University of Navarra

Working Paper

WP No 591

May, 2005

WHY STAKEHOLDER AND STOCKHOLDER THEORIES ARE NOT NECESSARILY CONTRADICTORY: A KNIGHTIAN INSIGHT

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Abstract

The normative foundations of the investor centered model of corporate governance, represented in mainstream economics by the nexus-of-contracts view of the firm, have come under attack, mainly by proponents of normative stakeholder theory. We argue that the nexus-of-contracts view is static and limited due to its assumption of price-output certainty. We attempt a synthesis of the nexus-of-contracts and the Knightian views, which provides novel insights into the normative adequacy of the investor-centered firm. Implications for scholarship and management practice follow from our discussion.

Keywords: Theory of the firm, corporate governance, entrepreneurship, business ethics, stakeholder theory.

Forthcoming in Journal of Business Ethics.

WHY STAKEHOLDER AND STOCKHOLDER THEORIES ARE NOT NECESSARILY CONTRADICTORY: A KNIGHTIAN INSIGHT[1]

Coase's seminal paper (1937) on the theory of the firm has led to a huge literature on the rationale for existence, and on the characteristics, of the firm as an institutional modality. Since the early 1970s, the mainstream literature has viewed the firm as a nexus of bilateral contracts between the suppliers of different assets: equity capital, debt finance, labor, materials, and custom. The rationale for the existence of the firm is taken to be the minimization of costs – for example, supervision and monitoring costs (Alchian and Demsetz, 1972), and transaction costs (Williamson, 1975, 1985). This nexus-of-contracts view of the firm (hereinafter, NC) has been influential in corporate law (Boatright, 1999), which has attempted to resolve the stockholder-manager agency problem by making managers fiduciaries for stockholders[2]. The literature within the NC tradition is in agreement on three central characteristics of the firm: first, that managers should owe a fiduciary duty only to owners (Boatright 1994; Williamson 1985); second, that only owners, who are the residual claimants, should have voting rights[3] (for example, Williamson 1984); and third, that the contracting relationships should be bilateral, i.e., that the stockholders, who are the central contracting party, "have rights to renegotiate any input's contracts independently of contracts with other input owners" (Alchian and Demsetz, 1972: 783). For the sake of simplicity, we shall refer to the variants of the NC view (for example, Alchian and Demsetz, 1972; Grossman and Hart, 1986; Jensen and Meckling, 1976; Williamson, 1975, 1985) as stockholder theories of corporate governance, because it is normally assumed by stockholder theorists that these three mechanisms are central to furthering the interests of stockholders. In the discussion that follows, we will be guided by this assumption.

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[1] We gratefully acknowledge the financial support of the Batten Institute at the Darden Graduate School of Business Administration, University of Virginia, for this research. We would like to thank John Boatright, Ed Freeman, Gordon Sollars, Patricia Werhane, and two anonymous reviewers for comments and suggestions on an earlier draft. Our special thanks are due to Alexei Marcoux for his painstakingly detailed comments and suggestions on an earlier draft.

[2] Indeed, for many theorists, corporate governance is concerned mainly with how the principal-agent problem is solved between the suppliers of equity capital (the principals) and the managers (the agents) (see Schleifer and Vishny, 1997).

[3] In this literature, the use of the terms owners, residual claimants, and stockholders mean the same thing.

A more recent body of literature, Normative Stakeholder Theory, considers the NC view as excessively stockholder-centered to the detriment of other stakeholders, and thus normatively inadequate[4]. Normative stakeholder theory (referred to simply as stakeholder theory in the remainder of this essay) offers two types of solutions to resolve the stockholder bias of the traditional NC models. The first type of solution consists of rights to be adjudicated at the time the contracts are negotiated. Three of the measures proposed are 1) that all stakeholders should have board representation, and those who have firm specific assets and face residual risk should have voting rights (Freeman and Evan, 1990)[5]; 2) that managers should be fiduciaries to all stakeholders (Evan and Freeman, 1988); and 3) that the firm should be conceived of as a set of multilateral contracts between all stakeholders (Freeman and Evan, 1990; Schmidt, 1997). The second type of solution focuses on managerial decision making after the contracts have been negotiated; it calls for the manager to take into consideration the interests of the stakeholders beyond what they have contracted with the firm (for example, Freeman and Evan, 1990; Donaldson and Preston, 1995).

In recent times, the criticisms expressed by normative stakeholder theorists of the normative foundations of the NC view have gained widespread acceptance. Jensen (2000) points out that stakeholder theory has been endorsed by many professional associations, special interest groups, and governmental organizations including the current British government. The OECD has published its “Principles of Corporate Governance” (1999), in which Boards of Directors are urged to “take into account the interests of stakeholders” (1999: Section V, item C). Furthermore, several US states have mitigated what they see as the stockholder orientation of the firm through legislation that permits managers to take into consideration the interests of other constituencies in limited circumstances (e.g., in determining whether and how to fend off a takeover bid). Even traditionally pro-business publications such as the Financial Times have supported a stakeholder oriented model of corporate governance (Sternberg, 1996).

Although proponents of the NC view have spoken out in defense of its normative adequacy and have pinpointed flaws in the arguments of stakeholder theorists (for example, Jensen, 2000; Williamson, 1984)[6], their defense is limited by the static perspective and the

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[4] Donaldson and Preston (1995) note that there are three broad aspects to stakeholder theory: descriptive accuracy, instrumental power, and normative validity. This essay is only concerned with the normative aspect, which makes the claim that the firm *ought to* be managed for the benefit of all stakeholders. This claim is distinct from instrumental stakeholder theory[4], which “establishes a framework for examining the connections, if any, between the practice of stakeholder management and the achievement of various corporate performance goals” (Donaldson and Preston 1995: 66). The fundamental difference between the normative and the instrumental views of stakeholder theory is that whereas the former view imposes a moral or ethical obligation on the manager to take into consideration (beyond what has been contracted for) the interests of all stakeholders, the latter makes the predictive (and prescriptive) claim that stockholder value will be maximized to the extent that the manager satisfies the interests of all stakeholders[4]. Thus, the latter view leaves the management of stakeholder relationships (beyond what has been contracted for) to the discretion of the manager, without calling on her to compromise her fiduciary duty to stockholders. This essay addresses only the normative stakeholder view, which has been put forward as a rival view to the NC view of corporate governance.

[5] Residual risk is interpreted by stakeholder theorists as the risk of the firm being unable to honor its contractual obligations (as would occur, for example, if it were forced to shut down). They do not distinguish between the risks faced by voluntary and involuntary creditors (such as victims of tort). The distinction is crucial, since the voluntary creditors can use the price mechanism to insure their risks.

[6] For example, Jensen and Williamson criticize stakeholder theorists: a) for not specifying *how* managers ought to make trade-offs between the competing interests of stakeholders; b) for undermining the accountability of managers by bestowing on them greater discretion through a poorly defined objective function that seeks to balance interests of multiple stakeholder groups, rather than the single and clear-cut objective function of stockholder value maximization; and c) for not realizing that stockholders are especially vulnerable because, unlike other stakeholders, they transfer their stocks of wealth to the firm.

assumption of price-output certainty[7] that serve as the points of departure for the NC models, as we will show in Section 2 of this essay. We will argue that incorporating Knight's (1965[1921]) ideas on uncertainty to the NC view provides us with several novel insights: first, it gives us a more general corporate governance model, of which the NC view is a special case; second, in contrast to the static NC view, it provides us with a dynamic view of the widely held public corporation, from its entrepreneurial beginnings; third, it highlights the different normative underpinnings, one substantive and the other procedural, that come into play in the evolution of a widely held investor-owned corporation; and finally, it opens the door to "managerial stakeholder theory" (Donaldson and Preston, 1995), even in instances where the contracting procedures between the different stakeholders are fair. We conclude by discussing the implications of our thesis for scholarship and for the practice of management.

The objective of this essay is not to articulate a blanket criticism of the NC view. This view has considerable explanatory power, and has furthered our understanding of such important issues as agency relationships, monitoring and supervision costs, and vertical integration. As such, an evaluation of the NC view, and indeed of any internally consistent theory, can only be made on the ability of the theory to satisfy specific criteria. In this essay, the criteria against which we will evaluate the NC view of the firm is 1) its generalizability, i.e., its ability to explain both the closely held entrepreneurial firm and the widely held corporation; and 2) its ability to provide a normative underpinning to the investor centered model of corporate governance. We will conclude that the more general Knightian theory satisfies these criteria better.

The remainder of this essay proceeds as follows. Section 1 deals with Knight's theory of the firm and its normative implications. Section 2 summarizes the differences between the NC and Knightian firm-as-contracts views. Section 3 analyzes the normative foundations of the two views, explores the possible responses to the stakeholder attack on the NC view, and outlines how the responses might be different from a Knightian perspective. Section 4 deals with the normative aspects of the transition of the firm from entrepreneur owned to a corporation with diffuse ownership. Section 5 presents concluding remarks and implications for scholarship and management practice.

Knightian uncertainty in the theory of the firm

An elegant and parsimonious explanation for the birth and existence of firms was given by Knight (1965 [1921]). According to Knight, the entrepreneur is the residual claimant because she is the only input provider for whose services there exists no market; she therefore guarantees fixed remunerations to the other input providers with the understanding that she will receive what is left over after these fixed payments have been made. Thus, the Knightian firm fits the firm-as-contracts view, and can be thought of in terms of the same six characteristics specified by Alchian and Demsetz (1972) as central to a firm –

1. joint input production;
2. several input owners;
3. one party who is common to all the contracts of the joint inputs;
4. who has rights to renegotiate any input's contracts independently of contracts with other input owners;
5. who holds the residual claim;
6. who has the right to sell his central contractual residual status" (1972: 794).

[7] By price-output certainty, we mean that under equilibrium models (which form the basis for the NC views), a seller's price is exogenously given (i.e., he has no influence whatsoever on it). Furthermore, he can sell any quantity at the market price, but can sell nothing above the market price.

The Knightian view, notwithstanding its similarities with the NC view, differs in one crucial respect, in that it incorporates the concept of uncertainty. Knight (1965[1921]) made a distinction between risk and uncertainty, and claimed that uncertainty is the reason for the non-existence of a market for the entrepreneurial opportunity. In the remainder of this section, we will discuss Knightian uncertainty and its implications for a theory of the firm.

Knight (1965[1921]) argued that uncertainty was crucial to understanding entrepreneurship and the concept of profit (see Weston, 1950). Knight's discussion on risk and uncertainty was interpreted to mean that a risky situation is one in which the probabilities of the outcomes are known, and an uncertain situation one in which the probabilities are not known. Several scholars (Boudreaux and Holcombe, 1989; Gunning, 1993; Langlois, 1984; Langlois and Cosgel, 1993; Leroy and Singell, 1987; Weston, 1950) have offered alternative interpretations of what Knight meant. They propose that uncertainty is a situation in which insufficient information exists even to classify outcomes, and in which it is meaningless to talk about probability distributions. More specifically, Langlois (1984) observes that the distinction between Knightian risk and uncertainty hinges on the difference between structural and parametric knowledge.

> "What is often overlooked in the neoclassical literature of information and uncertainty is that its formalism implies certain-knowledge as much as it allows for uncertainty. The agent is implicitly presumed to have an exhaustive list of possible actions and states of the world and, equally important, a means / ends framework relating the actions and the states of the world to his utility. We might say that the agent has certain-knowledge of the structure of the problem he faces or, put another way, that he has perfect structural knowledge. Imperfections in the agent's knowledge extend only to specific parameters of the problem – the x_i – that are obscured from his vision. He may have imperfect parametric knowledge but never imperfect structural knowledge; he may acquire parametric information but never structural information" (Langlois, 1984: 29).

Thus, according to Langlois (1984), imperfect structural knowledge (i.e., Knightian uncertainty) is not considered at all in neoclassical economics. Langlois and Cosgel (1993) point to Knight's use of the expression "estimate of an estimate" and conclude that he was referring to two separate exercises of judgment. They argue that under uncertainty there is no basis for the classification of outcomes, and the entrepreneur therefore has to exercise her judgment in estimating the possible outcomes, before she can estimate the probabilities of each. They emphasize that the first estimate of classification of outcomes is qualitative, while the second, probabilistic estimate is subjective. Boudreaux and Holcombe (1989) point to Knight's distinction between the ignorance theory of probability and the doctrine of real probability. The former holds that events in the entire universe can be determined if only an individual's knowledge is complete. The latter has a more open-ended world-view, and holds that there is no possibility of determining the future – "Knightian uncertainty arises mainly because the future is not bounded or determined to emerge from the present in a stochastically predictable way" (1989: p. 150). They go on to say:

> "New goods can only be produced on the basis of entrepreneurial judgment, without the guidance of market prices. Uncertainty implies that resource values will change in unpredictable ways as the process of production unwinds. It is therefore necessary for someone to take responsibility for the outcomes of the production process. This responsible agent is the Knightian entrepreneur. The entrepreneur's return is the residual (positive or negative) left by the excess of sales revenue over (or under) the costs incurred by the entrepreneur at the time the production decision was made" (p. 151).

For Knight, entrepreneurial profit is a reward for the uncertainty bearer, whose differential contribution is the initial judgment of possible outcomes, which results in the

recognition of an opportunity. Entrepreneurship occurs because an individual is unable to sell her opportunity at a price that she aspires for. Thus, the manner in which uncertainty is conceptualized has an important bearing on our understanding of opportunity and profit. Under the neoclassical economic model, opportunity is simply the difference between the benefit and cost of information, whereas in the Knightian view, entrepreneurial opportunity revolves around the judgment of the economic agent. According to Knight, uncertainty (that is, imperfect structural knowledge) is the source of entrepreneurial profit and it is the reason for the firm to come into existence.

Clearly, parametric uncertainty (Knightian risk) and structural uncertainty (Knightian uncertainty) are not different in kind; they differ only in degree (Knight, 1965[1921]; Weston, 1950). At one extreme is perfect structural knowledge but parametric uncertainty and at the other, an extreme case of structural uncertainty with no possibility of knowing what the relevant parameters are, and under which markets fail. An example of an extreme case of structural uncertainty is the range of outcomes from a basic research program. Assume that an entrepreneur wanted to explore the possibility of profiting from a discovery made in the current year by a theoretical physicist. How would she even go about structuring the problem? The discovery may have a commercial application in fifty to a hundred years (a time frame well beyond the investment horizons of most individuals)[8], and this possibility is itself a function of a multiplicity of other discoveries and events in the intervening period. Note that in this instance it is not helpful to classify outcomes as successes or failures. The only way this classification would be meaningful would be if it were possible for the entrepreneur to assign monetary values to these outcomes and to assign (subjective) probabilities to them. If this is done, and a premium can be agreed to by the parties to the transaction for possible unfavorable outcomes (which would point to broad inter-subjective agreement on classifications, monetary values, and probabilities), then the problem becomes one of parametric uncertainty. It is because of extreme structural uncertainty that there is no market for most outcomes from basic research programs, and governments have to intervene with financing to prevent the activity from coming to a standstill. The important contribution of Knight is to point out that a less extreme version of structural uncertainty is the breeding ground for entrepreneurs; it is the reason entrepreneurs exist. Entrepreneurs contribute their own classifications to uncertain projects, assign monetary values, but cannot sell the project in the market. For this reason, they become the center of the nexus of contracts and the firm is born.

In contrast to Knightian uncertainty, Knightian risk is a situation that is insurable, meaning simply that the outcomes can be classified, subjective probabilities can be assigned, and a premium can be charged for possible unfavorable outcomes. For example, let us assume that an executive who has worked for twenty years for an established Fortune 100 company and who draws a salary of $100,000 is contemplating joining a start-up firm as an employee. Clearly, there is risk associated with a change of employment and several things could go wrong in his future job – he may not get along with his colleagues, he may be unable to perform his job to the satisfaction of his superiors, or his future employer may be forced to cease trading, to name just a few. These possible outcomes can be classified in a meaningful way and probabilities assigned to each outcome. The classification will be subjective as will the probabilities, which means that different individuals will classify the outcomes differently and will assign different probabilities to the outcomes. Therefore, the problem is structurally manageable but parametrically uncertain. The executive can insure his

[8] Einstein's discovery that space is curved has still not resulted in any commercial profit for any private economic agent.

job change decision by asking for a risk premium from his new employer relative to what he earns currently. He could, for example, demand a salary of $200,000. If there were no Knightian uncertainty, then all situations would be insurable and, consequently, contractable in the market.

It is important to note here that the subjectivity of probabilities by itself does not impede the transaction from taking place in the market. Indeed, the executive's demand of $200,000 (i.e., a premium of $100,000) may be met with a counteroffer of, say, $150,000, and the two parties may finally settle for something in between, say $175,000. The executive would have obtained a risk premium of $75,000. Thus, the two parties can assign their own subjective probabilities to outcomes and still conclude the transaction in the market. This example illustrates that the price mechanism can be used to insure against most risks by parties to a contract. The result of an entrepreneur recognizing an opportunity through the exercise of judgment under uncertainty is that there is created an *unbridgeable* gap between her aspirations and what other market participants are willing to pay for the opportunity (Lee and Venkataraman, 2001).

As Dew, Velamuri, and Venkataraman (forthcoming) have argued, uncertainty can either be caused by an information asymmetry (Akerlof, 1970) or by the non-existence of futures goods markets (Arrow, 1974). Dew et al. (2002) refer to the first type of uncertainty as Akerlofian, and to the second as Knightian. Akerlofian uncertainty is caused by an imbalance in the distribution of information between the potential contracting parties. When one of the two has all or most of the information pertaining to a transaction and the other, none or very little, then the transaction may not take place. Akerlof (1970) gave the classic "lemons" (defective used cars) example to illustrate this concept. Therefore, under Akerlofian uncertainty, all the relevant information resides in the system, but its distribution is skewed. Knightian uncertainty is a current lack of information that can only be overcome over time with the unfolding of events. According to Arrow (1974),

> "the optimizer must replace the market commitment to buy or sell at given terms by expectations: expectations of prices and expectations of quantities to be bought or sold. But he cannot know the future. Hence, unless he deludes himself, he must know that both sets of expectations may be wrong. In short, the absence of the market implies that the optimizer faces a world of uncertainty" (6).

Knightian uncertainty means that, at any given point in time, all the parties to a potential transaction lack the information that could have a bearing on the transaction. Dew et al. (2002) have argued that Akerlofian uncertainty contributes to Knightian uncertainty. When Knight (1965) referred to uncertainty, he was referring mainly to the latter type of uncertainty, that is, the uncertainty caused by the non-existence of futures markets for most products and services (Langlois and Cosgel, 1993).

The following are the implications of Knight's insight on uncertainty for a theory of the firm:

1. A transaction can take place in the market only if the buyer and seller agree on a price. Intersubjective agreement is therefore a necessary condition for the transaction to take place in the market. The seller must find at least one party willing to pay a price that is close to what she demands.

2. When an individual recognizes an opportunity, she places a value on what that opportunity is worth to her. She (the entrepreneur) can try to sell the opportunity in the market at a price that is approximately equal to the value she has placed on it. If she cannot, then she has the option of pursuing the

opportunity through a firm. The firm thus comes into existence because of the failure of the parties to transact the entrepreneurial opportunity *at a specified price* in the market[9]. Furthermore, the likelihood that a firm will come into existence is positively related to the size of the gap between what the seller demands and what the buyer is willing to pay. Thus, viewed from a Knightian perspective, the question of comparing the costs of organizing the transaction in the market and inside the firm does not arise, for a firm comes into existence precisely because the transaction cannot take place in the market.

3. Uncertainty is the cause of the entrepreneurial opportunity, which in turn leads to an unbridgeable gap between entrepreneurial expectations and the valuation of the opportunity by other economic agents (Lee and Venkataraman, 2001). In essence, uncertainty coupled with the heterogeneity of individuals leads to some individuals and not others exercising their judgment (Dew et al., 2002). The existence of the unbridgeable gap is a necessary but not sufficient condition for the firm to come into existence, i.e., not all instances of an unbridgeable gap will lead to the creation of a firm.

4. The firm is therefore a mechanism that facilitates the pursuit of an opportunity that cannot be pursued using markets. This has important normative implications for corporate governance, and we discuss them later in this essay.

The NC and Knightian views contrasted

This section examines the implications of the assumption of price-output certainty of the NC views of the firm, most notably in the writings of Alchian and Demsetz (1972)[10], Demsetz (1983), Fama (1980), Fama and Jensen (1983), Grossman and Hart (1986), Jensen and Meckling (1976), Klein, Crawford and Alchian (1978), and Williamson (1975, 1985).

One general observation that applies to all the NC views of the firm is that they rely more on Akerlofian uncertainty than on Knightian uncertainty to develop the rationale for the firm. Alchian and Demsetz (1972) refer to the potential for shirking behavior that results from an asymmetry of information. Jensen and Meckling (1976) emphasize the heterogeneity of goals among the different self-interested individuals who make up the firm. Williamson (1975, 1985) does take into consideration longitudinal uncertainty in a very limited sense: future uncertainty is important in his theory only to the extent that it can lead to ex-post opportunistic behaviors by the contracting parties. Knight, although he was aware of the problem of information asymmetry, was more concerned with longitudinal uncertainty: he emphasized the unpredictability of the future and how this necessitates the exercise of judgment by the entrepreneur (see Langlois and Cosgel, 1993).

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[9] The recognizer of the opportunity may believe that no buyer will pay her a satisfactory price, and therefore she may not even attempt to find a buyer. This is the same as saying that there is no market for the entrepreneurial opportunity.

[10] We include the Alchian and Demsetz (1972) paper in the Coasian tradition, although they disagreed with Coase on his characterization of the firm as a hierarchical mechanism.

The NC and Knightian views would be equivalent in practice only if we assume that markets are perfectly competitive and that all firms are price takers. This would mean that a firm could not take value-creating action to generate differential revenue per unit vis-à-vis its competitors, and could only restrict itself to economizing. Furthermore, the assumption of the NC views in general is that cost is the only differential element between conducting a transaction in the market and organizing it within a firm. Conner (1991) highlights this facet when she observes that:

> "Transaction cost theory assumes that the *same* productive activity can be carried on either within the firm or by a collection of autonomous contractors: that is, except for problems of opportunism, the same inputs can be used equally productively in a firm or in a market context" (1991: 142-143).

Conner's (1991) view is borne out by the central place given to opportunism by Williamson (1975, 1985). What Williamson is concerned with is the prevention of rent erosion. What the Knightian view emphasizes are the sources of all rents: opportunities. If economizing costs is taken to mean maximizing net transaction revenues, then the NC views converge with the Knightian perspective. When markets are perfectly competitive, maximizing collapses into economizing.

The discussion above shows that the difference between the Knightian and the NC views rests on whether price is determined exogenously to entrepreneurial choice or not. The Knightian view, which proposes that the choice of activity and the setting of price are the central entrepreneurial functions, can thus be considered a more general view, of which the NC view is a special case that applies when the condition of price-output certainty is present. Knight (1965[1921]) would not consider this special case to be particularly interesting:

> "With uncertainty present, doing things, the actual execution of activity, becomes in a real sense a secondary part of life: the primary problem or function is deciding what to do and how to do it. In the first place,… the producer takes the responsibility of forecasting the consumers' wants. In the second place, the work of forecasting and at the same time a large part of the technological direction and control of production are still further concentrated upon a very narrow class of the producers, and we meet with a new economic functionary, the entrepreneur" (p. 268).

In summary, two important differences follow from the two different worldviews on which the Knightian and NC views are based. First, the NC view assumes that the transaction in question can take place either in the market or in the firm, and that it is only the economization of costs that motivates the transaction to be organized within the firm (Conner, 1991). Knight proposes that firms come into existence because a particular transaction *cannot* be carried out in the market at a specified price. Second, under the NC view, the purpose of the firm is simply to combine inputs in an optimal way to produce a *given* final output (Boudreaux and Holcombe, 1989; Langlois, 1984). In the Knightian view, the output of a firm is not given in any sense; the judgment of what to produce is the most important role of the entrepreneur.

Normative foundations of the theories of the firm

All the stockholder theories have normative foundations, although they are rarely invoked explicitly. The normative foundation most often associated with the NC theories of

the firm, and economic theories in general, is consequentialism. Consequentialism is "an umbrella term for any moral theories that state that the rightness or wrongness, goodness or badness of an action is solely dependent on the results the action produces" (Flew, 1979). Although most accounts of the Coasian theories have descriptive and predictive bents, a consequentialist normative foundation is implicit in their arguments. For example, it is implicit in agency theory (Jensen and Meckling, 1976) that firms that resolve the principal agent conflict satisfactorily will perform better than those that do not. Jensen (2000) has also argued that two hundred years of research in economics has established that, in the absence of externalities and other market imperfections, social welfare is maximized when each firm maximizes total firm value. In transaction cost theory (Williamson, 1975, 1985), the argument is that economizing on transaction costs contributes to greater efficiency. Notwithstanding this consequentialist underpinning, one can easily offer an alternative normative account for the stockholder theories of the firm. Hasnas (1998) notes that

> "Although the consequentialist account is the most frequently cited in support of the stockholder theory, it must be noted that there is another, quite simple deontological argument for it, as well. This argument is based on the observation that stockholders advance their money to business managers on the condition that it be used in accordance with their wishes. If the managers accept the money on this condition and then proceed to spend it to accomplish social goals not authorized by the stockholders, they would be violating their agreement and spending other people's money without their consent, which is wrong" (p. 23).

The attacks by proponents of stakeholder theory on stockholder theories have both deontological and consequentialist justifications. As an example of the former, Freeman and Evan (1990) aver that stockholder theories encourage managers to treat non-owner stakeholders as mere means to the ends of the stockholders, and thus violate Kant's categorical imperative. The consequentialist justification for the attack is based on the premise that, under stockholder theories, non-owner stakeholders come out worse than they would under the proposed stakeholder model.

The response to the stakeholder attack on stockholder theories can be classified into two broad categories. The first has consisted in undermining the claims of stakeholder theory as a viable alternative by pointing out its myriad shortcomings (see, for example, Child and Marcoux, 1999; Goodpaster, 1991; Jensen, 2000; Langtry, 1994; Marcoux, 1998; 2001)[11]. The second has addressed the criticisms of stakeholder theorists, showing them to be ill-founded, and has defended the normative foundations of stockholder theories (for example, Boatright, 1999; Jensen, 2000; Williamson, 1984). Since stockholder theories should and can be justified on their own merits, rather than on the demerits of alternative models, we will focus on three responses belonging to the latter category.

A first response to the stakeholder attack is to refute the claim that stockholder theories advocate treating non-owner stakeholders unfairly. The position of stockholder theories is that managers owe a fiduciary duty to maximize stockholder returns *while complying fairly with the terms of the contracts of other stakeholders*. If the bargaining process is fair, then it is assumed that all stakeholders are able to exercise their preferences as autonomous rational agents. Therefore, the legitimate claims of non-owner stakeholders stand

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[11] Some of the shortcomings of stakeholder theory that scholars have pointed out are a) ambiguity about *who* is a stakeholder (Marcoux, 1998, among others) – for example, based on the definition of Freeman (1984), anyone who affects or is affected by the firm is a stakeholder. If this is so, then would thieves, competitors, activists, and the environment be considered stakeholders? b) ambiguity on how stakeholder interests ought to be prioritized (Langtry, 1994; Goodpaster, 1991); and c) the lack of a robust normative core, such as Kantian deontology, utilitarianism, or contractarian ethics (Child and Marcoux, 1999, among others). See also footnote 5 for the criticisms of NC theorists of stakeholder theory.

as constraints to the pursuit of stockholder interests. Furthermore, there is nothing in stockholder theories that prevents any stakeholder group from negotiating any privilege (Boatright, 1999). Employees, customers, and suppliers can become residual claimants, and entitle themselves to the fiduciary duties of managers and to voting rights; they can do this through ownership. As Hansmann (1996) points out, there are several examples of employee owned corporations. Indeed, the really interesting question is why the investor owned firm is so dominant in the institutional landscape (see Hansmann, 1996 for an interesting explanation). Stockholder theories leave the issues open, to be decided in the bargaining process. Any privilege or right has a cost, and it is not clear why residual claimancy, voting rights, and a fiduciary relationship with managers should be best suited to the interests of non-owner stakeholders.

A second response is to outline the special treatment necessary for those who contribute capital. For example, Williamson (1984) argues that "suppliers of finance bear a unique relation to the firm: the whole of their investment in the firm is potentially placed at hazard. By contrast, the productive assets (plant and equipment; human capital) of suppliers of raw material, labor, intermediate products, electric power and the like normally remain in the suppliers' possession." Williamson's argument points to the fact that investors turn over a stock of assets to the firm, and this stock can be substantially devalued immediately through the inappropriate decisions of management. Non-owner stakeholders only contribute flows to the firm in the form of labor in the case of employees, materials in the case of suppliers, and custom in the case of customers, and keep for themselves their stocks of assets – human capital, machinery, and personal wealth respectively. Child and Marcoux (1997) offer a similar defense for managers being fiduciaries for stockholders only.

> "Fiduciary obligations arise where the beneficiary has some special disadvantage, i.e., when he is especially vulnerable without the ministrations of the fiduciary. Passive investors have just such a disadvantage when trying to protect their investment against a management in control of the firm and in possession of all the requisite knowledge. So, the firm and/or its management has a stronger affirmative moral duty than mere contract or promise would imply. The fact that this duty is defined by law and set out as a legal obligation does not mean it is also not a moral one."

A third response is a purely consequentialist one, and focuses on the social welfare effects of stockholder theories. As Jensen (2000) states, there is more than 200 years of research in economics that supports the proposition that, in the absence of externalities, social welfare is maximized when firms seek to maximize firm value. There is also considerable empirical support for this position. For example, La Porta, Lopez-de-Silanes, Schleifer, and Vishny (1999) analyzed the legal systems of 49 countries and found that those that provided the highest protection to investors and creditors had the best economic outcomes – less concentrated control of firms, more valuable stock markets, larger number of listed securities per capita, a higher rate of IPO activity, higher savings, and a more efficient allocation of resources.

Since NC views are special cases of the more general Knightian view, the three responses discussed above can be made equally easily from a Knightian position. From a Knightian perspective, however, there is a much stronger defense of the investor owned corporation. Knight's insight clarifies the difference between risk and uncertainty, and states that uncertainty entails residual claimancy and ownership (the two being inseparable). In other words, residual claimancy and ownership are solutions to Knightian uncertainty. According to Gunning (1993),

> "it is worth showing how residual claimancy would be defended by an entrepreneurist. The entrepreneurist would maintain that the prospect of becoming a

> residual claimant by means of an employment agreement provides an incentive for an individual to bet that his or her appraisals relating to a team production project are superior to those of others. If the entrepreneur had to share the prospective earnings, he or she would not be as likely to bet" (p. 46).

The current investor centered model of corporate governance provides an incentive for individuals to recognize opportunities, in conditions of Knightian uncertainty, and to act on those opportunities by creating firms. By adopting Knight's insight, we realize that the investor owned model creates the incentive for a larger number of opportunities to be discovered than the stakeholder model would.

The Knightian view of the firm neutralizes the deontological justification for the stakeholder attack on stockholder theories by pinpointing the absence of a market for the entrepreneur's services as the reason for the existence of firms. If it were possible for the entrepreneur to trade her judgment for a fixed remuneration, she would willingly do so. It is only because no other economic agent is willing to pay her what she aspires for that a firm is born. Far from using the non-owner stakeholders as means to the entrepreneur's ends, the current model of corporate governance reconciles many more transactions with uncertainty, which would otherwise preclude them.

Knight's theory similarly neutralizes the consequentialist attack on stockholder theories by arguing that there is no Pareto improvement on the firm as conceived by stockholder theories, because the alternative to the arrangement proposed by stockholder theories is very likely to be the non-existence of the firm in question. In other words, the likelihood of a firm coming into existence is endogenous to the model of corporate governance. Stakeholder theory takes it as given that there will be a contract between the different stakeholders regardless of the content of the agreement on how the value created by the firm will be distributed. It only concerns itself with the most equitable distribution of privileges and obligations, taking for granted the existence of the firm. For this reason, the defects of the stockholder theories are not compared to the alternative of there being no firm at all; they are compared to the ideal of achieving a "balance" among stakeholder interests (Evan and Freeman, 1988).

The transition to a widely held corporation

We now take up the task of answering two questions that Knightian theory may be asked to explain. First, can it explain the transition from an entrepreneur-owned firm to an investor-owned one? This question is relevant to stakeholder theorists since they restrict their theorizing to public corporations with diffuse ownership; they invariably propose a stakeholder theory of the corporation, as opposed to a stakeholder theory of the firm. Second, since the corporate investor can diversify her holdings amongst several established firms, it can be argued that she does not bear Knightian uncertainty in the same way as the undiversified entrepreneur in the start-up firm does. If this is the case, what is the claim of the diversified corporate investor to a fiduciary relationship with the manager, to residual claimancy, and to ownership? Why is it not normatively appropriate for the diversified corporate investor to be denied at least some of the rights of the entrepreneur?

The answer to the first question proceeds as follows. No firm becomes a widely held corporation overnight. All firms start off as ideas that some entrepreneurs believe may be worth pursuing. With the actions of the entrepreneur over time, the Knightian uncertainty (structural uncertainty) over the idea gradually diminishes and moves towards the category of Knightian risk (parametric uncertainty). Typical entrepreneurial actions may include gathering information to calibrate the viability of the idea, combining resources to produce the first batches of a product, and selling the product to customers. As the uncertainty diminishes, the entrepreneur may reach two alternative conclusions: one, that the opportunity

is not as promising as she had envisaged, in which case she may exit the business, and the firm may cease to exist; two, that it is indeed an opportunity with long term profit potential, in which case she may decide to continue with it. If she decides to continue, then the business at some stage may need more resources for growth, which may necessitate bringing in outside investors. One way of doing this is to make an initial public offering (IPO), which paves the way for the widely held investor owned firm. Therefore, the shift from uncertainty to risk is what allows the entrepreneur to price the opportunity in the market.

As far as the second question is concerned, it is clear that the substantive normative argument based on Knightian uncertainty (outlined in detail in the preceding sections) is no longer available to the diversified investor; that is, the diversified investor does *not* bear Knightian uncertainty. We must resort to Nozick's Entitlement Theory (1974) to give a procedural normative foundation for the ownership rights of the diversified investor. According to Nozick (1974), if a holding has been justly acquired through transfer (in this case by the investor) from someone else entitled to the holding (the entrepreneur), then the acquirer (the investor) is entitled to the holding. Holdings in this case are the rights that attach to the ownership of the firm. To satisfy Nozick's Entitlement Theory, the transfer of ownership must pass two tests:

1. Does the entrepreneur have alternatives to transferring all his rights to the diversified investor? The answer is that he clearly does: he can choose to raise further capital through debt, which will not necessitate the transfer of ownership rights to the debt holders. Whether he chooses equity or debt then becomes an empirical question. The answer depends on many issues, such as optimal capital structure and moral hazard, which have been extensively covered in other literatures.

2. Is the right to acquire equity in the firm available to all constituencies? An affirmative answer to this question would satisfy Rawls's second (difference) principle, which states that social and economic inequalities "are to be attached to positions and offices open to all under conditions of fair equality of opportunity" (Rawls, 1996: 6). The answer to this question is clearly in the affirmative, since employees, suppliers, customers, and non-contracting stakeholders can all purchase equity in the firm.

Our argument up to this stage can be summarized in three points: first, the entrepreneur is entitled to the ownership rights by virtue of being the bearer of Knightian uncertainty; second, at the time of bringing in fresh capital into the firm, the entrepreneur has a choice between equity and debt instruments, and all the ownership rights are transferred to the diversified investor only if he chooses to issue fresh equity capital; and third, in those cases where the entrepreneur does decide to transfer the ownership rights, their acquisition by the diversified investor is just, because the purchase of ownership rights is open to all.

Yet, it is undeniable that the substantive normative justification for the ownership rights that the entrepreneur has by virtue of being the uncertainty bearer is not available to the diversified investor. We have at best been able to provide a procedural justification for the diversified investor having the same ownership rights as the entrepreneur, which we have grounded in Nozick's Entitlement Theory.

Rawls (1996) points out that procedural and substantive justice are not separate but connected.

> "I take the distinction between procedural and substantive justice to be, respectively, the difference between the justice (or fairness) of a procedure and the justice (or fairness) of its outcome. Both kinds of justice exemplify certain values, of the procedure and the outcome, respectively; and both kinds of values go together in the

sense that the justice of a procedure always depends (leaving aside the special case of gambling) on the justice of its likely outcome, or on substantive justice" (1996: p. 421).

Rawls (1996) further provides the illuminating example of constitutional mechanisms – separation of powers, supermajorities, bill of rights, and others – placing restrictions on majority-rule democracy. He argues that these constitutional mechanisms are necessary to ensure just outcomes, in spite of the fairness of majority-rule democracy as a procedure.

Rawls's discussion underscores an important point about procedures, including the bargaining and contracting procedures between the stakeholders to a firm: procedural justice by itself does not preclude unjust outcomes for the participants to the procedure. Therefore, notwithstanding the procedural fairness of the contracting procedures, all stakeholders (including investors) might need substantive protections against unjust outcomes.

There are three broad ways in which we might strive to achieve just outcomes for all stakeholders. The first is a macro-level remedy, which involves legislation requiring compliance by all firms. The laws of most countries provide many such protections, such as a constitution, the Occupational Safety and Health Act (OSHA) of the US, and the laws against discrimination in the workplace. These laws are also referred to as exogenous contracts, in that they are exogenously imposed on the contracting parties. The second is a firm-level remedy, which involves a "constitution" for each firm, whereby all stakeholder groups voluntarily make certain pre-commitments to each other. The third relies on the moral deliberation and judgment of the manager. Micro-level remedies have the advantage of being fine grained responses to particular problems, in contrast to macro-level remedies, which necessarily have to be applicable to a very wide variety of problems and contexts. We propose that exploring the pros and cons of each of these three remedies is an interesting area for future research in management.

Implications and conclusion

Several implications follow from our discussion. First, incorporating the Knightian insight into the firm-as-contracts view places value creation squarely at the center of discussions of normative corporate governance (see also Freeman and Phillips, 2002); it emphasizes that the number and quality of opportunities perceived is a function of the model of corporate governance adopted. Second, Knight's discussion facilitates a dynamic perspective on firms, from their entrepreneurial beginnings to their widely held corporate forms. This perspective alerts us to the fact that at the time of a firm's IPO, its ownership rights are already in possession of the entrepreneur(s), and if we accept the rights of an individual to the ownership and sale of private property, then it is difficult to argue against the entrepreneur's rights to sell his property (i.e., ownership) to investors. Third, our discussion offers two different normative bases, one substantive and the other procedural, for the entrepreneur owned firm and the investor owned corporation.

The just acquisition of ownership rights by diversified investors does not guarantee the justice of the outcomes that are enjoyed (or suffered) by them vis-à-vis those that are enjoyed (or suffered) by other stakeholders. A corollary to our argument is that stakeholders may need protection against unjust outcomes (similar to the constitutional protections enjoyed by the citizens of majority rule democracies) beyond what they negotiate in the contracting process. These protections need not always take the form of legislation; they could be internalized as corporate or managerial codes of conduct. We suggest that a fruitful avenue for research may be to examine empirically the unjust penalties suffered by different stakeholders who contribute resources to large organizations, with a view to formulating

preventive measures against them. According to Schleifer and Vishny (1997), “in large corporations of most countries, the fundamental agency problem is not the Berle and Means conflict between outside investors and managers, but rather that between outside investors and controlling shareholders, who in particular have nearly full control over the managers.”

It would also appear from our discussion that the justification for normative stakeholder theory does not need to be based on the normative shortcomings of the investor centered model of corporate governance. We have shown that the investor centered model is normatively sound, and that there is still room for normative stakeholder theory. For a practicing manager, the maximization of stockholder value can never be an easy refuge from difficult moral dilemmas, such as whether or not to close a factory and lay off workers in order to save costs by outsourcing production, while knowing fully well that the workers have very little chance of getting a new job. In the absence of extensive legislation or detailed corporate codes of conduct that mitigate the deleterious outcomes for stakeholder groups (including investors), the ethical values and the capability for moral reasoning of the manager may be the only guiding forces in the face of difficult decisions.

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