

Towards a Stakeholder Theory of Strategic Management

Joseph T. Mahoney

Professor of Strategic Management
Department of Business Administration
College of Business
University of Illinois at Urbana-Champaign
140C Wohlers Hall
1206 South Sixth Street
Champaign, IL 61820
Phone: (217) 244-8257
Email: josephm@uiuc.edu

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Abstract

This paper suggests that due to the changing nature of the firm, viewing shareholders as the sole residual claimants is an increasingly tenuous description of the actual relationships among a corporation's various stakeholders. Thus, a shareholder wealth perspective is increasingly unsatisfactory for accurately answering the two fundamental questions concerning the theory of the firm: that of economic value creation, and the distribution of this economic value. Examining the corporation from a (team production) property rights perspective of incomplete contracting and implicit contracting provides a foundation for the revitalization of a stakeholder theory of the firm in the strategic management discipline.

The two fundamental questions in the history of economic thought concern the theories of economic value and the distribution of this value (Schumpeter, 1954). These questions are also --- or, arguably should be --- the two fundamental questions concerning strategic management. This paper addresses these two fundamental questions based on a property rights foundation for a *stakeholder* theory of the firm.¹

Property rights theory. Classical property rights theory defines ownership as residual rights to income (*residual claimancy*) (Alchian and Demsetz, 1972; Demsetz, 1967) while modern property rights theory equates ownership with residual control rights (Grossman and Hart, 1986; Hart and Moore, 1990). Effectively aligning residual claims mitigates ex ante contractual problems while the appropriate allocation of residual control rights mitigates ex post contractual problems. Residual claimancy and residual control (ex ante and ex post contractual) issues are at the heart of a definition of ownership.

The strategic management research literature has begun to utilize and develop both the classical and modern property rights theory in recent years (e.g., Argyres and

¹ There are numerous definitions of stakeholders in the governance literature, based in part on the economic salience of these stakeholders (Aoki, 1984; Coombs and Gilley, 2005; Frooman, 1999; Jawahar and McLaughlin, 2001; Jones and Wicks, 1999; Kassinis and Vafeas, 2002; McWilliams and Siegel, 2001; Mitchell, Agle and Wood, 1997; Rowley, 1997). The current paper defines stakeholders broadly as those persons and groups who contribute to the wealth-creating potential of the firm and are its potential beneficiaries and/or those who voluntarily or involuntarily become exposed to risk from the activities of a firm (Clarkson, 1995; Post, Preston and Sachs, 2002). Thus, stakeholders include shareholders (preferred and common), holders of options issued by the firm, debt holders (Parrino and Weisbach, 1999), (banks, secured debt holders, unsecured debt holders), employees (especially those investing firm-specific human capital) (Blair, 1996), local communities (e.g., charities) (Morris, Rehbein, Hosseini and Armacost, 1990), environment as “latent” stakeholders (e.g., pollution) (Buysse and Verbeke, 2003), regulatory authorities (Post, Preston and Sachs, 2002), the government (as tax collector) (Brouthers and Bamossy, 1997), inter-organizational alliance partners (Dyer and Singh, 1998), customers and suppliers (Freeman, 1984). These stakeholders often gain substantially when the firm does well and suffer economic losses when the firm does poorly. Bowman and Useem state that: “To exclude labor and other stakeholders from the governance picture ... is theoretically tidy and empirically foolhardy” (1995: 34).

Liebeskind, 1998; Chi, 1994; Foss and Foss, 2005; Kim and Mahoney, 2005; Liebeskind, 1996; Miller and Shamsie, 1996; Oxley, 1999). However, the implications of property rights theory for stakeholder analysis are still at a nascent stage of development (Aguilera and Jackson, 2003; Asher, Mahoney and Mahoney 2005; Blair 2005; Grandori, 2004).

The strategic management discipline has made conceptual and empirical progress concerning the question of economic value creation primarily from a shareholder wealth perspective rather than from a broader stakeholder perspective (Blair, 1995).² The second question of how the economic surplus generated by the firm is, or should be, allocated among the various *stakeholders* has been given little research attention. To answer more precisely these two fundamental questions of economic value creation and distribution, a property rights theory from a stakeholder perspective is developed.

Developing a property rights theory of the firm enables strategic management's primary theory -- i.e., resource-based theory (e.g., Penrose, 1959; Peteraf, 1993; Rumelt, 1984; Wernerfelt, 1984) -- to expand the concept of sustainable competitive advantage based on whether resources are valuable, rare, inimitable and non-substitutable beyond a shareholder wealth perspective (Barney, 1991; Coff, 1999). The commonality of property rights theory and resource-based theory is that both theories rely on market frictions. An important difference is that property rights theory seeks a set of market frictions to

² The shareholder vs. stakeholder debate has been ongoing for at least the last nine decades (cf. Clark, 1916). Berle (1931) argued for what is now called "shareholder primacy" --- the view that the corporation exists for shareholder wealth maximization. Dodd (1932) argued for what is now called the "stakeholder approach" --- the view that the proper purpose of the corporation also included more secure jobs for employees, better quality products for consumers, and greater contributions to the welfare of the community. Stout (2002) documents the intellectual progress made over the years concerning the Berle-Dodd debate.

explain the efficient boundary of firm-level ownership, while resource-based theory seeks a set of market frictions to explain firm-level economic rents (Mahoney 2001).

This paper emphasizes that it is no longer tenable to regard shareholders as the only residual claimants, where residual claimants are defined as persons or groups whose relationship to the “firm” gives rise to a substantial residual interest in the firm’s success or failure.³ Furthermore, it is a residual interest that is not ex ante contractually bargained over and it is not ex post perfectly allocated. The current paper maintains that property rights considerations not only influence economic value creation, but also enable a fine-grained analysis of distributional conflicts (Coff, 1999; Kim and Mahoney, 2002). Property rights theory, which we next consider, enables an economic foundation for stakeholder theory.

What are Property Rights? Property rights refer to *any* sanctioned behavioral relations among decision makers in the use of potentially valuable resources; such sanctioned behaviors allow people the right to use resources within the class of non-prohibited uses. This definition emphasizes both the legal aspect of property rights *and* the social conventions that govern behavior, such as corporate culture and reputation (North, 1990). Property rights include social institutions that define or delimit the range of privileges regarding specific resources granted to individuals. Private ownership of these resources may involve a variety of property rights including the right: to exclude non-owners from access; to appropriate the stream of economic rents from use of and

³ Clark (1985: 55) notes that much of the economics literature discusses “firms” rather than “corporations” and does not distinguish sharply between closely held business organizations (whatever their legal form) and publicly held corporations. Clark goes on to note that: “For a number of reasons, failure to make this distinction clearly can be a source of almost fatal confusion” (1985: 55). To be clear, the “firm” as used throughout the entire current paper refers to a publicly held business corporation.

investments in the resource; and to sell or otherwise transfer the resources to others (Libecap, 1989). Conceptualizing property rights to have multiple dimensions implies that different people can hold *partitions* of rights to particular facets of a single resource.

It is useful to think of resources as *the bundle of rights* rather than physical entities (Coase, 1960). Thus, resources that a firm “owns” are not the physical resources but rather are the property rights. The firm is viewed as a “method of property tenure” (Berle and Means, 1932: 1) in which each stakeholder has certain property rights (e.g., managers may have stock options and decision rights over organizational resources, and workers may have property rights concerning severance payments and pension benefits).

This paper maintains that property rights and transaction costs theory can be productively joined. In particular, it is emphasized here that asset specificity is the source of potentially appropriable quasi-rents (Williamson, 1985), and bundles of property rights allocations are ways of governing the division of economic rents to attenuate inefficient appropriation and inefficient investment. For example, reducing such problems can be a source of potential economic value creation since investments in complementary and/or co-specialized assets are promoted (Teece, 1986). Specifically, property rights are conduits upon which economic value of resources can be channeled to high yield uses. Thus, property rights theory complements resource-based and dynamic capabilities research (Mahoney and Pandian, 1992; Teece, Pisano and Shuen, 1997):

Currently, resource-based theory is lacking in at least two respects that can be remedied by property rights theory. First, resource-based theory has made little use of the property rights research literature in contexts of both positive externalities such as complementary and co-specialized resources (Helfat, 1997; Teece, 1986), and negative

externalities, such as the lack of oil field unitization for migratory oil (Kim and Mahoney, 2002; Libecap, 1989), and hence, cases where property rights resources are not secure often fall outside of its analytical framework. Second, the presence of a feedback loop with distribution issues impacting productive utilization of resources falls outside current resource-based theory. Property rights theory enables us to relax the implicit resource-based assumption that property rights to resources are secure, and thus takes into account *processes* where there are struggles in establishing property rights that enhance the realized economic value of resources.

Linking Property Rights- and Resource-Based- Theories. This paper suggests three primary reasons why a connection between property-rights theory and resource-based theory is now more than ever needed. First, changes in the (reconstructed) conceptualization of the firm is needed because the nature of the firm in practice is changing, with increasing importance placed on intellectual property rights and knowledge-based resources and capabilities (Itami and Roehl, 1987; McEvily and Chakravarthy, 2002; Nelson and Winter, 1982). With the increasing relevance of intangible resources and knowledge-based capabilities, dealing effectively with potential property rights problems due to asymmetric information and distribution conflicts becomes increasingly important.

A second reason for proposing new connections between property rights- and resource-based- theories is that business enterprises that historically could be usefully understood in large measure as leveraging physical resources to achieve both economies of scale and economies of scope (Chandler, 1990) are now becoming increasingly dominated by firm-specific human and organizational capital (Williamson, 1996). Purely

human capital and technology firms, whose main resources are key employees, challenge our understanding of the nature of the firm, where economically valuable human resources (Lado and Wilson, 1994) are often operating with commodity-like physical resources. Such fundamental economic changes call for changes in governance in terms of the constraints on management, compensation and/or board representation (Hillman, Keim and Luce, 2001; Luoma and Goodstein, 1997).⁴

Considerations of distributional conflicts among stakeholders and the evolution of property rights are essential for a more complete strategic management (resource-based) theory of *realized* and not just potential economic value creation (Kim and Mahoney, 2005). As resource-based theory is extended to studying economic value creation in transitional economies and intellectual property (Takeyama, 1997), property rights theory will take on even greater managerial significance. Where there are positive transaction costs, an important source of value creation stems from reduction of the dissipation of economic value in the exchange process (Barzel, 1997; Foss and Foss, 2005).

There is another important sense in which resource-based theory and property rights theory are complementary: the more economically valuable the resources the more economic incentives there are to make property rights of such resources more precise,

⁴ Indeed, if the defining dimension of the firm is that it substitutes authority for the price mechanism in determining how decisions are made (Coase, 1937; Williamson, 1985), what are the decision control rights of shareholders in a firm that consists of economically valuable human resources operating with commodity-like physical resources? In such a firm, should workers also be allocated decision control rights (Blair, 1995)? Such corporate governance issues can already be witnessed in medical practices, investment banks (especially “boutique” banks), law firms, and advertising firms (Zingales, 2000). Furthermore, along these lines, one of the more tangled thickets in corporate law concerns the proper interpretation of corporate constituency statutes at the state level, and the question of to whom, exactly, do the directors of the firm owe their fiduciary duty. Typically, these statutes require directors to consider the “best interests of the corporation” as a whole (Blair, 1995).

and the more precisely delineated the property rights of these resources, the more economically valuable resources become (Libecap, 1989; Mahoney, 1992). The process of making property rights of resources more precise can be another way of looking at the economic value creation process. Systems of property rights are conduits upon which value-creating activities are fostered so that resources can be channeled to these higher-yield uses (Kim and Mahoney, 2002).⁵

A third reason for connecting property rights- and resource-based theories is the need to address more precisely the fundamental question of economic value where the economic maximization of a single residual claimant is becoming increasingly tenuous. The stakeholder view requires that the *entire* economic value of the firm be considered and it is not only shareholders who extract economic value from the firm beyond their opportunity costs. In the case of collective action or small-numbers bargaining, the balance of bargaining power to extract economic value may reside in suppliers, customers, (unionized) labor or other stakeholders, whose benefits beyond their opportunity costs must be taken into account to capture fully the firm's entire economic value creation. While this advocated approach for strategic management is undeniably economically sensible, it is noted here that this stakeholder perspective is clearly at odds with the traditional shareholder wealth approach used in most finance textbooks, which identifies the economic value of the firm as the value of all market claims outstanding.

Whether this shareholder wealth approach or a stakeholder approach is justified depends on what theory of the firm we hold. The theory of the firm has fundamental

⁵ However, asymmetric information and distributional conflicts may limit resources from being channeled to these higher yield uses. Consideration of distributional conflicts and the (imperfect) evolution of property rights are essential for a more complete resource-based theory of (realized) economic value creation (Libecap, 1989).

implications for understanding economic value creation and distribution. Towards this objective, we next consider more closely the modern property rights research literature.

Two Property Rights Perspectives. Here we consider two prominent theories of the firm from a property rights perspective. First, the theory of the firm as a nexus of explicit contracts (and complete contracting) is analyzed. Second, the theory of the firm as a nexus of explicit and implicit contacts (and incomplete contracting) is developed.

The Firm as a Nexus of Explicit Contracts. The currently dominant (agency) theory of corporate governance in strategic management --- and a conceptualization of the firm prevailing in corporate finance --- can be traced to the seminal articles of Alchian and Demsetz (1972) and Jensen and Meckling (1976). This conceptualization defines the firm as a nexus of contracts. Sometimes this definition includes only explicit contracts and is typically studied from a (ex ante) complete contracting perspective (while allowing for asymmetric information and divergent goals between principal and agent). From the mathematical principal-agent model (e.g., Holmstrom, 1982) the only residual claimants are the shareholders and thus shareholders warrant the decision control rights. In fact, in the principal-agent model --- especially in its more formal mathematical form --- there are no residual rights of control, by definition, since the nexus of explicit contracts are posited to specify in advance all the future economic payoff-relevant contingencies. Thus, the economic basis for shareholders' supremacy is established.⁶

⁶ The proper firm-level goal in agency theory is to maximize shareholder wealth. The fiduciary duty of the managers acting as agents for the principals (i.e., the shareholders) is to maximize the firm's stock price. The economic logic under the nexus of explicit contract perspective is since, by implication, only shareholders bear risks from discretionary decisions made, then the firm should be governed to maximize shareholders' value by maximizing net present value (NPV). Finance texts typically assume that the NPVs for all stakeholders (other than the shareholders) are zero in competitive input factor markets. Thus, maximizing NPV refers to maximizing the firm-wide NPV exclusively in terms of shareholder value.

Zingales (2000) comments, however, that to accept this conceptualization of the firm at face value, one has to take a very narrow view of contracts. A firm's decisions typically influence the economic payoffs of many other members of the nexus, sometimes even to a greater extent than that of the shareholders. The claim that shareholders are the firm's only residual claimants fails to fit the facts in almost all real-world circumstances (Stout, 2002). First, employees are important residual claimants when firm-specific human capital is involved. Second, creditors and communities can be important residual claimants. Third, complex network relationships among suppliers and customers produce interdependencies and lead to important residual gains and losses.⁷

It should be noted here that the complete contracting approach is not necessary to defend the shareholder value maximization criterion for the firm. For example, one line of argument in favor of shareholder value maximization in a world of incomplete contracting is that shareholders have less contractual safeguards than other stakeholders (Hansmann, 1995; Sundaram and Inkpen, 2004). While respecting this important insight, nonetheless, bounded rationality, potentially opportunistic behavior, uncertainty, asset

⁷ The naked assertion that shareholders are the sole residual claimants in corporations not only does not hold in practice, it also does not hold as a matter of law (Stout, 2002). Shareholders of a corporation cannot set the level of dividends, nor can corporate law treat the shareholders of the corporation that is not in bankruptcy as "residual claimants." It is also unclear that shareholders enjoy the standing of residual claimants even when the corporation is in bankruptcy (PoPucki, 2004). To take this one step further the assertion that shareholders "own" the firm may no longer be considered technically accurate even in the economists reconstructed model of the "firm." For example, the assertion that even the single controlling stockholder "owns" the firm is questionable. As Black and Scholes (1973) make clear, once the firm has issued debt, it makes just as much sense to say the debt-holders "own" the right to the corporation's cash flow but have sold a call option to the shareholder, as it does to say that the shareholder "owns" the rights to the corporation's cash flows but has brought a put option from the debt-holders. Financial options analysis clarifies that bondholders and equity shareholders each share contingent control and bear residual risk in firms.

specificity, and asymmetric information do lead to inadequate contractual safeguards for those other than the stockholders (Simon, 1978; Williamson, 1985).

Another line of argument maintains that involving only shareholders in corporate governance enables both corporate decision-making costs and managerial discretion to be reduced (Hansmann, 1996; Jensen, 2001). Roe argues that: “a stakeholder measure of managerial accountability could leave managers so much discretion that managers could easily pursue their own agenda, one that might maximize neither shareholder, employee, consumer, nor national wealth, but only their own” (2001: 2065). To be sure, there are potential problems in moving to a stakeholder perspective, including potential increased discretion on the part of management and increased costs of corporate decision-making. However, there are potential benefits of moving towards the stakeholder view, which are highlighted in this paper. To balance these potential costs and benefits may require case-specific analysis: *There may not be a single ‘best’ governance structure.* While we should not abandon the shareholder as an important claimant, we should also at least allow the consideration of other claimants. There may be cases where the results from a shareholder-only perspective will coincide with the results from a stakeholder perspective. However, there will likely be many other cases where the results from the two perspectives will not coincide. It is warranted to hold open the *possibility* that the ex ante and ex post inefficiencies that flow from shareholder primacy may turn out to be worse than the increased agency costs that may occur using a stakeholder approach. This question ultimately cannot be answered except on the basis of empirical evidence.

The Firm as a Nexus of Explicit and Implicit Contracts. The relative neglect of stakeholder theory by corporate finance and especially by strategic management is a

primary reason why the current state of theoretical development of the theory of the firm, the theory of economic valuation in its entirety, and the theory of the distribution of that economic valuation is poor. What to do? In answering this question there are hopeful signs in recent years where there has been developing within industrial organization economics and corporate finance a new conceptualization of the property rights theory of the firm, which considers both explicit and *implicit* contracting (Baker, Gibbons and Murphy, 2002; Zingales, 2000). This seemingly minor change in premises has profound consequences for how we are to understand the theory of the firm, the economic valuation of the firm in its entirety, and the distribution of this economic value.

When considering both explicit and implicit contracts in assessing the economic value generated by the firm, one needs to assess the economic surplus captured by all stakeholders.⁸ To move from a stockholder to a stakeholder valuation, however, requires a theory of economic value distribution of how the surplus is divided among different stakeholders, be they financial claim-holders (e.g., holders of equity, debt or options issued by the firm) or non-financial ones (e.g., employees, key customers, and suppliers).

The current paper maintains that modern property rights theory (initiated by Grossman and Hart, 1986; Hart and Moore, 1990) will lead to a revitalization of a stakeholder theory of the firm. In recent years, the firm has become understood as a nexus of both explicit and *implicit* contracts, which are understood from an *incomplete contracting* perspective (Aghion and Bolton, 1992; Baker, Gibbons and Murphy, 2001).

⁸ Blair (1995) reports that accounting profits may represent less than sixty percent of the total economic rents generated by U.S. corporate activities in 1993. The remainder of the rents went to employees as returns for specialized human capital. Blair (1995) notes that rarely is this specialized human capital considered as one part of what the corporation as a whole should be trying to maximize.

Thus, the firm is no longer simply the sum of its components readily available on the market but is rather a unique combination of potentially complementary and co-specialized assets that can possibly be worth more (or less) than the sum of its parts.

For example, consider a firm with the reputation for upholding the “implicit contract” of not expropriating “quasi-rents” that have been generated by employees investing in firm-specific human assets (Klein, Crawford and Alchian, 1978). Relying on such a non-tradeable reputation (Dierickx and Cool, 1989), the employees may be willing to make firm-specific human capital investments that are greater than they would have been willing to make in the marketplace, where complete explicit contracting is not feasible. If such firm-specific human capital investments are indeed economically valuable, and could not have been elicited by explicit contracting, then the firm’s non-tradeable reputation adds economic value and represents an organizational asset.⁹

At least two major challenges face managers in attempting to build and maintain a reputation for fair treatment of stakeholders in an implicit contract. First, the managers of

⁹ Some have reinterpreted the modern property rights theory of the firm of Grossman and Hart (1986) and Hart and Moore (1990) --- the GHM model --- to support the shareholders’ wealth maximization approach (Shleifer and Vishny, 1997). However, such an interpretation misses the key point of the modern property rights approach that it might be efficient to allocate formal control rights to the stakeholder who has a lot of de facto power, as is the case for key workers who can easily leave (Blair, 1995; Zingales, 2000). This alternative view supports Donaldson and Preston’s astute commentary that: “The theory of property rights, which is commonly supposed to support the shareholder theory of the firm, in its modern and pluralistic form supports the stakeholder theory of the firm instead” (1995: 88). One might draw a similar conclusion based on Boatright’s provocative statement that: “The present system of corporate governance appears to sanction, indeed mandate, that managers externalize [externality] costs wherever possible” (2002: 1849). Holmstrom (1999) provides a mathematical model with distinctive features from that of the GHM model, where the firm is viewed as a sub-economy in which the top management team has the decision rights to regulate trade by assigning tasks, delegating authority, and delineating principles for how explicit and implicit contracts are to be structured. Kim and Mahoney (2005) list over 40 published papers that extend and/or critique the GHM model, with Holmstrom (1999) being a prominent example. It should be noted that modern property rights theory supports a narrow, rather than a broad, definition of stakeholders emphasizing those who make critical firm-specific capital investments (Blair, 1995; Hart, 1995).

the firm are subject to periodic shareholder vote, so that a future management team that does not share the current management stakeholder philosophy may replace the current management team. Second, managers that currently embrace the stakeholder focus may reconsider their approach if the firm faces financial difficulties; for example, the only way for the firm to survive an economic downturn may be to renege on promises embedded in previous implicit contracts. Therefore, even if a management team embraces the stakeholder approach, it could have difficulties ensuring that these ‘time consistency’ problems do not undermine their efforts.

From an incomplete contracting theoretical perspective, other contracting parties besides the stockholders are not fully safeguarded by explicit contracting, thereby undermining the foundational premise of shareholders’ supremacy (Blair and Stout, 1999). From this view, Zingales inquires: “If many members of the nexus are residual claimants, why are shareholders necessarily the ones affected the most by the firms’ decisions? Even if they are, are they the party that benefits the most from the additional protection granted by the control rights?” (2000: 1632).

It is not clear whether decision rights should reside exclusively with shareholders, because the unfettered pursuit of shareholders’ value maximization may lead to inefficient strategic actions, such as the breach of valuable implicit contracts. While in theory discretionary financial contracting can be desirable (Ayres and Gertner, 1989; Boot, Greenbaum and Thakor, 1993), it is often troublesome in business practice. For instance, hostile takeovers sometimes result in the takeover firms terminating defined

benefit pension funds mid-stream to enable economic transfers from workers to shareholders (Shleifer and Summers, 1988).¹⁰

Moreover, the presence of implicit contracts makes it impossible to identify precisely the entire economic value created by the firm. As a result, stock price changes are not reliable arbiters of social welfare changes even when financial markets are perfectly (strong-form) efficient (Demski, 2003).

Suggestions for Possible Research Agendas. In the economics literature, Masten put forth the argument that: “legal rules establish an institutional basis for the advantages and limitations associated with internal organization” (1988: 181). A fuller development of Masten’s (1988) key insight reached fruition in Blair and Stout (1999), which joined economic reasoning and legal scholarship in a seminal contribution to the governance research literature.

Blair and Stout’s (1999) team production theory of corporate law offers a cogent stakeholder paradigm, which rivals viewing corporate governance through the principal-agent lens. Blair and Stout (1999), along the lines of Rajan and Zingales (1998), go beyond the team production model of Alchian and Demsetz (1972) by considering that numerous corporate stakeholders may make firm-specific investments and that a “mediating hierarchy solution” requires team members, in their own rational self-

¹⁰ Pontiff, Shleifer and Weisbach (1990), in their sample of 413 takeovers, find that pension funds were reverted by 15.1% of acquirers in the two years following hostile takeovers compared to 8.4% in the two years following friendly takeovers. Further, reversions, in which employers unilaterally terminate pension plans and transfer the surplus resources in these plans into the corporate coffers, tended to occur when the potential for wealth transfer was the greatest. These empirical results are consistent with the view that hostile takeovers sometimes do (and may in some cases well be primarily intended to) breach implicit contracts between firms and employees. Economic efficiency losses will occur because stakeholders who anticipate opportunistic behavior will be reluctant to enter into implicit contracts with the firm.

interests, to relinquish important property rights --- including property rights over the team's joint output and over team inputs such as firm-specific human capital --- to a legal entity created by the act of incorporation. Thus, corporate resources are not "owned" by shareholders *but by the corporation itself*.¹¹ Blair and Stout (1999) join the incentive literature and the transaction costs literature. Or put differently, Blair and Stout (1999) insightfully join: property rights theory (Rajan and Zingales, 1998); transaction costs theory with special attention to asset specificity (Williamson, 1985); and measurement

¹¹ In this regard, Clark makes the following comments: "Corporate officers, like the president and treasurer are *agents of the corporation itself*; the board of directors is the ultimate decision-making body of the corporation; ... neither officers nor directors are agents of the stockholders; but both officers and directors are 'fiduciaries' with respect to the corporation and its stockholders. ... [Furthermore] a review of elementary corporate law shows that this power of the principal to direct the activities of the agent does not apply to the stockholders as against the directors or officers of their corporation. By statute in every state, the board of directors of a corporation has the power and duty to manage or supervise its business" (1985: 56). Indeed, as a matter of statutory law, stockholders decision control rights in a public corporation are quite limited. To go even further Clark (1985) finds the Alchian and Demsetz (1972) and Jensen and Meckling (1976) description of the firm as a "nexus of contracts" dubious. Clark states that: "[I]s it realistic or useful to view the modern public corporation as consisting only, or even principally, of a set of contracts? I think not. This extreme contractualist viewpoint is almost perverse. It is likely to blind us to most of the features of the modern public corporation that are distinctive, puzzling, and worth exploring. To see this, we must first consider the notion of contract, and then note the extent to which the corporation, considered as a multitude of legal relationships, consists of non-contractual relationships"(1985: 60). In short, the economists repeated claim that the firm is (like) a nexus of contracts is a seriously misleading metaphorical statement. Most corporate case law deals with alleged breaches of fiduciary duties by managers and these duties are highly unlikely to have been the result of any actual (explicit or implicit) voluntary consent or understanding between manager and investor. Therefore, the legal relationships among participants in the modern public corporation are not primarily the product of actual (explicit or implicit) contracts. Many economists, I suspect, might concede that in practice a corporation is not literally a nexus of contracts, but that nonetheless it is useful to have a "reconstructed logic" (Kaplan, 1964) of the firm *as if* it was a nexus of contracts. Clark, however, does not let the economist off the hook here either and maintains that: "Economic analysis could help a great deal in the study of the law's special concept of the fiduciary, but a militantly contractualistic approach may make it difficult to realize this contribution. With some exceptions, agency costs theorists to date have done little to explain the concept of the fiduciary, to develop positive theories as to why fiduciary law have developed its particular doctrines and characteristics, and to assess whether particular fiduciary doctrines are efficient or sound" (1985:62).

theory with special attention to “nonseparabilities” in team production (Alchian and Demsetz, 1972).¹²

In business circumstances where it is impossible to draft complete contingent claims contracts that deter shirking and opportunistic rent seeking among various corporate “team-members,” it can be comparatively efficient to substitute the institutional solution of *the law of public corporations*. Specifically, Blair and Stout (2002) maintain that public corporation law can offer a second-best solution to the team production problem under conditions of high asset specificity because it allows individuals to gain sufficiently in team production by attenuating shirking and rent seeking through voluntarily choosing an internal governance structure or “mediating hierarchy.”

Within the corporation, a mediating hierarchy exercises decision control rights over these resources. This hierarchy has responsibilities to: coordinate the activities of team members, allocate the resulting output, and mediate disputes among team members. At the peak of this mediating hierarchy is a board of (non-stakeholder) directors that has decision control rights (i.e., authority) over the use of corporate resources and that should not be under the direct control of either shareholders *or* stakeholders. This theory is consistent with the legal protection afforded to board members to be independent of individual team members and to act as *trustees* to do what is best for “the firm.” For example, the basic structure of the rules of *fiduciary duty* insulates directors from most claims of breach of duty of care, even when the directors deliberately sacrifice

¹² Considering Williamson’s (1985: 24) “Cognitive Map of Contract,” one can interpret Blair and Stout’s (2002) team production theory of corporate law as a hierarchical mediating stakeholder approach to corporate governance *through an efficiency lens*. Put simply and directly, Blair and Stout (1999) offer an exciting research agenda for the Strategic Management discipline in joining corporate finance (e.g., Rajan and Zingales, 2001), economics (e.g., Williamson, 1996), law (Hansmann, 1996), and organization theory (e.g., Godfrey, 2005; Margolis and Walsh, 2003).

shareholders' interests to serve other stakeholders. In fact, *an independent board of directors is one of the most important characteristics distinguishing public corporation from other forms of enterprise* (Blair and Stout, 1999).¹³ Such independence is essential as co-investors who make substantial sunk cost investments need mutual *lock in* (Blair, 2005) and thus voluntarily choose to place decision control rights into the hands of a board of directors who have neither the economic motive nor an easy opportunity to profit by withdrawing resources from the corporation [see Kaufman and Englander (2005) for an elaboration of the team production model that uses the corporate

¹³ It is noteworthy that a truly independent board may be an anomaly under the principal-agent paradigm, which regards the governance mechanisms evolving towards minimizing agency costs. It would be an anomaly precisely because increased discretion afforded to the board of directors will, in all likelihood, increase agency costs. However, Blair and Stout (1999) provide an efficiency explanation where the independence of the board of directors encourages firm-specific investments essential for team production. In other words, the primary function of the board of directors is not to protect shareholders per se, but to protect firm-specific investments of all members of the corporate team including shareholders, managers, and key employees. Blair and Stout's (1999) team production theory of corporate law is a worthy rival to the principal-agent theory of corporate governance because it not only challenges agency theory with an alternative efficiency explanation for understanding our "institutions of capitalism" but also because in comparison to the received wisdom of agency theory, the mediating hierarchy approach of corporate governance is more consistent with the way a corporation actually works. For example, empirical results from a survey of 2,361 boards of directors in the United States found that the vast majority viewed their roles from a stakeholder orientation and viewed their responsibilities as protecting the interest of *the firm* (Wang and Dewhurst, 1992). The stakeholder approach passes the market test in practice, and the team production theory of corporate law passes the test of foundational economic (property rights and transaction costs) theory and legal scholarship. To end with a cautionary note to the reader, there are prominent legal scholars that match Blair and Stout (1999) in terms of economic sophistication who view things quite differently. For example, Hansmann and Kraakman forcefully maintain that: "There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value." (2001: 439). Hansmann and Kraakman do, however, acknowledge Margaret Blair and Lynn Stout as: "sophisticated American advocates of the [stakeholder] fiduciary model" (2001: 447). Nonetheless, Hansmann and Kraakman (2001) may have underestimated the possibility that, in the realm of foundational economic theory, the modern property rights approach (e.g., Rajan and Zingales, 1998) will rival the principal-agent approach within the next decade and that its implications for corporate law (Blair and Stout, 1999) will turn out to be a serious competitor to the view that corporate law should be devised to facilitate the maximization of a firm's stock price.

stakeholders who add economic value and incur unique risk to establish the criteria for selecting boards of directors.]

In this mediating hierarchy model of the modern corporation, the firm is frequently not so much a “nexus of contracts” as a “nexus of firm-specific investments” (Blair and Stout, 1999). Members who voluntarily enter into the mediating hierarchy agree not to specific terms or outcomes --- as in a traditional contract --- but to participation in a *process* of internal goal setting and dispute resolution. Indeed, one of the importance characteristics of effective (mediating) hierarchy is that it assumes and effectively discharges certain *quasi-judicial functions* (Williamson, 1975: 30).

In addition to the team production approach to corporate law, there are other avenues of research in stakeholder theory that look promising. In further developing the stakeholder perspective, a useful distinction is offered by Berman, Wicks, Kotha and Jones (1999) between an “instrumental approach” (McGuire, Sundgren and Schneeweis, 1988; Ogden and Watson, 1999) --- in which concern for other stakeholders is in the enlightened self interest of shareholders¹⁴ --- and an “intrinsic commitment” view --- concern for stakeholders as ends and not merely as means (Agle, Mitchell and

¹⁴ Empirical research studies frequently focus on stakeholder issues in terms of the bottom line to shareholders (Harrison and Freeman, 1999; Hillman and Keim, 2001; Meznar, Nigh and Kwok, 1994; Waddock and Graves, 1997). For example, product recalls generate negative market returns (Davidson and Worrell, 1992); product innovations through R&D are generally shown to be positively associated with market stock price (Sougiannis, 1994); and improved customer satisfaction measures are found to be value relevant to shareholders (Ittner and Larcker, 1997). These empirical papers suggest an “instrumental approach” (Jones, 1995) in which concern for other stakeholders are in the enlightened self-interest of shareholders.

Sonnenfeld, 1999; Donaldson and Dunfee, 1994).¹⁵ For example, a well-developed theory of justice (Rawls, 1971) needs to be applied to the second fundamental question of the distribution of economic value among various stakeholders. One cannot sidestep the fact that stakeholder (or stockholder) theory will require value judgments and dialogue about the purpose of the corporation (Donaldson, 1999). As Andrews noted: “Coming to terms with the morality of choice may be the most strenuous undertaking in strategic decision” (1980: 89). Similarly, Barnard (1938) --- a seminal management book providing the foundations for a stakeholder theory of the firm --- maintains that executive leadership requires the personal capacity for affirming decisions that lend quality and morality to the coordination of organized activity and to the formulation of purpose (see Miller (1992) for an economic reconstruction of Barnard’s (1938) writings).

Ansoff (1965: 35-36) noted that the Carnegie School’s *Behavioral Theory of the Firm* (Cyert and March, 1963), which emphasized firm-level objectives derived from a negotiated outcome by subgroups, has much in common with stakeholder theory. Moreover, the “inducements-contributions model” in which each participant (e.g., entrepreneur, employee, customer) is offered an *inducement* (e.g., revenue from sales, wages, goods and services) for participation in the organization and in turn makes a

¹⁵ In this regard, it is worth pointing out that a more fine-grained and potentially useful classification has been offered by Donaldson and Preston (1995), which offers three interrelated but distinct aspects of the stakeholder theory: *descriptive accuracy* (does the theory describe or explain characteristics or behaviors observed in the world of experience?), *instrumental power* (can the theory be used to identify connections between stakeholder analysis and traditional corporate objectives?), and *normative validity* (can the theory be used to guide managers in the moral or philosophical decisions to be made in the corporation?).

contribution to the organization (e.g., costs of production, labor, purchase price) was an early seminal research framework from the stakeholder perspective (Simon, 1952).¹⁶

If property rights systems are conduits through which resources can be channeled to their highest-valued uses, several empirical implications emerge. Countries in which the legal regimes of property rights are more poorly protected will find it harder to attract financial capital or develop specialized human capital (North, 1990). Furthermore, within a given legal regime, industries that rely on resources that have attributes that are inherently more difficult to specify completely (*ex ante*) in a standardized contract (e.g., it may be more difficult to contract on intellectual than on commodity-like outputs), will find it necessary to develop relational contracts between the firm and the specialized resources. Within an industry, firms that are innovators in specialized relational contracts will be able to attract financial capital and will be better positioned to outperform their non-innovating rivals. A unique building and handling of network linkages and stakeholder relationships can be a firm-specific capability and a source of sustained advantage (Coff, 1999). Firms may currently be on a learning path towards adopting a broader stakeholder oriented view as stakeholder relations are an important source for gaining and sustaining knowledge-based advantages (Post, Preston and Sachs, 2002).

Property rights from a stakeholder approach sheds light on well documented but poorly understood strategic management decisions and processes. For example, the

¹⁶ In addition to highly influencing the Carnegie School (Cyert and March, 1963; March and Simon, 1958; Simon, 1947), Barnard (1938) also influenced Selznick (1957). Selznick writes that: “This process of becoming infused with value is part of what is meant by institutionalization. As this occurs, *organization management* becomes *institutionalized leadership*. The latter’s main responsibility is not so much technical administrative management as the maintenance of institutional integrity. ... The building of integrity is part of what we have called the ‘institutional embodiment of purpose’ and its protection is a major function of leadership” (1957: 138-138).

Saturn car division of General Motors' original mission, governance structure, and internal processes fit the key criteria of a stakeholder firm. Employees establish themselves as influential stakeholders who contribute to problem solving, conflict resolution, and quality improvement (Kochan and Rubenstein, 2000).¹⁷

Conclusions. The governance literature in strategic management over the past two decades has been dominated by agency theory and its conceptualization of the firm as a nexus of complete explicit contracts. Improvements in the scientific rigor within journal publications, however, have come at a high price in terms of relevance. The main point here is that it is far superior to have a reasonably accurate understanding of the right (stakeholder) issues in the discipline of strategic management than rigorous and perhaps even precise answers to less relevant or contrived questions. Indeed, scholarship from the complete contracting approach (which essentially suppresses economic problems stemming from bounded rationality and limited information processing) often finesses difficult stakeholder questions that managers typically face. As a result, there is a lack of transparency in our business school curriculum concerning how difficult the problems of economic value creation and the distribution of that value really are, not only in practice but also in our current stage in the evolving science of organization (Mahoney, 2005).

The intellectual heritage of the discipline of strategic management owes much to what used to be called business policy (e.g., Andrews, 1971; Ansoff, 1965). This early business policy perspective was unabashedly dedicated to a stakeholder perspective --- which made the subject of management within the business school truly differentiated

¹⁷ Other exemplars of stakeholder management include: Cisco Systems, Costco, Cummins Engine, Lincoln Electric, Merck, Motorola, and Royal Dutch/Shell Group (Freeman, Wicks and Parmar, 2004; Kaufman and Englander, 2005; Post, Preston and Sachs, 2002).

from the stockholder wealth perspective of industrial organization economics and corporate finance. However, in recent years, the discipline of strategic management, perhaps due in part to the pursuit of greater academic standing and scientific legitimacy, has significantly retrenched from the stakeholder perspective (both in research journals and major textbooks) and has gravitated toward the shareholder wealth perspective, where stock price data are readily available.¹⁸

This paper maintains that the modern property rights perspective of incomplete contracting and implicit contracting provides a solid economic foundation for the revitalization of a stakeholder theory of the firm in strategic management. In order to make progress in strategic management an improved (conceptual and empirical) understanding of implicit contracting is needed (Bradley, Schipani, Sundaram and Walsh, 1999). Currently, a firm's resources are certainly understated by the economic value of the implicit contracts with a firm's employees, when valuable firm-specific human capital is excluded from the balance sheet (Blair, 1995; DeAngelo, 1982). The same can be said for the economic value that other stakeholders bring, or the loss in economic value these stakeholders suffer when decisions are made strictly on the basis of shareholder value.

¹⁸ At the beginning of the current paper, we noted that Berle (1931) was a major proponent of the shareholder primacy view of the corporation. Berle offered the following account of the Berle-Dodd debate concerning the shareholder supremacy versus stakeholder approach: "Twenty years ago the writer had a controversy with the late Professor E. Merrick Dodd of the Harvard Law School, the writer holding that corporate powers were powers in trust for shareholders while Professor Dodd argued that these powers were held in trust for the entire community. The argument has been settled (at least for the time being) squarely in favor of Professor Dodd's contention" (1954: 169). Blair and Stout (1999) note that Berle's (1954) retreat is supported by a series of mid- and late-twentieth-century cases that have allowed directors' decisions to sacrifice shareholders' profits to stakeholders' interests when necessary for the best interest of "the corporation." Case law interpreting the "business judgment rule" often explicitly authorizes directors to sacrifice shareholders interests to protect other stakeholders. Stout comments that: "Half a century after Berle's concession, academics continue to argue the merits of the [shareholder primacy] versus the [stakeholder] model of the firm. The business world continues to prefer the [stakeholder] model of the firm" (2002: 1209).

For example, financial distress can create a tendency for the firm to take actions that are harmful to debt-holders and other non-financial stakeholders (Opler and Titman, 1994). If the goal is to maximize total economic value, and this value is to be allocated among those contributing to/gaining from this economic value then one needs a property rights stakeholder theory, which recognizes the role each of these groups plays in the creation and distribution of that economic value.

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