Chapter 10
Stakeholder Board Representation as a Means of Governance

After over 10 years of unending financial scandals, scandals that have continued well beyond the passage of Sarbanes-Oxley (SOX) and Dodd-Frank, perhaps it is time to look at some out of the box proposals to improve corporate governance. My suggestion which rests on the theoretical work of R Edward Freeman and more recently of Patricia Werhane is to suggest that many governance problems could be resolved if the corporate boards of publicly held companies were composed of representatives of the most important stakeholders of that corporation. This chapter consists of four parts. In "Section One: Proposals for Reform" I mention some of the reforms that have taken place and point out that although these reforms may be necessary for a system of appropriate corporate governance, they will not be sufficient. In "Section Two: Stakeholder Theory" I briefly review stakeholder theory with a special emphasis on Freeman's suggestion that corporate boards consist of stakeholder groups. In "Section Three: Stakeholder Governance", I explain my model of stakeholder governance. In the final section, "Section Four: Objections and Replies", I will consider some objections to stakeholder governance and provide some suggestions as to how these criticisms can be answered.

Section One: Proposals for Reform

Regulatory Reform

Certainly the most ambitious reforms in response to the wave of corporate scandals were changed laws and expanded regulations. The first in response to the scandals of 2001 was the Sarbanes-Oxley Act, now known affectionately as SOX. Among

This chapter is a greatly revised version of a paper I read at the Transatlantic Business Ethics Conference, Wharton, University of Pennsylvania, April 6, 2006.

N.E. Bowie, *Business Ethics in the 21st Century*, Issues in Business Ethics 39,
DOI 10.1007/978-94-007-6223-7_10, © Springer Science+Business Media Dordrecht 2013

the reforms of that time SOX was the most comprehensive. However, in addition during this time the Securities and Exchange Commission created a new set of regulations as did the New York Stock Exchange. Finally, the influence of New York State Attorney General Eliot Spitzer's aggressive enforcement of existing law cannot be underestimated. The second response in response to the financial crisis of 2008–2009 was the Frank-Dodd act that is still being implemented.[1]

I am not one to quarrel with these new laws, regulations, and more vigorous enforcement of current law. I am not overly concerned about the alleged increased costs they impose on business since business has brought this on itself. For decades I have reminded my students that one of the advantages of ethical conduct on the part of corporations is less regulation. Bad apples create more regulation and much of the regulation that is enacted ignores unintended consequences and overreaches. I think Dodd-Frank is a perfect example of this phenomenon of overly complicated and onerous response to unethical behavior. However, even these laws on their most draconian interpretation will not go far enough to improve corporate governance.

The first point to make is that the laws do not work. A number of excellent papers presented at the U of Minnesota conference Ethics in the Financial Services Industry (April 2004 and published in a special issue of *Business and Professional Ethics Journal)* made this point. Two of the most developed critiques were by Daryl Koehn and Karim Jamal.[2]

Koehn, who was especially prescient when one looks at the 2008–2009 financial crisis, pointed out that many of the new financial instruments and processes are so complex that the regulators do not understand them. She cites one example where bank officials who had devised new models to monitor and assess risk had to explain them to the regulators. In addition there are simply not enough regulators. As part of the Republican strategy to reduce the size of government, the regulatory agencies have been starved for personnel. In addition, regulators, although supposedly independent, are political beings. They are aware of the election returns. Also regulators quarrel among themselves-sometimes over turf and sometimes over content. New York State Attorney General Eliot Spitzer and the Securities and Exchange Commission (SEC) had had public disagreements over regulatory issues on a number of occasions as federal and state regulators responded to the Enron and other debacles of 2001. For a more complete discussion of these matters see Koehn's complete paper.

Jamal asks the following pertinent question: "Seventy years after the Securities Acts of 1932 and 1933, which set up a regulatory body called the Securities and Exchange Commission (SEC), why do we think more regulation will lead to better

[1] For more on the ethical issues surrounding the financial crisis of 2008–2009, see Chap. 9 written with Ronald Duska.

[2] Koehn, Daryl. (2004). "What Form of Business Regulation is Workable?" *Business and Professional Ethics Journal,* 12(1 and 2), 43–63 and Jamal, Karim. (2004). "After Seven Decades of Regulation, Why is the Audit Profession in Such a Mess?" *Business and Professional Ethics Journal,* 12(1 and 2), 65–92.

auditor behavior?" Jamal's basic negative answer is that the actions of regulators often exacerbate the conditions that lead to fraud rather than limit fraud. Why is that? Jamal begins by pointing out there is a fundamental conflict of interest in the way that publicly traded firms hire auditors. That conflict of interest results because firms hire and fire the auditor firms that do the audit. When I did my first research into accounting ethics, this conflict of interest jumped out at me yet the auditing profession seems to steadfastly ignore the problem.[3] Jamal recommends a third party intermediary to hire the auditors. Another of Jamal's salient criticisms of the rules based approach is that a kind of game, I would say choreographed dance, takes place. Jamal describes it this way. "We appear to be getting into a game of escalating rule-writing, followed by creative games by management to get around the new rules." The third problem is that the regulators have eliminated the professional norms and rules that restrain competition among auditors. Auditing may provide an example of a case where restraint of competition is a good thing. Jamal argues that we need less commercialization of auditing and he praises SOX for eliminating some of the consulting services that an auditing company can offer to client firms.

Other scholars have focused on the topic of direct concern in this Chapter-the failures of governance by corporate boards. Several scholars have shown that Boards cannot act at arms length and protect shareholder interests due to managerial power. Many have noted that there is often an inverse relationship between profitability of the firm and the amount of executive compensation. A good summary of many of the issues along with recommendations for greater transparency can be found in an article by Bebchuk and Fried[4] With respect to the Board's use of stock options to reward executives, Jamal[5] argues that we should revise Section 162n of the US tax code that has permitted the abuse of stock options in publicly held companies. Later work by Harris and Bromiley has shown that the likelihood of an accounting restatement due to misrepresentation is statistically proportional to the amount of stock options granted to the CEO.[6] Thus the greater the amount of the stock options the greater the likelihood of misrepresentation. It is interesting to note that excessive executive compensation is recognized as a major problem in business ethics yet despite various attempts at reform it remains intractable. I believe one of the strengths of my proposal for stakeholder Board voting representation is that the problem of excessive executive compensation can finally be meaningfully addressed. I provide much more discussion of this issue later in the Chapter since I use executive compensation as a test case for the effectiveness of stakeholder representative boards.

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[3] Bowie, Norman E. (1988). "Accountants, Full Disclosure, and Conflicts of Interest." *Business & Professional Ethics Journal*, 5(3 and 4), 59–73.

[4] Bebchuk, Lucian A. and Jesse M. Fried. (2006). "Pay Without Performance: Overview of the Issues," *Academy of Management Perspectives,* 5–24.

[5] Jamal, op.cit.

[6] Harris, Jared and Philip Bromiley. (2007). "Incentives to Cheat: The Influence of Executive Compensation and Firm Performance on Financial Misrepresentation," *Organization Science,* 18(3), 350–367.

Limitations of the Compliance-Based Approach

The emphasis on solving business ethics issues by regulation is an example of a compliance-based approach. Proponents of regulation argue that a stiff climate of compliance is an appropriate element in preventing corporate malfeasance. Even if the arguments discussed above concerning the pitfalls of the regulatory approach could be circumnavigated, even the best regulatory approach cannot be sufficient. Arguments against the sufficiency of compliance have been made by such scholars as Weaver and Trevino and Reynolds and Bowie.[7] In their empirical research Weaver and Trevino showed that a values- based program, unlike a compliance based program, was positively correlated with greater commitment to the organization, was more supportive of employee integrity, and with the willingness of employees to deliver bad news to a superior. In their normative research, Reynolds and Bowie emphasize the importance of motive or good intentions in ethics. Simply following the law or checking the boxes is not acting from a moral motive and as a result there is no real buy-in to ethical integrity. Laws are seen as an imposition whereas acting on ethical principles is agent determined and indicates both rational and emotional commitment to ethics. With compliance, ethical conduct can be or seem forced. With a values-based program, ethical conduct feels authentic or in the popular phrase, “real.”

Board Reforms

There have been a number of calls for Board reforms with the aim of improving governance. The Board of Directors was a prime target of SOX. Companies listed on the major stock exchanges need to have a majority of the Board consist of independent directors. The nominating committee and staff compensation committee of the board must consist entirely of independent directors. However, achievement of true independence has been difficult. After all, most Board members are CEO’s or high officials of other corporations. Thus there is a common outlook on management since there is a tendency for the CEO’s to think alike. There is also a natural tendency to get along with one’s colleagues. There is the danger that the Board becomes a kind of club or, in more scholarly terms, that it suffers from groupthink. These criticisms help explain why even after the Board reforms that were required by SOX, there is still a serious issue of excessive executive compensation.

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[7] See Weaver, Gary R. and Linda K. Trevino. (1999). “Compliance and Values Oriented Ethics Programs: Influences of Employee Attitudes and Behavior,” *Business Ethics Quarterly,* 9(2), 315–335 and Reynolds, Scott J. and Norman E. Bowie. (2004). “A Kantian Perspective of the Characteristics of Ethics Programs,” *Business Ethics Quarterly*, 14(2), 275–294.

Even when the heads of non-profits or former political leaders are appointed to the Board, there is a strong management orientation. The Board still primarily consists of managers. To put the issue in stakeholder terms, current corporate boards are composed almost exclusively of one stakeholder-managers. Other corporate stakeholders are either not represented or at most have minimal representation. By having the Board be composed of stakeholder representatives, I believe real independence could be achieved.

I am not alone in calling for reforms. Additional reforms have been called for. For example, Bebchuk and Fried[8] want to make it easier for stockholders to replace directors, to eliminate staggered board terms, and to force managers to honor majority backed stockholder resolutions. However, these reforms have not been forthcoming. Business interests led by the Business Roundtable have successfully fought these reforms during the entire decade of crises. I have always found it interesting that many of those corporate executives who embrace the philosophy of Milton Friedman that the purpose of business is to create shareholder wealth continue to fight any attempt to give the shareholder greater voice in the management of the corporation.

However, it should be pointed out that even if these reforms were successful, they would only improve the position of one stakeholder constituency,-the stockholders. The interests of the other stakeholders are not touched by these reforms. Having made that criticism, I want to emphasize nonetheless that one of the major failures of current Board governance practice is that Boards have failed to protect the interests of the stockholders, as they are legally and morally required to do. That is why, as we shall see, I advocate voting representation on the Board for stockholder interests. Current Boards have failed as agents of the stockholders.

Principles Rather than Rules

One idea, which is prominent in debates surrounding accounting and auditor independence, is the suggestion that the focus should be on principles rather than on rules. In the philosophical literature this distinction between rules and principles is most prominent in the work of Ronald Dworkin. Using that distinction Dworkin[9] has argued that there is one and only one correct decision regarding any legal case because even in the absence of a legal rule to settle the case, there is an applicable principle that will do so. Whereas rules are highly specific, principles are not. We all know what a rule is. Rules are highly specific and usually codified or at least written down. Dworkin defines a "principle" as follows: "I call a "principle" a standard that is to be observed … because it is a requirement of justice or fairness or some other dimension of morality."[10] In the absence of a rule to cover an ethical issue, look for a principle.

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[8] Bebchuk and Fried, op.cit.

[9] Dworkin, Ronald. (1977). *Taking Rights Seriously*. Cambridge: Harvard University Press.

[10] Ibid., 22.

In debates surrounding international accounting standards much has been made of the distinction between the American system of elaborate rules and the European system based on principles. A principle might be something like: Make sure the financial information fairly reflects the financial position of the company. It is more general than a rule. With a rule-based approach, the auditors try to use rules to reflect the financial position of the company. However, sometimes carefully following the rules will not provide the best indication of the financial health of the company. A number of scholars including Jamal[11] have spoken on behalf of the principles based approach.

Other scholars have gone on to suggest a conceptual framework for maintaining auditor independence which relies on principles rather than rules but is much more extensive than just providing a list of principles. For example, The Independence Standards Board commissioned a group to provide such a conceptual framework. The late Thomas Dunfee was one of the members of that task force. That task force used a risk assessment strategy. Of particular concern were threats to auditor independence, the type and adequacy of the safeguards put in place to mitigate the threats, and a perception measure of independence risk which was "the likelihood that an auditor's objectivity (a) would be compromised or (b) reasonably would appear compromised to well-informed investors and other users."[12] The task force then developed basic principles of auditor independence. One of those principles was "considering the views of investors and other interested users…."[13] This principle provides an opening to the kind of stakeholder governance I endorse in this paper.

Governance by principles rather than rules may well be an improvement over the current rules based approach. However, a change in orientation from rules to principles will not get to the heart of the matter. I maintain that the current problems of Board governance result from a homogeneity of interests on the part of Board members. The perspective of the Board is primarily a management perspective. If the various stakeholders are to be protected, then real live representatives of stakeholders need a place on the Board. Since the suggested reforms will not get us where we need to be with respect to governance, I suggest a strategy of stakeholder representation with voting rights on Boards of Directors of publicly held corporations.

Section Two: Stakeholder Theory

In the business ethics literature, the father (perhaps now grandfather) of stakeholder theory is R Edward Freeman. As we have seen earlier, in developing stakeholder theory, Freeman and his colleague the late William Evan distinguished a broad definition of stakeholder from a narrow definition. Under the narrow definition,

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[11] Jamal, op.cit., 74.

[12] Staff Report, "A Conceptual Framework for Auditor Independence" Independence Standards Board, July 2001, 6.

[13] Ibid., 9.

stakeholder groups are "those groups who are vital to the survival and success of the corporation." On the broad or wide view, stakeholder groups or individual stakeholders "include any group or individual who can affect or is affected by the corporation."[14] That distinction will be important as I develop my proposal for stakeholder Board representation.

In some of his early work with William Evan, Freeman explicitly endorsed a "Stakeholder Board of Directors" where the Board would consist of representatives of five stakeholder groups: employees, customers, suppliers, stockholders, and members of the local community.[15] In addition there would be a board member who would be the metaphysical director who would speak for the corporation. These directors would be sure that the corporation was managed for the benefit of the corporate stakeholders. With the exception of the metaphysical director, much of this is plausible and deserves serious consideration. Unfortunately, from my perspective, Freeman seemed to have abandoned his advocacy of a stakeholder board-at least until very recently.

In a later version of the aforementioned essay in his own name, Freeman adopted a Rawlsian perspective so that rather than an actual stakeholder board, there was an original position where the stakeholders acting under a partial veil of ignorance adopted the basic principles of corporate governance. There were six such 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 and (6) The Principle of Limited Liability.[16] I endorse these principles and point out that they function as principles rather than rules and thus are consistent with the observations made for governance reform discussed in "Section One: Proposals for Reform". However, for the purposes of this chapter, I am less concerned with the principles and more concerned with the actual participants on stakeholder Boards of Directors. I will have more to say on this shortly.

A stakeholder board of directors disappeared from Freeman's writing for over 15 years- at least to the best of my knowledge. However In his most recent book, *Stakeholder Theory: The State of the Art*, Freeman and his colleagues have continued to flirt with the idea of stakeholder representatives on the Board of Directors. In discussing the nascent idea of a stakeholder board of overseers mentioned by some transaction cost economists, Freeman calls the idea of such a board "intriguing." He indicates that such a board could function as a governance mechanism and has assigned the board the following tasks: "(1) To reduce information asymmetry among key stakeholders so that management could more easily create even more value,

[14] Evan, William M. and R. Edward Freeman. (1988). "A Stakeholder Theory of the Modern Corporation: Kantian Capitalism" in Tom L. Beauchamp and Norman E. Bowie (eds.), *Ethical Theory and Business,* 3rd ed. Englewood Cliffs: Prentice Hall Inc., 100.

[15] Ibid., 104.

[16] Freeman, R. Edward. (1997). "A Stakeholder Theory of the Modern Corporation" in Tom L. Beauchamp and Norman E. Bowie (eds.), *Ethical Theory and Business,* 5rd ed. Englewood Cliffs: Prentice Hall Inc., 74.

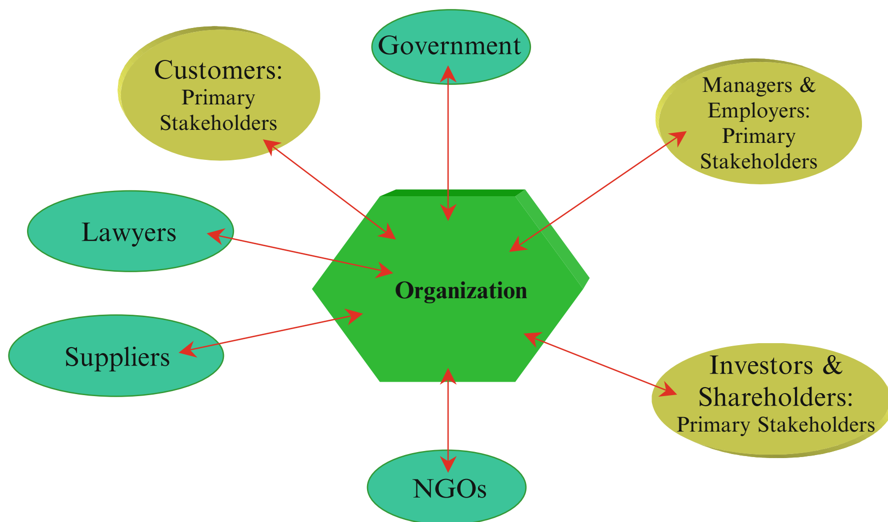

Fig. 10.1 Standard stakeholder "map"

(2) to view the interest of financiers, customers, suppliers, communities, and employees as joint, and (3) assume the continuation of the corporation through time."[17]

Later in the same work, Freeman and his colleagues say, "For this function [providing a firm with resources] stakeholder theory would advocate appointing external stakeholders to the board."[18] And there is empirical support that appointing external stakeholders would provide the firm with greater resources. Freeman and his colleagues cite studies by Johnson, Daily and Ellstrand as well as Stearns and Mizruchi that appointing representatives from financial institutions facilitates capital acquisition.[19]

I have criticized current Board governance procedures on the grounds that the Board represents a homogenous management perspective. Early stakeholder theory made a similar error when the typical stakeholder map always showed management at the center of the stakeholder wheel with spokes out to the other stakeholders. The conversation centered on the obligations management had to these other stakeholders. However, as George Bush would put it, on this model management is the decider. Patricia Werhane has characterized the traditional stakeholder map as follows (Fig. 10.1):

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[17] Freeman, R. Edward, Jeffrey S. Harrison, Andrew C. Wicks, Bidhan L. Parmar and Simon E. DeColle. (2010). *Stakeholder Theory: The State of the Art.* Cambridge: Cambridge University Press, 19.

[18] Ibid., 112.

[19] For details see Johnson, J.L., C.M Daily, and A.E. Ellstrand. (1996). "Boards of Directors: A Review and Research Agenda," *Journal of Management,* 22(3), 409–438. See also, Stearns, L.B. and M.S Mizruchi. (1996). "Board Composition and Corporate Financing: The Impact of Financial Institution Representation on Borrowing," *Academy of Management Journal,* 36(3), 603–618.

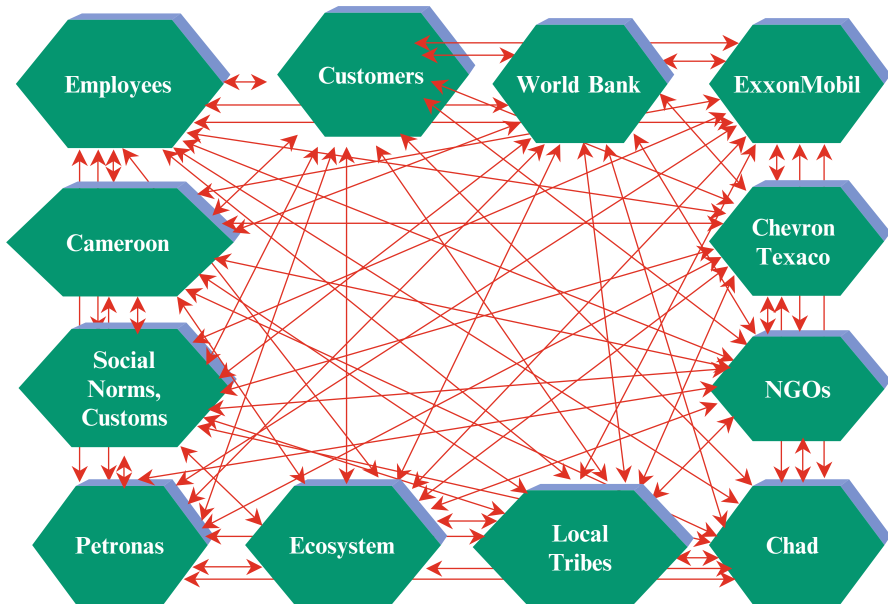

Fig. 10.2 ExxonMobil stakeholder networks

Patricia Werhane's significant contribution to stakeholder theory is to point out that our perspective and hence the perspective of management would change if management were not at the center of the wheel. Werhane has teased out the implications of putting various stakeholders at the center. In doing this work, the wheel disappears as Werhane develops a systems approach of stakeholder alliances. One example of her re-characterization is provided here (Fig. 10.2).

Werhane's contribution will become important as I develop my suggestion of a stakeholder Board of Directors.

Section Three: Stakeholder Governance

Among the advantages of this proposal is that it is consistent with some of the more enlightened approaches to corporate strategy. Just after the turn of the century I took 25 MBA students to Europe to give them the opportunity to hear first hand corporate executives explain their corporate social responsibility programs. As the public has grown more skeptical of corporate behavior, major companies have recognized the need to change how they communicate with stakeholders. Officials at Shell put it this way: We have had to move from "trust me" to "tell me" to "show me" to "engage me." The obvious way to engage is through stakeholder dialogues, which is exactly what Shell has done. British American Tobacco has said that its old strategy was

"decide, deliver, and defend." Its new strategy is "listen, understand, decide, and deliver." Listening and understanding require stakeholder dialogues. In Europe, there is constant reference to managing for the 3 P's, people, planet, and profits. How is a manager to do that, unless he or she engages in dialogue with stakeholders?

I should point out that stakeholder management or stakeholder engagement is hardly new. It might seem so to many business ethicists because we have been so concerned about how managers could possibly prioritize stakeholder interests and then harmonize them for win-win situations. But *as Stakeholder Theory: The State of the Art* indicated, Robert Ackoff pointed out that systems design could be accomplished by stakeholder participation as early as 1970 and as Freeman et al.'s Chapter on the history of the development of the idea of stakeholder theory makes clear, stakeholder "theory" resulted from the actual practices of research centers and companies who were actually managing by stakeholder theory even before they had given it that name. We did not start with stakeholder theory and then apply it; rather stakeholder theory was a way of understanding certain new management practices.[20]

It is now a natural step, I believe, to bring stakeholder engagement into the boardroom. Besides the function of the Board is governance. That is what the Board is supposed to do. This proposal is designed to enable the Board to fulfill its function of governance more effectively.

How would this proposal work? The first question to be asked is "Which stakeholders should have board positions." I find the Ronald K Mitchell, Bradley R. Agle, Donna Wood, topology useful here and will adopt it.[21] One implication of using their theory of stakeholder salience is that there is no list of stakeholders that can be given a priori either for all corporations or even a single corporation. Moreover, those stakeholders deserving of board membership can change over time. (Pragmatists should find this view congenial.) What is crucial is that the corporation identify those stakeholders that are salient. Salience in the view of Mitchell, Agle and Wood is a function of power, legitimacy, and urgency. For ease of explanation, I accept their definition of these central concepts.

It is important to note that although I accept their definitions, I use the notion of saliency differently. Whereas they use the term descriptively to identify which stakeholders that management in fact pays attention to, I use the concept normatively to determine which stakeholder groups deserve voting membership on the Board of Directors.

On the Mitchell, Agle, and Wood conception, power is "a relationship among social actors in which one social actor, A, can get another social actor, B, to do something that B would not otherwise have done." Legitimacy is "a generalized

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[20] See the marvelous history of the development of the concept in Freeman, Harrison, Wicks, Parmar and DeColle, op.cit., Chapter 2.

[21] Mitchell, Ronald K., Bradley R. Agle, and Donna Wood. (1997). "Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts," *Academy of Management Review,* 22, 853–886.

perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions." Finally, urgency is "the degree to which stakeholder claims call for immediate attention." For my purposes, stakeholders, which have power, are legitimate, and whose claims are urgent, should have voting representation on the Board of Directors.

Having said that, we can assume that the following stakeholder groups will almost always be found salient and thus deserving of Board membership: stockholders, employees, customers, suppliers, and the community. One might note here that the notion of salience allows for a broader range of stakeholder representation than one would get if one stayed with a narrow definition of stakeholder that limited stakeholders to those groups necessary to the survival of the firm. However, my list of stakeholders that would almost always be included on the Board fits rather closely with those stakeholders that are listed under a traditional narrow definition. The primary stakeholder groups should almost always have a voting membership position on the Board of Directors.[22]

The Composition of a Stakeholder Board

My first innovation here is to add an official representative of the shareholders as a voting member of the Board. Under the status quo, it is presumed that the traditional Board speaks for the shareholders. Of course the unrelenting scandals over the past 12 years give the lie to the conventional wisdom. To start, I propose that the largest, or one of the largest, institutional investors have Board representation. Since I do not want boards with token stakeholder membership, large boards should have more than one representative from shareholders. This proposal should find support from followers of finance based capitalism of Milton Friedman's ilk. However, I note the tremendous resistance to proposals for more shareholder involvement and say in board elections and board policies. Resistance to board representation for shareholders will be even more fierce.

As in Germany and some other European countries, labor would have official representation. Even in the US, which is so hostile to labor, some companies have won cooperation from unions in times of financial distress by putting representatives from labor on the Board. The suggestion that employees be represented on the Board is not a radical idea. Of course many publicly held companies do not have a labor union, so who would represent those non-union employees? Since I am a union advocate, perhaps a reform of Board governance that provided for stakeholder representation from labor would encourage corporations to think about unions in a new light and see them as partners in the enterprise. I think having labor

[22] In what follows mentally add "almost always" to "should."

represented on the Board might help reduce the animosity that one often finds between management and labor. In the absence of a union, some mechanism-perhaps an election-would determine who sits on the Board to represent labor. However, it is important that the determination not be made by management. In the context of current U.S. management/labor relations, the appointment of the representative of labor by management would undermine the legitimacy of the labor representative. Also it is important to note that I am not recommending that labor's representation be limited to one person. I do not envisage a Board with a large number of management representatives and then a token representative for each salient stakeholder. However, the actual number for each stakeholder group will be a function of the size of the corporation and its board. Also in corporations with both unionized and non-unionized employees, it will be important to have representation from both groups.

Customers should have representation. Depending on the type and size of the business one of the larger customers could serve as a board member. However, for many businesses the number of customers is diverse and extremely large. Which customers should be represented on Wal-Mart's Board of Directors for example? Rather than have management pick a customer or a few customers, I would suggest that a representative of a NGO representing customers could serve. When I think of an advocate for consumers, I think of *Consumer Reports*. Perhaps someone from that organization would be an appropriate representative. If more than one customer representative is required, then other NGO's could contribute.

Suppliers present some similarities and some differences from customers. With respect to suppliers, size matters. The larger the supplier account, the greater the salience and thus the greater claim for that supplier to be a representative on the board. If there are a large number of suppliers of roughly the same size, there are a couple of suggestions that I would make. If there is a NGO that could represent the suppliers, I would recommend that as I did in the case of customers. In the absence of an appropriate NGO, I would suggest a random assignment based on a drawing or some such device. However, I wish to emphasize that I am not committed to one selection method for this supplier stakeholder or any other stakeholder group. What is important is that the selection criteria or criterion be seen as legitimate by the stakeholder group under consideration. That always or almost always means that management should not be making the choice.

The local community, listed as a stakeholder by Freeman and most stakeholder theorists, presents some challenges. When a corporation is located in a single community or a few communities in geographical proximity, the choice is somewhat easier. A representative from a local charity like the United Way, or a local political official such as the mayor might be an obvious choice. However, I think the representative should not come from a business organization such as the local Chamber of Commerce. Remember I am trying to dilute the overwhelming dominance of managers on current Boards of Directors.

With respect to large international companies, e.g. General Motors, that have plants or business facilities in many communities, what is to count as the local community? To help resolve this issue we need to use the notion of salience. The adjective

"local" may not be appropriate for many corporations when it comes to determine how the community should be represented.

Perhaps we need to move to the abstract level and discuss briefly the notion of corporate social responsibility. For American corporations the socially responsible corporation is one that helps address environmental and other social problems often through corporate giving, corporate volunteer programs, or a corporate foundation. In practice what social problems a corporation seeks to address is determined by the business they are in. The Target Foundation supports education and the arts. Target believes that educated citizens are a good business investment for Target as are investments in the arts since Target is in part in the fashion industry. (It is no accident that Target hired the artist Michael Graves to design its line of kitchen appliances,) Corporate practice in this instance is in line with academic recommendations. In choosing a social problem to attack, the choice should fit with the corporation's overall strategy. This type of investment goes by the name "strategic philanthropy" With that in mind, for large companies like Target they should get board representatives from NGO's or other institutions that are involved in or promote the good works that the corporation is trying to achieve. A high profile educator and the CEO of a museum or symphony makes sense for a corporation like Target. Other corporations should pick representatives that fit their peculiar corporate mission.

Procedures for a Stakeholder Board

With respect to procedure, the Board needs to be reminded that the traditional stakeholder map with management at the center is not the appropriate mental model for stakeholder governance. Rather the operations of the Board should function as a stakeholder alliance in the way that has been outlined by Werhane. The Board of Directors should not be conceived of hierarchically but rather as a committed group of equals seeking the corporate good. Perhaps something like Rousseau's "general will" would be the right mental model. Another way of putting this is that the stakeholder board should strive for consensus. Such a board would present greater challenges, especially to strong CEO's who prefer compliant boards. Stakeholder boards would certainly be less compliant. However, I would argue that the greater independence that would come with a stakeholder board is a good thing and not a weakness. Besides the stakeholder board would perform the same basic functions as a traditional board. The chief change from the status quo is the composition of the board members although I concede that such a board does have implications regarding the power of the CEO.

In defending the notion of a stakeholder board, I am taking issue with some of those who maintain that there are arguments for employees to participate in the governing of the corporation, but these arguments do not work for other primary stakeholders. In other words, some argue that the case for putting representatives of employees on the board is stronger than it is for putting representatives of any other stakeholder group on the Board. Contrary to that position, I find the arguments of

Jeffrey Moriarity in "Participation in the Workplace: Are Employees Special?" to be convincing.[23] Toward the end of that article, Moriarity suggests that those who defend a special right to participation for employees should follow where the logic of their arguments leads them and extend a right to participation to all primary stakeholders. My suggestion is that a practical way to implement a right to participation for all primary stakeholders is representation on corporate Boards of Directors.

A Test Case: Executive Compensation

One of the most vexing problems in business ethics today is excessive executive compensation. Executive compensation is the responsibility of the Board of Directors and it is widely perceived that the Board has not acted responsibly here. Lots of suggestions, many of which come from finance and agency theory, have been tried. The goal of each is to align the incentives for management with the interests of the stockholders. Stock options were perhaps the most famous-or now infamous.[24] It is widely agreed that such aligning devices have not succeeded.

Suppose the Compensation Committee of the Board consisted of representatives of labor, customers, and investors. These representatives all have an interest in keeping executive compensation reasonable enough to attract and retain good managers but they also have an interest in not providing a cookie jar. Rather than align the interest of the CEO with the shareholders, a stakeholder board would have the incentive to oppose inordinate financial interests of management when they conflict with the interests of other stakeholders who have a stake in the game. Does anyone doubt that executive compensation would be lower and thus more fair and equitable under this kind of arrangement? That's how to address the specific governance issue of executive compensation. My proposal is that other governance problems can be most effectively addressed in the same way. The god-like supposedly "objective" perspective of the traditional Board is replaced by flesh and blood representatives of the conflicting stakeholder interests. The good for the corporation is forged through dialogue and compromise rather than discovered by a supposedly objective Board.

Section Four: Objections and Replies

Pragmatic Objections: The foremost pragmatic objection is that stakeholder governance would paralyze Board operations. Board meetings would resemble faculty meetings. Stakeholder representatives would insist on supporting their own

[23] Moriarity, Jeffrey. (2010). "Participation in the Workplace: Are Employees Special?" *Journal of Business Ethics,* 92, 373–384.

[24] See Harris and Bromiley, op.cit.

groups and no one would take the point of view of the corporation as a whole. In other words there would be no Rousseau's General Will in the corporate setting. Board meetings would be overly long, extremely contentious, and unable to reach consensus or even compromise for the good of the corporation as a whole.

The problem with this type of objection is that it is not empirically borne out. The same kind of objection was made in the debate between those who uphold a Friedmanite stockholder view of the purpose of the firm and those who hold a stakeholder view. Michael Jensen is the most influential of the critics of the stakeholder view arguing that it is impossible to maximize two different criteria[25] Of course advocates of the stakeholder view were not advocating maximizing but balancing. Even so critics of the stakeholder view argued that stakeholder management was management by paralysis.

Nonetheless, as we saw in "Section Three: Stakeholder Governance", major international companies including some of the largest in the world now practice a stakeholder strategy that includes stakeholder dialogues. Stakeholder concerns expressed through stakeholder dialogues influence corporate strategy. Corporations report that NGO's need not be adversaries. Indeed in my trips with Minnesota MBA's to Europe, I was struck by the number of times major corporations pointed out that they learned from NGO's, that NGO's had expertise and thus possessed information that was not available to corporate management. If stakeholder dialogues work now as an effective management tool, why should stakeholder Boards of Directors fail? (As an aside, despite the common notion that faculties paralyze universities, universities seem to be one of the best run institutions in the country right now. In the language of business, there are plenty of customers all over the world that want the products universities offer.)

Normative Objections: The chief normative objection centers on rights. By what right would stakeholder representatives be voting members of the Board of Directors? It is tempting to take a Friedmanite line here and argue that the firm should be managed for the benefit of the stockholders and the job of the Board is to see that management operates the business for the benefit of the stockholders. One might even cite Oliver Williamson's argument[26] that all the other stakeholder groups can write contracts with the firm to cover agency risks and as a result the stockholders, who cannot write such a contract, are entitled to the residual-namely profits.

Even if one adopts this line of argument, one cannot avoid noting that the current system of Board oversight is a failure. Management, with the approval of the Board, has feathered its own nest over and over again at the expense of the stockholders. In way too many cases, the Board has not protected the stockholders. Under my suggestion, the stockholders would have formal voting representation on the Board. My plan gives the stockholders real voice in corporate governance and the opportunity to protect their own interests.

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[25] Jensen, Michael. (2002). "Value Maximization, Stakeholder Theory, and the Corporate Objective Function," *Business Ethics Quarterly,* 12, 235–256.

[26] Williamson, Oliver. (1984). "Corporate Governance," *Yale Law Journal,* 93, 1197–1230.

Second, one can take the Friedman approach and still argue that stakeholder Board representation is the best means for increasing shareholder wealth. In other words if employees are treated fairly, if customers receive high quality products, if suppliers are loyally rewarded for high quality on time delivery, and if the relevant communities believe that business is in fact contributing to the health of the community and indeed if the interests of any salient stakeholders have representation, then the business and the stockholders will profit. This is a familiar story: Companies that do well by their stakeholders will do well for their stockholders.

The problem is that management far too often has not bought into the story. As my colleagues in organizational behavior and human resource management point out, there is a literature that goes back more than 50 years that shows that enlightened human resource policy increases profits, yet management has consistently failed to practice what the literature shows will work. Jeffrey Pfeffer[27] with a colleague has just published another book in which he argues for evidence based management-management by social science evidence and not management by the gut. Given this failure by management and by the Board that has oversight responsibility, how can management be made to do what is in the interests of the stockholders? My answer with respect to the human resource issue is: give formal Board voting rights to employees. In other words, if treating stakeholders well is the best formula for profitability, then we need a governance mechanism that will ensure that management treats stakeholders well. Giving those stakeholders voting rights on the Board will increase the likelihood that management will take their interests seriously. Note that Board voting rights for stakeholders, on this argument, protect stockholder interests, which is traditionally what the Board is supposed to do.

Often then there is no conflict between Board voting rights for the stakeholders and stockholder wealth. My proposal for governance and Milton Friedman can live in harmony. But what of those cases where the interests of the stockholders and the interests of one or more of the other stakeholders are in conflict, not just in the short run but in the long run as well? In such cases the harmony of my stakeholder governance proposal with the Friedmanites is broken. And when it is broken, don't the stockholders have the right to have the conflict resolved in favor of them?

Not necessarily. First there is a pragmatic argument. If an essential stakeholder group believes that its interests will always be compromised whenever they conflict with the interests of the stockholders, why should they remain loyal to the firm? In other words, a rule, which always favors the stockholders in time of conflict, is ultimately self-defeating.

Second, R Edward Freeman and William Evan's paper[28] that points out the failure of Williamson's argument regarding contract writing, leads one to ask why does ownership in the firm give the stockholders the right to have their interests prevail

[27] Pfeffer, Jeffrey and Robert I. Sutton. (2006). *Hard Facts, Dangerous Half Truths, and Total Nonsense: Profiting from Evidence-based Management.* Boston: Harvard Business School Press.

[28] Freeman, R. Edward and William M. Evan. (1990). "Corporate Governance: A Stakeholder Interpretation," *The Journal of Behavioral Economics,* 19, 337–359.

in cases of conflict? This model of governance assumes that each stakeholder group represented on the Board is essential to the long run well being of the firm. Look again at Freeman's original definition-in the narrow sense- stakeholder groups are those groups necessary for the firm's survival. If each stakeholder group on the Board represents a group necessary for the survival of the firm, why should the interests of one of these groups, the stockholders, always trump when there is a conflict? I submit there is no good answer to that question. The essentialness of stockholders is not more essential than the essentialness of other stakeholders and thus there is no moral argument for its predominance.

Some might argue that using the notion of salience to determine Board representation will mean that some stakeholders who have moral claims against the corporation will be left out since they will not be represented. Specifically those who have moral claims and thus pass the test of legitimacy, may have neither power nor urgency. What about them? I agree that those stakeholders would not have Board representation but that does not mean that their legitimate moral claims should be ignored. Stakeholder groups that do not have power or that do not have urgency may lose their right to Board representation, but they do not lose the right to have their moral claims addressed. If a corporate action causes harm to any stakeholder, it is the obligation of the corporation and its management to address that issue and see if the harm can be avoided and, if not, whether the corporate action that causes the harm should cease. All I am arguing is that the existence of a moral claim against a corporation is not sufficient for Board representation.

Conclusion

A Board of Directors in a publicly held corporation has as its most important function a governance function. One of its most important jobs is to keep management honest. Over 10 years of unremitting scandals show that it has not done this job well. I suggest that the Board of Directors will do a better job of governance if it consists of representatives of the corporate stakeholders, narrowly defined according to the concept of salience, who have voting rights on the Board. In most cases the stockholders will benefit from such an arrangement and in those cases where there is conflict between the interests of the stockholders and some other stakeholder groups narrowly defined, the stockholders have no moral right to always have their interests trump those of the other stakeholders narrowly defined.