MITSloan
Management Review

SUMMER 2003

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Vol. 44, No. 4 | Reprint #44411 | http://mitsmr.com/1g2ZmLj

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The stakeholder theorists smell blood. Scandals at Enron, Global Crossing, ImClone, Tyco International and WorldCom, concerns about the independence of accountants who are charged with auditing financial statements, and questions about the incentive schema and investor recommendations at Credit Suisse First Boston and Merrill Lynch have all provided rich fodder for those who question the premise of shareholder supremacy. Many observers have claimed that these scandals serve as evidence of the failure of the *shareholder theory* — that managers primarily have a duty to maximize shareholder returns — and the victory of *stakeholder theory,* which says that a manager's duty is to balance the shareholders' financial interests against the interests of other stakeholders such as employees, customers and the local community, even if it reduces shareholder returns. Before attempting to declare a victor, however, it is helpful to consider what the two theories actually say and what they do *not* say.

Both the shareholder[1] and stakeholder theories are *normative* theories of corporate social responsibility, dictating what a corporation's role *ought* to be. By extension, they can also be seen as normative theories of business ethics, since executives and managers of a corporation should make decisions according to the "right" theory. Unfortunately, the two theories are very much at odds regarding what is "right."

Shareholder theory asserts that shareholders advance capital to a company's managers, who are supposed to spend corporate funds only in ways that have been authorized by the shareholders. As Milton Friedman wrote, "There is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profits so long as it … engages in open and free competition, without deception or fraud."[2]

On the other hand, stakeholder theory[3] asserts that managers have a duty to both the corporation's shareholders and "individuals and constituencies that contribute, either voluntarily or involuntarily, to [a company's] wealth-creating capacity and activities, and who are therefore its potential beneficiaries and/or risk bearers."[4] Although there is some debate regarding which stakeholders deserve consideration, a widely accepted interpretation refers

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to shareholders, customers, employees, suppliers and the local community.[5] According to the stakeholder theory, managers are agents of *all* stakeholders and have two responsibilities: to ensure that the ethical rights of no stakeholder are violated[6] and to balance the legitimate interests of the stakeholders when making decisions. The objective is to balance profit maximization with the long-term ability of the corporation to remain a going concern.

The fundamental distinction is that the stakeholder theory demands that interests of *all* stakeholders be considered *even if it reduces company profitability.* In other words, under the shareholder theory, nonshareholders can be viewed as "means" to the "ends" of profitability; under the stakeholder theory, the interests of many nonshareholders are also viewed as "ends."[7]

Unfortunately, shareholder theory is often misrepresented in several ways. First, it is sometimes misstated as urging managers to "do anything you can to make a profit," even though the shareholder theory obligates managers to increase profits only through *legal, nondeceptive means.*[8] Second, some criticize the shareholder theory as geared toward short-term profit maximization at the expense of the long run. However, more thoughtful shareholder theorists often refer to a need for "enlightened self-interest," which — if embraced — would lead a corporation's managers to take a *long-term* orientation. Third, it is sometimes claimed that the shareholder theory prohibits giving corporate funds to things such as charitable projects or investing in improved employee morale. In fact, however, the shareholder theory supports those efforts — insofar as those initiatives are, in the end, the best investments of capital that are available.[9]

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Similarly, the stakeholder theory is sometimes misunderstood. It is sometimes claimed that the stakeholder theory does not demand that a company focus on profitability. Even though the stakeholder theory's ultimate objective is the concern's continued existence, it must be achieved by balancing the interests of all stakeholders, *including* the shareholders, whose interests are usually addressed through profits.

Also, because many stakeholder theory descriptions provide no formula for adjudicating among the stakeholders' disparate interests, some have claimed that the theory cannot be implemented. While it is true that some versions of the theory provide no guidance in this regard, many stakeholder theorists have provided algorithms for trade-offs among stakeholders' interests. For example, one might assess the level of risk that each stakeholder has embraced and rank their interests accordingly, or one might simply assert that one stakeholder group's interests should always prevail, as Richard Ellsworth has recently argued.[10]

Has There Always Been a Dispute?

As many observers have pointed out, the stakeholder view does have a historical tradition in the U.S. economic system. Historically, argued John Cassidy in the New Yorker, "Many chief executives saw their main task as overseeing the welfare of their employees and customers. As long as the firm made a decent profit every year and raised the dividend it paid its stockholders, this was considered good enough."[11] But it is also clear that, in the past two decades, expectations have shifted, driven by two forces.

One force was the pointed arguments of free-market economists. In a widely cited 1970 article, Milton Friedman argued that the fundamental obligation of managers is to return profits to shareholders — not to invest corporate funds in endeavors that they find socially beneficial but that reduce shareholders' returns.[12] In 1976, Michael Jensen and William Meckling explored the notion of "principal-agent" conflicts, arguing that executives often fail to maximize profits unless the shareholders invested their time and money in creating appropriate incentives to do so and monitored the resulting behavior.[13] That suggestion, and others that followed, heightened investor awareness that many managers might not be maximizing profits.

Second, and probably related to the growth of the "principal-agent" arguments, many corporate raiders during the 1980s bought stock of companies they considered undervalued, jettisoned the existing management and often dismantled the companies. There is scant evidence that such takeovers (sometimes subsumed under the rubric of "market discipline") lead to long-term gains for those who finance them. However, the prospect of such takeovers seemed to have made it, for a time, more dangerous for executives to acknowledge publicly anything other than the shareholder theory[14] or to behave in any fashion that could suggest a nonoptimal return to shareholders.[15]

To be sure, many would prefer that the shareholder-stakeholder dispute simply go away. In particular, many shareholder theory advocates are quick to claim that the theories actually converge, that our society's norms clearly favor the shareholder theory or that market forces and the law leave one no choice but to embrace that theory. However, none of these assertions can withstand logical scrutiny.

First, consider the assertion that the theories converge — that if managers take care of the stakeholders, they will wind up maximizing profits and shareholder returns in the long run. In that vein, one thoughtful treatise recently argued that stakeholder relationships are not a "zero-sum game" (that is, anything gained by employees comes out of the pockets of investors or customers) but a mutually reinforcing, interactive network.[16] However, that is clearly not the case in all situations.

Consider a business with many long-term employees that has manufactured its products for more than 30 years in a small Midwestern town. Those products have been sold in many foreign markets — but for the past 10 years, not in the United States. Its executives have recently concluded that they can no longer afford to manufacture the products domestically, and the most cost-effective solution is to outsource the manufacturing to another country. The shareholder theory would support closing the plant and would direct the executives to provide only what the law requires to the community and the employees, since there is little possibility of a backlash against the company due to a plant closing (because the products are solely for export). To expend any corporate funds on retraining affected employees or on contributions to the community would be a waste of shareholders' money, since the investments would never be returned. However, the stakeholder theory would infer a normative obligation to both the community and the employees; while it might not demand that the company continue to operate the plant, it would expect some attempt to retrain the employees, help the community attract new industry and so on. Obviously, these efforts would reduce the concern's profitability, but the stakeholder theory would not support a "cut and run" approach to the situation.

That example and many others like it show that reasonable applications of the theories will sometimes yield different normative obligations on managers' parts. To claim that the theories converge requires that one assume that actions in favor of stakeholders ultimately resonate positively to the bottom line and/or actions against stakeholders are eventually punished on the bottom line. In many cases, though, the linkage between such actions and the profit and loss statement is either nonexistent or so indirect as to strain credulity. The stakeholder theory demands that stakeholder interests be considered *as an end in themselves.* If stakeholder interests are being considered only *as a means to the end of profitability,* then managers are using stakeholders to effect the results dictated by the shareholder theory. These are two very different concepts.

Second, consider the assertion that U.S. society's norms clearly align with the shareholder theory. To be sure, most U.S. economists and those closely associated with the financial markets accept the shareholder theory's premises unquestionably, and the nation's business schools have seemingly embraced the shareholder mantra. However, it is startling to note that there is evidence that public perceptions may not comport with those of economists and the financial community.

Perhaps the most telling data regarding perceived societal norms are found in a long-term research study, in which researchers surveyed 15,000 managers from various countries selected "from the 'upper-middle' ranks of management" to attend international management seminars over an eight-year period. The researchers asked the managers whether they thought the majority of their fellow citizens felt that a company's only goal was profit, or if they thought that companies were also responsible for the well-being of various stakeholders. (Note that the study did not ask the managers about their *own* views on the question.)

Interestingly, 40% of U.S. managers chose the former response — the highest percentage of any country in the study.[17] It seems likely that these managerial perceptions represent solid evidence of a disconnection between the views of free-market economists and those of the rest of the general population.

Finally, consider the assertion that companies have no choice but to follow the shareholder theory, on the basis of law and market forces. Although some people claim that U.S. law respects the supremacy of shareholder interests (and, therefore, that a concern's directors are liable for any decisions that go against such interests), analysis of legal statutes does not, in the main, support that assertion. Jay Lorsch states that two principles form the nexus of directors' legal responsibilities: a *duty of care* and a *duty of loyalty.* The duty of care simply means that directors should gather necessary information before making decisions; the duty of loyalty means that directors should be careful to act appropriately when there are conflicts of interest.[18] As noted by Richard Ellsworth, "As long as directors fulfill their dual duties of care and loyalty, courts do not challenge their decisions,"[19] even if they are made according to the stakeholder theory. More specifically, in at least 38 states, there are now "'stakeholder' laws, which permit (or even require) directors to consider the impact of their actions on constituencies other than shareholders."[20] In addition, courts in Delaware — where the majority of large U.S. corporations

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are incorporated and where laws are largely consistent with the shareholder theory — have begun "to liberalize their interpretation of the state's laws."[21] Indeed, professors Margaret Blair of Georgetown University Law Center and Lynn Stout of the University of California at Los Angeles have recently concluded that, legally speaking, a board of directors in the United States is "not a policeman employed by shareholders but a neutral umpire for all involved."[22] According to Blair, "We have a director primacy model in this country, not a shareholder primacy model."[23]

The year 2002 saw corporate executive behavior that was at best disruptive and, at worst, illegal. The real question, of course, is whether the shareholder theory prescribes and rewards this.

But even if the law cannot be counted on to enforce the shareholder theory, economic forces, it is claimed, will drive managers to embrace it. One obvious way in which this can be done is for the board of directors to dismiss senior executives who do not maximize profitability. However, research indicates that the forced departure of executives who do not maximize profits is by no means assured, showing it to be more likely when there is an outsider-dominated rather than an insider-dominated board.[24] The probability of such dismissal differs over time for an executive: For a similarly weak performance, a CEO is two to three times more likely to be dismissed during the first four years on the job or after having been on the job 10 years or more than in the period in between.[25] In short, one can hardly count on the thesis that states that the "board of directors will remove non-profit-maximizing managers" to hold uniformly.

However, based on economic theory, there is still a way in which managers who do not maximize profits, and whose boards do not remove them, will wind up unemployed: The company's underperformance will be noted in the marketplace, the company will be subjected to a hostile takeover, and the board and the managers will be replaced. Some have argued that the large number of mergers and acquisitions in the late 1990s provides evidence that this assumption is accurate. However, the bulk of these M&As were not grounded in removal of existing managers due to suboptimal profitability, as would normally be the case in hostile takeovers. The fact that there are many M&As (or, for that matter, hostile takeovers) does not, in and of itself, tell us whether the "disciplinary" market control is working.

In fact, a seminal study by Julian Franks and Colin Mayer concluded that we *cannot* rely on hostile takeovers to perform such a disciplinary function. They noted that high bid premiums are associated with hostile bids, but found no evidence that these bids are driven by management's delivery of suboptimal profits relative to others in the same industry.[26] Of course, one can never know exactly how far below the maximal profit threshold a company is performing (after all, it is possible that *all* the businesses in an industry could be suboptimizing). But since Franks and Mayer found that hostile bidders do not even distinguish significantly between the companies *within* an industry, we should view predictions that the market will punish managers who do not follow the shareholder theory more as a statement of religious conviction than as an empirical observation that has withstood rigorous scrutiny.

In sum, despite the attempt by some observers to "make the dispute go away," the facts remain that the theories demand very different things; that perceptions of U.S. norms across the broad society are likely more suggestive of a stakeholder than of a shareholder orientation; and that neither legal nor marketplace mechanisms can be relied on to enforce the shareholder theory in a uniform fashion. Therefore, the dispute seems to be with us for the time being and the suggestions that recent financial scandals prove the failure of the shareholder theory deserve careful scrutiny before they can be accepted.

Whither the Shareholder Theory?

The year 2002 saw a good deal of corporate executive behavior that was at best disruptive to the free flow of commerce and, at worst, illegal. Few would dispute that such behavior should be discouraged rather than rewarded. The real question, of course, is whether the shareholder theory prescribes, and therefore rewards, behaviors that are actually detrimental to society.

Many of the more strident critics of shareholder theory seem to claim that as executives are charged with maximizing shareholder value and are given large incentives to do so through stock options or other schema, they will respond by embracing whatever manipulations are necessary to achieve that goal. It is further suggested that if those manipulations include setting up illegal partnerships and then shredding incriminating evidence, shareholder theory will encourage the behavior, as long as the executives do not get caught. Since society deems these behaviors reprehensible and since it is suggested that the shareholder theory drove executives to behave that way, these commentators conclude that the theory is bankrupt and must be jettisoned.

The argument relies, however, on an incomplete and somewhat misrepresentative interpretation of the shareholder theory.

First, while the mantra of maximizing shareholder value was indeed chanted by many in the economic and financial communities in the late 1990s until the scandals hit in 2002, it is not at all clear that such a goal is completely consistent with the intent of the shareholder theory. It must be remembered that shareholders get a return from their invested capital in two different ways: through dividends paid out by the corporation and through increased share prices. If we return to the most often cited and most accessible statement of the shareholder theory, Milton Friedman's 1970 essay "The Social Responsibility of Business Is To Increase Its Profits," it becomes apparent that the shareholder theory spoke more to increasing dividends through profitability than to increasing share price in a (possibly irrational) stock market. Yet those who criticize the mantra of maximized shareholder value seem to be most disturbed by the recent fixation on market returns, which the theory never viewed as the primary end state to begin with.

> **Even if one concedes that linkages of executive misbehavior to shareholder theory are misplaced, it is hard to claim that the theory has done anything to help the situation.**

Second, the argument seems to suggest that the shareholder theory prescribes any action in pursuit of shareholder returns. But the theory clearly dictates that the pursuit of profits should be done legally and without deception, and there is little wiggle room for the kinds of overtly illegal behavior alleged in many recent financial scandals. Thus, the executives who broke the law were *not* operating according to the shareholder theory.

Third, it must be remembered that many of the executives undertook actions that, from all outward appearances, were more for their own benefit than for that of the shareholders. For example, Enron Corp. CFO Andrew Fastow, who created a partnership that was bankrolled with Enron stock and populated with very risky ventures, "stood to make millions quickly, in fees and profits, even if Enron lost money on the deal," according to the Washington Post. Actually, Enron lost more than $500 million from these initiatives and entered bankruptcy.[27] Similarly, several other executives, including Kenneth Lay of Enron, Garry Winnick of Global Crossing Holdings Ltd. and Scott Sullivan of WorldCom Inc., also benefited from bonuses and stock options at the same time that their companies' shareholders were suffering. In fact, the shareholder theory finds such behavior inexcusable, since the basic premise of the theory is that executives should act only in the shareholders' interests and *not in their own.*

Thus, the strident line of argument does not appear terribly compelling, since it seems to misinterpret the shareholder theory even as it indicts the theory. However, others who also argue that recent financial scandals augur a move to the stakeholder theory take a less hostile, more compelling tack. While they accept that much of the recent bad behavior was grounded in human weakness and not inherent in the shareholder theory, they contend that if society embraced the stakeholder theory, executives would develop an innate self-correcting mechanism that would temper tendencies to act in a manner that ignores certain stakeholders' interests. If U.S. society entered an era in which the only "politically correct" perspective was that of the stakeholder theory, it is likely that executives would shift their language to include references to stakeholders' interests. Over a period of time, if psychological theories are to be believed, managers' behaviors, and then their true attitudes, would also begin to shift toward the stakeholder theory. That argument is more compelling.

In this context, we can see that the dispute between the shareholder and stakeholder theories in the United States, in which it appeared for several years that the shareholder theory was emerging as a victor, is now best viewed as a standoff. The stakeholder theory may have a slight edge, because the shareholder theory's less-strident critics do have a logically defensible argument and because the strident argument that the shareholder theory encourages bad behavior, while not logically defensible, has emotional resonance with many people. Rightly or wrongly, the theory is being tarnished by association. Still, even if one generously concedes that many recent linkages of executive misbehavior to the theory are misplaced, it is hard to claim that the shareholder theory has done anything to *help* the situation.

What Are Executives and Boards To Do?

Against this backdrop, U.S. executives and board members might reasonably ask what they should do differently. First, executives should consider changing their language, getting rid of the phrase "maximizing shareholder value." Indeed, many of the most ardent supporters of the shareholder theory have quietly shifted to "maximizing our company's value" and other similar phrases. An even more temperate phrasing of the corporate objective would be "maximizing our company's contribution to our economic system."

Second, executives should feel freer to change their attitudes and behaviors openly. If a CEO or board member's only reason for not verbalizing a belief in the stakeholder theory was a fear of takeover, it is likely that such pressures will abate given the increasing evidence that the "market discipline" of takeovers during the last few years has proven less than efficient in maximizing returns. Assuming that a CEO's board approves, the CEO should be able to operate freely under either theory for the foreseeable future.

Third, whichever theory is embraced, executives need to be clear about the choice in organizational communications. If midlevel managers are confused about the corporation's objectives, they will likely make inconsistent decisions, probably by relying on their own normative beliefs about the appropriate theory. Richard Ellsworth has suggested a six-step series of "challenge-sessions" in which executives work through their collective attitudes toward the company's stakeholder obligations and priorities and then take overt steps to communicate their conclusions throughout the organization.[28] An approach like his should at least provide a firm grounding upon which operational decisions can then be made.

ACKNOWLEDGMENTS

I am indebted to Bob Hebert for his research assistance and to Ram Baliga, Jim Flynn, John Hasnas and Gary Shoesmith for enlightening conversations. This research was supported by the Babcock Graduate School of Management at Wake Forest University, Research Fellowship Program.

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3. Note that I am considering only the *normative* version of the theory, which states how managers *ought* to behave. There are also *descriptive* versions of the stakeholder theory, which describe actual behavior of managers, and *instrumental* versions, which predict outcomes (for example, higher profits) if managers behave a certain way. These distinctions are drawn crisply in T.M. Jones and A.C. Wicks, "Convergent Stakeholder Theory," Academy of Management Review 24, no. 2 (April 1999): 206-221.

4. J.E. Post, L.E. Preston and S. Sachs, "Managing the Extended Enterprise: The New Stakeholder View," California Management Review 45, no. 1 (fall 2002): 5-28.

5. W.M. Evan and R.E. Freeman, "A Stakeholder Theory of the Modern Corporation: Kantian Capitalism," in "Ethical Theory and Business," 3rd ed., eds. T.L. Beauchamp and N.E. Bowie (Englewood Cliffs, New Jersey: Prentice-Hall, 1988), 97-106. It is to this version of the normative stakeholder theory that the following description refers. Note, however, that Post, Preston and Sachs, who take a more instrumental than normative view of stakeholder theory, embrace a wider enumeration of stakeholders, including regulatory authorities, governments and unions.

6. Note that these are *ethical* rights. They may or may not correspond to *legal* rights or to rights established by professional/industry codes and so on.

7. Some authors — for example, see J. Hasnas, "The Normative Theories of Business Ethics: A Guide for the Perplexed," Business Ethics Quarterly 8, no. 1 (1998): 19-42 — view the "social contract" theory as providing a third, and differing, normative viewpoint that is at an equivalent level to the shareholder and stakeholder theories. However, the most recent writings by the leading proponents of the social contract theory — including T. Donaldson and T.W. Dunfee, "Ties That Bind: A Social Contracts Approach to Business Ethics" (Boston: Harvard Business School Press, 1999), see especially chapter 9 — instead seem to view the "social contracts" perspective as a meta-theory that provides guidance in sorting through the stakeholder obligations.

8. Friedman, "Capitalism and Freedom," 56, 61.

9. N.E. Bowie and R.E. Freeman, "Ethics and Agency Theory: An Introduction" (Oxford, England: Oxford University Press, 1992), 3-21.

10. R.R. Ellsworth, "Leading With Purpose: The New Corporate Realities" (Stanford, California: Stanford University Press, 2002). Here, Ellsworth argues for the primacy of customers' interests over those of other stakeholders.

11. J. Cassidy, "The Greed Cycle," The New Yorker, Sept. 23, 2002, 64-77. Also see Cassidy for a thorough and accessible treatment of the factors driving the shift to a "shareholder value" perspective.

12. M. Friedman, "The Social Responsibility of Business Is To Increase Its Profits," New York Times Magazine, Sunday, Sept. 13, 1970, sec. 6, p. 32.

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15. J. Magretta, "What Management Is: How It Works and Why It's Everyone's Business" (New York: Free Press, 2002), 30-33.

16. Post, "Managing the Extended Enterprise," 18.

17. See C. Hampden-Turner and A. Trompenaars, "The Seven Cultures of Capitalism: Value Systems for Creating Wealth in the United States, Japan, Germany, France, Britain, Sweden and the Netherlands" (New York: Doubleday, 1993). The percentage of managers choosing the first option varied from lows of 8% (Japan) and 11% (Singapore) to highs of 34% (Canada), 35% (Australia) and 40% (the United States).

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23. Ibid.

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28. Ellsworth, "Leading with Purpose," 327-357.

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