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Maximizing the firm's value to society through ethical business decisions: Incorporating 'moral debt' claims

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Abstract

We argue that all three forms of justice (economic, legal, distributive) require to be incorporated into the firm's business decisions in order to protect stakeholders' alienable and inalienable rights. In addition, the firm has 'moral debt' obligations which require to be distributed fairly amongst all stakeholders. We develop a model that demonstrates that just distribution of stakeholders' 'moral debt' and residual claims leads to the maximization of the firm's value to society in the long-run.
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1. Introduction

Authors of corporate finance literature argue that the main objective of the firm is shareholder wealth maximization (see for instance, Brealey and Myers, 2000; Copeland and Weston, 1992). Shareholder wealth maximization is usually defined as the maximization of the discounted cash flows, whether in the form of dividends or capital gains, over time. Clarkson (1991) argues that the concept of shareholder wealth maximization is being

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replaced with the concept of stakeholders' wealth maximization through moral corporate behaviour and decision making (see also Stiglitz, 2006; Donaldson and Dunfee, 2002). Clarkson (1991, p. 190) defines stakeholder groups as those that are "actively or passively involved in the corporation's activities, those groups, in effect, without whom the corporation could not operate or make a profit, and those groups who may be affected by the corporation's actions." In contrast to shareholder wealth maximization, stakeholder wealth maximization is based on the premise that not one group of individuals are made better off while some other group of individuals are made worse off. As Jensen (2001, p. 304) states "the real issue to be considered here is what firm behavior will result in the least social waste – or equivalently, what behavior will get the most out of society's limited resources – not whether one group is or should be more privileged than another" (see also Pieper, 1966; Steiner, 1999). In order to reconcile the idea of shareholder or stakeholder wealth maximization with minimum social waste, business decisions of the firm would need to be ethical. As Pieper (1966, p. 6) points out quite distinctively "virtue is a 'perfected ability' of man as a spiritual person; and justice, fortitude, and temperance, as 'abilities' of the whole man, achieve their 'perfection' only when they are founded upon prudence, that is to say the perfected ability to make right decisions." Ethical business decisions are defined as decisions which would maximize the value of the firm to society. Thus, the "nexus contracts that constitute the firm" (Boatright, 2002, p. 1849) would require to incorporate all three forms of Justice (Pieper, 1966; Wilson, 1991): economic, legal, and distributive. If the firm does not make Pareto optimal business decisions then all three forms of justice are not incorporated which implies that stakeholder rights will be violated due to unfair redistribution of residual[1] and non-residual claims. Stiglitz (1981) argues that Pareto optimal efficient market exists when there is no feasible allocation of resources which can make some individual better off without making someone else worse off. Thus, the marginal social cost of a firm's activity increases with no corresponding marginal increase in social benefit.

In order to achieve business decisions that are Pareto optimal, three forms of justice would require to be integrated into business decisions (Pieper, 1966; Wilson, 1991):

- Economic justice can be defined as the right to receive the equivalent for a service rendered or reparation for a loss sustained. Jensen and Meckling (1998) observe that the market system is based on the ownership of private alienable[2] (property) rights and the ability to capture proceeds from decisions to sell these rights thus capturing the benefits from exchange of goods or services.
- Legal justice[3] can be defined as the individual's or the organization's obligation which "relates to the fairness of participation by individuals in the economic system" (Wilson,

[1] The right to net cash flows differences between stochastic inflows of resources and promised payments to agents (Fama and Jensen, 1998).

[2] Alienable property rights include intangible assets and intellectual property (Claessens and Laeven, 2003).

[3] Jensen and Meckling (1998) state that the assignments of rights in the USA was derived through the legal system via: court decisions (common law), legislative enactments (statutory law) and administrative decrees (administrative law). The USA's legal system is based on the English common law tradition "characterized by the independent judges and juries, relatively lower importance of statutory laws, and the preference for private litigation as a means of addressing social problems" whereas other legal systems are more 'socialist' based on civil law tradition that regulate activity more heavily (Shleifer, 2005, p. 448). See also Stultz and Williamson (2003) on the relationship between religion, law, and rights.

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