# Chapter 2
# Why stakeholders?

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## 1. Introduction

### 1.1 The topic, purpose and point of departure

The distinction between stakeholder and shareholder theory – and their advocates – is dominant in the literature on companies and governance. At the core of the debate is the question of whether or not state interference in company activity is perceived as legitimate. A further issue in the debate is the question of shareholder rights and the possible role of the state of empowering other stakeholders at the expense of shareholder power.

Two very simple questions make up the foundation of this discussion: Who owns the companies? And: Who has the right to make decisions about company activities? Here the question arises of whether the principle of private property can be applied to the question of company control and governance. By using property rights theory (Demsetz 1967)[1] and agency theory (see e.g. Jensen and Meckling 1976) the answer for the advocates of shareholder theory is: Yes! Advocates of the other tradition, i.e. stakeholder theory, emphasise that people inside and outside the company have a right to exercise 'voice' in its affairs because the company's activities might influence their lives. In other words, the company has responsibilities vis-à-vis a number of stakeholders.

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1. 'Three important criteria for efficiency of property rights are (1) universally – all scarce resources are owned by someone, (2) exclusivity – property rights are exclusive rights; and (3) transferability – to ensure that resources can be allocated from low to high yield uses. In Demsetz's (1967) neoclassical economic framework, all three criteria are in place (in the long run)' (Mahoney 2004).

But what is the basis for arguing that specific groups of actors have a right to be included in decision making processes and bodies in a privately owned company in a capitalist economy? For shareholder theorists, property rights lead to 'shareholder democracy' and legal regulation of decision making power, voting and election procedures and certain company bodies. Up to now, stakeholder theory has to a far lesser degree defined such rules and regulations (Clarke 1998). Assuming that stakeholder interests should be represented: how should stakeholders be selected and how should principles for representation and election procedures be determined? The stakeholder theory answer to this question could be characterised as a mixture of opinions on the legal framework and normative or moral statements. The legal framework defines the company's legal liabilities towards the state, shareholders and other contractual partners as the basis of the moral responsibility of any company.

For stakeholder theorists, the reasons for Corporate Social Responsibility (CSR) are seen as either instrumental (the so-called business case) or as an overall moral duty. Little attention has been devoted to the normative foundations for stakeholder rights; stakeholders are seen as important due to their contribution to productivity and profit, either directly (through production) or indirectly (through company reputation in the consumer and/or capital market). The moral obligation is taken for granted without any thorough consideration of its democratic foundation. The result is that the relationship between CSR and political regulation remains ambiguous or vague in stakeholder theory. Political regulations in this, as in any other sphere of society, need democratic arguments and foundations to be legitimate. Thus, the importance of self regulation remains a common feature of both shareholder and stakeholder theory. Company actors shall and must decide on company activities and where to draw the line between company activity and the outside world.

However, we need to ask who these company actors are and which interests are to be included as part of company interests and how these interests are legitimatized. The foundation of this legitimacy is the main issue in this chapter: what makes a stakeholder a legitimate stakeholder with rights to participate in company decision making? The legitimacy may in principle be drawn from two sources; from the legal framework or from an understanding of fairness (or justice). The legal definition of property rights is our point of departure when analyzing this framework.

When entering the area of fairness we use the work of John Rawls (1971, 2001) on social justice and in particular Jon Elster's (1992) concept of local justice when scarce goods are distributed.

In this chapter we argue that the legal framework and theory of fairness define and legitimize the stakeholders that are entitled to participate in the company's decision making. These legitimate stakeholders are the shareholders and the employees.

## 1.2 Definitions and delimitations

What does it mean to participate in decision making processes in a private company? In order to answer this question we need to define both 'decision making processes' and 'company'. Our point of departure is a strict definition of power distribution as distribution of board seats, which implies that power is a 'divisible good' materialized as board seats. Our focus is on decision making power. We do not investigate whether or not board actions are important for the organisation (and stakeholders' interests) as such; here we assume it is true and do not look into implementation power (Falkum 2008), agenda power (Bachrach and Baratz 1969) or thought control (Lukes 2005).

Our analytical approach is quite simple: taking the current legislation as our point of departure, how can we argue for introducing new stakeholders onto the board? What are the normative foundations for shareholder representation today? Is it possible to use the same normative foundations for new stakeholder groups and does this imply the need to define certain participation rights for these other stakeholders?

The present owners of the company are subject to a number of restrictions. Through company law as well as a number of other legal acts, the state (or legislator) has defined the framework for ownership and the activity of shareholders. These restrictions need a democratic foundation in order to be legitimate. We ask: is it possible to use the same democratic arguments to defend the right of other stakeholders to elect 'their' director(s) to the board?

The company is defined here as a work organisation. This definition emerges in three steps: First, an organisation is a collective of individuals with common objectives (Morgan 1988; Dotevall 2009; Bergström and Samuelsson 2012; Johansson 2011). Second, this organisation is regulated by contracts; at the core of the organisation we find the employment contract, since only through paid labour can the objective of the organisation be fulfilled (Hagen 2012; Dotevall 2009; Bergström and Samuelsson 2012). The objective depends on processing input and the goal is reached by producing added value or surplus. Third, the work organisation is a legal person operating in a market; added value is not realized until the product is sold.

This chapter is divided into four parts. Following these introductory remarks we present the legal framework in part two, that is the legal position of property rights and the connection between property rights and the right to dispose of or control the property. Then we turn the table and move on to distribution of board seats in part three: if board positions are distributed according to fairness criteria, which stakeholder groups will be among the privileged? This line of thought is elaborated by using Elster's concept of local justice and the four different distribution principles; equality, merit, need and productivity. In the final part we return to the question of democratic arguments and the effect on different stakeholder interests.

## 2. Property rights in a capitalist economy

### 2.1 Some general remarks

We hardly need to argue that the question of company control is important. Companies, mainly in the form of limited companies (private as well as public) are the most important production units in the industrialized world. A number of multinationals have turnovers far greater than the GNP of some countries. Dividend, or the result of company activity, is one of the most important distribution criteria of wealth. Privately owned companies are inseparable from private property.

Western – if not all – social systems rely on the assumption of private property rights as a given and fixed phenomenon, almost considered as natural law. The foundations of private ownership can already be seen in Roman law and have developed into a central part of individual human rights as they are now known. The principle of property rights and its affiliation with powerful interests in society has made it appear to be eternal and independent of all codification. The principle has also had immense significance as a political, judicial, economic and social argument. Property rights can be said to be a formalised principle of a social/behavioural pattern (the contract, organisation forms, etc. (see Lindgren, Magnusson and Stjernquist 1971)). Within the industrialised part of the world, the idea of property rights in the liberal market economy is that they shall be decentralised so that economic decision making will be done by individual producers and consumers. This has indeed occurred to a great extent.

Property rights are given extremely strong legal protection in several legal systems in the industrialised part of the world. Ever since the 1776 United States Declaration of Independence and the 1793 French Declaration of the Rights of Man and Citizen, up through the United Nations declarations on human rights issues, property rights have enjoyed a strong position (see Eckhoff and Sundby 1991). The International Labour Organization (ILO), the Council of Europe and the European Union have followed up on the importance of property rights. Through this legislation on property rights, the individual's human and fundamental rights constitute not only a moral, but also a legal principle. These principles are mainly enforced in the national legal systems.

From an economic perspective, property rights constitute an institution that forms an essential condition for the liberal capitalistic market economy on which the Western social order is built. However, there is no general definition of the concept of property rights, which tend to be defined negatively (see e.g. Håstad 1996); the owner is allowed to use his or her property according to their own free will, provided that there are no limitations defined by law or by contract signed by the owner. Property right is the most absolute right to a property, but it can be restricted or changed through legal or conventional means. A general restriction on proprietorship is provided by necessity; the owner is responsible that his or her possession or belonging can be at disposal by anyone to avoid imminent and unanticipated danger that could cause greater damage than the damage created by the encroachment.

Proprietorship symbolizes a complex system of both privileges and obligations. For describing the legal system, the concept of proprietorship is used as an instrument and the concept does not per se refer to something specific (cf. Ross 1951; Håstad 1996). As a legal concept, the concept of proprietorship is an intermediate link, a so-called middle term (see Ross 1958 and Lindahl 2004) which connects circumstance (legal facts in issue) and meaning (legal consequence). From a legal perspective, the concept of proprietorship is dependent on the context and couples legal facts in issue (circumstances) with legal consequence (content). The actual situation and the legal rules applicable to the situation in question decide what legal facts are at issue and should be coupled with the legal consequences.

Proprietorship in company and labour law has to be conceptualized in a private law context. It is not sufficient to refer to proprietorship per se to apply legal rules, because proprietorship as a legal concept has to be coupled with legal facts at issue and legal consequence.

## 2.2 Association and property rights

The principle of property rights is used by individuals, collectives and corporations as an argument against the state's attempt to regulate the exploitation of property (Berle 1923; Nozick 1974; Åhman 2000.) The companies owned by the shareholders are private property. Thereby the interest of ownership is protected against external (governmental) requirements of control. This argument can be used against encroachment on the proprietor's interest through industrial democracy and employee involvement. If the employees' interests are equal to shareholders' interests when legitimizing involvement and authority, reasons other than property rights have to be used as justification.

From a legal standpoint, ownership of a company means indirect joint ownership. This is regulated by company law, whose starting point is to protect the partners' or the shareowners' monetary interests and the investors' interests. Company partners' rights and obligations are regulated by the relevant law applying to the specific company form. Shareholding results in both property right and obligatory right. Property right implies both an economic right and an administrative right. Obligatory right is only connected to an economic right and is based on a contract (Mellqvist and Persson 2011).The holding of shares involves the right to a share of the company and, by that, indirectly to the company's wealth. This is expressed e.g. in the 2005 Swedish Companies Act.

A joint stock company is an association of capital and as such a legal person separate from the owner of the company. The joint stock company is nevertheless legally bound to act in the interests of shareholders, who are at the same time principals. That follows from the ideological principle that the company's property is private property, which is protected by the constitution. The contract constituting a joint stock company establishes competence for the management of the company. The joint stock company is also legally bound to act in the interests of shareholders by the legislation regulating the joint stock company's constitution, through which the representatives of the management of the company obtain status in the company's organs. Thus, the management's competence is defined by both contract and legislation (cf. Samuelsson 2005: 465).

The objective of the company's business is the generation of profits for distribution to the shareholders, i.e. of invested financial capital (Bergström and Samuelsson 2012; Sandström 2012). Considering the importance of the joint stock company's capital base and the absence of personal liability of the shareholders, it is essential that dividend payouts have to be strictly regulated. As a starting point, the possession of shares grants substantial influence through the share owners' right to direct and control. Shareholders' interests are the dominant decision making criteria. As residual risk-takers, the shareholders derive their right to exercise control in the company, including the appointment of the management of the company. Furthermore, the shareholders as residual risk-takers have an incentive to supervise management and govern the company (Bergström and Samuelsson 2012). In Europe, this shareholder governance model has attempted to disperse the powers of the company through different models, such as a dualistic company management structure, interlocking boards of directors (i.e. boards of different companies with common directors), cross-ownership of shares between companies, corporate alliances, registration requirements for possession of shares, rules on insider trading, etc. It is however the company's management that, under the supervision of the board of directors, has the competence to implement the objectives of the company.

However, corporate governance models have developed towards other interests than maximizing shareholder value. This applies e.g. to business ethical considerations, but also to CSR. The aim of business is not only a question of maximizing shareholders' interests, but also of a wider social interest or engagement through which the distinct interests in the company are taken into account. Of course, it is conceivable, even probable, to discover an opposition between the shareholders' interests of maximizing profit and other stakeholders' interests. Typically, these stakeholders are consumers, suppliers, employees, the local or regional community, banks and other financiers, and the management of the company (Freeman 1984). As shown above, property rights are negatively defined in the legal framework. The most important limitations are aimed at protecting minority shareholders and creditors. That shareholders have a favourable position in the company follows from the utilitarian point of view that self-interest drives individuals to increase their wealth and that this self-interest at the same time benefits society at large (Samuelsson 2005). In the 2005 Swedish Companies Act, when the joint stock company has an objective other than the generation of profits for distribution to the shareholders, this should be stated in the articles of association. These articles can be altered by a majority of the shareholders. In the Swedish case, there is no requirement for the joint stock company to have a (moral) responsibility to operate as a socially responsible company, neither if the company bases its legitimacy on contract or law, nor by international norms for corporate governance (Samuelsson 2005). Such a requirement can be stated in internal policies of corporate governance (cf. Governmental Bill (prop.) 2004/05:85 Ny aktiebolagslag (Sweden)) or in the articles of association.

It can be argued that a commitment to social responsibility means a shift of power from shareholders to the management of the company or to the legislator. According to the rule of law ideology in democratic states, the legislator already has the option to define or demand expectations on company decision making. And of course, when considered a profitable strategy, the company might take other interests than profit maximisation into consideration ('business case').

## 2.3 Decision making processes inside the company – the implications of property rights

Not only legal scholars, but also social scientists, emphasize the importance of the nature of the owned object. The types of decisions that can be made are dependent on the object owned. This applies both to the level of state regulation of ownership and to how ownership establishes authority towards other actors and possible contract partners. This authorisation is important both for the company as such, for the owners and for the relationship between different owners. The protection of minority shareholder rights is one of the common features of all company law. Shareholding, i.e. the ownership of shares, generates certain rights but not complete disposal rights over the company. Here it is important to add that shareholders enjoy risk protection, i.e. the fact that shareholders may not suffer losses larger than their investments in shares and that share ownership does not imply any responsibility for company debt or other commitments. This is the core of the limited company as an economic construction, which allows shareholders to manage and minimize risk. As Engelstad (2011: 125, our translation) puts it: 'If the amount lost by bankruptcy exceeds the company's share capital, the rest of the loss is shifted to "society", that is employees, creditor, suppliers and others.' This shifting of risk is an important argument for state interference; the fact that society covers the loss provides the normative foundation for regulation of private property rights.

Armour *et al.* (2009) lists the main features of a company or a business corporation, i.e. i) legal person, ii) limited liability, iii) transferable shares, iv) delegated management under board structure, and v) investor ownership.

The focus in this chapter is on the board as a company decision making body with comprehensive authority which is elected by the shareholders. The authority to elect the board can be conceived of as the most important shareholder right, which is even more important than the possibility of proposing certain issues at the general assembly. The general assembly has no direct ability to instruct management; but even if limited, the possibility to instruct the board is far more extensive. The shareholders depend on the board to enforce their interests in the control and governing of the company. The degree of possible instruction from the general assembly to the board varies between jurisdictions. The Nordic countries are distinguished by a large degree of discretion and a relatively broad span of authority. The shareholders, by using the general assembly as their tool, may basically 'do anything' as long as they do not violate any legal acts or current contracts self-imposed or signed by the company.

The legal basis for the behaviour of management vis-à-vis the interests of actors other than shareholders, particularly employees' interests, also varies widely between countries. In the Anglo-American countries the organisation of companies is characterised by a monistic (one-tier) board system, with a board coordinated by a managing director in close cooperation with the chairman of the board of directors. There is no formal division between a supervisory body and executive board in the one-tier board system. All directors form one board, including both executive and non-executive (independent) members. In many continental European countries, e.g. Austria, Germany, France and the Netherlands, the governing structure of the company consists of a dual (two-tier) board system. In such a system the board is divided into a supervisory board and an executive board with a strict division of functions. In this system the supervisory board appoints the executive board and controls the management and the administration of the company. The Nordic corporate governance structure could be said to be somewhere in between the one-tier and two-tier board systems (Nørby 2001). The board is responsible for the company's organisation and the administration of the company's matters and also appoints the managing director. Employee representatives are members of this board. The managing director is subordinate to the board of directors, but runs the day-to-day management of the company pursuant to guidelines and instructions issued by the board. This system is not a one-tier system, because there are two management bodies in the company, but also not a two-tier system, because these bodies not are equal.

## 2.4 Internal and external stakeholders

In Table 1 we make a distinction between potential internal and external agency conflicts. Here we use the notion of 'agency conflict' to i) pinpoint the fact that all stakeholders might be perceived as the owners of the company and thus in the position of being the principal in the agent-principal relation, ii) look at conflicts between what we define as the internal actors (or stakeholders) and iii) examine possible conflicts between the company and the external actors. Some of these actors have the possibility to safeguard their interests through legal contract; this is indicated in the third column. In the last column we have indicated a sort of quasi-contract safeguarding or different 'soft law' obligations. We will however focus on the legal contracts. Table 1 below illustrates the focus we have chosen in this chapter.

Safeguarding interests through contract is the basis of company law. This must be analysed in line with contract law principles. These principles are critical not only because contracts are important mechanisms to avoid or solve conflicts, but also because of the central position of the residual risk argument in all corporate governance debates. The argument states that, since all other stakeholders but the shareholders are

Table 1 **Internal and external stakeholders: potential conflicts and safeguards**

| | Potential conflict | Contractually safeguarded stakeholder | Safeguarded by policies and other mechanisms |
|---|---|---|---|
| Internal agency conflicts (internal stakeholders | CEO vs. shareholders | CEO (by his/her employment contract) | Corporate Governance codes |
| | CEO vs. employees | Employees (employment contract) and collective agreements) | Employer policy and self imposed obligations |
| | Shareholders vs. employees | | Corporate Governance codes |
| | Shareholders vs. shareholders | Shareholders – only if shareholder agreements | Corporate Governance codes |
| External agency conflicts (external stakeholders) | Company vs.<br>Creditors<br>Suppliers<br>Costumers<br>Environment<br>Local community<br>State | Creditor<br>Suppliers<br>Costumers | Corporate Governance codes<br>Codes of conduct<br>Reporting and transparency obligations |

safeguarded by contract, the shareholders must be in control and are the legitimate owner of company surplus. Only the unsecured group of actors has a sufficient incentive to make the company prosper, since groups with secured interests will 'stop' at the fulfilment of the contract. The company as a 'nexus of contracts' is the prevailing view of the firm among economists (Parkinson 2003). The company is viewed as a collection of contractual relations between actors on the input side and actors on the result side. By using contract theory we might argue that companies wish to reduce their transactions costs in the market and the contract is the major tool. The different actors or individuals are perceived as 'economic man', i.e. as formally rational actors, and the relationship is built on the wish to maximize their utility. The contents of the contracts define the responsibility of the company towards other actors (or contractual partners). This strengthens the 'legalistic view of the firm' (Richter 2010: 628): no contract, no responsibilities.

However, from a strictly private law perspective, it can be debated to what extent the joint stock company really is built upon the idea of a nexus of contracts. The joint stock company is a capital organisation, with little or no rights and obligations vis-à-vis the owners (shareholders). The main right for the shareholders is to benefit from increasing capital. The company – with its rights and obligations – is constituted by the legislative system, by which the company is found on normative (legislative) binding procedures, due to inter alia the important role in economic society the joint stock company has. This perspective will not be elaborated further in this chapter.

As a starting point we might look upon the different relationships as a result of contracting in a free market. The rationale behind the contract is twofold. First is the principle of freedom of contract, or the fact that the legislator entrusts actors to organise relationships between themselves because all actors have the right to control their own property. Freedom of contract and property rights are two sides of the same coin. Second, on the next level, we have to include an assessment of the content of the contract. To use a different phrase: we look at how dangerous or detrimental to the interest of the society the contract might be (e.g. employment contracts might imply a level of damage to health that might ruin the state economy because of high medical costs). If so, the state has a legitimate right to step forward and regulate the content of the contract. In addition to the interests of society (or overall welfare), the need to correct unequal market power is important, as the state needs to protect the interests of the weaker actor.

The state confines the extent of ‘freedom of contract’ by referring to both welfare or efficiency arguments and fundamental rights (as the assumed least powerful actor needs to be empowered). At the same time the state, based on the important and normative foundation of private property, needs to ensure the ‘freedom of contract’. This double commitment may be viewed in light of the two principles of John Rawls (see also below). First: ‘each person is to have an equal right of the most extensive basic liberties compatible to a similar liberty for others’ (Rawls 1971: 60); freedom of contract could be conceived as a basic liberty. And secondly: ‘Social and economic inequalities are to be arranged so that they are both (a) reasonably expected to be to everyone’s advantage, and (b) attached positions and offices open to all’. The weaker contract partner needs to be empowered by the state in order to be able to enter into contract as an equal partner and thus be able to enjoy and attain ‘attached position’, even if this means that the state has to give the powerful partner less than their fair share.

# 3. Distribution of seats

## 3.1 Stakeholder theories

Stakeholder theory takes into account of a much wider group of constituents than just the shareholders. Shareholder value is not paramount; instead a larger group of actors or interests is taken into account (Freeman 1984; see also above, section 2.2). The two different theories have different foci. Shareholder theory focuses on shareholder value to ensure that resources are used to maximum effect (i.e. not seldom maximum profit), due inter alia to the fact that the shareholders are the recipients of the residual free cash flow. Stakeholder theory in contrast focuses on the distinctive interests that the different stakeholders have and on balancing these interests. It could also be argued that the focus of stakeholder theory is on the long-run value of the company, rather than maximisation of value in the short-term. In this chapter we will, however, not further discuss these theories per se.

What standards should define the right to involvement in company decision making? Employees' interests are linked more closely to the company than most other stakeholders. In this chapter we argue that this internal link establishes an entitlement for the employees to be involved in the company's decision making, alongside with the owners of the vested capital.

As already briefly mentioned, Rawls' theory of justice as fairness focuses on the design and effect of social institutions. How can institutions be established which may ensure a distribution of social goods which will be perceived as fair by the citizens? Whether or not encroachment upon property rights is perceived as fair is an important practical political and moral question. Engelstad (2011) emphasises that state interference into private property is founded in market failures which creates unreasonable (or unfair) patterns of distribution. These patterns prevent (some of) the citizens from obtaining the resources needed to act responsibly on their own behalf and to pursue their possibilities according to our individual goals. But this possibility is also embedded in private property as such. Property rights are one of the basic foundations of our liberal democracy. Citizens have the right to feel secure and protected against encroachments on personal property and objects necessary for their subsistence. Property rights are considered a prerequisite for the ability to achieve individual autonomy and self-determination and thus also the ability to participate in representative democracy at local and national level.

The justification for state encroachment is twofold: 1) welfare of all and 2) the desire to establish well-functioning democratic processes and to ensure individual autonomy. However, as Engelstad (2011) also points out, the arguments protecting private property rights also support welfare and democracy. He states that theories of property rights have three arguments in common: i) labour – the object in question (the property itself) is the result of the labour effort of the owner; ii) efficiency – we need property rights in order to maintain the free market: without property, no market; and iii) democracy – the individual needs to be able to have his of her property at their disposal in order to become an autonomous individual, therefore this is the fundamental democratic right. Thus, labour and effort point to why ownership (of the object) arises, efficiency to why ownership is maintained and at disposal, and democracy points to the reasonableness of keeping one's property in order to use it as a basis for creating 'the good life' for oneself and to be able to participate in society in a democratic manner. This is in line with the cornerstones of what liberal capitalistic market economies are built upon, namely property rights, freedom of contracting, and freedom of trade; these cornerstones are essential for Western industrialised countries' economic and legal systems.

This discussion illustrates the complex nature of private property; we are using the same arguments to defend and at the same time to regulate private property rights. How then should property rights be treated as the foundation for decision making in private companies, for determining the legitimate constituency for the election of board of directors? Our way out of this dilemma is to focus on the distribution of goods and look for legitimate distribution criteria based on the three arguments above: why ownership arises, why it is maintained and why it is continued (kept). An emphasis on labour, efficiency and democracy (or equality) in a particular distribution process makes Elster's (1992) framework of local justice the natural point of departure.

Labour, productivity and equality are also important arguments in Rawls' theory of justice as fairness (1971), even if his analysis concerns the structure of social institutions and their distributional effects. Rawls idea is that these institutions comply with two (sometimes counted as three) principles. The first principle is that of greatest equal liberty. This equality may only be violated in two ways, either as a result of (the principle of) equality of fair opportunity (positions are to be open to all) or by making sure that the worst off ends up in a better position (the difference principle).

Labour enters the picture by pointing to the fact that the first principle implies that we all have an equal right to the results of our working efforts.[2] Both parts of the second principle are also important to us, when entering 'positions open to all' individual effort is important and a legitimate source of inequality. The violation of the first principle (equal right to the result) is obvious in a capitalistic market economy, since the surplus is in the hands of the shareholders. It is, however, hard to argue against the fact that capitalism with its unequal distribution of means of production has increased the over-all standard of living. The worst off is better off; the distribution is in line with the principle of difference. In his later work Rawls (2001) seems to be highly critical of what we might label as 'unregulated property rights'. The society, or the state, or the legislator, has both a right and an obligation to regulate the means of production in a far stricter way than to regulate personal property. This is in line with our legal point of departure; with a negative definition of property rights, it is legal facts in issue and the legal consequence of property rights that determine the situation. The consequence of one's ownership of a personal object (e.g. a house) is something different than in the sphere of action of shareholders.

## 3.2 Different distribution criteria

In this chapter we consider board seats as a scarce good: which of the possible interest groups, which stakeholders, should be able to participate in electing one or several directors? The possibility to represent certain stakeholders' interests in the most important decision making body in the company is defined as the result of a distribution process that must use fair selection criteria to be perceived as legitimate. To illustrate this line of thought: the criteria behind the stakeholders' right to elect board members is analyzed; then we examine whether the use of this particular criteria make room for a legitimate claim from other stakeholder groups for board seats.

The different distribution criteria, or principles, emerge by asking a set of very simple questions (Elster 1992; Engelstad 1992; Hagen 1995,

2. Føllesdal (1999) points to Rawls' emphasis on 'labour theory of value' and thus his use of John Locke, Adam Smith and Karl Marx. All three maintain that all individuals who contribute to the making of a good have a right to an equal share.

1999) about the different actors and their characteristics or features. The basic questions are: should different characteristics make a difference?

1. No! This implies using equality as the distribution criteria. All actors, irrespectively of any individual feature (gender, wealth, education etc.) should be considered in the same way and have the same right to any scarce good. Using equality as our criterion might be possible by entrusting the election to political democracy, or, in other words, by leaving it to the elected politicians to appoint company boards. Below, we will refer to this as the equality principle.
2. Yes! And the first follow-up question is whether the emphasis should be placed on individual or group characteristics?
   a. Group characteristics, e.g. all individuals with this particular feature will be treated equally in the distribution process. This will imply that membership in a given group (e.g. NGO members, citizens in a local county, all female citizens, etc.) have the right to participate in the election of board members. We refer to this as the membership principle.
   b. Individual characteristics only. When this choice is made, one needs to ask about or separate the features in question.[3] To be able to do so time is introduced by considering former, present and future features.
      i. Former characteristics. This covers the circumstances where the actor has used his or her characteristic to obtain or earn the right to the good in question. In this context, it might be deposited capital or work effort. The actor deserves a part of the good because of his or her former contribution. This is referred to as the principle of merit.
      ii. Present characteristics. What features does the individual have at a given point of time? If present features are to be important they must be connected to needs; what you did or earned on former characteristics is a question of merit, and a future feature is a question of what one might do in the future (see below). The principle of needs concerns what the individual needs now. In our context this principle implies actors with the need to be

3. These questions might obviously also be asked when distinguishing between different group features

protected against harmful company activity. Environmental hazard or violation of labour rights comes easily to mind and customers of a monopoly have a legitimate claim to participate.

iii. Future characteristics. How can, based on their features, the individual contribute to production? What are the future company inputs or requirements? This is referred to as the productivity principle, for example the board should consist of highly competent directors.

By answering these questions five distribution criteria or principles can be drawn up: equality, membership, merit, need, and productivity. The principles as such are empty; they have no substance until arguing – in a normative way – why it is fair to distribute according to one of the criteria. For example: i) democratic values are important arguments for equality, ii) it is fair that people, who have invested their time or capital in a company, should have a say in controlling the company, and should therefore be given a chance to elect board members, iii) by emphasising the importance of company surplus as the financial basis for the welfare state, productivity is used as the guiding principle, iv) individual needs must be fulfilled or v) individual needs to be protected against company harm is the highest priority.

The membership criteria might be seen as a secondary principle due to the fact that the normative arguments behind the choice of principle would be the same whether or not we focus on individuals or groups of individuals with that particular feature. Do individuals fit into the particular prioritised group, and would it be possible to either identify any group interests or organise an interest formation process?

## 3.3 Criteria in the present regime

How then might the different criteria in present legislation be identified? Shareholders are the most important constituency in all board member elections and are entitled to elect the majority of the board in all jurisdictions.[4] However, in 19 out of 30 countries in the European Economic

4. The German *Montanmitbestimmung* is an exception. Also to some extent quasi-parity codetermination, however, if there is a tie vote between labour and shareholder representatives, the chairman (always elected by the shareholders) has the tie-breaking vote.

Area (EEA), the employees are entitled to elect board level representatives (BLERs). The arrangements differ to a large degree (Conchon 2011) and in no country are BLERs found in all company forms and sizes, but the characteristic of 'being an employee' is widely recognised in Europe. In a number of countries, more than half of board members must be citizens from EEA member states. In certain types of companies, e.g. financial institutions or investment funds, board members must demonstrate industry competence and experience. As the first country, Norway introduced gender quotas in publicly limited companies; several other countries are considering such quotas. Property, work effort, geography, competence and gender are features found in the legislation of one or more countries.

But it is important to add that, besides work effort, the characteristic is a requirement for the directors elected by the shareholders; they might elect whoever they choose, as long as the ones chosen comply with the regulation. Whether or not the shareholders want to emphasise certain interests in line with the particular feature, e.g. female or geographical interests, it is entirely their own prerogative. Thus, only two interests are represented: capital and labour, or shareholders and employees.

How then, might the different criteria for examining the normative arguments behind these distributions of board seats be used, and may the same criteria be used to support the inclusion of new stakeholder interests into the board?

## 3.4 Capital

The value creating factor capital can consist of many different kinds of assets. It can comprise tangible and intangible assets, natural resources and labour. Capital represents power. These powers vary, depending on the individuals that are competent to exercise the power.

Property as a criterion for participation or, in this context, the individual characteristic of being a shareholder (owning shares) is built on the principle of merit. The shareholder has invested capital in the company and deserves to have a say and to have their interests considered. The normative foundation for merit is work; only by original work may capital emerge (cf. Fahlbeck 1998), either by paid labour, by the shareholder himself or as the result of the shareholder's legitimate right to use the result of work by others (inheritance, partner(s), etc.) as a capital input. Merit is the normative foundation for the shareholders' right to elect board members, the driving force of shareholders' right. As a second principle, equality is used as an organising devise: one share – one vote. The number of shares equals the invested effort.

Now, moving on, we analyze shareholding as a present or future characteristic. It hardly seems relevant to use needs as an argument in this context; need for position is not a legitimate need here. And further, based on the fact that risk management and minimisation is the rationale for the company (i.e. shareholders cannot lose more than what they paid for their shares), need as means for subsistence hardly seems relevant. The fact that the actor bought shares indicates assets above what is needed for subsistence, and thus the need for return on investments (and the right to elect representatives in order to secure this return) is hard to defend. It does not seem fair to use need as a criteria here to benefit people who might sell their shares to satisfy their needs. On the other hand, we might argue that the importance of securing their investment is a significant argument. However, this argument refers to the future and thus the productivity principle. In order to survive, the company needs shareholders who want their invested capital to stay (secure) in the company.

If the productivity principle is based on the demand of the company in the future, which characteristics are important for the company's prosperity and well-being? It seems obvious that the company needs to be controlled and governed in a way that prevents shareholders from selling all their shares at the same time. And further, the company may need new capital in the future. But, is this argument strong enough to defend the right of the present shareholders to exclusively elect the board? We need to look at the nature of capital, that is, the ability to obtain the necessary input. This ability is independent, thus whether it is the present or a future investor is not decisive.[5]

To sum up, the right to be represented on the board due to the characteristic 'shareholder' is based on the merit principle. Work effort is the

5. Who are the shareholders and what and how might the owners (especially the larger ones) contribute to the company? This is an important question in the corporate governance debate. Who the owners are is, however, a question of the characteristics of owners (knowledge, skills, network, long v. short-term interest etc.) and not a characteristic of capital itself.

normative argument behind merit. When put in action, the principle of equality is used to organise and regulate the election process. In other words, we end up with shareholder democracy as the main tool for electing the board of directors.

## 3.5 Labour

Let us now to turn to the employee-elected representatives. How can the distribution criterion be used to understand the normative foundation for this arrangement? The employees' right to elect their representatives are, as with the shareholder, based on the principle of merit; the employees have put a lot of effort into the company and they deserve to have a say at the board level. This argument is twofold: value added and profits are made by human processing of input; capital in itself does not create value (see Fahlbeck 1998). And secondly: if profit was made, the employees have not received the entire surplus, i.e. part of the surplus is taken away from the ones who made it, and thus merit is involved.

Employee representation may also be justified by the need criterion. Employees need their employment to continue and this need is often connected to a particular company in order for the employee to make the most of his or her abilities and competence, e.g. through firm-specific skills. The relationship between the company and the employee is not based on risk management, as we would argue is the case for shareholders. Employees may, like the shareholders, exit the company, but in contrast to the shareholders, no capital for subsistence is realized as a result. Shareholders can choose alternative investments, while the employees face a labour market that may either be very difficult or not able to utilize their company-specific knowledge. Furthermore, it might be added that, while employees are necessary for providing labour, shareholders are not the only actors who provide financial capital.

We would also argue that the productivity principle is in favour of employee interests being represented on the board. The future of the company and the future level of productivity depend on the employees and their knowledge. It is far easier to change shareholders than to replace the workforce. It would probably be easier and far less time consuming to raise new capital than to acquire the particular competences which the current employees have. Capital is more easily replaced than knowledge, or to put it a different way: it is easier to make changes in your investment portfolio than in your labour contract.

The characteristic ‘employee’ is important as a foundation for participation in company control and governance when using all three criteria; merit is build up by the work itself, the employees are in need of their employment for their subsistence and the employees are important for the company’s future, thus their interests need to be represented. The equality principle is used when organising the election of board level employee representatives (BLERs); one employee – one vote. In some countries we do find some sort of membership principle; for example, in Sweden a collective agreement is a prerequisite for demanding representation while in the largest publicly limited companies in Germany the national trade unions nominate representatives to the supervisory board.

The ‘standard’ or authoritative justification for shareholders’ right to control is the residual risk argument. All other stakeholders might rely on their contractual rights (employees have rights through the employment contract; the creditors have claims through their contracts, as well as the suppliers, and so on). So the lack of contractual rights for shareholders justifies their call for a right to ‘the rest’, and in order to secure this ‘rest’, they need to be in control. The residual argument may, however, could also apply to employment. Employees do receive a reward, but some of the surplus created by them is withheld from them. It is argued that work, or processing input, is the normative foundation of property rights, thus, it could also be argued that the labour contract is incomplete. Neither future profit nor future wage increases are contractual.

## 3.6 Stakeholders not (presently) represented on the board

In Table 1, management, creditors, suppliers, customers and the state are also included as stakeholders. The state (or the legislator) plays a subordinate role in stakeholder theory. A stakeholder position implies that the state as such represents a self-interests in conflict with other stakeholders in the company. The state might – as a state – have certain interests regarding employment and tax revenue, but has in principle no interests in a particular company as such. Any conflict of interests between the state and the other stakeholder interests must be perceived as an ordinary political dispute between the political majority and minority, and solutions are found in the political process.

It might be argued that management deserves a dedicated stakeholder position. The managers – as private persons – might have a certain interest in the company. But in fact this will be either a private interest, as any other employee might have, or specific interests connected to being an agent of the principal, i.e. the shareholders and the board.

Creditors and suppliers are in a prominent position since they are completely covered by contract. This makes the merit criterion irrelevant; no merit is developed. It is also hard to argue for board positions for these interests when looking at their present characteristics or focusing on their needs. They do need the company to honour the contact, but needs beyond that are caused by either an incomplete or an unfair contract due to competition, market failure or misuse of power. Representation on the board would not alter these circumstances.

Considering the customers, the principle of merit might be rejected, since former contact with the company has been as a contractual partner and, in most cases (monopoly excepted), a free and market-based contact has regulated the relationship with the company. Any overcharge has been accepted. The principle of need only applies to monopoly companies and, as in our supplier example, including this interest group on the board does not alter that situation.

Turning to the productivity principle, the costumers are important, if not decisive, for company's future. Customer interests on the board could provide important input on product design, etc. But even so, organizing customers as a constituency seems to be an impossible task. And in addition, we will have to assume that what might be the most important customer interest (low price) will be neglected by the costumer representative when performing his or her board duties. Individual interests in a cheap product do not reconcile with the directors' duty to the company's general interests.

Company environmental responsibility, locally as well as on a global scale, is an important part of the CSR debate and a crucial issue among the stakeholder advocates. Environmental interests need to be taken into account because most company activities have implications both for the environment at such and for actors dependent on environmentally sound surroundings. This argument leans on the principle of merit; the environmental interest deserves to have a say because the environment or environmental harm has been (an unpaid) input into company production. The principle of merit, based on previous work effort, favours both the shareholders' and the employees' demand for board representation. How then will environmental interest end up in our distribution based on the four criteria?

The use of an unpaid input might, however, be conceived as someone establishing a (financial) claim on the company. Inviting environmental interests to the board would be equal to inviting creditors, which would imply that the board should function as a creditor towards the company. Unlike shareholders and employees, this claim does not connect to work effort, but to harm or exploitation of common goods. And secondly, while the merit argument concerns the effort of the present employees and the present capital of the shareholders, the actors claiming environmental harm as an input might not be the present actors, but also both present and future generations. Thus, any legitimate claim of the environment or the local county needs political legitimacy.

Turning to future characteristics, environmental harm transforms into an input needed to continue company activity. However, the company's future need in this regard hardly justifies a board seat. When environmental harm is defined as an input we need to dedicate ownership to the environment: someone needs to own e.g. the land and 'offer' the company the possibility to harm this land. Ownership implies that we need to return to merit.[6] The need for this dedication implies that we need to return to political regulations; nobody may 'own' the environment or even the possibility of exploiting their own property (e.g. farmland or rivers) beyond sustainable limits.

In addition, and more in line with traditional stakeholder theory critique: using need for protection as a criterion is hard to combine with reasonable secondary principles, that is: which individuals have this particular characteristic and how to elect their representatives? Using geographical

6. This argument is naturally not valid in the case of air pollution, since it is possible to own both land and water (rivers, seashore) but not the air. But, in contrast to water- or land pollution, air pollution is also less local, thus making it more difficult to decide who the victims of that particular company are. Asthmatics far away are greater victims than non-asthmatics closer to the factory.

borders and equality seems like the only option. This would either imply building a parallel system with the only aim of electing board members or using the existing political arrangements like the local council as constituency.
Summing up, need as a distribution criterion is tied up in the present; earlier (and unfulfilled) need, which may be tied to company activity, must be grounded in the principle of merit, i.e. someone did something that deserves to be rewarded because of a contribution to the establishment or continuation of the company. This reward, however, is a claim on the company and not a legitimate demand for representation on the present board of the company. Future needs may only be connected to company activity as such in order to be a legitimate distribution criterion; the need for environmental protection may be fulfilled by alternative power mechanisms, the most obvious being political regulations. The principle of need belongs to the normative stream of stakeholder theory, while the principle of productivity belongs to the instrumental; in order to demand a say you have to prove your worth to this company, e.g. the characteristic 'knowledgeable' in general is not important, your characteristic must make a difference for company future and company productivity, the company needs your specific knowledge.

## 4. Representing shareholder interest and attending to shareholder interest?

The equality principle as a legitimate foundation for the distribution of board seats is rejected. This is done on several levels: First, equality means setting aside private property as a democratic value. Second, history has shown that state ownership in the old Eastern European way has important welfare implication. Third, and as a consequence of our first objection; some sort of company ownership or contractual commitment to the company is needed to make a legitimate claim for participation.

Quite contrary, by using the different distribution criteria, we end up by assigning board level participation rights to labour and capital, i.e. the same interests we find in the legal framework. The normative foundation behind this choice of interests is found in present work, the labour contribution itself. Only through labour might legitimate control rights emerge; this is the democratic foundation for property rights. The relevant question then is: how distant from the actual work (from the worker transforming input into surplus) may the result, the capital itself, be, and still claim control rights? Rawls (2001), as we have seen, makes a distinction between personal belongings and the means of production. Even if Rawls does not want to take an absolute stand, his advice is clearly to build political instructions able to control capitalism in a 'social democratic manner'.

Merit is the far most important foundation for shareholder legitimacy. Merit is also important when we focus on employee representation at board level. But, the 'being an employee' characteristic also makes sense on both the need and productivity principles.

It is argued that any claim anchored in merit must be based on having a company attachment or connection, a relation between the actor(s) and the company. Companies organise their relationships through contracts. The more precise and extensive the contract is, the less merit is achieved, because the contract will cover the exchange between input provided and payment. The less precise the contract (and purely 'social contracts' are included), the more merit is created. To measure this 'non-contractual' merit is complicated; it seems reasonable to assume that this places demands on the political process to make the claims and rights legitimate. We return to this issue in the concluding paragraph.

The principle of need has important points in common with normative stakeholder theory. Need emerges when people are affected by company activities. Democratic values imply that the ones affected have the right to participate in the decisions. However, if the principle of need is the foundation of a legitimate claim to participate, it is necessary to make a distinction between the different social roles of the individual. A citizen has a legitimate need to be protected against e.g. environmental contamination. One's need for a product as a customer is a far more complicated question. Choosing the particular product is the choice of an individual, a result of their autonomy, and it seems reasonable to say that they have no claim or right to buy that product from that company. The crux of the matter is how to emphasise the different needs and how the needs of different actors may be weighed against each other. In the end only democratic procedures might legitimate the distribution.

The productivity principle resembles in many ways the part of stakeholder theory closest to traditional management literature. How can we take care of the different interests needed for the company to grow and prosper? Which stakeholder interests are decisive for company productivity? Employees and the actors on the capital and consumer market are indispensable. These different actors affect the market in different way. In addition: we need to distinguish between the actors who are important to that particular company and actors able to sell the same characteristic on the market at the same price and with more or less equal transaction costs. Employees are in a unique position because they might incur severe costs when searching for alternative buyers of their labour. Again, one also has to add that, without a direct attachment to the company, one ends up with arguing the merit principle based in labour.

The principle of need is based on the relationship between the individual and the company; you have to be affected by company activity. Merit, on the other hand, does not only need a relationship as such, but a direct attachment to the company; merit is only possible to develop by adding surplus value to the input, either directly by own labour or indirectly (through prior labour) by providing capital. This argument, besides being based on the labour argument, also depends on whether or not there is any alternative way of fulfilling the legitimate claims of the actors. The shareholders and the employees of a company might only secure their interests by participation in the decision making process of the company; their interests may only realized through the company's activities. A citizen might both be affected by and observe environmental harm that needs to be compensated and/or prohibited, but the citizen does not necessarily do this by participating in decision making processes in the company. Several measures are possible, the most obvious being a ban on the production process as such or the substance in question. These measures need to be taken into consideration by the authorities in order to be legitimate; only then is it possible to violate the interests of the stakeholders to keep the production process running.

## 5. Interests legitimizing involvement: some concluding remarks

Summing up the discussion in this chapter, labour and capital seem to be the two legitimate stakeholders for electing the board of directors. The relationship between the two stakeholders has not been discussed so far.

The possession of shares is thus an interest or a joint ownership and constitutes a share in a company's value. The company is through this mechanism owned by the shareholders (Fahlbeck 1998). Does this mean that investment of financial capital should be given preference vis-à-vis the investment of labour or designers of product or business concept? Does it matter whether the investment of financial capital is intended for the long or short run? The long-term investor's engagement calls to mind the engagement of the core workforce. Both are interested in the welfare of the company and its ability to yield a good return and reinvest. Their interest differs in the way that the financial investor can exit more easily than the employee if business does not meet expectations, whilst an employee often does not really have this choice to leave. The short-term investor has a more immediate interest in business profitability. The core workforce does not typically have this interest, because it is more interested in sustainable business in the long run. The financial investors' interests can coincide with the more mobile or coveted workforce, but hardly with that of the core workforce. In these circumstances, is it justified to grant to any of these groups greater influence than to the others?

The investment of financial capital does indeed often provide a condition for the realisation of work or an idea, but the investment of labour is the investment that directly shapes value: 'Nothing material has any intrinsic value, only work or the fruits of work can turn into something or value. "Capital" is created by humans and ruled by human labour. The bulk of capital is collective, even if owned by private individuals or institutions, e.g. private investment funds or pensions' (Fahlbeck 1998: 251).

In order to legitimize the power advantage of financial capital, it has been given precedence vis-à-vis the investment of labour and of other investors. This condition has been a necessary prerequisite for the rise of the liberal capitalistic market economy system (Eckhoff and Sundby 1991). The financial investors have been and are dependent on the investments of labour and, in order to exercise powers superior to the work force and others, the financial investors have awarded themselves the right to exercise these powers. In employment and labour law this is obvious in most Western European countries, giving the owners managerial prerogatives through the employer.

The employees' possibilities to support themselves are not protected by property rights. This is instead a matter of regulation through the employment contract. In the employment contract, the balance of powers between the employee and the employer typically does not prevail. This imbalance in the employment relationship can, however, to some extent be equalised by the trade unions' position on the labour market and by collective agreements. The application of the principle of property rights leads to the exercise of powers over other individuals by the management of the company as a representative of the company's owners (Renner 1929).

According to principal-agent theory, costs arise as a consequence of the principal's and agent's differing interests. These costs have to be reduced. The only principal in the joint stock company is the shareholder. The other, including the employees and trade unions, are to be regarded to as agents. By exercising their rights to take decisions at the general meeting, the shareholders supervise the board of directors, which in its turn supervises the managing director. This, however, assumes independent members on the board (Samuelsson 2005).

What legitimizes the right to participate in a company's decision making? In this chapter, it is argued that property rights are one legitimizing force for participating. However, it is also argued that all internal stakeholders are legitimate participants in decision making. Thus, both shareholders and employees are equally entitled to participate in company decision- making.

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