

# The dark side of stakeholder management

March 26, 2009

## **In the wake of white-collar crime, people are calling for corporate social action. But does stakeholder management have a dark side?**

Can a company act ethically and make a profit? Stakeholder Management (SM) theory suggests so: If managers take everyone with an interest in the company into account, they will act responsibly. It follows that if you act ethically, you build a shining reputation, which will inevitably affect the bottom line. Right?

In their paper, "[Does Stakeholder Management have a Dark Side?](#)" published in the *Journal of Business Ethics*, Carmelo Cennamo, IESE Prof. Pascual Berrone and Luis R. Gomez-Mejia caution against always looking on the bright side of SM.

To address the wants and needs of everyone with an interest in a firm, you have to give managers greater discretion than if they were just concentrating on shareholders. Of course, good managers will try to use this power to build relationships with and manage stakeholders in the interests of them and the firm.

But there is also the potential for things to go wrong when CEOs put certain stakeholders, or themselves, first.

The authors explore avenues that could lead to managers using SM with dark incentives. They warn companies committing to the SM approach not to be overambitious. It seems the only way to avoid the potential pitfalls is to deal with a limited number of interested parties. Although this would mean ignoring the claims of other stakeholders, it would at least keep a tighter rein on managers and help to avoid "social overinvestment."

## **Murky waters**

When a firm has multiple objectives, as is the case with an SM approach, managers need more freedom to carry out the web of tasks necessary to managing expectations. These actions can't be measured by fixed benchmarks, so the relationships between them, the good of stakeholders and firm performance can be virtually opaque to everyone but the CEO.

On the one hand, this causal ambiguity is great for competition: If rivals don't know how you're achieving success, they can't copy you. But if no one but the CEO knows what's going on, at best, they could develop an inflated image of their own value and, at worst, they could use this opacity to mask self-interest.

To deal with a host of different parties, the CEO has to be charismatic, and this could become the foundation of a romanticized image. A manager with total discretion can have successes attributed to them, while failures are down to external factors. Inevitably, such pretenses can't help stakeholders or firm performance.

But a self-interested CEO can be even worse news for business. Managers have the discretion to drive resources away from corporate goals and towards particular stakeholders - with the subtle aim of "winning" their support. These stakeholders can reimburse managers for their efforts by supporting decisions in their favor, such as anti-takeover amendments and perks.

## **Perfect conditions**

So who is likely to favor an SM approach and could, therefore, be potential prey for managers out for themselves?

You might initially think that firms with diffuse ownership would be prime targets - particularly if the owners show little interest in the day-to-day running of the company. But managers of these firms already have so much latitude of action that they have little incentive to increase it with SM.

The authors point out that managers in firms with very influential owners might turn to SM for more power. And such firms owned by long-term, activist investors - such as family companies and pension funds - are likely to look to SM for a way to build a good reputation and increase long-term value. In these cases, managers could be using SM to overcome otherwise tight control and pursue self-interest.

The less debt, the more likely a firm is to commit to stakeholders. The priority of high-

leveraged firms is efficiency, achieved through very un-shareholder-friendly means - layoffs, cuts in social spending and so forth. Paradoxically, companies with less debt are also more vulnerable to managers with uneconomical or, even worse, dark incentives, since they have freer cash flow.

## **Taking control**

So how can directors tell if CEOs are actually benefiting stakeholders and the company? More importantly, how can they make sure managers aren't taking advantage?

Causal ambiguity makes their performance very difficult to assess. It seems the only way is for directors to become more knowledgeable about management practices and put controls in place - but these are expensive and not very useful in exposing managers' faults, when it is even hard for CEOs to know exactly what parts of strategy affect performance anyway.

Long-term, outcome-based compensation plans could provide managers with an incentive for focusing on gradually increasing the value of the company. This could give them the push they need to use resources for practices with long-term effects, which would be in the interests of stakeholders and the firm - everyone's happy.

But in the highly politicized and risky environment of a stakeholder-committed firm, managers would need more compensation to make up for all the extra responsibility.

When such compensation plans are stock-based, they can encourage some shady behavior: Managers might engage in short-term trading or manipulate accounting figures to boost the value of stock linked to their compensation. Managers could be rewarded for actions that already have dark incentives and "an unethical double cost can arise."

None of this looks good to stakeholders, undermining the whole point of this method of corporate governance.

## **So what next?**

On paper, SM sounds like the perfect way to balance ethical considerations and profit. But when you think about the practical complexities involved, it seems firms may need to restrict managerial discretion by limiting the number of stakeholders considered. However, more research must be done in order to decide which parties these should be.

The authors maintain that, when used legitimately and properly accomplished, an SM

strategy has a "bright side." But their focus on the reverse may help to explain mixed results of literature on the SM/firm performance relationship.

"Only by recognizing the costs and risks associated with SM will firms be able to successfully implement this approach and obtain the purported benefits."

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