

## Behavioral Economics, Federalism, and the Triumph of Stakeholder Theory

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**ABSTRACT.** Stakeholder theorists distinguish between normative stakeholders, those who gain moral standing by making contributions to the firm, and derivative stakeholders, those who can constrain the corporate association even though they make no contribution. The board of directors has the legal authority to distinguish among these stakeholder groups and to distribute rights and obligations among these stakeholder groups. To be sure, this stakeholder formulation appropriately seizes on the firm's voluntary, associative character. Yet, the firm's constituents contribute assets and incur risks to participate in market, economic activities. And, as such, the firm's "stakeholders" must share an imperfect language to assist in making two key economic decisions: (1) who are the legitimate and who are the derivative stakeholders; and (2) who should sit on the board? Still, stakeholder theorists have good reason to be skeptical of neoclassical economics. Its assumptions that all act opportunistically and that all can calculate rationally and fully hardly correspond to studies on the managerial experience of corporate coordination. However, advances in behavioral law and economics now provide a cogent economic logic that readily fits into a stakeholder mode. In brief, we argue that (1) the firm's economic purpose designates legitimacy to core stakeholders, to those who add value, assume unique risk, and can incur harm; (2) the board serves as the principal who coordinates these core stakeholders to sustain competitive advantage and new wealth creation; and (3) state incorporation law, Delaware in particular, reinforces the board's function. These, in turn, supply selection criteria for board membership. We aim to synchronize concepts from behavioral law and economics with stakeholder theory.

**KEY WORDS:** behavioral economics, stakeholder theory, corporate governance, board of directors, team production

As in the Cold War's conclusion, when the Berlin Wall fell, stakeholder theory's victory over financial agency theory occurred with a tumultuous event – the 2001 stock market crash. Financial agency theorists were left to concede that financial markets were less than perfect (Fama and French, 2004; Jensen, 2002; Jensen et al., 2004). This was a point painfully reinforced during the recent financial crisis. Even Michael Jensen, agency theory's most prominent apostle, proclaimed himself an "enlightened" stakeholder advocate. This qualification permitted Jensen to distinguish himself from those managerial theorists who had for two decades resisted agency theory's advance. Yet, his distance seems rather odd, given the recent widespread acceptance of behavioral economics and law. For, when these are incorporated into stakeholder theory, the contentious descriptive disagreements find a satisfactory resolution, leaving discord on that enduring ethical issue – a fair surplus divide.

In "The Corporate Objective Revisited," Sundaram and Inkpen (2004a, b) hearken back to pre-enlightened agency theory by reciting the well-worn complaints against stakeholder theory. The authors summarize these in a series of questions posed to stakeholder advocates: (1) "How should a manager identify the important stakeholders and on what basis should other stakeholders be classified as unimportant"? (2) "Who should determine the criteria that distinguish important and unimportant stakeholders"? And, (3) "[w]hose [core] values should be represented in such management decision making?" (Sundaram and Inkpen, 2004a, pp. 352–353). Answers to these questions, Sundaram and Inkpen insist require a discriminating economic theory.

Unfortunately, the stakeholder response, offered by Freeman et al. (2004) conforms to Sundaram and Inkpen's stereotype. For Freeman et al., dismiss economic theory insisting that it derives from self-

contained academic discursive communities rather than from empirical explorations into “how managers operate.” Once scholars embark on this inquiry, Freeman et al., insist, values become the linguistic/behavioral medium by which managers consolidate corporate associations. And, once placed on this terrain, then, stakeholder theory provides the means for answering Sundaram and Inkpen’s queries: Stakeholder theorists distinguish between normative stakeholders, those who gain moral standing by making contributions to the firm and derivative stakeholders, those who can constrain the corporate association even though they make no contribution (Mitchell et al., 1997; Phillips, 2003). The board of directors has the legal authority to distinguish among these stakeholder groups and to distribute rights and obligations among these stakeholder groups (Phillips et al., 2003).

To be sure, this stakeholder formulation appropriately seizes on the firm’s voluntary, associative character. Yet, the firm’s constituents contribute assets and incur risks to participate in market, economic activities. And, as such, the firm’s “stakeholders” must share an imperfect language to assist in making two key economic decisions: (1) who are the legitimate and who are the derivative stakeholders; and (2) who should sit on the board? Still, stakeholder theorists have good reason to be skeptical of neo-classical economics. Its assumptions that all act opportunistically and that all can calculate rationally and fully hardly correspond to studies on the managerial experience of corporate coordination. However, advances in behavioral law and economics now provide a cogent economic logic that readily fits into a stakeholder model (Blair and Stout, 1999; Jolls et al., 1998; Kaufman and Englander, 2005). Once appropriated, stakeholder theory can readily offer answers to Sundaram and Inkpen’s questions that stay within the queries’ frame.

In brief, we argue that (1) the firm’s economic purpose designates legitimacy to *core* stakeholders, to those who add value, assume unique risk, and can incur harm; (2) the board serves as the principal who coordinates these core stakeholders to sustain competitive advantage and new wealth creation; and (3) state incorporation law, Delaware in particular, reinforces the board’s function. These, in turn, supply selection criteria for board membership.

We aim to synchronize concepts from behavioral law and economics with stakeholder theory (Freeman, 1984; Harrison and Freeman, 1999; Jones and Wicks,

1999; Marens and Wicks, 1999). “The managerial thesis and stakeholder theory” section elaborates the economic model. Team production and resource-based economics furnishes the foundation, the first layer (Barney, 1991; Blair and Stout, 1999; Conner and Prahalad, 1996; Grant, 1996; Kaufman and Englander, 2005). The team production model firmly resides within the behavioral law and economics literature; resource-based economics belongs to the strategic management literature. Arguably, resource-based economics extends team production’s constructs into useful managerial tools. The section begins with behavioral economics’ *homo socius*. The new “rational actor” supplies team production with the “raw material” for categorizing (describing) the firm as a cooperation game, in which corporate directors broker (coordinate) the surplus divides (or allocations) that stakeholders consider fair (Aoki, 1984). Mutual gain sets the base line “fairness” standard within the market. The divide itself has no objective, impartial standard – only the parties’ subjective estimate that cooperation (Pareto and Kaldor/Hicks efficiency) beats non-cooperation. Thus, mutual gain “fairness” (economic efficiency) has an intrinsic ethical standard, do no harm. However, its assessment depends wholly on each group’s voluntary agreement to a deal.

This formulation integrates ethical (distributive) norms and strategic action. Yet, we dissent from the usual stakeholder rendition that enables boards to select among the primary distributive policies of mutual gain and impartiality (Donaldson and Dunfee, 1999; Freeman and Evan, 1990; Phillips et al., 2003). Product and financial market competition constrain U.S. boards from deviating far from a Pareto/Kaldor Hicks standard. Thus, we concur with economists that directors cannot choose between an impartial standard (Rawls’ difference principle, utilitarianism) and mutual gain (reciprocity/procedural justice) (Barry, 1989; Bowles, 2003; Fehr and Gächter, 2000). Public policy, instead, becomes the site for remedying “unfair” market outcomes. Here, we simply follow the customary distinction between local justice and public policy (global) justice (Child and Marcoux, 1999; Elster, 1992; Phillips, 1997, 2003; Rawls, 1999; critique of Freeman and Evans, 1990.)

Unregulated markets reproduce bargaining advantages. Among them, liquidity confers to money-market-managers’ substantial power. A focal firm

corporate control group may fully structure divide/ allocation rules to benefit the most powerful, e.g., shareholders and managers; or the control group may strike deals that distribute benefits to coalesce stakeholders into a new wealth-generating team. Moreover, team production generates (descriptive, instrumental) concepts – value creation, unique risk, and strategic information – that corporate directors can deploy in constructing an economic strategy and in assembling a board demographically fitted to the firm’s core competencies (Kaufman and Englander, 2005; Prahalad, 1993). These concepts neatly coincide with resource-based economics’ powerful contributions to strategic practice (Barney, 1991; Grant, 1996). As conceived by these two theories, the board, rather than senior managers *per se*, acts as the team trust initiator (trustor) (Bhattacharya et al., 1998; Gulati, 1995; Kaufman and Englander, 2005; Lewicki and Bunker, 1995; McKnight and Cummings, 1998; Whitener et al., 1998). And, because various constituents participate in the firm’s surplus value (e.g., above spot-market wages) and because new wealth creation occurs over extended capital allocation periods, we use total value maximization as the corporate objective – a maxim on which agency and stakeholder theorists can now concur (Jensen, 2002; Post et al., 2002).

“State incorporation acts and directors’ fiduciary duties” section considers how corporate law defines the board as coordinator and team fiduciary. Our argument challenges the widely held academic belief that the state courts actually conceive of shareholders as the corporate principal and directors as their agent. To right this factual error, we review Delaware corporate law. It defines directors the principal and encumbers them with fiduciary duties to the firm as a going concern. By defining directors as corporate trustees, Delaware demands that they behave in other-regarding ways – that they should be trustworthy (Bainbridge, 2002a, b; Hardin, 2002; Rock, 1997). On this matter, behavioral law and economics has remained silent while stakeholder theory has exhibited a bias toward fairness, toward impartiality. By including these behavioral law and economic analytics (along with a customary ethical norm) into stakeholder theory, we generate a variant that affords individually corporate boards a cogent competitive tool and collectively a persuasive “technocratic” public policy language.

## The managerial thesis and stakeholder theory

### *Managerial theory’s enduring relevance*

The theory of the firm (despite the definite article, “the”) has been contested among and between neo-classical economists and managerial theorists. Stakeholder theory belongs to the latter, even if it has not directly entered formal economic debates. In the immediate post-WWII years, neo-classical economists spent little time considering the firm. Instead, they pursued a general equilibrium model (Arrow and Debreu, 1954). Economists constructed this based on *homo economicus*, who had unlimited rational powers (unbounded rationality), full information and selfish motivation. These sufficed to demonstrate that perfectly competitive markets equilibrated efficiently (Fama, 1970).

Managerial theorists found the exercise useful but raised a simple objection: As an historical fact, firms existed and markets churned. The most influential managerial works came from Carnegie Mellon University (CMU). Unlike their neo-classical counterparts, the CMU group proceeded from behavioral assumptions that humans had limited mental abilities (bounded rationality), that they acted from imperfect information, and that they would engage in cooperative (other regarding) undertakings (Cyert and March, 1963; Simon, 1955, 1959/1976). Firms, consequently, formed to augment bounded decision-making powers.

This formulation, however, lacked sufficient precision and pushed managerial theorists to consider alternatives. Initially, transaction cost economics promised the most. Williamson (1970), himself a CMU product, combined the two traditions. He agreed with his CMU mentors that humans had unbounded rationality and imperfect information. However, he dissented on rationality’s collaborative nature. Accordingly, Williamson presumed an imperfect, opportunistic *homo economicus*. With these assumptions in hand, Williamson set about to answer systematically, Coase’s (1937) famous question – how do firms improve on market transactions (Englander, 1986; Williamson, 1985). Managerial hierarchies appear, Williamson argued, when administrative rules are less costly to perform than contractual arrangements. Thus, in Williamson’s

rendering, firms are transaction cost minimizing devices and managers are sophisticated accountants.

### *Resource-based economics*

At first, managerial economists found Williamson's formulation insightful but lamentably not sufficient (Ghoshal and Moran, 1996). They agreed that transaction costs rose as firms invested in specialized assets. However, the firm's ability to assemble, coordinate and sustain specialized innovative assets seemed a better account of the firm's potential "economizing" advantages than transaction cost reduction.

Resource-based managerial theorists have contributed the most in developing an alternative. These scholars, following the lead of Penrose (1959/1995), and Nelson and Winter (1982), argued that the firm could improve on the market by combining complementary assets into unique competitive know-how relationships (Barney, 1991, 2001; Grant, 1996; Kay, 1997; Wernerfelt, 1984, 1995). So long as managers could preserve this know-how within the firm's singular social relationships, then, the firm's members would enjoy above average returns, both on capital and labor. Thus, rather than conceiving the firm as a transaction cost minimizing organization, resource-based theorists depicted the firm as a rent-seeking collaborative project and managers as coordinators (Amit and Schoemaker, 1993).

Moreover, resource-based economics contested Williamson's opportunism premise. Conner and Prahalad (1996) develop the latter argument explicitly. They reason that cognitive limitations, even when all act non-opportunistically, establish sufficient motivation for individuals to collaborate in hierarchical arrangements. These command systems allow knowledgeable managers to direct uninformed and inexperienced workers, thereby economizing on learning costs and augmenting innovation opportunities.

### *Homo socius and team production*

Most neo-classical economists remained outside these debates, pursuing instead a theory based on joint or team production. Like their transaction

cost and resource-based counterparts, neo-classical economists introduced bounded rationality and imperfect information. These two sufficed to account for the gains that occurred when individuals entered joint, team production relations (Alchian and Demsetz, 1972; Aoki, 1984). These economists, who chronologically preceded resource-based theorists, recognized that firms were able to generate innovations faster than solitary efforts by melding complementary assets into coordinated action. And, so long as firms sustained their joint production advantages, they earned quasi-rents, which like resource-based theorists, defined the firm's primary aim.

Team production addresses this issue by introducing "other-regarding" behavior such as bounded self-interest. The concept comes from behavioral economics, which like managerial theory, has deep connections to the CMU managerial school (Bowles, 2004). Nevertheless, behavioral economics has not been adequately integrated into stakeholder theory.

Although cooperation brings gains, neo-classical economists have had great difficulty in explaining why individuals would cooperate. Economists encounter two hindrances. First, because the firm can temporarily escape the market's price-setting mechanism, the team has no way of disaggregating marginal contributions (the non-separability problem). Hence, the team must devise a method for allocating the surplus that exceeds marginal returns. Second, individuals of the *homo economicus* variety find it difficult to agree on division and work rules or effort – the free-rider problem (Alchian and Demsetz, 1972; Hart, 1990; Holmstrom, 1982). As rational economic agents, each seeks to maximize utility, and each is indifferent to the other. Thus, each wishes to gain as much as possible while expending as little as possible. This "preference" order can easily turn cooperative behavior into a prisoner's dilemma (PD), where all recognize cooperation to be the best choice but defection the rational (default) choice (Hardin, 1982).

One solution would have the individuals distribute control rights to a member who would act as coordinator and set surplus division and work rules (Alchian and Demsetz, 1972, 1973). However, the solution comes with inherent problems: How would the individuals select the "owner"

endowed with control and residual rights (Grossman and Hart, 1986)? Even if the team members could resolve this issue, they would encounter another: The owner has the right to sell off the team's assets, discouraging team members from making firm specific human capital investments (Rajan and Zingales, 1998). Finally, how would the "owner" set division and work rules, *ex ante* or *ex post*? If *ex ante*, then, members have incentives to shirk: if *ex post*, then each fights for the largest share, stalling or even preventing a final division and repeated play.

#### *The behavioral foundation for team (joint) production*

Recent advances in behavioral economics has provided an economic agent who does not have the same maximizing, non-other-regarding attributes. *Neo-homo economicus*' "other-regarding" behavior easily accommodates cooperation. Those engaged in this research enterprise have identified numerous behavioral and cognitive characteristics – e.g., aversion to loss, over-optimism, self-serving bias, other-regarding preferences, and spite – that are not found in neo-classical economics' rational actor model. We consider those – bounded self-interest (fairness, spite, and endowment) and bounded rationality (rule of thumb) – that rewrite *homo economicus* into a cooperative species (Jolls et al., 1998; Sen, 2002; Thaler, 2000; Bowles, 2004).

The concept of bounded self-interest comes primarily from empirical studies. Behavioral psychologists have used an experiment, the ultimatum game, to assess whether actual (rather than theoretically constructed) individuals behave acquisitively (self-interestedly) or with regard to others (fairly) (Fehr and Gächter, 2000). Like the PD, the ultimate game is deceptively simple. The game has two players. One acts as the proposer, the other as the responder. Each can receive a sum of money if they strike a deal. The proposer sets the divide and offers it to the responder. If she rejects the offer, then, neither gets the proposed payoff. If she accepts then they each get the sum allocated by the proposer. Neither knows the other's identity. And, they play the game only once. This eliminates reputation effects, retaliation, and learning from the game (Kahneman et al., 1986).

Unfortunately, the experiments do not follow the predicted pattern. Instead, they demonstrate that individuals act with regard to others. Individuals have bounded self-interest as well as bounded rationality. Thus, ultimatum game deals get struck within a well-defined range. It functions as a convention, a rule of thumb. It appears as a 50/50 split, adjusted for bargaining power. Common parlance would label such a deal fair. This rule of thumb has real clout. The responder's willingness to impose harm on both of the players illustrates fairness' power.

That each plays by a rule of thumb conforms neatly to cognitive psychologists' objections to *homo economicus*. They have long doubted the economist's construct of a rational actor who calculates alternative options with exacting scientific accuracy. Indeed, experimental research has demonstrated that individuals calculate probabilities by using rule of thumb (heuristic) devices (Simon, 1955, 1959/1976; Tversky and Kahneman, 1974).

The ultimatum game provides another lesson: Human behavior is malleable. When experimenters slightly alter the game's circumstances, alternative behavioral patterns arise. Still, they do not conform to rationality's predictions. Ultimate game outcomes also vary when rules or processes are changed. Even a change in the game's name, substituting "exchange" for "ultimate," has a significant effect. In the exchange game (played exactly as the ultimatum game), the proposers typically offered less and responders usually accepted. A simple name change permits previously unacceptable behavior. This is an important point to remember when we review fiduciary duty later in our article (Hoffman et al., 1994).

In all, the ultimatum game provides two generalizations about human nature. First, human behavior varies (Bowles, 2004). The empirical experiments uncovered distinctive response patterns – selfishness, mutualism, spite, and altruism. Of these, other-regarding behavior dominates. However, it typically does not arise from altruism. To the contrary, the ultimatum game suggests that the proposer acts fairly because, on average, it outperforms rational maximization. Thus, the ultimatum game reveals reciprocal rather than altruistic other-regarding behavior (Greenfield and Kostant, 2003). Individuals willingly reduce their immediate gain

when they know others adhere to rules that all deem fair (Rabin, 1993). And, both adjust their expectations according to their bargaining power. Reciprocity reformulates self-interested behavior: Individuals best promote their self-interest when they recognize that gains occur through cooperation and that cooperation bounds self-interest (Bowles, 2004; Thaler, 2000).

Second, process matters. One can accept an outcome that breaks the norm when the process denies the proposer free will. And, both can act like rational economic actors when the game signals acquisitive behavior to be the norm. For managerial theorists, this finding is hardly novel. It merely reinforces well-established literatures about the managerial function and about setting rules for communication and negotiation (Barnard, 1938; Raiffa, 1982).

Bounded self-interest, loss aversion (endowment/entitlement), rule of thumb (fairness) and spite offer the material for a complex utility function, one that better explains experimental results than the utility function found in neo-classical economics (Bolton and Ockenfels, 2000; Bowles, 2004; Fehr and Schmidt, 1999; Rabin, 1993). Together they provide the basis for cooperation and for “rational” resistance. Each may refuse offers that, while giving them gains over the non-agreement point, challenge their sense of entitlement and fairness.

Of course, resistance comes with costs – with effort expended, harm imposed, and increased risk for disagreement. For an agreement to occur, one party must either concede to the other’s best outcome or the two must make concessions. To strike a rational agreement, each must make concessions that are the other finds fair, i.e., that the other’s bargaining power (endowment and entitlement) demands.

#### *Team production and the coordination function*

The coordination function emerges out of efforts to mitigate costly and contentious bargaining. This analysis relies heavily on Aoki’s *Co-Operative Game Theory of the Firm* (1984) (See also Rajan and Zingales, 1998). The coordinator stands-in for the price system that if it were operative, would indifferently set terms among all stakeholders, including third parties (Aoki, 1984). Background conditions – the

distribution of rights (entitlements), income and wealth (endowments) – affect each party’s bargaining power. These (or, their lack) contribute to each party’s willingness to set reserve prices and to inflict injury when unfair deals provoke outrage, thereby, turning the best of intentions into disagreeable behavior (Luo, 2005; Morrison and Robinson, 1997). The coordinator must carefully explain the bargaining advantages and disadvantages that each bears, if each is to acknowledge the others actual circumstances.

Fairness, itself, serves as a rule of thumb that minimizes conflict (Rabin, 1993). Fairness functions, by setting expectations that allow for long-term cooperative relationships in which both parties can gain (Phillips, 1997). And, deviations from the rule can provoke “irrational” behavior, refusal to close a mutual advantage deal. Yet, fairness, itself, has no readily objective designation. Placed within an economic vernacular, a deal is either optimal or sub-optimal (Hardin, 1995). It either allows for the largest surplus possible under given circumstances or it falls short. The optimal outcome, however, has no unique division or surplus allocation rule and requires that human agency reach an accord (Barry, 1989).

Consequently, the players may delve deeply into distributive justice and select a rule on which all can agree, e.g., Rawls’ difference principle (Rawls, 1999). Or, they may accept mutual gain as the distributive norm and proceed formally by adopting a bargaining scenario. For example, the one with the most to lose concedes (Nash equilibrium). Or, the players might just adopt the simple 50/50 rule, disregarding bargaining differences among them (Barry, 1989).

To be an effective replacement, the coordinator develops informational and communication skills to accomplish the following: (1) For assessing each stakeholder’s contributions, risks and bargaining power; (2) for facilitating agreement on the surplus division rule that each finds fair, i.e., one that recognizes each party’s bargaining power and entitlements; (3) for defining the team’s unique know-how and planning ways to augment it; (4) for monitoring and administratively enforcing division and work rules; and (5) for forecasting future market opportunities and threats (Phillips, 2003). All this requires specialization – individuals schooled in the coordination functions abstract principles. However, proficiency in abstract reasoning does not suffice. A coordinator

must be able to apply these principles in practice and to earn a reputation by her brokered deals.

This description suggests that coordinators have flexibility in selecting between a mutual gain procedure and an impartial standard (Phillips, 1997). However, markets operate through mutual gain transactions (Barry, 1989, 1995; Gauthier, 1986; Nozick, 1974). And, competition imposes a bargaining power band between capital and labor. Hence, coordinators typically must adhere to mutual gain's bargaining logic, though tempered by reciprocity (Bowles, 2003; Fehr and Gächter, 2000; Fehr and Schmidt, 1999; Phillips, 2003). Outcomes must reproduce bargaining differences among the contracting parties. Take disadvantaged labor and advantaged capital. Labor gains bargaining power from firm specific human capital investments. On the other hand, capital's fungible nature advantages it over labor. Capital resides in financial portfolios that, with electronic speed, traverse financial instruments to obtain maximum risk adjusted returns. Nevertheless, reciprocity tempers capital. It must acknowledge labor's bargaining power (effort and shirking), forcing deals that beat the theoretic minimum above non-cooperation.

Because mutual gain (Pareto or Kaldor/Hicks efficient) "naturally" belongs to market transactions, we label it *focal-firm* or *local* distributive justice, thereby recognizing that the state may readjust market outcomes based on an impartial (utilitarian or a Rawlsian minimax) standard (Barry, 1989; Elster, 1992; Rawls, 1999). This logic differs from Phillips, 1997, 2003. He claims that market-brokered deals are impartially fair. Those who engage in these negotiations may employ fairness when procedures permit full discussion. However, market outcomes hardly conform to a fairness standard whether in the Rawlsian or utilitarian sense. And, we speak of the coordinator as a neutral or technocratic broker (Phillips, 2003). A discussion of this distinction occurs in a later section.

#### *Core competencies and team production*

If coordinators are to be successful, they must gain each team member's trust. The team's constituents consider the coordinator trustworthy when individual self-interest encapsulates the team interest

(Hardin, 2002; Whitener et al., 1998). Coordinators' self-interest derives from their privileged participation in a small, but powerful community.

As the teams grow in complexity, the coordination function cannot be performed by a single individual. The team's core competencies coalesce and evolve as members invest in team-specific skills which impose unique risk on each and collectively render market substitutability baseless (Bainbridge, 2002a; Blair and Stout, 1999). This complexity requires a set of coordinators – in corporate governance terms, a board of directors. Their combined know-how can apprehend the diverse human capital components that comprise the firm's innovative powers (Mohrman et al., 1995).

Value creation, unique risk and strategic information comprise the basic categories for selecting corporate directors (coordinators) who can reproduce, in effect, the firm's core competencies – the firm's core stakeholders (Kaufman and Englander, 2005). To illustrate, consider the U.S. corporate setting in which control (board) and residual rights (shareholder/portfolio investor) are separated. Value creation refers to those stakeholders who have specialized skills to generate the firm's competitive advantage. Because these core stakeholders (employees, suppliers, and customers) invest in specialized human capital and capital stock, they incur unique risk. Here, we consider the firm as a supply chain member. Hence, customers (e.g., original equipment manufacturers) cooperate with suppliers to augment productivity and product functionality (Kaufman et al., 2000). Team members possess skills that do not easily transfer to other firms. The individual's skill has full value only within the team's social interactions.

Shareholders, too, create value even though they neither participate in the firm's core processes nor assume unique risk. Actually, the category shareholder has become an anachronism. Today, shareholders typically find themselves part of an investor's diversified portfolios. These investors allocate liquid capital as alternative investments (stocks, bonds, commercial loans, real estate, etc.) promise higher yields than current ones. And, money market managers (institutional investors) have aggregated investor capital into large funds that can augment and diminish a firm's value. Thus, investors, while they keep financial score, incur diversified risk,

adjusted to their preferences. A corporate board (a team coordination committee) requires members who have expert knowledge on the capital markets, if the team is to compete effectively against other financial instruments.

Boards require strategic information beyond the financial markets – for example, on commodity markets and on technological possibilities. Such information is neither readily available nor easily decipherable. Hence, boards (coordination committees) must include outside coordinators with specialized knowledge, i.e., know-how in those domains critical to the firms success.

Finally, the firm's practices may impose unique risk on non-contractual stakeholders who endure third party harm (negative externalities). The chemical industry provides a salient example. Its toxic substances can degrade a community's environmental well-being. A region dependent upon a single employer or industry supplies another example. Should technological improvements or outsourcing jobs dislocate workers, then, the community will confront economic hardships above the market average. When a cooperative team imposes unique risks on third party stakeholders, the board must have directors familiar with this group's circumstances, if the firm is to avoid harm (unethical behavior) – by pushing costs onto others.

With such a diverse group won't coordination committees (boards) simply become an arena for distributive conflicts? Won't these squabbles merely undo the solution that a neutral technocrat provided? Or, perhaps, the board will work by compromise, "satisficing" each stakeholder group instead of maximizing "surplus value." Behavioral research has shown that powerful incentives are available for consolidating groups – even those whose short-term interests may conflict (Bainbridge, 2002a). Individuals bond well when they identify themselves as part of an "in-group." In fact, empirical research indicates that coordinators develop a social network that promotes trust and open dialog (Westphal, 1999).

### **State incorporation acts and directors' fiduciary duties**

All of these corporate coordination activities occur, in theory, without government assistance,

without the law and police powers. Yet, as a historic fact, complex teams that amalgamate production factors take on a special legal status – the business corporation. Incorporation requires a coordination committee, the board of directors. The directors' public identity legally emerges from the law from incorporation and regulatory initiatives.

Consider the classical liberal account of the state that proceeds from Hobbes' brutish state of nature where all would gladly concede to a dictator if that would guarantee security (Olson, 2000). The state, by monopolizing military force, abates civil strife and patterns cooperative behavior. Yet, even the most authoritarian state cannot suppress crime nor fully enforce all contractual promises and fiduciary obligations. The state merely reduces the risks of contract and fiduciary breaches.

Risk reduction provides the central impetus for state incorporation laws. Within a secure property rights system, suppliers and customers develop ongoing, mass production relationships. Inter-firm supply chain dependencies increase business risk. Specialized assets and relational contracts put each firm at risk – the risk to be held-up or to be gouged. Under these circumstances, the integrated firm betters the market in managing the asset and bearing the risk (Williamson, 1985). However, vertical integration requires large amounts of capital for the initial purchases and for daily cash flow requirements. These large capital sums typically exceed an investor's, a creditor's, or a group of investor/creditors' risk limitations. Incorporation grants limited liability for an investor class, shareholders (Klein and Coffee, 2004). Reduced financial risk lessens equity capital's cost.

Limited liability forms the usual economic account for incorporation. However, team production offers another – a coordination committee. Incorporation acts establish the corporate board as coordinator and inscribe the board, corporate directors, with fiduciary duties (a duty of care and a duty of loyalty) to the corporation as a going concern (Stout, 2003). Thus, corporate law facilitates coordination by assuring stakeholders that the board is trustworthy (Rock and Wachter, 2002). The law imposes on directors a local obligation to assure the welfare of all corporate stakeholders.

*U.S. federalism and corporate law*

In the United States, federalism stands among the most efficacious means for restraining governmental abuse (Hardin, 2003). The states' rivalries and their common competition against the federal government lessen the chance for government mischief whether by the states or the national government. Within these overlapping jurisdictions, incorporation and internal governance belong to the states and stakeholder regulation belongs to the federal government (Romano, 1993). In principle, state governments allow for a geographic pluralism that engenders competition for corporate franchise revenues although there is disagreement over whether this turns into a "race to the bottom" or a "race to the top" (Bebchuk, 1989; Cary, 1974; Romano, 1993; Winter, 1977). There is also a third account in which interest groups, investment bankers and lawyers benefit from Delaware's dominance and lobby to sustain it (Macey and Miller, 1987).

During the twentieth century, state competition for business incorporations has turned into an anachronism. Delaware has effectively "won" the race, at least for large publicly traded firms as nearly half of the firms listed on the New York Stock Exchange and almost 60% of the Fortune 500 firms are incorporated in Delaware. Data also clearly shows that nearly all corporations that leave their home state to incorporate in another end up in Delaware (Bebchuk and Cohen, 2003; Bratton and McCahery, 2006). Consequently, we follow convention and use Delaware as our standard for our discussion of state corporate law and regulation.

*Contract vs. trust*

An incorporation charter instructs corporate directors to act on behalf of all of the firm's constituents and treat each of them equitably. The charter legally obliges directors to consider the corporate team's interests first. This legal restraint on *homo economicus* (i.e., board members acting in their own self-interest) does not arise from contract law but rather from trust law. Both trust and contract come into play in the legal definition of the firm. Yet, they uneasily amalgamate into the business corporation (Kaufman and Zacharias, 1992).

This amalgam now divides legal scholars. One group emphasizes contract and the other, trust. Those who stress corporate law's contractarian language belong to the law and economics movement (Cheung, 1983; Coase, 1937; Easterbrook and Fischel, 1991; Meckling and Jensen, 1976). It repeatedly speaks of the firm as a spontaneous association of individuals choosing to organize themselves in order to produce and sell something, but having no public responsibilities. In contrast, team production (arising within the constructs of behavioral law and economics) considers the law to be an enabling device that binds the firm by encumbering directors with fiduciary duties (Bebchuk, 1989; Eisenberg, 1989, 1999). Where law and economics labels directors as private-sector rational actors, team production portrays directors' standing ambiguously: As the firm's principal and fiduciary, the directors coalesce private-contracting stakeholders into a publicly traded firm.

Trust and contract form the conceptual building blocks of U.S. corporate law. Contract seems clear enough. But why trust? Why has it been an enduring tradition within U.S. corporate law? Why hasn't contract law, on which the firm's activities depend solely, informed state incorporation statutes? The answer seems simple enough. Trust law predated contract law. And, trust's properties – enablement, elasticity, and flexibility – have sustained its prominence in corporate law (Maitland, 1981; Sitkoff, 2004).

A trust is a state enforceable bargain which was originally established between a donor and a trustee (Langbein, 1995). In the pure donative trust, the law regulates relationships in which a donor (settlor) employs another (trustee) who acts on a beneficiary's behalf. The trustee or fiduciary assumes responsibilities to preserve and augment the beneficiary's property without the donor's oversight. Even though the donor and the trustee enter into a contractual agreement, the beneficiary's dependency (vulnerability) binds the state to ensure the trustee's loyalty (Sitkoff, 2004). In its classical legal formulation, the fiduciary duty of loyalty forbids the trustee to engage in self-interested transactions, even when these can be profitable for the beneficiary. Corrective action requires the trustee to disgorge any profits (Langbein, 1995).

*Law and economics*

The law and economics movement does not deny that, historically, trust first facilitated the business corporation's formation. Yet, if history granted trust prominence in corporate law, then, trust rested on a contingent privilege. Consequently, law and economics scholars have enjoined an abstract logic (like their classical legal predecessors) to bring corporate law under contract's dominion.

Their deductive argument begins with Frederic Maitland's original account of trust's historic contractual basis (Langbein, 1995; Maitland, 1981). Trusts work like contracts in two essential ways. First, trust arrangements involve autonomous individuals who enter into a voluntary, but legally binding agreement. Donor trusts are, in effect, contracts for a third party beneficiary (Atiyah, 1995; Langbein, 1995). Second, the donor and the trustee, like the promisor and promisee in contract law, typically rely on default rules.

In recent years, the courts have distinguished between short-term and long-term contracts, rendering trust unnecessary to corporate law (Atiyah, 1995; MacNeil, 1980). When individuals enter discrete, short-term contracts, contingencies and their associated risks rarely matter. In contrast, long-term contracts inevitably encounter contractually unspecified events and outcomes. To enter a long-term contract, the parties must trust the other to act in good faith, to suppress opportunist impulses, and fulfill obligations (MacNeil, 1980).

When one party breaches the contract, the injured party seeks redress from the courts. The courts willingly order compensation when the plaintiff demonstrates that the defendant has acted unconscionably or in bad faith. To do this, the courts use *ex ante* reasoning. Thus, good faith has taken on a fiduciary-like quality. Each must strive, when the unexpected arises, to assure the contract remains mutually beneficial (Langbein, 1995).

Finally, law and economics advances only a superficially satisfying answer to the knotty question: To whom are directors accountable (Dodd, 1932)? Law and economics tries to banish ambiguity by engaging modern microeconomic theory, in particular, financial agency theory. The argument proceeds by analogy and transports agency law into corporate law. Financial agency theory declares that

shareholders are the principals and boards are their agents (Easterbrook and Fischel, 1991).

This contractual logic does yield substantive insights. Law and economics scholars, for example, present a better account of the courts' permissiveness with fiduciary duties than trust doctrine. Under certain conditions, the courts find director self-dealing beneficial to the corporation. For example, the Delaware court permits directors and senior managers to dispose of corporate assets self-servingly as long as the corporation is treated fairly and outside or independent directors approve the transaction. (Bainbridge, 2002b).

This contractual logic provides an equally satisfying explanation for the courts' long refusal to subordinate the business judgment rule to the duty of care. Until the 1980s, the courts routinely deferred to the lesser business judgment rule rather than the prudent person rule, unless unusual circumstances were proven (such as self-serving deals, fraud, or illegality) (Dent, 1981; Horsey, 1994). Where the prudent person rule asks the courts to consider whether directors acted reasonably, with the care of a prudent person, the business judgment rule simply acquiesces to the firm's internal hierarchy as a legitimate arbiter (Bainbridge, 2002b).

*Behavioral law and economics*

Trust law, by demanding that the fiduciary acts in another's interest, differs substantively from contracts (Marens and Wicks, 1999). Yet, contracts are the mediating mechanism that coalesce individuals and groups into corporate production teams. Why then does corporate law rely on a legal tradition outside contracts? Why trust? Why fiduciary duty? Since the 1960s, differences between trust and contract have narrowed. However, the two have not collapsed into one.

Delaware illustrates this argument. Corporate case law in Delaware defines the board as the corporation's authoritative body or as the corporation's principal (Bainbridge, 2002a, b; Springer, 1999). Shareholders elect directors, but Delaware instructs directors that their fiduciary obligation extends both to the shareholders and the corporation, itself (Johnson and Millon (2005)). Delaware's incorporation charter is unequivocal on the corporate board's

primacy and on its authority to oversee the firm (Bainbridge, 2002b; Clark, 1985; Rock, 2000). The charter plainly states that the corporation shall be under the direction of a board of directors who are encumbered with fiduciary duties.

The board assembles a management team or delegates this responsibility to senior executives. The board has the authority to specify administrative work rules, to draw and redraw the firm's boundaries, and to provide incentives for recruiting, retaining, and motivating employees. In all, the board animates the firm's physical assets (capital stock) by allowing or disallowing human capital access to these resources (Rajan and Zingales, 1998). Once hired, corporate officers conduct business as the directors' agents. They, not directors, come under agency law – contrary to financial agency theory (Johnson and Millon, 2005; Langevoort, 2003; Marens and Wicks, 1999; Rock, 2000). Still, directors remain accountable to shareholders who are endowed with specific rights: (1) the right to vote on directors, bylaw amendments, mergers, sales of corporate assets, and dissolution and (2) the right to initiate derivative suits. More important, shareholders, as institutional investors, hold boards accountable by reallocating funds among financial portfolios, and augmenting the value of some instruments and diminishing the value of others.

#### *Team production and trust*

The team production model uses these legal facts to counter claims that fiduciary status is a mere default rule and that the duty of care is subordinate to the business judgment rule (Blair and Stout, 1999, 2001). The counterpoint begins with corporate law's specific adaptation of trust. How does the fiduciary relationship between directors and the corporation differ from the donative trust law? From agency law? How has the concept of trust been adapted within corporate law?

Each fiduciary relationship involves trustworthiness and trust; all make demands that exceed spot market contract relations; and all rely on the courts as background enforcer. Where the principal–agent relationship covers party to party transactions (including entities), trust and corporate law regulate relationships between the trustee and a beneficiary. In a donative trust relationship, the donor transfers to

a trustee (fiduciary) a critical resource (whether tangible as land, or intangible as confidential information). This transfer legally binds the fiduciary to use the resource on the beneficiary's behalf. Unlike a principal–agent relationship, the beneficiary does not directly control or oversee the trustee.

Corporate law does not conform to either the agency or donative trust structure. Corporate law establishes its own variant though it is derived from donative trust. The corporation forms when individuals or contracting parties commit (by analogy, donate) resources to a joint effort. The corporate team members expect the board to transform their critical resources into the firm's core competencies and to enhance the firm's competitive capabilities. These trustees, then, act on the corporate team's behalf (beneficiaries) and augment their wealth-generating powers and distribute the benefits among team members. To enable the board to function as coordinator, corporate law establishes clear fiduciary (behavioral) expectations. In imperfect markets, corporate donors cannot write complete contracts and instead rely on fiduciary duties as gap fillers (Kaufman, 2002).

Although elastic, corporate duty of loyalty differs from good faith and fair dealing in relational contracting. Relational contracts, even when clearly tempered by good faith provisions, permit the contracting parties to act self-interestedly, even injuriously to the other, as long the contract countenances the questionable actions (Smith, 2002). When courts are asked to interpret a party's good faith actions, the weight does not favor either party. Rather, the courts seek out the mean between the two (Brudney, 1997). Hence, the distinction between corporate fiduciary loyalty and relational contracts remains (Smith, 2002).

If the courts permit corporate fiduciary unwinding, then, they lose their role in superintending director trustworthiness (Frankel, 1995; Stout, 2001). Corporate value-adding stakeholders would only have protection under relational contract's good faith standard. They would lose the court's interventions to shape director "other-regarding behavior" (Rock, 2000; Rock and Wachter, 2001). Fiduciary duty cognitively biases judges (and, consequently, directors) to perceive directors as fiduciaries, as those who have a legal obligation to be trustworthy. The judges' cognitive bias encourages

them to survey from the corporate case law best practices and to transmit them in each new ruling (Veasey, 2001, 2003). The courts' rulings, which include moral language, inform directors (as advised by legal counsel) on their responsibilities and cajole them to constrain their rational maximizing persona (Alexander, 1997; Mitchell, 2001a, b).

Corporate law enables the firm. Fiduciary duty's legal definition and its sanctions for breach enable corporate stakeholders to deem directors' trustworthy and to transfer resources to their care. Directors coordinate stakeholder contributions as corporate trustees for the corporate constituents' benefits. Even though the law encumbers directors with responsibilities, the law cannot organize a new wealth-creating association. This occurs spontaneously, contractually, as each seeks to gain from joint production. As deals get struck and boards emerge as coordinators, a director community materializes, establishing a socially privileged group whose membership depends on each director's trustworthiness (Herman, 1981; Westphal, 1999; Westphal and Zajac, 1995, 1997, 1998). Those who violate this trust face communal sanctions, e.g., reputation loss, public shame, etc. The law codifies this community and promulgates evolving behavioral norms. Together, the statutory and the self-generative, can invest trustworthiness into a director's self-identity (Cook et al., 2005; Eisenberg, 1999; Hardin, 2002; Mitchell, 2001a).

Fiduciary duty defines the coordinator's *focal good*. The coordinator acts "selflessly" to secure the corporate team and to distribute neutrally its generated surpluses. The distributive standard proceeds from Pareto to Kaldor/Hicks efficiency and, if necessary, to a utilitarian cost/benefit outcome (Hardin, 2006). The director-community's collective function, to oversee the corporate sector's wealth-producing capabilities, engages the directorate in debates over a large social good, a social distributive justice standard. Democracy's basic values, liberty and equality, establish the options. The U.S. federal government provides the stage.

## Conclusion

Stakeholder theorists have often claimed that their insistence on integrating ethics into corporate strat-

egy differentiates them from neo-classical economics (Freeman et al., 2004). To be sure, many economists stubbornly enforce the distinction between efficient and fair. However, economists who belong to the law and economics (Chicago School) movement, similarly, find the rigid separation artificial. They have waged a protracted intellectual campaign to integrate ethical norms and descriptive paradigms, distributive justice and Pareto efficiency (Yergin and Stanislaw, 1998). These libertarians did not have to go outside economic theory for an entry way into ethical reason: Contract's underpinnings – autonomy, liberty, secure property rights – provided the materials that naturally led to a procedural justice standard (Knight, 1947; Nozick, 1974; Posner, 1981; von Hayek, 1944, 1960). Still, their reliance on *homo economicus* distances law and economics from stakeholder theory. Freeman and Phillips (2002) claim the libertarian terrain among stakeholder theorists. Yet, these two differ from the Chicago School by arguing for a complex human psychology and by suggesting that fairness – of a Rawlsian sort – be incorporated into the firm's contracts (Freeman, 1994).

These differing conceptions of human nature returned us to the Carnegie Mellon managerial tradition. Our retrospective includes a prospectus on behavioral law and economics, which has done much to advance the CMU perspective. Behavioral economists and their legal scholar partners have generated a contrary archetype, *homo socius*, one that we argue "naturally" inhabits to stakeholder theory.

Our argument devolves into five summary propositions. First, the make-over of *homo economicus* into *homo socius* permits the creation of a parsimonious firm. Team production, the behavioral law and economics' joint product, proceeds deductively to construct the firm and to analyze corporate law's supportive role. Second, team production and strategic management generate categories – value creation, unique risk, and strategic information – for identifying the firm's "core" wealth-producing stakeholders (Conner and Prahalad, 1996; Grant, 1996). This categorization brings stakeholder theory into the strategic management literature, with its emphasis on core competencies and resource-based competitive advantage. These categories do not displace stakeholder theory's well established "contingent" analytics, e.g., legitimacy, power, urgency, and salience (Mitchell et al., 1997). The firm's

dynamic development, its actions among various social and political arenas, resists a single managerial schematic. Still, ours provides a means for designating core competency salience by linking stakeholder analysis to resource-based economics. And, our categories amplify the other important stakeholder identification method, the normative/derivative distinction (Phillips, 1997). Like ours, it uses contributions, benefits and harm. However, our procedure refines these terms by bringing stakeholder theory into the strategic management literature.

Three, corporate law has a greater importance in our synthetic paradigm than is normally the case among stakeholder theorists. True, stakeholder theorists speak of the firm as a bundle of rights and obligations (Donaldson and Dunfee, 1999), however, our model requires state incorporation charters and corporate laws as being essential to the U.S. firm's constitution. Incorporation solidifies team production by requiring a board of directors whose members must exhibit other-regarding behavior. In turn, they set standards for their agents, senior managers, demanding them to be trustworthy (Whitener et al., 1998). Our detailed account of the courts' assistance in coalescing corporate stakeholders brings an extra, empirical benefit: Incorporation, as practiced in Delaware (and in most other states) conceives of the firm as a stakeholder association, rather than as a shareholder maximizing institution, as agency theory normatively instructs.

Fourth, team production (behavioral law and economics) identifies corporate boards as the corporate coordinator. Typically, stakeholder theorists speak of managers as the corporate coordination/control group. Of course, the separation of residual and control rights has allowed managers/senior executives to dominate the board and the board's nominating committee. However, even inside directors are encumbered with fiduciary duties.

Fifth, and finally, the corporate board fits within an interlocking network, generating a corporate directorate – a community that has eluded stakeholder theory. The recent reforms (new governance guidelines at the New York Stock Exchange and the Sarbanes-Oxley legislation in particular) have changed this interlocking network's members and their identities. Where insiders once dominated boards, now outsiders do. When insiders predominated, they sat on the nominating committee to secure

their control. Now, outsiders, primarily, current and retired CEOs, populate this committee. These new circumstances encourage board members to consider themselves as corporate sector stewards rather solely as the focal firm control group. This reformation reinforces the corporate directors' ability to resist collectively challenges to managerial – now, collective CEO – control, even if this means punishing the few who perform inadequately (Englander and Kaufman, 2004; Kaufman et al., 1995; Khurana, 2002).

These concluding propositions contain rich research implications, of a theoretical, empirical and practical sort. We only consider here two, one empirical, one theoretical. Recent empirical work evaluating stakeholder management's impetus – whether it proceeds from ethical rules or from strategic needs have upheld the latter. This finding has disturbed some who find it difficult to reconcile stakeholder theory's ethical instructions – that stakeholders be treated as autonomous moral ends – with the market's preponderance to convert all into loss or gain (Berman et al., 1999; Harrison and Freeman, 1999; Jones and Wicks, 1999). The anomaly vanishes if one considers managers constrained by market competition and “coerced” into the old-fashion strategic (instrumental) way (Hendry, 2001). Still, the Kaldor/Hicks standard furnishes a reasonable limit on market instrumentality. And, procedural processes do count in establishing a fairness-felt sense.

This conclusion, though, does not insinuate that managers are unable to act by non-market generated norms. However, the possibility occurs in the political sphere where managers may lobby for policies to correct the market's “unfair” consequences. These correctives may rely on direct redistribution or they may be regulatory initiatives to strengthen the least advantaged's bargaining position. Of course, if managers have volition, they may simply affirm procedural justice, which, in effect, corroborates market outcomes. Historically, U.S. corporate managers have demonstrated a preference for each. After WWII, until the 1980s, managers promulgated a technocratic creed in which they conceived of the firm as a stakeholder coalition and public policy as means for correcting bargain advantages. Since then, managers abandoned their neutrality and rallied to shareholder partisanship and to a collective preference for procedural justice. Thus, managers abandoned their former corporate

social responsibility doctrine and viewed indifferently two decades of stagnant wages and an expanding chasm between those who diversified portfolio investors and those who have not (Englander and Kaufman, 2004; Kaufman and Englander, 1993). In considering these alternative distributive justice options, our revised stakeholder theory permits agnosticism, as long as managers dissuade themselves of the focal firm shareholder creed. Still, we do have a decided preference for technocratic impartiality.

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