Journal of Management and Governance (2005) 9:33–39
DOI 10.1007/s10997-005-1566-y
© Springer 2005

Views and Debates

Closing the Theory Gap: How the Economic Theory of Property Rights Can Help Bring "Stakeholders" Back into Theories of the Firm

MARGARET M. BLAIR
Vanderbilt University Law School, 298 law school Bldg, 13 1 21st Av S, Nachville, TN, 37203, USA (Author for correspondence, e-mail: margaret.blair@law.vanderbilt.edu)

Comment on Asher, Mahoney and Mahoney, "Towards a Property Rights Foundation for a Stakeholder Theory of the Firm"

The so-called "stakeholder theory of the firm" has been a much-maligned concept in academia for the last few decades. Developed in the 1970s and 1980s by management theorists to provide a framework for analyzing how large corporations interact with, and manage their relationships with various parties who are involved in or affected by activities of the corporation, stakeholder theory enjoyed a brief period of ascendancy in the late 1970s and early 1980s. The theory, as Edward Freeman, one of the leading advocates of stakeholder theory explained it, "identifies the relevant set of actors in the environment of a business" and defines "stakeholder management" as "the idea that the tasks of managers in a business are to manage the stakeholder relationships in a way that achieves the purpose of the business."[1]

Stakeholder theory has faced two serious intellectual challenges from the time it emerged.[2] First, it did not have rigorous theoretical underpinnings to give it substance and to make it useful for fashioning decision rules that have proved to be helpful in practice. The idea of a stakeholder – defined by Freeman as "any group or individual who can affect or is affected by a business,"[3] – was overly broad, for example, giving no guidance as to how competing interests of various stakeholders should be balanced. And the various formulations of stakeholder theory have been almost completely *ad hoc*. Second, an alternative model of the critical relationships in a corporation emerged from economic theorists at about the same time that stakeholder theory emerged from management theorists. The alternative model – agency theory – appeared, by contrast to be highly rigorous and well-specified. It could even be modeled mathematically to generate seemingly clear decision

rules, such as what proportion of a corporate manager's compensation should be variable and based on the performance of the firm.[4] The apparent precision of agency theory contrasted starkly with the indeterminacy and contextual messiness of stakeholder theory, and the contrast proved irresistible to academic theorists in economics, law, finance, and eventually even management.

Agency theory, in its most stripped-down form, is simply a mathematical way to model the relationship between two parties, one of whom (the so-called "principal") wants to hire the other (the "agent") to carry out some task or more generally to act on behalf of the principal. The allure of agency models is that they provide neat and tidy way to take into account that agents might have goals and incentives that are different from those of the principals. Thus agency theory is a subset of contract theory, a more generalized approach to understanding and modeling business relationships. Because it fits neatly within contract theory, agency theory provided a powerful tool to legal theorists engaged in a long-running debate over whether a corporation should be understood as a special creation of the state, with implicit or explicit duties to operate for the public good, or alternately, should be understood as a contractual mechanism through which an aggregation of shareholder/investors pool their resources to undertake a business venture, presumably for their own benefit rather than the benefit of the larger society. The suggestion by economists and finance theorists Michael Jensen and William Meckling that corporations should be understood as "simply legal fictions which serve as a nexus for a set of contracting relationships among individuals"[5] was quickly seized upon by legal scholars who had resisted the idea – dominant in legal scholarship from the 1940s through the 1970s – that corporations have social responsibilities in addition to maximizing profits or share value. Thus the "contractarian" school of corporate law was born, and came to dominate legal scholarship since the 1980s.[6]

Cheryl Asher, James Mahoney and Joseph Mahoney remind us that stakeholder theory did not die an easy death, however.[7] Management theorists, who try to make sense of the inner workings of firms, have been much less willing as a group to adopt the simplifying assumptions of shareholder primacy and the contractarian approach to interpreting relationships within corporations, and much more eager to find a theoretical framework that speaks more realistically to the day-to-day balancing act that corporate managers actually engage in.[8] Nonetheless, management scholars have faced pressures – arising from the hegemonic influence of economics on the intellectual climate in academia – to utilize more rigorous social science models. But with the search for a clear definition of "stakeholders" apparently continuing more than 30 years after the concept was first introduced into management theory,[9] it is clear that stakeholder theory has, so far, failed the "rigorous model" test and continues to be rather *ad hoc*.

In recent years, a few scholars have attempted to provide a theoretical bridge that could build on well-accepted conceptual frameworks borrowed from economics, but still provide a path through which the role of corporate participants other than shareholders and managers can be explicitly acknowledged and analyzed. As Asher, Mahoney and Mahoney note, economists have long acknowledged that not all "contractual" relationships are based on complete and explicit contracts. In fact, most actual contracts in the business world are incomplete in that they fail to specify who is to be responsible for what, and who is to get what, in all states of the world. Thus a group of economic theorists have been working on economic theories of incomplete contracts.[10] The gaps in incomplete contracts can be filled by a variety of different decision rules, or institutional mechanisms for decision-making. One such decision rule is the assignment of "property rights" which give the holders the right to make all decisions about the use of some assets that have not been otherwise assigned by contract.[11] This is the path Asher, Mahoney and Mahoney advocate in their article in this volume, and apparently find most promising.

Lynn Stout and I have argued in a related way that corporate law itself creates a decision-making institution that acts as a substitute for elusive (or impossible) complete contracts.[12] The institution is a mediating hierarchy in the form of a board of directors and hired managers, and the critical aspect of corporate law that distinguishes this solution to the contracting problem from other solutions is that, under default rules of corporate law, control rights over corporate actions and assets are yielded to the board by all participants in the corporation.[13] Under the Blair and Stout framework, the decision-making mechanism provided by the corporate form helps to solve what we call a "team production" problem. Our definition of a "team production" problem, in turn, suggests a rule for deciding who is part of the "team" and who is not: Team members are those parties who have invested "specific" assets in the enterprise and for whom a return on their investment is therefore dependent to some degree at least on the overall performance of the corporation.

In further development of this line of thinking, I have explored the role and significance of property rights in a theory of corporate law, particularly in the 19th century, when corporate law emerged as the dominant way to organize large business enterprises.[14] What corporate law achieved for business organizers in the 19th century (and continues to achieve today), I argue, is that, in contrast to the rules under partnership law, corporate law creates a separate legal entity that owns the property rights to assets used in production, and to the output of the enterprise (at least until the output is sold or paid out). This entity provides a mechanism for holding valuable firm-specific assets together, for use in the enterprise over a long period of time (a result I refer to as "capital lock-in"), even as individual investors,

managers, employees, suppliers, and customers come and go.[15] This is achieved by the delegation of property rights to the separate entity which is "the corporation," and the delegation of decision rights to its board of directors. Thus the so-called "separation of ownership from control," which, since Berle and Means wrote their famous book in the 1930s[16], has been viewed as a major infirmity of corporate law under agency theory, is seen under team production/mediating hierarchy theory as being the principle advantage of corporate law over partnership law.

These two related bodies of work – on team production theory and the role of capital lock-in – are intended to elucidate features of corporate law that are not well explained by a contractarian corporate law scholarship that assumes shareholder primacy. Together, they point to a theory of the firm (and a theory of corporate law) that is more closely related to the law of property than to the law of contracts.[17]

This intellectual development is in its infancy, but it is enormously encouraging to find that scholars in the discipline of strategic management are also picking up on some of the same themes and moving in some of the same directions.

In this vein, the Asher, Mahoney and Mahoney article moves the discussion forward by articulating how the economic theory of property rights might be used to develop a theory of the firm for strategic management purposes that recognizes the importance of stakeholders, as well as stockholders, in value creation and value distribution. These authors suggest that property rights theory is consistent with resource-based theories that have been the mainstay of strategic management theory for the last few decades. But it holds the promise of providing a framework for addressing not only questions of wealth creation (i.e., through access to and use of resources that are "valuable, rare, inimitable and non-substitutable"[18]), but also of wealth distribution.

The authors use a broad definition of property rights – "*any* sanctioned behavioral relations among decision makers in the use of potentially valuable resources"[19] – that includes social conventions as well as legally enforceable claims, and, following Coase (8), they suggest that property should be thought of as bundles of rights rather and as physical entities. Approaching a theory of the firm from the perspective of who holds what rights, in what circumstances, to use, sell, convey, or capture the rents from what assets, and who is liable for harm caused by the use of those assets, holds the promise of closing the intellectual gap in theories of the firm that had kept the role of non-shareholder stakeholders out of the conversation. A property rights approach does not assume away the problem of determining the allocation of de facto control rights over assets. Rather, it addresses head on the problem that an important aspect of value creation in contemporary corporations involves the use of *intangible* assets, such as ideas, brand names, and

relationship networks and reputational assets (Asher, Mahoney and Mahoney use the phrase "human and organizational capital" to refer to all of these types of assets[20]), for which usage and control rights might be difficult to enforce. In fact, a central problem for strategic management theorists is how to structure relationships within the firm, and across the boundaries of the firm in ways that both create and capture wealth for distribution among the corporate participants, and how to distribute the wealth to provide incentives for all participants to make necessary specific investments.

It seems likely that rethinking strategic management theory along these lines will enhance the insights and guidance the theory can provide for managers, but it also implicates a very long agenda of further research, a small part of which Asher, Mahoney and Mahoney identify in their article.[21] Some of the bigger questions that need to be studied, in addition to those identified by Asher, Mahoney and Mahoney, include developing metrics for measuring the value of certain intangibles (such as reputational capital), and measuring the incremental value created by investing in intangibles,[22] not only through explicit investments in, say, training, but also by foregoing opportunities to shift value away from human capital toward shareholders by breaking implicit contracts. I commend the effort to push the agenda of strategic management researchers in these important new directions.

Notes

[1] Freeman and Gilbert (1987), at p. 397.

[2] Though considered the Godfather of stakeholder theory, Freeman attributes the term to others, noting that the term "stakeholder" first appeared in a Stanford Research Institute internal memorandum in 1963, and was defined there as "those groups without whose support the organization would cease to exist." See Freeman (1984), at 31.

[3] *Id.*

[4] Never mind that using agency models to derive "optimizing" decisions requires heroic (and demonstrably false) assumptions about the knowledge, information processing capabilities, preferences, and motivations of actors, and that the decision rules generated by such models, such as "maximize share value," often provide no real guidance to what actions must be taken on a day-to-day basis to implement the rule.

[5] Jensen and Meckling, (1976), at 310.

[6] Contractarian" theory by itself simply stresses that the relationships among participants in a corporate enterprise is volitional and should be governed by the terms of the "contract" through which the participants engage each other. But contractarian thinking has been most often adopted by individuals who view shareholders as the "owners" of the aggregation of assets in a firm, or at least as "residual claimants" to cash flows generated by the firm, and hence has been strongly associated with the normative perspective of "shareholder primacy". The contractarian theory of corporate law was articulated thoroughly in Easterbook and Fischel (1991). Sundaram and Inkpen, (2001), provide a concise history of how legal thinking has swung back and forth over the last century and a half between the view of corporations as creatures of the state with corresponding social responsibilities, and the view that corporations existed solely for the benefit of shareholders.

Former Chancellor of the Delaware Courts William T. Allen, (Allen (1992)), argues that the law has been guided by both perspectives, though judges have avoided confronting the conflict by reasoning that, "in the long run" shareholders are better off if stakeholders are appropriately accommodated.

[7] See Asher, Mahoney, and Mahoney, in this volume.

[8] See, for example, *id.*, at note 5, where the authors list numerous articles by management scholars published since 1984 that explore and attempt to apply stakeholder theory to strategic management problems

[9] Asher, Mahoney, and Mahoney (this volume) note that the 50 articles and books cited in their note 5 all struggle, in one way or another, with defining stakeholders.

[10] See especially Coase (1960), Demsetz (1972), Grossman and Hart (1986), Hart and Moore (1990) and Hart (1995).

[11] This is the approach taken in all of the articles cited in note 10.

[12] Blair and Stout (1999).

[13] *Id.*, at __.

[14] Blair (2003). Corporations were rarely used for organizing businesses prior to 1800, but by 1900 there were more than 500,000 incorporated business entities in the U.S. See Blair (2003), at note 3.

[15] *Id.*, at __.

[16] Berle and Means (1932).

[17] Hansmann and Kraakman (2000) laid an important foundation for this line of thinking by arguing that the central role of laws governing a variety of organizations that are treated as "entities" is to delineate clearly what assets "belong to" what organizations or persons. This is important, according to Hansmann and Kraakman so that creditors know what assets are available to pay whose debts.

[18] Asher, Mahoney and Mahoney (this volume), citing Barney (1991).)

[19] *Id.*, at 6. Emphasis in the original.

[20] Asher, Mahoney and Mahoney (this volume), p. 14.

[21] *Id.*, pp. 14–30.

[22] Blair and Wallman (2001) consider the public policy implications of the lack of adequate measures of intangible assets.

References

Allen, W.T., 1992, Our Schizophrenic Conception of the Business Corporation. Cardozo Law Review 142.

Asher, C.C., J.M. Mahoney and J.T. Mahoney, "Towards a Property Rights Foundation for a Stakeholder Theory of the Firm" (this volume).

Barney, J., 1991, "Firm Resources and Sustained Competitive Advantage", *Journal of Management* 17: 99–120.

Berle, A.A. Jr. and G.C. Means, 1932, *The Modern Corporation and Private Property* (New York: Commerce Clearing House Inc.).

Blair, M.M., 2003, "Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century", *UCLA Law Review* 51(2): 387–455.

Blair, M.M. and L.A. Stout, 1999, "A Team Production Theory of Corporate Law", *Virginia Law Review* 85(2): 247–328.

Blair, M.M. and S.M.H. Wallman, 2001, *Unseen Wealth: Report of the Brookings Task Force on Intangibles* (The Brookings Institution).

Coase, R.H., 1960, "The Problem of Social Cost", *Journal of Law and Economics* 4: 386–405.

Demsetz, H., 1972, "Toward a Theory of Property Rights", *American Economic Review* 57: 347–359.

Easterbook, F. and D. Fischel, 1991, *The Economic Structure of Corporate Law* (Harvard University Press).

Freeman, R.E., 1984, *Strategic Management: A Stakeholder Approach* (Pitman).

Freeman, R.E. and D.R. Gilbert Jr., 1987. "Managing Stakeholder Relationships", in S. Prakash Sethi and M. Cecilia Falbe (eds.), *Business and Society: Dimensions of Conflict and Cooperation* (New York: Lexington Books).

Grossman, S. and O. Hart, 1986, "The Costs and the Benefits of Ownership: A Theory of Vertical and Lateral Integration", *Journal of Political Economy* 94: 691–719.

Hansmann, H. and K. Kraakman, 2000, "The Essential Role of Organizational Law", *Yale Law Journal* 110: 387.

Hart, O., 1995, *Firms, Contracts, and Financial Structure* (Oxford: Clarendon Press).

Hart, O. and J. Moore, 1990, "Property Rights and the Nature of the Firm", *Journal of Political Economy* 98: 1119–1158.

Jensen, M.C. and W.H. Meckling, 1976, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", *Journal of Financial Economics* 3: 305–360.

Sundaram, A.K. and A.C. Inkpen, 2001, "The Corporate Objective Revisited", Working paper, October, ssrn cite.