

Corporate Ethics and Shareholder Wealth Maximization

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The 1990s have come with a heightened awareness of business ethics, and many faculty members have dedicated a particular portion of a course to ethical concerns. A general theme of business ethics discussions is that many of the concepts taught in a traditional business curriculum are not in tandem with ethically correct behavior and that ethical discussions may temper or dissuade students from applying business concepts. For example, business ethics often teaches that shareholder wealth maximization (SWM) is a goal that is inconsistent with ethical behavior. We demonstrate that the corporate goal of SWM neither adds nor subtracts from the weight given to ethical consideration by market participants. A corporation that embraces SWM does not establish a moral or ethical position but rather merely acts as a conduit for the ethical beliefs and desires of market participants.

■ The 1990s have come with a heightened awareness of business ethics. One theme of many business ethics discussions is that the corporate goal of maximizing the wealth of shareholders needs to be broadened to include a broad array of corporate claimants. This “stakeholder” approach is argued to have advantages over the narrower shareholder view. These advantages include, among others, the removal of incentives for unfair or illegal business practice that benefits one constituency over others (Cloninger, 1995), the reconciliation of the apparent conflict between short-term and long-term interests of the firm (Aggarwal and Chandra, 1990), and providing a framework for understanding the linkages between corporate finance and other corporate functions (Cornell and Shapiro, 1987).

An unfortunate theme of the stakeholder approach is that the traditional view of shareholder wealth maximization (SWM) is inconsistent with ethical behavior. It is often suggested or concluded that people’s desire for money in general and shareholders’ wealth maximization in particular are in direct opposition to ethical concepts such as honesty, fairness, and the good of society. This article discusses the economic laws that contraindicate this viewpoint and details an alternative framework for discussing business ethics.

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I. Economic Laws and Markets in the Ethics of a Free Society

Students often enter a discussion of business ethics with the idea that traditional business concepts, such as profit maximization or shareholder wealth maximization, are in direct opposition to ethical behavior, and therefore, they are rather easily convinced regarding the need for “higher” objectives and for government control. This section discusses the role of economic laws and markets in providing incentives for ethical behavior.

A. Pricing Ethics

Perhaps the most important point that this article addresses is that shareholder wealth maximization serves as a conduit of ethics rather than a net determinant of ethical behavior. Market values can price ethics just as they can price anything else. A corporation that maximizes shareholder wealth by maximizing the firm’s stock price is making the stock as desirable as possible to investors. A corporation that embraces SWM does not establish a moral or ethical position but rather merely acts as a conduit for the ethical beliefs and desires of market participants.

In theory, market prices can reflect ethics just as they can reflect all other items of value to the firm, such as the expected cash flows. Thus, a corporation that maximizes shareholder wealth by maximizing the firm’s stock price is making the stock as desirable as possible to investors. If investors care about ethical issues, they will find the stock of

an unethical firm to be less desirable and its stock price will be lower than if it were an ethical firm.

In recent years, many investors have demonstrated that they do care about ethics. With divestiture from South Africa leading the way, ethical concerns have entered corporate boardrooms worldwide. Throughout our society, we find that ethics are priced. For example, hiring somebody to perform an unethical task generally costs more than hiring somebody to do what is considered to be ethical work. Are shareholders any different from other members of a society that values ethical behavior? If not, then the goal of shareholder wealth maximization forces corporate decisions to be made in a way that most satisfies investors—including their ethical concerns.

In order to maximize shareholder wealth, corporate decisions must be made using the same ethical beliefs that investors have and use in making everyday investment decisions. In other words, market prices are mirrors or gauges of the values of the free society that produces them. To claim that maximization of shareholder wealth results in unethical behavior is really to claim that the society that trades the stock is unethical. In such cases, the real criticism is against the views of society and is unrelated to corporate finance.

B. Unanimity, Separation, and Corporate Ethics

Modern corporate finance teaches that shareholder unanimity enables financial managers to make efficient decisions on behalf of shareholders. For example, since all shareholders have a time preference for money, financial managers should prefer a current cash flow to an otherwise equal distant cash flow. The foundation for the separation of corporate financial decisions from the composition of the shareholders rests on the shareholder unanimity that results from the access of the shareholders to well-functioning markets. Shareholders will transact in well-functioning markets until their preferences at the margin reflect identical rates of substitution. Thus, financial managers can efficiently serve their shareholders by using market prices to make decisions.

However, there is substantial reason to believe that shareholders are not unanimous with regard to ethical issues. For example, let's consider a corporation that makes a generous donation to a non-profit organization that is widely viewed as supporting a particular cause. Some shareholders might be delighted to see their corporation promote such a cause while others might be outraged by such a donation. This example illustrates that shareholders will not generally be unanimous with regard to ethical issues. In fact, any ethical issue that is even nearly unanimous would not be referred to as an "issue." Thus, financial managers will generally not be

acting in the best interest of all the shareholders by taking sides in an issue.

The reason that shareholders are not unanimous with regard to ethical issues is the existence of corner point solutions. For example, politically conservative shareholders will not view a contribution to a liberal organization as being attractive even if their personal contribution level to the organization is reduced to zero. It is generally not possible for the shareholders to hedge the corporate donation by short selling goodwill generated by the donation. In other words, conservative shareholders generally can not sell this "commodity" (goodwill) to liberals who would enjoy it.

In the absence of well-functioning markets in which shareholders can buy and sell claims related to ethical issues, a strong efficiency argument can be made that everyone is at least as well off or better off if the financial manager of the corporation maximizes shareholder wealth and therefore allows shareholders to best maximize their private and social utility functions. In other words, the money should be passed through to the shareholders and then they can donate to the causes of their choice.

C. Shareholder Wealth Maximization and Reputation

Another important implication or aspect of economic laws is their ability to provide incentives for shareholders to behave according to the ethical standards of the product market participants. In other words, even if the shareholders do not care about behaving ethically, the behavior of consumers and other product market participants can provide incentives for the shareholders to act as if they cared about the issue.

An important aspect of ethical conduct in financial and product markets is typically discussed in the context of reputation or reputation capital (Smith, 1992). To the extent that a good reputation is valued in the market place, a firm attempting to maximize shareholder wealth will have an incentive to preserve and enhance its reputation.

Most people already understand that a corporation might have an incentive to respond to ethical concerns, such as a desire that tuna be harvested without hurting dolphins. A corporation that responds to a clear public preference, such as in the case of tuna, might enjoy higher sales and/or avoid lower sales from boycotts. However, the issue of reputation runs deeper than reflected in this example.

In a situation where a consumer depends on the honesty of a corporation, the consumer may look to the reputation of the corporation as a signal of the product's reliability. Many consumers purchase products whose ultimate quality or value cannot be determined at the time of purchase. To some

extent, the purchase decision regarding these products will involve an appraisal of the reputation of the corporate manufacturer.

For example, a consumer purchasing fire insurance is concerned about the promptness and generosity with which claims would be settled in the event of a fire. An insurance firm with a large capital investment and excellent profitability level might be reasoned to have an incentive to maintain a good reputation by providing better claim service relative to a new entrant. Notice that this argument does not rely on the idea that the shareholders or managers of the large insurance firm have high ethical standards. The consumer does not rely on the ethical standards of the shareholders but rather relies on the incentive for a well-capitalized and highly profitable firm to maintain its reputation.

Thus, many product markets reflect value that depends on reputation. The objective of shareholder wealth maximization can force firms operating in these markets to behave as if they cared about ethical standards.

D. Market Failures and Information Asymmetries

The ability of markets to provide incentives for ethical behavior is predicated upon well-functioning markets. This subsection describes the potential effects of market failures and information asymmetries.

Market failures are generally viewed as circumstances in which markets fail to function properly. Accordingly, to some extent, market failures are in the eyes of the beholder. Some might argue that a market failure has occurred whenever a market produces grossly unequal distributions of resources. Others would argue that a market failure has occurred only when opportunities for people to transact and achieve mutually enhanced utility have been lost (i.e., Pareto efficiency is lost).

Market failure can result, for example, from government taxation or regulation of markets that inhibits or prohibits mutually utility-enhancing exchanges. Externalities, such as environmental damage, are another frequently cited example of market failure. Externalities can negatively effect the utility of parties not involved in the transaction and, in the absence of third-party claims, can result in Pareto inefficiency. Obviously, to the extent that a market failure occurs, the pricing of ethics as well as the implication for shareholder wealth maximization and the valuation of reputation discussed earlier will no longer necessarily follow.

However, in another sense, market failures can strengthen the points of this article, such as the argument that it may be possible for a market to value non-cash ethical considerations such as the ethics of a corporation that exploits a market failure. For example, if a market fails to

price an externality (e.g., air pollution) directly, we may argue that the market may indirectly price the externality by penalizing (paying a lower stock price) the firms that exploit externalities and rewarding firms that do not exploit unpriced externalities.

Information asymmetries are an essential issue in corporate ethics since information about unethical behavior might be less readily observable to market participants compared with information about cash flows. In order for the implications of this article to apply, desired information regarding ethical and unethical behavior must be available. If market participants view information regarding ethical issues as important, one might generally expect that private information agencies would emerge or expand to fill the market demand (e.g., Standard and Poor's, Moody's, Value Line, Consumer Reports, Greenpeace, and others).

Finally, it might be argued that some information about ethical activities is private and would not be made available to the public even if pursued by private information agencies thereby necessitating government interference. One might argue that while government authorities, such as the Securities and Exchange Commission (SEC), require publication of accounting values and cash flow, no such authority exists to require publication of most ethical aspects.

II. Summary and Conclusions

Shareholder wealth maximization is the process of making a stock as desirable as possible in the marketplace. If market participants do not price ethical considerations, then share prices are based solely on cash flows and SWM would consider only cash flows in making decisions.

However, if market participants care about ethics enough to price them, utility maximization will drive participants to incorporate their preferences in their buy and sell decisions. Accordingly, ethical considerations can affect equilibrium prices.

In a world where market participants "price" ethical considerations, SWM will force managers (ignoring agency conflicts and information asymmetries) to include the market's ethical considerations in making decisions. Accordingly, corporations in general and SWM in particular are conduits of ethics rather than net creators or destroyers of ethical considerations.

Even when agency conflicts or information costs obscure the incentive for corporate actions to mirror the ethical values of investors, other market-based pressures remain. Consumers can vote with their expenditures, and markets can price corporate reputations. Finally, based on grounds of economic efficiency, it can be argued that shareholder wealth

maximization puts money in the hands of shareholders who can efficiently pursue their own ethical agendas. ■

References

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