Not All Stakeholders are Created Equal: A Tribute to Michael Jensen

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Financial economist Michael Jensen passed away on April 2, 2024. Dr. Jensen was known primarily for his seminal work on agency theory, but his legacy spans numerous conversations on management and governance. In this essay, I draw upon Dr. Jensen's insights on corporate governance to discuss stakeholder analysis.

In his relentlessly analytical and unapologetically candid approach to corporate governance, Michael Jensen maintained that an actionable approach to governance must offer managers and boards clear insight on how to choose among multiple competing and inconsistent constituent interests.[1] Measured against this yardstick, discussions of corporate governance leave much to be desired. Legal scholars and business ethicists Eric Orts and Alan Strudler[2] minced no words by describing stakeholder conversations as "so broad as to be meaningless and so complex as to be useless." Alas, I concur.

Problems start with overly permissive definitions. If we adopt the common definition of stakeholder as "any group or individual who can affect or is affected by the achievement of an organization's purpose," then just about everyone, everywhere, becomes a stakeholder. Among the most absurd implications of this broad definition is the notion that all of us become stakeholders of terrorist organizations.

To add to the confusion, many stakeholder discussions call for the *balancing* of stakeholder interests. But when interests are, as Jensen aptly noted, not only competing but also inconsistent, how exactly does one balance? Jensen bluntly called *balancing* a "hurrah word" that "cannot ever substitute for having to deal with the difficult issues associated with specifying the tradeoffs among multiple goods and bads."[1]

The ubiquitous problem with stakeholder discussions is that they tend to resort to exercises in rhetoric that fail to provide the decision-makers with actionable guidance. As we avoid stepping on anyone's toes, we cautiously conclude that everyone is important. But if everyone is important, no one is, and all our work is still ahead of us.

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A hasty reading of Jensen's work (especially if one reads just his early work) suggests that he was interested in *shareholder value maximization*. But a detailed reading of his later works (post-2000) unveils important nuance, which is captured by his term *enlightened value maximization*. Here are its three central principles, as I see them:

First Principle	Effective corporate governance must provide all constituencies with a structure that discourages maximization of short-term financial performance (e.g., profits or earnings per share). Short-term profit maximization is “a sure way to destroy value.”[1]
Second Principle	Long-term success is impossible if one ignores or mistreats any important constituency.
Third Principle	Stock price is relevant, but *total long-term firm value* is central.

Maximizing value is, therefore, not about maximizing the value of the firm’s equity (stock price) but the value of the entire firm. The two are related but not synonymous (e.g., isn’t it obvious that debt, and debt-financed firms, can have value as well?). Most importantly, enlightened value maximization incorporates shareholder interests but does not privilege them. To me, the Third Principle further implies that the principal in the principal-agent relationship is the corporation, not the shareholders, which squares nicely with the notion of the *best interest of the corporation*.

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A clarification on *maximization* is in order. When we say we want to maximize value, what we really mean is much more modest—we *seek* value. Jensen elaborates: “It is not necessary that we be able to maximize, only that we can tell when we are getting better—that is moving in the right direction.”[3]

The notion of moving in the right direction becomes operational in specific, strategic decision situations in which managers and boards must choose one of several feasible alternative courses of action. Tesla’s acquisition of SolarCity is representative of a situation in which the board of directors chose a direction that was considered controversial by some shareholders:

> “In 2016, Tesla paid $2.6 billion to acquire SolarCity, a company that sells solar energy generation systems. The acquisition created controversy among a number of union pension funds and asset managers whose organizations held stock in Tesla. In 2017, a number of dissatisfied shareholders filed a lawsuit against Tesla’s board of directors, alleging that the SolarCity acquisition amounted to a bailout, and that it was Tesla’s CEO Elon Musk, his friends, and his family who had benefited from the acquisition.”[4]

The plaintiff’s position was that of the two feasible options (acquire or don’t acquire), Tesla’s board chose the path that did not “move Tesla in the right direction.” However, the Delaware courts concluded that the acquisition—most importantly, the price Tesla paid for SolarCity—was ultimately *entirely fair*.[5]

However, as a general guideline of what managers should do when they go to work Monday morning, the maximization imperative becomes less relevant, and often simply inoperational.

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Covid-19 taught us many things, chief among them the necessity of prioritizing the allocation of scarce resources such as vaccine doses. The needs of the 75-year-old asthmatic and the 25-year-old college student with no respiratory issues did not have to be "balanced" but prioritized: The 75-year-old would get the vaccine before the 25-year-old.

The same logic applies to stakeholder management: Rigorously analyze what the organization's constituencies (shareholders, employees, lenders, suppliers, customers, etc.) have at stake and then prioritize accordingly. The problem with trying to "balance" is that those with the most at stake will feel short-changed, which effectively violates Jensen's Second Principle: You end up mistreating an important constituency.

The problem with the organization losing credibility in the eyes of those who have the most at stake is that they tend to be comparatively more important in creating long-term firm value (Jensen's Third Principle). This problem becomes even more pronounced when we analyze *prospective* stakeholders, that is, those who are asked to put something at stake in the organization but haven't done so yet. The objective of effective stakeholder management is to convince the prospective stakeholder to commit.

Imagine a situation in which you are among those who are asked to put more at stake than others. I would be surprised if your first question would not be, "How is the fact that I am asked to put comparatively more at stake than others taken into account?" What if the reply was that your interests would need to be balanced with the interests of those with less at stake? Assuming you wouldn't already walk away at that point, I predict your next question would be, "What do you mean by balanced?"

The comparatively higher stakes tend to be crucial to the functioning of the organization, which means a failure to secure them threatens the very survival of the organization. Anyone who has had to raise equity financing for a startup knows this painfully well.

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How, then, does one prioritize? I think we can derive some insights by building on Jensen's three principles. First, we need to rewrite the definition of a stakeholder to include only those constituencies that have an interest in the success of the organization and who have voluntarily placed an economic wager on the future of the organization. It also enables the treatment of stakeholdership not as a binary but continuous variable: the *extent to which* one is a stakeholder is determined by the size of one's wager. This, in turn, paves the way toward prioritization: Higher wagers require more attention. Finally, we might treat stakeholders symmetrically: Do not ask whether A is B's stakeholder, ask whether A and B are *one another's* stakeholders. This is ultimately not about the firm but its relationships with its value-creating constituencies, whoever they happen to be in the specific situation.

In summary, let me offer a symmetrical definition of stakeholder: A and B are one another's stakeholders when they (1) have obligations toward one another, (2) are

interested in one another's success, and (3) have both put something voluntarily at stake in the relationship.[4]

The next step is to take one constituency category at a time and analyze which specific relationships exhibit stakeholder characteristics. Of the hundreds of component suppliers HP contracts with, let me suggest that AMD, Canon, Microsoft, and Intel are comparatively more important because HP depends on these four *specific* firms. For numerous other components, existing alternate sources of supply are readily available, which means HP depends on them only in the aggregate. It makes no sense to treat nuts-and-bolts suppliers as stakeholders because it diverts attention away from what is critical. Supplier switching costs can be used as a metric to prioritize suppliers.

Then rinse and repeat: Conduct a comparative analysis of all other constituencies (financiers, employees, customers, etc.) to arrive at a clear prioritization of all relationships. Do not treat any constituency group as monolithic because all groups exhibit potentially relevant heterogeneity in terms of the wagers made.

The ultimate objective of a stakeholder analysis is to identify the most critical relationships and then implement the requisite safeguards to ensure their long-term viability (more on safeguards in Ketokivi and Mahoney, 2023, chapter 4). The more critical the relationship, the more attention it requires in governance decisions. But always pay heed to Jensen's Second Principle: Do not ignore or mistreat any important constituency. And never shy away from concluding that some constituencies simply are not stakeholders. For example, I submit that, as a general rule, consumers are *not* stakeholders of the firms whose products they use.

I am typing this essay on a Logitech keyboard. The proposition that I would voluntarily put something at stake in Logitech (a company I know absolutely nothing about) is absurd. Why on earth would I commit? No, I want to make sure that my switching cost to using another brand is negligible. Luckily, thanks to the automatic configuration technology known as *plug-and-play,* my switching cost is simply the price of the new keyboard. But this being the case, it would be hypocritical for me to claim that I am Logitech's stakeholder. I am pretty sure that executives at Logitech would agree that my relationship with Logitech is purely transactional. In plain English, I am their customer, not a stakeholder.

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Five years ago, an executive student approached me after our class discussion on stakeholder analysis and said, "So, are you saying that I should never become anyone's stakeholder?" I replied: "Unless you can think of a very compelling reason to put something at stake, then yes, that is exactly what I am saying."

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To me, Michael Jensen's legacy is summarized in the maxim, "Don't balance, prioritize." Effective prioritization requires a board of directors that is independent of both the corporation and its shareholders and, most importantly, independent *in its thinking and decision-making*. Insofar as the total long-term value of the firm is concerned, an independent board offers the best chance of moving the firm in the right direction.

[1] Michael Jensen, 2002. Value maximization, stakeholder theory, and the corporate objective function. *Business Ethics Quarterly*, vol. 12, pp. 235-256. https://doi.org/10.2307/3857812

[2] Eric Orts and Alan Strudler, 2002. The ethical and environmental limits of stakeholder theory. *Business Ethics Quarterly*, vol. 12, pp. 215-233. https://doi.org/10.2307/3857811

[3] Michael Jensen, 2001. Value maximization, stakeholder theory, and the corporate objective function. *Journal of Applied Corporate Finance*, vol. 14, pp. 8-21. https://doi.org/10.1111/j.1745-6622.2001.tb00434.x

[4] Mikko Ketokivi and Joseph T. Mahoney, 2023. Efficient Organization: A Governance Approach. Oxford: Oxford University Press. https://global.oup.com/academic/product/efficient-organization-9780197610282

[5] Chief Justice Valihura's Opinion, In *Re Tesla Motors, Inc. Stockholder Litigation*. The Supreme Court of the State of Delaware, No. 181, 2022 (June 6, 2023), p. 106. https://courts.delaware.gov/Opinions/Download.aspx?id=348500

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