



Who is in charge? A property rights perspective on stakeholder governance

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In matters of philosophy of science, authority has ever been the great opponent of truth. A despotic calm is usually the triumph of error. In the republic of the sciences, sedition and even anarchy are beneficial in the long run to the greatest happiness of the greatest number. (Jevons, 1965 [1871]: 275–6)

Introduction

The fields of strategy and organization are dominated by the stylized idea that the purpose of the firm is to maximize returns on investment for equity shareholders. This idea is based on simplifying assumptions about externalities, contractual ties, investments, and the nature of competition. As a result, the dominant conceptualization of the firm's purpose as shareholder value maximization may lead to serious misunderstandings regarding the firm's contractual obligations. Furthermore, the idea of shareholder value maximization may lead to problematic and inaccurate representations of organization, innovation, and other aspects of value creation and capture. Creating and capturing value in the presence of spillovers, relationship-specific investments, and complex contractual ties is difficult in ways that are obscured by a relentless focus on shareholder value. In this essay, we develop these claims and point to the consequences for the canonical business school curriculum, which does not deal sufficiently with the challenges of value creation and capture under more realistic assumptions.

We compare the shareholder view with a stakeholder view and seek to advance a synthetic agenda that puts limits on stakeholder claims without problematic, stylized assumptions.

Stakeholder theory has been proposed as an alternative to shareholder theory. We maintain that the two views on the firm's claimants may be aligned by returning to first principles that deal with both the set of relevant claimants on the firm and the relationships between ownership and control rights over firm behavior. Following Zingales (2000), we describe a new version of the Carnegie School stakeholder model, reconstructed from modern property rights theory, and suggest that focusing on this model advances various shareholder–stakeholder debates and leads to a potential synthesis. For example, this approach shows that maximizing shareholder returns corresponds to maximizing the value of the firm only under particular assumptions about property rights. Inspired by Jevons, we challenge the simple, stylized shareholder primacy model that dominates strategy and organization research, and advocate a corresponding revision of the canonical business school curriculum.

Note that our critique is not based on accusations of greed or complaints about the role of academic finance departments but the idea that an exclusive focus on shareholder interests obscures important distributional mechanisms and value-creation opportunities in strategy and organization. Nor do we support a freewheeling, undisciplined view of stakeholders, which is as untenable as the reductionist assumptions underpinning the shareholder view. We are proposing a modest, straightforward, and robust approach to stakeholders that can revitalize the fields of strategy and organization by focusing on stakeholders with property rights arising from co-investment with shareholders under the reasonable expectation of mutual return.

First, let's review the canonical shareholder model, which derives largely from agency theories of corporate governance. Following Alchian and Demsetz (1972) and Jensen and Meckling (1976), agency models typically view the firm as a nexus of contracts. Some definitions include only explicit contracts and typically take an *ex-ante* complete contracting perspective, while allowing for asymmetric information and divergent goals between principals and agents. In formal principal–agent models (e.g., Holmstrom, 1982), the sole residual claimants to income are the shareholders. In the typical principal–agent model there are no residual rights of control because contracts are complete: under simplifying assumptions, the nexus specifies in advance all of the future economic payoff-relevant contingencies.

In this approach, the firm's proper goal 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 market value. The economic logic under the nexus of explicit contract perspective is straightforward: only shareholders bear risks from discretionary decisions made, so the firm should be governed to maximize shareholders' value by maximizing net present value (NPV). Some texts typically assume that the NPVs for all stakeholders (other than the shareholders) are zero in competitive input factor markets. Thus, maximizing shareholder NPV is equivalent to maximizing the NPV of the firm.

These simplifying assumptions have been challenged by transaction cost and incomplete contracting theories of firm boundaries and organization (Grossman and Hart, 1986; Hart and Moore, 1990; Williamson, 1985). At the same time, scholars outside economics and law have approached the problem from a different direction, developing *stakeholder* theories of the firm (Clarkson, 1995; Freeman, 1984).¹ Stakeholder theories have also gained currency in strategic organization for their claims that shareholder-oriented theories, particularly those based on assumptions imported from neoclassical economics, do not adequately explain how firms create and capture value (Asher et al., 2005; Post et al., 2002; Sachs and Ruhli, 2011).²

The stakeholder literature is diverse, but a mainstream view is emerging based on the idea that a firm's transactions with buyers and suppliers often involve co-specialized investments, both tangible and intangible, which should be encouraged and protected (Osterloh and Frey, 2006; Penrose,

1959; Pitelis, 2004). In recurring, standardized transactions, such investments may be modest but, in other cases, substantial amounts of relationship-specific capital are at stake (Baker et al., 2002; Helfat, 1997). Moreover, new relationship-specific investments may arise after a particular transaction is completed (Williamson, 1985). Agents with foresight make such investments in expectation of reasonable returns and based on appropriate safeguards (McGahan, 1997; Wang and Barney 2006; Wang et al., 2009).

Some critics have engaged these ideas directly, maintaining for example that the set of potential stakeholders is too large (Jones and Wicks, 1999) or that co-created value is too difficult to measure (Roe, 2001). On the whole, however, shareholder–stakeholder debates sometimes seem to generate more heat than light. Disagreements within this contested terrain are partly based on misunderstandings, unstated and contradictory assumptions, inconsistent terminology and lack of familiarity with some of the research literature on both sides. Fortunately, discussions on the economic foundations of the theory of the firm, economic value creation, and value capture – which better inform the shareholder–stakeholder debates – can be given a fresh start using concepts, theories, and models from organizational economics and the economic analysis of property rights (henceforth, ‘property rights economics’).³

Defining stakeholders, stakeholder interests, and the firm

Shareholder approaches hold that the firm exists to maximize value for its equity owners. Other parties – debt holders, suppliers, customers, etc. – may have contractual obligations to and from the firm, but those payments are taken by the firm as costs. Only equity holders have claims to the firm’s residual income. Stakeholder theories maintain that a broader set of agents, including labor, suppliers, customers, and other economic agents, may also have legitimate claims to the economic value created through the firm’s operations (Brandenburger and Stuart, 1996; McGahan, 1997). Co-investments by buyers and suppliers make the firm’s assets more valuable, and thus are integral to the firm’s capacity for both creating and capturing value – where value is defined by buyer willingness to pay and supplier opportunity cost (Brandenburger and Stuart, 1996). The firm’s residual income is thus shaped not only by the firm’s specific investments, but by those of its transactional partners and by the division of created value among claimants (Brandenburger and Stuart, 1996; Grossman and Hart, 1996; McGahan, 1997).

In property rights theory, the relevant stakeholders are defined as all investors who create transaction- and/or firm-specific property under the reasonable expectation of a return on investment through interaction with the firm (Aguilera and Jackson, 2003; Asher et al., 2005; Blair, 1995). These parties may also have a claim to the value that is co-created by firms through the deployment of resources in concert with the assets owned and controlled by trading partners such as labor and suppliers. The joint value that is co-created by the mutual deployment in tandem of property owned by buyers or suppliers in concert with the property of the firm must be apportioned between the parties (Brandenburger and Stuart, 1996). The terms of this apportionment depend in a sensitive way on both contractual terms and on each party’s forecasts about the value that may be created through future exchange (Brandenburger and Nalebuff, 1996).⁴

Because the act of deploying resources by enacting property rights *inherently* depletes, enhances, and/or exposes the underpinning property itself, the engagement by buyers and suppliers in transactions creates a ‘residual interest’ *a priori*. The mechanisms for apportioning co-created value between the parties that contributed jointly to its creation depend on the ability to appropriate the already co-created surplus. Residual decision rights held by each party on how the underpinning resources are redeployed in the future affect the apportionment because they shape expectations.

As a result of the complex, inter-temporal relationship between the firm and its trading partners, the residual interests that arise from a firm's activities accrue to buyers and suppliers as well as to shareholders. This representation of the theory of the firm is more general than the prevailing shareholder view, which sees the owners of equity shares as the only residual claimants on the firm, thereby ignoring other stakeholders' residual interest.⁵ In this context, the simplifying assumptions of neoclassical theory can be seen as a stylized special case of a more basic stakeholder theory of the corporation, which focuses on system-wide co-created value.

Property rights and ownership: Alternative views

Which approach is better? Unpacking this problem requires us to examine different meanings of 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 prescribed limits. This definition emphasizes both the legal aspect of property rights and the social conventions that govern behavior such as corporate culture and reputation (Libecap, 1989; North, 1990; Ostrom, 1990). Conceptualizing property rights as having multiple dimensions implies that different people can hold partitions of rights to particular facets of a single resource (Alchian, 1965; Barzel, 1997; Eggertsson, 1990).

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).

In transaction cost economics, asset specificity can be source of potentially appropriable quasi-rents (Klein et al., 1978; Williamson, 1985), and bundles of property rights allocations are ways of governing the division of economic rents to attenuate inefficient investment and appropriation. 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 (Foss and Foss, 2005; Mahoney, 2005).

Classical property rights theory defines ownership as *residual rights to income* (residual claimancy; Alchian and Demsetz, 1972), while modern property rights theory equates ownership with *residual control rights* in the deployment of property such as specialized assets (Grossman and Hart, 1986; McGahan, 1997). Residual claimancy and residual control (*ex-ante* and *ex-post* contractual) issues are at the heart of the definition of ownership (Milgrom and Roberts, 1992). A residual control right over an asset is defined as the legal right to determine the use of that asset in situations that are not covered by explicit, prior agreement. In other words, residual rights of control are relevant only when contracts are incomplete, meaning that they do not specify a course of action for every conceivable contingency. Effectively aligning residual control claims mitigates *ex-ante* contractual problems while the appropriate allocation of residual control rights attenuates *ex-post* contractual problems.

Strategy research has begun to utilize and develop both classical and modern property rights theory in recent years (e.g., Argyres and Liebeskind, 1998; Chi, 1994; Foss and Foss, 2005; Kim and Mahoney, 2005, 2010; Liebeskind, 1996; Miller and Shamsie, 1996; Oxley, 1999). However, the implications of property rights theory for stakeholder issues are just starting to be worked out

(Asher et al., 2005; Blair, 2005; Blair and Stout, 1999; Donaldson, 2012; Donaldson and Preston, 1995; Mahoney, 2012).

Property rights theory is essential for understanding economic value that is jointly created by a complex web of contractual partners including, but not limited to, shareholders. In the case of incomplete and implicit contracting, the effects of decisions and actions on jointly owned assets and jointly created value are especially difficult to discern. Economic value may reside in buyers or suppliers, including labor, whose benefits beyond their opportunity costs must be taken into account to evaluate fully the firm's entire economic value creation (Blair, 1995; Coff, 1999).

The firm as a nexus of explicit and implicit contracts

The shareholder primacy view of the firm takes a narrow view of contracts (Zingales, 2000). 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 critical criterion for identifying enfranchised buyers and suppliers in modern stakeholder theory relates to the reasonable expectations that underpin transaction- and firm-specific investments. A firm is irrevocably tied to act in concert with particular buyers and suppliers by these expectations; and these expectations define a mutuality of interests that makes the value of a firm to shareholders dependent on the decisions of buyers and suppliers to deploy their owned resources collaboratively.

A critical distinction arises between residual income and residual control rights. We suggest that the fundamental concept of ownership is under-theorized in shareholder-stakeholder debates. Under the canonical Grossman-Hart (1986) model, several scenarios are described. Under non-integration, party 1 makes decisions (e.g., about its relationship-specific investment) to maximize its own benefit (such as its share of *ex-post* joint surplus, depending on the bargaining assumptions), without taking into account the effect of its actions on party 2. Under this scenario, non-integration fails to maximize joint wealth. Yet the point of this model is to endogenize ownership. If integration increases joint surplus, then the parties should integrate. Shareholders maximize their wealth when they account for the effect of their decisions on the well-being of a trading partner who also has relationship-specific capital.

Under many circumstances, an efficient solution is for the firm to buy out the trading partner. But in a wide variety of situations, property cannot be transferred: labor skills cannot be purchased; brands cannot be easily transferred; property cannot be tangibly contracted upon. It is this range of situations that create mutual interdependence between the owners of complementary property. When such complementary property is co-specialized, then no market-sorting relation uniquely identifies a specific allocation of joint returns (Brandenburger and Stuart, 1996). It is the prospect of future collaboration that compels a negotiated solution as the continuing engagement of each of the enfranchised parties depends on each party projecting an acceptable return on the investment in co-specialized property (McGahan, 1997). Such a prospect makes both expectations about the future and uncertainty central to re-investment and allocation decisions, and ties together decision rights to ownership. In other words, stakeholder theories must address not only how rights are distributed between firm owners and non-owners, but *who is an owner and who isn't*.

While all parties to a transaction have property rights over their inalienable assets (i.e., their labor), property rights over alienable assets are in question primarily because these assets have value when deployed collaboratively with the assets of other parties. When transaction costs or other impediments to efficient bargaining may prevent these property rights from flowing to those parties best able to generate economic value from holding them, alternative instruments for

allocating residual rights of control – board composition, pre-contractual commitments, and so on – may emerge as substitutes.

Modern property rights theory (initiated by Grossman and Hart, 1986; Hart and Moore, 1990) (GHM hereafter) has a lot to contribute to shareholder–stakeholder debates – as suggested by Donaldson and Preston (1995). Consider the firm as a nexus of both explicit and *implicit* contracts (Aghion and Bolton, 1992; Baker et al., 2001; Dyer and Singh, 1989). Implicit contracts involve obligations that are mutually understood, and enforced via reputation, without being explicitly stated. For example, a firm may choose not to appropriate ‘quasi-rents’ generated by employees investing in firm-specific human assets because this affects the willingness of employees to invest in the future. Such reputation effects (Dierickx and Cool, 1989) may be sufficient to mitigate opportunistic behavior by the firm even without complete, explicit contracting. This non-tradable reputation adds economic value and represents an organizational asset that has value because it can be deployed in tandem with labor in a co-creation process.

The presence of such incomplete and implicit contracts makes it impossible to identify precisely the entire economic value created by the firm. Further, it is no longer clear whether decision rights should reside exclusively with shareholders, because the unfettered pursuit of shareholder wealth maximization may lead to inefficient actions such as the breach of valuable implicit contracts (Pontiff et al., 1990; Shleifer and Summers, 1988).⁶ At the same time, tasking managers or boards with maximizing a more complex, harder-to-measure notion of stakeholder value may exacerbate agency problems (Roe, 2001).

Two property rights models

The GHM model recognizes the importance of co-specialized investment but defines controlling stakeholders narrowly. This approach holds that residual control rights – in this case, ownership of the firm’s assets – should be assigned to the parties whose relationship-specific investments have the largest marginal impact on joint value creation. In this view, while many stakeholders make co-specialized investments, it does not follow that all stakeholders should share residual rights of control in proportion to the private value of these investments. A GHM-style stakeholder theory thus explores not the rights of stakeholders, but the various means that stakeholders employ to protect themselves against economic holdup, given transaction costs, inertia, and legal and political constraints.

The Blair and Stout (1999) model, in contrast, focuses on a different property rights tradition, emphasizing not only asset specificity (Williamson, 1985) but also technical inseparabilities in team production (Alchian and Demsetz, 1972; Rajan and Zingales, 1998). Rajan and Zingales (1998) note that assigning ownership to the team member with the largest marginal contribution to shared value may actually reduce incentives to firm-specific investments by all team members, including the one that is assigned ownership. Rajan and Zingales’ (1998) proposal is to use the property rights mechanism of restricted access to critical assets, instead of ownership, to promote firm-specific investment.

Blair and Stout (1999) draw upon this theory and apply it to the law of the public corporation. In particular, this stakeholder theory uses the idea of third-party ownership from Rajan and Zingales (1998) to develop a team production approach to the public corporation. The idea of third-party ownership suggests that an ‘outsider’ to the actual productive activity can be granted access to the team’s assets and incentivized by the reward of a nominal share of the team’s output. Blair and Stout (1999) thus explain that the role of the board of directors in public corporations is not simply to reduce agency costs, but to also encourage firm-specific investment of various stakeholders.

This is similar to Schelling's (1960) idea that restricting one's own choices can make one better off. Team members of a public corporation voluntarily relinquish important control rights over firm-specific inputs and outputs to an independent board of directors, acting as neutral decision-makers, and addressing contracting problems inherent in team production via a mediating hierarchy. Directors act as trustees to maintain the inducement–contributions balance of the coalition.

Where do we go from here?

These ideas are complex, and we hasten to add that we do not have all the answers. But we think these are the right questions to address, not only for improving research in strategy and organization, but also for making our teaching more valuable and relevant.

Which raises an important point: If ideas about property rights are useful in clarifying shareholder–stakeholder debates, then why do business schools continue to teach, without much qualification or reflection, the idea that maximizing shareholder wealth is equivalent to maximizing the economic value of the corporation? Property rights economics is increasingly influential in strategy, entrepreneurship, and organizations research and teaching, but mostly absent from discussions of governance. One possible answer is that shareholder primacy models serve as a useful benchmark, like the Modigliani–Miller (1958) theorem in corporate finance, against which alternative approaches can be compared. Another reason relates to scholarly culture: Advocates of stakeholder theory sometimes take strong, normative stances and can seem preachy and undisciplined. Mainstream scholars may prefer not to engage these issues out of concern for the reputational damage arising from association with unprincipled advocacy over reasoned scholarship. A less flattering reason is inertia: Shareholder primacy is easy to model, easy to teach, and builds on familiar concepts from neoclassical economics. Property-rights-based theories of governance can be more challenging and complex. Another reason is that strategy and organization research, as in other fields, is often driven by measurement. Stock prices are right there in front of us; vague concepts of shared, co-created value do not lend themselves to big-*N* empirical studies. At the same time, these issues are inherently difficult. There is no universal stakeholder model or theory, but a series of frameworks, propositions, and findings.⁷

We can do better. A more nuanced and sophisticated understanding of the entire value chain requires that we look beyond shareholder primacy. The analyses described here point to the possibility that shareholders may choose to cede control rights to *independent* agents who attach primacy to the interests of *the corporation itself* precisely because the alignment of shareholder interests with those of trading partners is central to both the value of the firm and shareholder wealth (Blair and Stout, 1999; Rajan and Zingales, 1998). For instance, in cases of high investments in firm-specific human capital, shareholders might welcome labor representation on the board of directors (Osterloh and Frey, 2006). In this situation, the role of the board of directors is not simply to reduce agency costs, as most principal–agent model proponents would suggest, but to also encourage *the nexus of firm-specific investments* via *mutual lock-in* to safeguard such investments by managers, employees, and other stakeholders, which enables the firm to appropriate sustainably as much as possible of co-created value.

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. We suggest that the field of strategic organization would benefit by revisiting and building upon these theories but without imposing the restrictive assumptions that were originally imposed by neoclassical economists for the purpose of identifying a simple base case. The modern property rights perspective of incomplete contracting and implicit contracting, alongside recent debates in

value co-creation and appropriation, provides an economic foundation for developing a stakeholder theory of the firm that can be joined with shareholder wealth maximization.

Note that we are not proposing a particular set of stakeholder claims as uniquely true and universally relevant. The underpinning problems are difficult, and a variety of approaches, techniques, and methods can be useful, depending on the problem at hand. Nor are we proposing any particular regulatory scheme,⁸ such as laws mandating independent directors, limiting the terms of directors, restricting who can chair the board, or adding labor or other stakeholder groups to the board; laws extending liability to directors or requiring boards to make certain decisions; statutory restrictions on director or manager compensation levels or formulas; limits on directors' roles in takeover attempts; or a host of other proposed interventions. Instead, we are calling on scholars in strategic organization to leverage property rights theory, as well as recent advances on value capture, value co-creation, and sustainable advantage, as these relate to sustainable system-wide value co-creation (Mahoney et al., 2009), to propose a stakeholder value theory of the firm that goes beyond the narrow confines of neoclassical economics. Under conditions of uncertainty, limits to rationality, and change, and recognizing the link between value co-creation and value capture, seeking stakeholder value rather than an unfettered pursuit of shareholder value is better for achieving sustained value for the firm. Such a focus is more relevant for strategic organization scholarship. Despite the challenges, progress is being made. In the evolving science of strategic organization we can and will do better.

Notes

1. The shareholder vs stakeholder debate has been ongoing for almost a century (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 a '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 (see Stout, 2002).
2. Yet another alternative is the entrepreneurial theory of the firm offered by Foss and Klein (2012), which criticizes neoclassical economic models of the firm for ignoring Knightian uncertainty (Knight, 1921) and the subjective, tacitly perceived nature of heterogeneous resources.
3. Relevant concepts include transaction costs (Coase, 1960), asset specificity or relationship-specific investment (Klein et al., 1978; Williamson, 1985), and ownership defined as residual rights of control (Hart, 1995). Mechanisms that are relevant include how asset ownership and *ex-post* bargaining power affect *ex-ante* incentives (Grossman and Hart, 1986; McGahan, 1997). Indeed, recent literature incorporating these issues has helped revitalize the debate between shareholder and stakeholder perspectives (Asher et al., 2005; Rajan and Zingales, 1998; Zingales, 2000).
4. This approach requires clarity about the construct of 'reasonable expectation' under customary terms of contract law and assumes that returns to co-specialized investments take priority over other investments that are affected by the firm's actions. Some stakeholder approaches define stakeholders broadly as all 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; Freeman, 1984). We find these definitions too broad to be operational.
5. Note that this conceptualization is broader than the traditional definition of those who have a legal claim on the firm's net receipts. Also, 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, 1985). The 'firm' as used throughout the current essay refers to a publicly held business corporation.
6. The mechanism for this destruction of shareholder value is underinvestment by stakeholders in property that is integral to value creation who are not fully safeguarded from these time-inconsistency problems

- (McGahan, 1997; Wang and Barney, 2006). More generally, an ownership structure in which only one of the contracting parties – in this case, equity holders – hold residual rights of control can lead to underinvestment by other contracting parties, such that owners can increase their own share of the created value by ceding some residual control rights to other parties (Blair and Stout, 1999; Rajan and Zingales, 1998).
7. There also can be sunk cost investments by scholars and vested interests. For example, as already noted by classical economists, such as David Ricardo and Karl Marx, the market economy (capitalism) is about private appropriation of socially created value. Shareholder value helps deflect attention from value co-creation (the social part) (Lepak et al., 2007; Pitelis, 2009) by emphasizing the efficiency implications of private value appropriation.
 8. As Manne (2010: 193) puts it: ‘The selection of one approach or the other is an organizational decision that is best left to private decision makers and the vagaries of infinite circumstances. . . . Mandatory regulation . . . is guaranteed to get it wrong much of the time, is guaranteed to protect the more politically powerful interests, is guaranteed to inhibit the discovery of new approaches and is guaranteed to create needless argument and litigation. Well, at least it is good for the trial lawyers.’

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