Each stakeholder, in ignorance of its actual role, would seek to avoid such a situation. In reality this principle translates into each stakeholder never giving up its right to participate in the governance of the corporation, or perhaps into the existence of stakeholder governing boards.

The third groundrule I shall call “The Principle of Externalities,” and it says that if a contract between A and B imposes a cost on C, then C has the option to become a party to the contract, and the terms are renegotiated. Once again the rationality of this condition is clear. Each stakeholder will want insurance that it does not become C.

The fourth groundrule is “The Principle of Contracting Costs,” and it says that all parties to the contract must share in the cost of contracting. Once again the logic is straightforward. Any one stakeholder can get stuck.

A fifth groundrule is “The Agency Principle” that says that any agent must serve the interests of all stakeholders. It must adjudicate conflicts within the bounds of the other principals. Once again the logic is clear. Agents for any one group would have a privileged place.

A sixth and final groundrule we might call “The Principle of Limited Immortality.” The corporation shall be managed as if it can continue to serve the interests of stakeholders through time. Stakeholders are uncertain about the future but, subject to exit conditions, they realize that the continued existence of the corporation is in their interest. Therefore, it would be rational to hire managers who are fiduciaries to their interest and the interest of the collective. If it turns out the “collective interest” is the empty set, then this principle simply collapses into the Agency Principle.

Thus, the Doctrine of Fair Contracts consists of these six groundrules or principles:

1. The Principle of Entry and Exit
2. The Principle of Governance
3. The Principle of Externalities
4. The Principle of Contracting Costs
5. The Agency Principle
6. The Principle of Limited Immortality

Think of these groundrules as a doctrine which would guide actual stakeholders in devising a corporate constitution or charter. Think of management as having the duty to act in accordance with some specific constitution or charter.

Obviously, if the Doctrine of Fair Contracts and its accompanying background narratives are to effect real change, there must be requisite changes in the enabling laws of the land. I propose the following three principles to serve as constitutive elements of attempts to reform the law of corporations.

**The Stakeholder Enabling Principle**

Corporations shall be managed in the interests of its stakeholders, defined as employees, financiers, customers, employees, and communities.
The Principle of Director Responsibility

Directors of the corporation shall have a duty of care to use reasonable judgment to define and direct the affairs of the corporation in accordance with the Stakeholder Enabling Principle.

The Principle of Stakeholder Recourse

Stakeholders may bring an action against the directors for failure to perform the required duty of care.

Obviously, there is more work to be done to spell out these principles in terms of model legislation. As they stand, they try to capture the intuitions that drive the liberal ideals. It is equally plain that corporate constitutions which meet a test like the doctrine of fair contracts are meant to enable directors and executives to manage the corporation in conjunction with these same liberal ideals.

Notes


2. The metaphor of rebuilding the ship while afloat is attributed to Neurath by W. Quine, Word and Object (Cambridge: Harvard University Press, 1960), and W. Quine and J. Ullian, The Web of Belief (New York: Random House, 1978). The point is that to keep the ship afloat during repairs we must replace a plank with one that will do a better job. Our argument is that stakeholder capitalism can replace the current version of managerial capitalism.


10. At the Toronto workshop Mark Starik sketched how a theory would look if we took the environment to be a stakeholder. This fruitful line of work is one example of my main point about pluralism.