Chapter 1

Recent developments in stakeholder theory: from the productive coalition to the governance of social cost

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1. Introduction[1]

Since the 1980s, policy debates about corporate governance have been dominated by a contractual model which insists that the sole goal of corporate management should be to enhance shareholder value as expressed by the company's share price. According to this view, since shareholders are dispersed and diversified, they do not have the correct incentives to hold management to account. This task therefore falls to the corporate governance system, which is supposed to supply the carrots (stock options and other 'high-powered incentives') and sticks (threat of hostile takeover) that encourage managers to raise the share price. The influence of the shareholder value model can be clearly detected in many aspects of European corporate governance systems. The original proposals for a takeover directive sought to prohibit managers from defending against unwelcome takeovers, while the first 'Winter Report', which was produced for the European Commission, concluded that takeovers are 'basically beneficial' because they discipline management where shareholders are dispersed (High Level Group 2002a: 2).[2] More recently, in debates and arguments about how the EU ought to regulate hedge funds and private equity, adherents to the contractual model repeatedly – and influentially – opposed intrusive regulation on the basis that these alternative investors enhance social wealth by disciplining self-interested

1. Some of the research on which this chapter is based was supported by a New Researcher Grant from the University of Queensland.

2. A second 'Winter Report' made detailed proposals for reform of European company law on the basis of an assumption that 'shareholders are the residual claimholders (they only receive payment once all creditors have been satisfied) and they are entitled to reap the benefits if the company prospers and are the first to suffer if it does not. Shareholders need to be able to ensure that management pursues - and remains accountable to - their interests.' (High Level Group 2002b: para. 3.1).

managers. Its influence can also be detected in the spread of corporate governance codes, whose primary goal is to make executives accountable to shareholders. Finally, its influence can be detected in the way politicians of all stripes view the exponential rises in executive pay over the last two decades with equanimity.

This chapter examines two recent developments in stakeholder theory which highlight the limitations of the contractual model of corporate governance. In contrast to earlier stakeholder theory, which treated as stakeholders all those 'affected by', or able to affect, corporate activities, these more recent theories identify stakeholders by reference to market or governance failures within the corporate 'nexus of contracts'. The productive coalition approach, which builds on the work of Margaret Blair, insists that employees who specialise their skills to a corporation's requirements cannot adequately protect their interests through contract, and so require protection of their interests through corporate governance. The governance of social cost approach suggests that, while employees may be a special category of stakeholder because of their proximity to a single corporation and particular vulnerability to expropriation, other groups may also be harmed by corporate decision making. These other stakeholder groups are less monolithic and harder to identify, but they too require some measure of protection, given that the corporate governance system gives managers powerful incentives to create shareholder value by externalising costs onto society. Under this approach, the corporate governance process operates to trace these harmful effects and develop socially acceptable solutions to them.

The chapter begins by briefly examining the historical origins of stakeholder theory and the emergence of the shareholder value model of corporate governance. It then examines the productive coalition theory, and the demands it makes of the law. Following that, it examines the governance of social cost approach to stakeholding, which makes greater demands on regulators but potentially provides the basis for a reflexive, dynamic stakeholder model which could better align corporate decision making with the common good.

2. From shareholder owners to shareholder value

This first section examines how corporate theorists responded to the 'separation of ownership and control' which occurred in the late nineteenth century as corporations began to raise financial capital from outside investors. The view that corporate managers ought to take account of stakeholder interests became widespread and relatively uncontroversial. It then describes how the contractual model of corporate governance emerged as a response to these assumptions and refocused attention on the position of shareholders.

Classical economics had generally assumed that entrepreneurs would manage their property efficiently so as to produce profits, and therefore maximise social wealth. As companies expanded in size and raised capital more widely, not all shareholders could – or wanted to – be involved in management. This had important implications for the assumption that businesses would necessarily be managed so as to increase social wealth, and with it the social interest or the common good. From the 1920s onwards, a number of theorists examined the implications of this separation of ownership and control for classical economic assumptions.

Robert Brookings first recognised in 1925 that 'management and capital collectively constituted ownership' and of the 'gradual recognition of the evil possibilities which resulted from the carrying over of the ancient legal concept of unlimited ownership into a social setting where its significance was very different' and the resultant 'demand for "industrial democracy"' (Brookings 1925: 18). He concluded that

> The more completely management is separated from ownership the more it comes to be regarded as the representative of all the cooperating parties and conflicting interests, and not simply of the stockholders .. while the trade-unions and the politicians have been increasing the external pressure on the manager, the internal pressure from the stockholders has decreased. Management is thus coming to occupy the position of trustee, and to maintain its position it must serve the public with the greatest efficiency consistent with a fair return to labor, and with the return to capital necessary in order to keep it in industry (Brookings 1925: 21–3).

In a famous 1931 article, Berle argued that 'all powers granted to a corporation or to the management of a corporation .. are necessarily and at all time exercisable only for the ratable benefit of all the shareholders as their interest appears' (Berle 1931: 1049). He did however recognise that shareholders had become 'passive' property owners who merely had a set of economic expectations, in contrast to earlier, 'active' entrepreneurial owners (Berle 1932: 1369-70). This left the control of property in the hands of corporate managers. Berle accepted that it was as yet unclear as to whether in law the shareholders would maintain their 'primary property right over residual income' or whether it would be shared in some way with other claimants, but he was sceptical that the correct approach was to 'grant uncontrolled power to corporate managers in the hope that they will produce that development' (Berle 1932: 1372).

However, in his more famous discussion of the separation of ownership and control, co-authored with Means, which is viewed as the beginning of the modern corporate governance debate, Berle abandoned this apparent aversion to leaving such discretion in the hands of management. Berle and Means' radical conclusion, which is rarely cited these days, was that the separation of ownership and control had divided the entrepreneurial function between managers and shareholders. As a result, the company had been turned into a quasi-public institution, in which managers should be charged with balancing the claims of the great variety of groups and assigning the income stream in line with public policy, rather than simply maximising returns to shareholders.

Once they recognised that the logic of private property no longer applied, these theorists argued that company directors ought to pursue their vision of the common good by taking into account both shareholder and non-shareholder interests. This may have been the first articulation of a stakeholder vision of the corporation. The main argument raised against this approach was not that shareholders ought to take priority over other interests, but that there was a danger that directors would become completely unaccountable. This approach ushered in the era of managerialism, which saw managers to a considerable extent balancing the claims of the corporation's different stakeholder groups, even if they were under no legal compulsion to do so. This continued until financial capital reasserted its power, beginning with the first wave of hostile takeovers in the 1960s, and then again in the aftermath of the stagnation of the mid-1970s, and brought the shareholder interest back to the forefront of the corporate governance debate.

From the 1980s, advocates of shareholder primacy began to argue that the corporation was a mere legal fiction, which was better understood as a 'nexus of contracts'. Corporations were therefore simply a group of interconnected contracts for the sale and purchase of already existing things: claims on the income stream; labour; land; financial capital and the goods or services produced.[3] These theorists argued that employees, for example, freely entered into their employment contracts with the corporation, and so must, by definition, be better off a result. They must have valued their wages under that contract more highly than the other possibilities open to them, such as enjoying leisure, working for themselves or working for another firm. The same would apply to consumers and lenders who voluntarily entered into contracts with corporations which must have made them better off than alternative uses of their money. It was then only a small step to insist that the interests of all these 'stakeholder' groups were fully protected by the terms of their contracts, and therefore they had no need of any protection through the corporate decision making process, whether in the form of authorising managers to take account of their interests, or in the form of rights to participate in decision making. Other stakeholders, such as local communities and the environment, which have no contractual connection to the corporation, should be protected by specific legislation as necessary.

The key implication of this was that there was no distinction between the firm and the market; instead there was simply a 'multitude of complex relationships (i.e. contracts)' (Jensen and Meckling 1976: 311). This change of frame allowed its advocates to sidestep the issues arising from the separation of ownership and control, and to rely on the familiar argument that, as a market, corporations would automatically, as if by an invisible hand, further the interests of society. Accordingly, intervention in the internal affairs of corporations could not be justified in the absence of market failure.

It was argued that the one group affected by market failure was the shareholders, who contract for a residual claim to what is left over after all other contracting groups have been paid their fixed entitlements. They could therefore justify additional protection through the corporate decision making process, and this explained corporate law's default allocation of rights to them. According to this model, shareholders contract with management 'for a promise to maximize long-run profits of the firm, which in turn maximizes the value of their stock' (Easterbrook and Fischel 1991: 36). Alone among the contracts which make up the corporation, this contract is incomplete. Uncertainty about the future, bound-

3. These are economic rather than legal 'contracts', which implies that they are reciprocal arrangements which are allocatively efficient, but are not necessarily legally binding in relation to all the risks which arise.

ed rationality and transaction costs make it impossible for shareholders to specify in advance precisely how managers should advance their interests. This argument appears plausible, since it is clearly impossible to anticipate the risks and opportunities with which corporate management will be faced in the future. The fundamental impossibility of drawing up an exhaustive, complete contract between shareholders and management offered an explanation for the default governance structure provided by law for modern corporations. Managers are granted considerable discretion, but the shareholders retain a number of rights in the corporate governance process which they could use to hold managers to account, thereby maximising the value of their residual claim. In the language of agency theory, the shareholders were the principals, managers were their agents, and shareholder rights could be used to reduce agency costs. When these rights are used to increase the value of the shareholders' residual claim, while all other contractors were being paid fixed claims that made them better off, social wealth would be increased.

This comprehensive model of the corporate 'nexus of contracts' left shareholder primacy theorists facing one main difficulty: although shareholders theoretically valued these rights very highly, in practice they did not exercise them. This was described as 'rational apathy' and a collective action problem. No rational shareholder would expend the time and effort to improve corporate governance by monitoring management and intervening, because other shareholders would free ride on their efforts. The whole field of corporate governance sprang up to resolve this problem, and this theory justifies many of the innovations witnessed over the last few decades. Hostile takeovers use the current share price to identify and remove managers who underperform in shareholder value terms;[4] incentive pay is supposed to align executives' incentives with the interests of shareholders; and corporate governance codes require a majority of the board to consist of non-executives with a view to protecting the shareholders against the self-interest of executives. These solutions to the 'agency problem' facing shareholders were for the most part market adaptations rather than legal interventions, at least in the beginning. The UK's City Code on Takeovers, which greatly

4. As Henry Manne argued as long ago as 1965, 'Apart from the stock market, we have no objective standard of managerial efficiency' (Manne 1965: 113). The efficient markets hypothesis appears to have remained intact – for the time being at least – despite the obvious pricing failures in the run up to the global financial crisis.

facilitated hostile takeovers, was a self-regulatory measure put in place by the City of London to give greater protection to shareholder interests than was available in company law (Johnston 2007). The UK's corporate governance code, which resulted from a review of the 'financial aspects of corporate governance', was also a self-regulatory response, this time to a perceived lack of accountability of management to shareholders. Both of these instruments were the product of their time and place, but both now form an essential part of the blueprint for shareholder value corporate governance in Europe, and are disseminated through a combination of directives, soft law and investor pressure.

The nexus of contracts model provides intellectual support for a system of corporate governance oriented towards short-term shareholder value as reflected in the current share price. Until recently, stakeholder theory was confined to a political perspective and was not able to articulate an economic response to this model. At its broadest, it defined stakeholders as 'any group or individual who is affected by or can affect the achievement of an organization's objectives' (Freeman 1984). As such, these groups ought to be taken into account by managers in order to achieve the long-term success of the firm. However, this pluralism left it open to accusations of indeterminacy by shareholder value theorists, who claimed it would simply result in managerial unaccountability (Jensen 2002). Recent developments in stakeholder theory have focused more sharply on the flaws in the economic methodology underlying the pro-shareholder conclusions drawn from the contractual model to demonstrate that shareholder value and social wealth cannot necessarily be equated. This is important because arguments for a stakeholder model of corporate governance must be grounded in an economic as well as a political logic.

3. Margaret Blair and the productive coalition

The most important theoretical challenge to the argument that increasing returns to shareholders can be equated with an efficient allocation of resources, and therefore increasing social wealth, was advanced by Margaret Blair (Blair 1995). Blair's argument revolves around the notion of firm-specific human capital (FSHC), which refers to skills acquired by employees in a particular employment context, which have no value in other employment contexts. These investments are desirable from an efficiency standpoint because they enable the employee to be more productive in that employment, and therefore to generate quasi-rents.

In order to encourage employees to specialise their skills to the firm's requirements, managers have to promise employees wages which rise in line with their increasing productivity. Those wages will be above market rates, and reflect the fact that the firm is sharing the proceeds of the productivity gains generated by the employee's specialisation with the employee. Blair estimates that the returns to employee investments in FSHC are of a similar order to shareholder profits (Blair 1995: 266).

The difficulty with employee investments in FSHC is that they cannot be governed by an ex ante, legally binding contract. Governance has to take the form of an implicit contract which is not legally binding because corporate managers do not know in advance the extent to which particular employees will specialise or their likely contribution. The essential point is that, where employees specialise their skills to the needs of the corporation which employs them, their contract will, like that of the shareholders, be incomplete, and, like shareholders, they will be vulnerable to agency costs. Under the threat of hostile takeover, or in response to the incentives provided by their own contracts to increase shareholder value, corporate managers may breach the implicit contracts they made with employees, and distribute the surplus to the shareholders and themselves, increasing the share price but imposing agency costs on the employees.[5] The more this happens in an economy, the less willing employees will be to invest in FSHC, and the lower their productivity will be. This contracting problem amounts to a market failure, and if investments in FSHC are to be encouraged and productive coalitions held together, the employment relationship must be embedded within a protective governance structure, just as the shareholder-manager relationship is.

There has been considerable debate as to the form this governance structure should take, and whether the law should provide default or mandatory rules, or perhaps even a menu of options for corporations to choose from. Many shareholder value theorists simply deny that employees invest in FSHC (see, for example, Romano (1992)). Those that do recognise the possibility of investments in FSHC resist more pluralist forms of corporate governance through a variety of strategies, including claiming that only managers make significant investments (Coffee 1988) or in-

5. Shleifer and Summers advanced the important argument that hostile takeovers which result in breaches of implicit contracts are 'rent-seeking and not value-creating exercises' which can actually reduce social wealth (Shleifer and Summers 1988: 42).

sisting that employees, either individually or collectively, can get around their contracting problems and design a system of severance payments to protect their investments (Easterbrook and Fischel 1991: 37; Fischel 1984: 1067-8). Insisting that employees can obtain legal protection for their investments through contract is a vital step in support of the shareholder value argument that corporate governance should be a single purpose mechanism aimed at reducing the agency costs imposed on shareholders. This is not a convincing argument, since employees who invest in FSHC face contracting difficulties at least as serious as those facing shareholders. However, advocates of shareholder value have studiously ignored this critique.

Margaret Blair's position on this question is that the system of managerialism which lies at the heart of corporate law provides an adequate basis for the governance of investments in FSHC. In this view, the various groups who invest in the corporation hand over control rights to the board, and the board act as 'mediating hierarchs' between the competing claims of, for example, employees and shareholders with the aim of holding this 'productive coalition' together. The corporation is a means of locking in investments and becomes the locus for a political contest over the distribution of the contractually unallocated quasi-rents or surplus generated by specialisation (Blair and Stout 1999: 277 and 323).

There are difficulties with the assumption that current corporate law could fulfil this mediating function, both because it gives control rights over the board by default exclusively to shareholders (Mitchell 2001: 99), and because the broader corporate governance system exposes executives to strong pressure to maximise returns to shareholders in the short term. Given the existence of these extralegal incentives, David Millon wonders whether it is 'possible to conceive of a set of legal rules capable of establishing this state of ivory tower autonomy' which is necessary for managers to play the role of mediating hierarchs (Millon 2000: 1027-9).

Blair's work is fundamental to any policy discussion of stakeholding for two reasons. First, it shows that a stakeholder approach to corporate law can be justified on efficiency grounds. Second, it shows that managerial autonomy is one of the mechanisms by which corporations could be governed in the interests of all stakeholders. Mitchell's and Millon's critiques of the productive coalition model emphasise that there would be a need for legal reform before managerialism could be relied upon as the foundation for a stakeholder model of corporate governance. At the very least, fairly far-reaching changes would be required to the rules on hostile takeovers and executive remuneration, both of which are intended to align managerial interests with those of shareholders and therefore undermine the impartiality which is essential if they are to play convincingly the role of mediating hierarchs. Such reforms would be politically very difficult, and this does call into question the viability of using renewed managerialism as the basis for governing corporations which operate as productive coalitions. However, two relatively recent developments give cause for hope. First, the Takeover Directive[6] gives the Member States the option of making managers more autonomous from shareholder pressure by not allowing them to opt out of a prohibition on defensive measures against hostile takeovers. While this was a pragmatic compromise which was necessary for the adoption of the directive, it does accommodate greater diversity in terms of corporate governance across the Member States (see Johnston 2010). Second, since the financial crisis, the European institutions have perceptibly changed their approach to executive pay. Where previously the Commission was content to issue recommendations that executive pay should be aligned with shareholder interests, there is now a greater willingness to intervene, even if, to date, this has been limited to restricting practices within financial institutions which are thought to encourage excessive risk-taking and so threaten the stability of the financial system.[7]

The alternative to governing productive coalitions through greater managerial autonomy is to grant rights to participate in corporate governance to employees. Agency theorists justify the law's decision to grant governance rights to shareholders on the basis of a hypothetical bargaining process, which assumes that the shareholders value the rights most highly, since they alone can use them to increase the value of their residual claim. These theorists argue that if employees value rights to

6. Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, OJ L 142, 30.4.2004, p. 12.
7. See Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies, OJ L 329, 14.12.2010, p. 3, which provides for supervisory review of remuneration policies in credit institutions and investment firms, and Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, OJ L 174, 1.7.2011, p. 1, which regulates remuneration policies in hedge funds and private equity firms.

participate in corporate decision making, it is open to them to bargain and pay for them. Legal intervention, they claim, will damage the efficiency of the nexus of contracts, and cannot be justified. Some theorists argue that the default grant of rights to shareholders can become quasi-mandatory as endowment effects and network externalities create barriers to reallocation of the rights, even where this would be more efficient (Sunstein and Ullmann-Margalit 2000; Klausner 1995). This implies that it is not appropriate to assume that corporate governance rights are allocated efficiently to shareholders simply because the employees fail to bargain to reallocate them. Other theorists argue that there are considerable obstacles to employees bargaining for participation rights, and that legal intervention can be justified as a solution to market failure (Sadowski *et al.* 1999; Smith 1991).[8] Finally, Germany's imposition of mandatory employee codetermination has been justified on the basis that it is a 'beneficial constraint' which forces companies to compete on the basis of employee skills and product quality rather than on the basis of cost (Streeck 1997). As well as supporting rights to participate in decision making, these arguments also support less far-reaching participation rights, such as employee information and consultation, which through the institution of dialogue can generate greater trust between the parties and reduce management's willingness to breach implicit contracts. Again, however, if weaker participatory rights are to support investments in FSHC, changes to the corporate governance system will be required. One key implication of the productive coalition model is that employee participation in corporate governance has a key role to play in supporting the specialisation which will give European companies a comparative advantage on global markets.

4. Constructing social cost – a new model for the stakeholder company?

The productive coalition model is very important because it challenges the shareholder value model from within its contractual methodology,

8. Transaction costs too may prevent efficiency-enhancing reallocations of rights. However, economists such as Oliver Williamson, who explain corporate governance structures on the basis of transaction costs, appear reluctant to extend their analysis to the difficulties facing employees where they cannot know the extent of their future investments in FSHC (Johnston 2009: 84-5).

and suggests that market failure is not confined to the relationship between shareholders and managers. It shows that corporate governance should have a broader scope, which at the very least ought to encompass employees as key stakeholders who face particular vulnerabilities to opportunism. However, it is possible to go further and argue that the scenario dealt with by the productive coalition model is one example of a whole swathe of market failures which arise where corporate managers focus exclusively on producing easily quantifiable increases in short-term shareholder value at the expense of longer-term and more nebulous costs to society and the various corporate stakeholders. Even though employees have a contractual link to the corporation, they find it impossible adequately to protect their interests by means of contract alone, and the gaps in protection give corporate management scope to redistribute the contractually unallocated surplus to the shareholders and themselves (via their shareholdings and stock options). Other stakeholders also face a risk of corporate opportunism, and are also likely to face considerable barriers to bargaining for protection of their interests because they do not have a contractual link with the corporation.

The conventional, shareholder value approach contends that stakeholder interests should be protected through a combination of bargaining and regulation, giving the corporate governance process the single purpose of ensuring that shareholder wealth is maximised. However, the assumption that bargaining and regulation will result in an efficient and socially adequate level of protection is questionable.

The majority of law and economics scholars argue that, as long as there is a clearly defined system of property rights, those who are affected by the corporation's activities can rely on their property rights, or bargain for protection of their interests. In their view, if rights are not reallocated by a bargain between those concerned, it follows that they are allocated efficiently, that is, to their most highly valued use. Following their (arguably flawed) reading of Coase's seminal 1960 article, 'The Problem of Social Cost', they do recognise that transaction costs will sometimes prevent stakeholders and corporations from concluding contracts which would enhance social wealth. In that situation, it is commonly argued that the courts should allocate property rights to the party which values them the most highly. The overall aim is to bring about the allocation of rights which would have resulted from bargaining between the parties in the absence of transaction costs. The difficulty with according such primacy to bargaining as a solution to social cost is that there are numerous significant barriers to stakeholders bargaining with corporations for protection of their interests. The social costs which affect communities are often nebulous and difficult to prove. Affected groups have to emerge and organise themselves (Callon 2008). There are problems of free riding, and corporations faced with allegations of creating social costs can exploit community interdependencies, making coercive settlement offers or otherwise exploiting vulnerabilities (Parchomovsky and Siegelman 2004). These factors mean that agreements between corporations and their stakeholders will be few and far between, and that the absence of an agreement reallocating rights cannot be equated with efficient resource allocation. Moreover, since the law's allocation of property rights is frequently unclear ex ante, any bargain which does emerge will be more akin to a 'mutual accommodation' than an efficiency enhancing reallocation (Simpson 1996).

In contrast to its emphasis on 'Coasean bargaining', conventional law and economics spends remarkably little time discussing regulation, which is viewed as prima facie inefficient because it interferes with market outcomes. However, in his original article, Coase was far less reticent about discussing the possibility that regulation might be used to correct social costs, although he doubted whether intervention would normally enhance social wealth. Coase argued that, before they intervene, regulators need to give greater consideration to the effects of their proposed actions on social wealth, and compare them with doing nothing, in which case the cost will be left where it falls, or reallocated by bargaining between the parties, depending on the incidence of transaction costs (Coase 1960). In particular, he argued that regulators should take account of the direct costs and benefits of their proposed intervention (in terms of its effect on existing patterns of wealth generation), the likely second order effects of intervention (as producers respond to the intervention) and the administrative costs of designing and enforcing the regulation. They should then compare these costs with the costs of doing nothing, which obviously does not give rise to any regulatory costs, but leaves intact the existing distribution of social costs (which may reduce social wealth), and gives rise to transaction costs where the parties seek to enter an efficiency enhancing contract to reallocate those costs. These are obviously not easy questions to answer ex ante.

Coase was pessimistic as to the prospects of justifying government intervention on the basis of a cost-benefit analysis, and concluded that 'most "externalities" should be allowed to continue if the value of production is to be maximized' (Coase 1988: 26). Accordingly, social costs would remain 'ubiquitous'. Coase's pessimism as to the viability of regulation did not deter other agency theorists from insisting that social costs should be dealt with by government intervention, even whilst arguing against intervention in particular situations on the basis of cost-benefit analysis. This was a satisfactory outcome because leaving social cost entirely to the regulator left corporate managers with the clear goal of 'making as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom' (Friedman 1970). However, as Eric Orts puts it, this argument 'allows corporate executives conveniently to ignore the effects that their operations may have on society and the natural environment, except to the extent that these effects are translated into formal economic and legal constraints' (Orts 2005: 190).

There are considerable doubts about whether regulation alone can bring corporate decision making into line with the common good. First, as Orts emphasises, corporations can use their lobbying power to influence politics and prevent or at least limit regulatory intervention, which makes 'the Friedmanesque argument that one can depend on the liberal democratic process to constrain business behaviour .. naive at best, or at worst, hypocritical' (Orts 2005: 191). Second, and more importantly, conventional instrumental regulation is in a secular crisis. Increasing social complexity and the tighter coupling of financial and productive systems means that regulators are confronted with what Teubner calls the regulatory 'trilemma': regulation is 'either irrelevant, or produces disintegrating effects on the social area of life or else disintegrating effects on regulatory law itself' (Teubner 1987: 21). These concerns that regulation will be – at best – ineffective in achieving its goals creates further pressure on regulators not to intervene in an attempt to cure the social costs of economic activity.

Where regulation appears unfeasible under the cost-benefit analyses now carried out as a matter of course by regulators, and contracts between dispersed stakeholders and corporations face insurmountable obstacles, only 'ethical custom' stands in the way of highly-incentivised managers 'making as much money as possible' by imposing social costs on stakeholder groups. However, ethical custom is of marginal relevance to the governance of social cost. Self-interested but 'enlightened' proclamations of corporate social responsibility are more likely to be public relations exercises than genuine attempts to address the social costs of corporate activities. Corporations can profit by externalising costs onto society where they are not prevented from doing this by regulation or contract. Where they do this, increases in shareholder value cannot be equated with increasing social wealth or furthering the common good. Where shareholder value is created by externalising costs onto society and the environment, this is simply a wealth transfer rather than the generation of a surplus.

The issue for stakeholding theory now – and in the future – is whether a more viable and cost-effective means of governing social cost is possible, so as to bring corporate governance into better alignment with the common good. As is well known, Teubner argues that the law can get around the probable failure of instrumental regulation by adopting a reflexive approach (Teubner 1993). This entails designing and imposing procedures which work with the logic of the system which it is sought to regulate (here, the corporation), rather than imposing substantive outcomes on it from the outside, which will simply act as an irritant, changing the way the system responds to its environment without necessarily achieving the regulatory goal. One form of procedural regulation, which has been used fairly frequently, has been to require corporations to allow stakeholders to have input into their decision making processes as a means of protecting their interests. As discussed above, employee participation is the best example of this. Another possibility is to require directors to take account of both the public interest and the corporate interest in their decision making. The reason that this kind of intervention is more likely to be successful is that it works with the logic of corporations, which systems theory treats as a form of organisation, consisting of linked decisions. Reflexive regulation channels corporate decision making to take greater account of its impacts on its environment but without prescribing the content of those decisions. It allows more effective governance of social cost than is possible through conventional regulation, albeit that it does not guarantee that any particular instance of social cost will be internalised by any particular corporation.

Yet both of these stakeholder approaches also suffer from limitations. Granting participatory rights to stakeholders requires that they be identified in advance. This works well in the case of employees, where the regulator recognises that they face a number of risks, including opportunistic breach of their implicit contracts by management and an inability to diversify their investments. However, it is more difficult in the case of other stakeholder groups, where the incidence and distribution of risks and social costs may be more uneven. Conventional approaches to stakeholding are essentially static, with stakeholders given rights only if they fall into one of those groups whose interests are considered by regulators to be at risk. While a reflexive approach relieves the regulator of having to determine substantive outcomes, there are serious epistemological problems to be resolved before social costs can be governed. The regulator cannot simply impose an obligation on directors to take account of the common good or public interest in their decision making, because it cannot be assumed that the board are in possession of all the facts about the corporation's effects on its social and natural environment. However, any attempt on the part of the regulator to bypass this difficulty by designating the corporation's stakeholders in advance risks the return of the trilemma, if unaffected groups are given rights or affected groups are excluded. The essence of the problem is that, once we move beyond employees as the most obvious stakeholder group, it becomes increasingly difficult for a regulator to catalogue those affected by corporate activity. Moreover, the distribution of social costs may cut across any regulatory categories. Perhaps the solution is to treat identification of affected groups as the end point, rather than the starting point of the regulatory process. As Michel Callon emphasises, affected groups emerge when individuals or small groups are concerned by and inquire about a particular externality, or 'overflow' of corporate activity, as he puts it. As those affected identify matters of common concern, 'new, original and often unforeseen identities emerge, which sometimes demand to join the collective and recompose it' (Callon 1998 and 2008).

At present, then, both shareholder value and stakeholder models are static, identifying those with a residual claim in advance, and then considering different ways in which their interests can be protected through the corporate decision making process. This works well in the case of clearly defined groups like employees whose interests are clearly at risk from corporate decision making, but far less well in relation to other, more nebulous stakeholder groupings. Michel Callon's work hints that a dynamic approach to stakeholding is possible, in which those with a stake in each corporate decision are identified on an ongoing basis through a reflexive process of fact construction, rather than through a one-off,

9. As O'Sullivan points out, the possibility of market and technological changes mean that both shareholder and stakeholder regulation risk becoming 'de facto theories of corporate welfare' (O'Sullivan 2000: 56).

ex ante determination by a regulator or a best guess by a board, which does not possess all the relevant facts but is charged with furthering the public good. Under a dynamic approach, those who consider themselves affected by corporate activity would have the opportunity to engage in a process of dialogue with corporate decision-makers with a view to reaching agreement not only on the nature and existence of the 'overflows' of corporate activity, but also on ways in which the costs which result might be minimised or eliminated. Callon describes this as a hybrid forum because it is a place where 'facts and values … become entangled' (Callon 1998). The forum's function is to establish 'an acceptable alignment between what one knows (or believes one knows), what the actors want and expect (which is often contradictory) and the procedures to follow to elaborate norms'. The output of the hybrid forum is a set of facts which are acceptable to all concerned and a means of reconciling differences about those facts, at least for a limited period (Callon and Rip 1992).

Callon never explicitly applied these ideas to corporate governance, but it is suggested that they provide important insights into how constructivist processes might be used to create a better alignment between corporate activities and the common good. We are now in a position to sketch out, in a very preliminary way, an institutional framework which would allow the interests of stakeholders to be protected through corporate governance in a dynamic rather than static way. In addition to giving designated stakeholders, such as employees, rights to participate in decision making or to information and consultation, the law could require corporations to establish hybrid forums on a regular basis, allowing affected groups to meet with managers to trace the actual or potential effects of corporate decisions on them, and to identify solutions to those adverse effects. This process would allow the corporation's other stakeholders to be identified on a case-by-case basis and externalities to be internalised in a satisfactory way.

The question arises of whether this reflexive process should be legally mandated or a voluntary matter for corporations. Voluntary action on the part of corporations is normally dealt with under the rubric of corporate social responsibility (CSR). Since 2001, the Commission has viewed CSR as 'a concept whereby companies decide voluntarily to contribute to a better society and a cleaner environment' (Commission 2001). However, the Commission recently announced that it was abandoning this approach and now considers CSR as a mechanism by which corporations internalise the costs they impose on their stakeholders. Under this new approach, CSR refers to 'the responsibility of enterprises for their impacts on society' (Commission 2011: 4-6). Inter alia, this will require that corporations 'have in place a process to integrate social, environmental, ethical, human rights and consumer concerns into their business operations and core strategy in close collaboration with their stakeholders, with the aim of maximising the creation of share value for their owners/shareholders and for their other stakeholders and society at large; [and] identifying, preventing and mitigating their possible adverse impacts'. In terms of 'identifying, preventing and mitigating', corporations are 'encouraged to carry out risk-based due diligence, including through their supply chains'. This change in approach is broadly to be welcomed. Under the previous approach, CSR encompassed any 'socially responsible' action which improved the corporation's reputation, and therefore its profitability. This meant that spending on charity and the arts, for example, was viewed as socially responsible, even though there was no connection between the beneficiaries of this largesse and the corporation's business activities. Under the new approach, CSR will be more firmly connected to the effects of the corporation's business activities, and will encompass far fewer pure public relations exercises. More importantly from the perspective being discussed in this book, CSR will become one possible mechanism by which corporate activities can be governed in the public interest.

In fact, the Commission's new approach begins to blur the line between CSR and stakeholder-oriented corporate governance. While CSR remains primarily voluntary, and the Commission continues to place considerable emphasis on the 'business case' for social responsibility, it also notes the 'supporting role' of public authorities in introducing 'a smart mix of voluntary policy measures and, where necessary, complementary regulation, for example, to promote transparency, create market incentives for responsible business conduct, and ensure corporate accountability'. In this early phase of the Commission's new approach, it is not clear whether regulation aimed at ensuring accountability is envisaged at national or supranational level. It might be suggested that regulation will be necessary to require corporations to meet with affected groups. Without an obligation to meet, managers would be likely to avoid meetings with groups wherever this is likely to generate adverse publicity. In line with the discussion above, corporations might be required to meet and engage in discussions with affected groups in order to promote accountability. Subject to appropriate procedures being established, this would potentially enable otherwise invisible social impacts to be traced.

Once it has identified its 'adverse impacts', the corporation would then be expected voluntarily to 'prevent and mitigate' them in order to demonstrate its social responsibility. This will not pose any difficulty where there is a 'business case' for doing so. However, in addition to identifying these 'win-win' situations, this more intrusive approach to CSR is likely to identify impacts which cannot be internalised profitably, and these are less likely to be dealt with voluntarily. Corporate decision-makers will run up against the same corporate governance constraints which undermine the prospects of mediating hierarchy in the productive coalition model. Will managers really be likely to take decisions which sacrifice the current bottom line in order to mitigate social impacts?

At this point, stakeholder approaches to corporate governance part company with CSR. In order to be effective, a dynamic stakeholding approach would require, at the very least, a legal obligation on management to do something about any 'adverse impacts' identified in meetings with affected groups. At its most prescriptive, an obligation might be imposed on directors to internalise externalities of which they become aware in the course of these consultations. Less prescriptively, and more in keeping with the managerial core of company law, directors might be obliged to take 'adverse impacts' into account as an aspect of a broader obligation to manage the corporation in pursuit of the common good. There would clearly be significant political obstacles to imposing this type of duty on corporate decision-makers. However, this chapter has sought to demonstrate that shareholder value is not an adequate proxy for social wealth, and that economic arguments can be used to support a stakeholder-oriented approach to corporate governance.

In concluding this discussion of a stakeholder approach to governing social cost, three caveats should be raised. First, this chapter has not sought to argue that employee codetermination should be replaced with a more flexible approach. The economic arguments for mandating employee participation in corporate governance have been clearly articulated by theorists such as Blair, Sadowski and Streeck. Economies can gain comparative advantage by putting in place an institutional structure which encourages firm-specific investment by employees. The procedures for identifying and governing social cost advocated in this section would operate in addition to – and not in place of – existing employee participation rules. Second, this chapter has not sought to argue that social costs should only be addressed within corporate governance. Mandatory regulation through legislation remains indispensable, particularly in relation to the intractable environmental problems facing us. However, regulation will frequently be incomplete, inadequate or missing entirely for a variety of reasons, and, where that is the case, requiring companies to construct and address the social costs their operations create would be a useful complement. Third, a number of issues remain to be ironed out. What procedures would the hybrid forum follow? Would the law become involved in the event of disputes? What would happen if participants acted disruptively or in bad faith? These are difficult questions that require further research. Here it can simply be noted that both corporate law and administrative law have dealt with similar issues for many years without paralysing decision making or descending into doctrinal incoherence.

5. Conclusion

This chapter has sought to demonstrate that confining the corporate governance, or decision making, process to the narrow function of furthering the shareholder interest is a lost opportunity. The corporate governance process is often the most effective means of governing, or exercising control over, the social costs of corporate activity. Indeed, the currently dominant shareholder value approach may even exacerbate the problem, as corporate managers have powerful incentives to externalise as many costs as they can in order to increase the corporation's share price.

That the law might intervene in corporate governance in pursuit of the common good has been recognised since at least 1975 when Christopher Stone argued in favour of 'more straightforward "intrusions" into the corporation's decision structure and processes than society has yet undertaken' (Stone 1975: 121). Of course, this has been fiercely and repeatedly resisted by advocates of shareholder primacy on the all-too-familiar basis that making corporate managers accountable to more than one constituency would release them from all accountability. However, leaving aside their unreasoned insistence that employees can protect their interests through contracts, shareholder value theorists have not offered a convincing response to Margaret Blair's argument that employees who specialise their skills to the corporation's requirements are vulnerable to managerial opportunism just as shareholders are. Their lack of concern for employees in this situation suggests that these theorists may be more concerned with achieving a preferred distribution than improving allocative efficiency. Their contractual model of corporate governance – with all its failings – remains the main argument against greater employee participation in corporate decision making. This chapter has hopefully demonstrated some of the dominant model's weaknesses. Advocates of shareholder value have shown even less interest in sociological arguments that economic activity always creates overflows. Friedman was happy to accept that governments can regulate to control externalities which are 'widely regarded as sufficiently important to justify government intervention', but then to argue that, as a rule, they should avoid doing so because the costs of intervention are normally higher than the benefits and because it somehow reduces 'freedom'. This argument forecloses the possibility, first suggested by Brookings, and later taken up by Berle and Means, that corporate governance could become a political process, with managers seeking to identify means to further the common good through engagement with the various groups who consider themselves affected by the corporation's activities. This is what a true stakeholder model of the corporation would look like: directors and managers would be under an obligation to further the interests of the corporation, whilst internalising all the externalities of which they become aware in the course of their legally required engagement with stakeholders, with participation rights granted to shareholders and employees as the corporation's residual claimants.

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