INVISIBLE TIES: IMPLICIT CONTRACTING AND ITS IMPLICATIONS FOR THE AGENCY RELATIONSHIP IN CORPORATE GOVERNANCE RESEARCH

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ABSTRACT

Research that applies agency theory to boards of directors suffers from being quite narrow as it does not recognize the true legal relationships between directors, managers and shareholders. Instead, the board of directors is best conceptualized as the principal, management as agents and stockholders' relationships as a mix of legal and implicit contracts. I propose a recast agency relationship and develop a contingency approach that proposes (1) how a corporation's goals vary with a board's implicit contracting and (2) a reconceptualization of the agency problem facing boards.

INTRODUCTION

Agency theory has long dominated corporate governance research. Over the past several years, however, scholars have increasingly called for a broadening of this agenda (e.g. Hillman & Dalziel 2003; Huse 2003). For some time critics appear concerned with the rather limited empirical advances (e.g. Garen 1994; Daily, Dalton, & Cannella 2003) and the narrow view of the role of human behavior prescribed in a traditional application of agency theory (e.g. Donaldson 1990; Jensen 1994). In particular, agency theory's focus on the monitoring role of the board of directors has seen exhortations for reinvigoration of the field (Daily et al. 2003).

These concerns with the application of agency theory are well justified, but neglect a key point – the true nature of the stockholder-board-management legal relationship. Research agendas in economics, psychology, management and law all highlight the importance of the stockholder-board-management relationship that is so central to traditional agency theory (Jensen & Meckling 1976; Fama 1980; Fama & Jensen 1983b). The traditional application of agency theory to corporate governance research positions the board as either a mechanism to control agency costs associated with the separation of ownership (i.e. stockholders) from control (i.e. management) (Eisenhardt 1989) or as ineffectual "pawns" irrelevant to agency costs where there is an efficient stock market (e.g. Lorsch & MacIver 1989; Walsh & Seward 1990). Consequently, research pays insufficient attention to the true nature of the relationship between stockholders, boards and management. Stockholders are not the owners of the corporation (Blair & Stout 1999; Bainbridge 2003), but rather residual claimants (e.g. Jensen 1988) and so any application of agency theory that equates stockholders with principals is a misspecification of any principal-agent relationship. This misspecification significantly underemphasizes the importance of context in determining a corporation's goals. Correctly specified, agency theory in corporate governance studies would conceptualize the board as the principal and the individuals in the corporation (i.e. individual managers and directors) as agents. Based on this recasting of the agency relationship, I employ contracting theory to develop a series of propositions that raise new questions for agency theory research into boards and directorship.

AGENCY THEORY AND CORPORATE GOVERNANCE

Agency theory involves one person (i.e. the principal) delegating work and authority to another (i.e. the agent) while retaining an interest in the outcome such that the agent is in a position to affect the well-being of the principal (Eisenhardt 1989). The so-called agency costs arise because of the 'distance' between the principal and the agent, which originates with the lack of direct and continuous observation of the agent's actions. Agency relationships are found throughout the business world in many forms. For instance, there are legal business to business agreements, such as formal agency contracts like franchising (Carney & Gedajlovic 1991; Combs & Ketchen 1999; Shane 1998, 1996) and individual to individual relationships such as when one person or a company employs another (e.g. Cadsby, Song, & Tapon 2007; Gerhart & Trevor 1996; Shaw, Gupta & Delery 2000).

One key stream of agency research involves studying the role of boards, stockholders and managers in the modern corporation. This stream of research has a prestigious and lengthy tradition founded on the problem caused by the separation of ownership from control (e.g. Berle & Means 1932; Jensen & Meckling 1976; Rutherford, Bucholtz, & Brown 2007; Smith 1776). It has an intuitive appeal to corporate governance scholars as the structure of the modern corporation mirrors that of the general theory. Stockholders (as principals) delegate the running of the company to the management (as agents) such that agency theory "provides the theoretical foundation for the vast majority of research conducted in corporate governance" (Dalton, Daily, Certo, & Roengpitya 2003: 13) and "is secure among the pantheon of conceptual/theoretical foundations" in the field (Dalton, Hitt, Certo, & Dalton 2007: 2). The widespread adoption of this argument has also attracted practitioners and policy makers who continue to develop advice, regulation and policy guidelines largely based on addressing this concern (e.g. see guidelines and advice from Australian Stock Exchange Corporate Governance Council 2007; Higgs 2003; Sarbanes-Oxley Act of 2002; Toronto Stock Exchange Committee on Corporate Governance in Canada 1994). Both academics and practitioners exhort prescriptive requirements or preferences for independent directors to control the potential problems brought about by the proposed agency relationship.

Agency theory in corporate governance research centers on the relationship between the shareholders, the managers and the board (Eisenhardt 1989; Hendry, 2002). In particular, it relies on shareholders, as owners, being the principal who delegate their power to run the company to the management team. Boards are then most often portrayed as a mechanism for controlling the potential misalignment of goals between principals (shareholders) and agents (managers) through monitoring, bonding and optimal contracting (e.g. Bebchuck & Fried, 2003).

The absence of stockholder-manager agency relationship

Despite its widespread adoption, this conceptual frame does not reflect the legal relationship between shareholders, boards and managers (Bainbridge 2003). In most common law and civil law countries courts have rejected the 19th century argument that boards of directors are trustees for shareholders or that a form of agency contract existed (e.g. Aglietta 2008). The basis of rejection is that the company is a separate legal person (Salomon v Salomon) not a trust or similar legal structure. Instead of a trust relationship, corporations in modern economies are governed by a statutory contract (called variously constitutions, articles and memorandums of association, and so on) where the respective rights, responsibilities and accountabilities of the parties to the contract are specified. In most cases (particularly for listed corporations), companies adopt standard clauses (or sections) that specify these powers.

The standard clause establishing general control of the company is contained in a provision that is strikingly similar across jurisdictions, namely that the company "*shall be managed by or under the direction of the board of directors*" (Corporations Act 2001(Aust) Replaceable Rule s198A; Delaware Code Title 8 § 141 (a); see also model Articles of Association under the UK Companies Act 2006). Quite simply, the contract in place establishes the company as a separate legal entity under the direction of the board of directors as *sui generis* (separate or unique body). There is no instrument of delegation from one party to another; prior to the formation of the contract there was no company and there was nothing to delegate.

Furthermore, just like a city, state or country, the separate legal person of the company cannot be "owned" in any legal sense (Bainbridge 2002b; 2003). A simple agency view of stockholders' rights most often employed in agency theory research ignores the benefits of incorporation. Incorporation means that stockholders are not owners, but rather residual claimants and one party to the statutory contract that makes up the legal person. As Stokes (1986: 164) highlights: "If…the company was viewed as no more than a contractual obligation between the members much like a partnership, it was difficult to explain why each stockholder should not be liable for the full extent of the debts, as was the case with a partnership."

More specifically, stockholders do not possess the attributes of ownership associated with an agency relationship. Stockholders do not have the power to direct a company to undertake (or refrain from undertaking) any particular action; that is the sole responsibility of directors whose powers are "original and undelegated" (*Manson v Curtis*). Boards are not constrained to focusing solely on shareholders interests. For instance, they are specifically allowed to take the interests of stakeholders into account when making decisions (*Shlensky v Wrigley*)[i]. Similarly, no matter how incompetent or egregious the behavior of a CEO, stockholders cannot appoint a new CEO, cannot approve or vary the CEO's remuneration package nor can they remove the offending individual, a position that does not reflect ownership of the company. Instead, "…the directors in the performance of their duty possess [the corporation's property], and act in every way as if they owned it" (*Manson v Curtis:* 562). Finally, stockholder claims to ownership are undermined by the inability of even a sole stockholder to deal with the property of the company. For instance, in the US it is well established that even a sole stockholder would be subject to trespass and/or conversion actions if they attempted to deal with the company's assets (*Clay Jackson Enters v Greyhound Leasing & Fin Corp*).

Logical review of the legal position makes it clear; stockholders are not owners. Instead, stockholders possess the right to any residual profit left after the other factors of production have been paid along with a number of quite limited and specific powers set out in a company's constitution (Blair & Stout, 1999). The most important stockholder power (which inadvertently gives credence to an ownership claim) is the power to appoint and remove directors, a point to which I return in the following section. Beyond this power, however, stockholders' influence is quite deliberately limited and would not be sufficient to be considered ownership under a legal definition that would require managers and directors to act in their interests.

Directors must act in the interests of the company as a whole

The conclusion that stockholders possess a residual claim (not ownership of the firm) does not suggest that directors have unfettered power. There is a clear fiduciary duty on directors and managers not to act self-interestedly (Kraakman, Hansmann, Davies, Hertig, Hopt, Kanda, & Rock 2004). Instead most legal systems clearly indicate that managers (and directors) need to act in the interests of the company as a whole (Companies Act 2006 s172; Corporations Act 2001 s181; Delaware Code Title 8 s121). The nature of what represents the interests of the company as a whole is developing, highly nuanced and often misunderstood. For ease of explanation, I concentrate on the meaning within the single jurisdiction of Australia to highlight that interests of the company as a whole represent more than simple stockholder interests. The conclusions are largely applicable across jurisdictions, and differences in interpretation would be worthy of a separate article.

In the Australian context (as in most other common law and international jurisdictions) sections 181 and 184 of the *Corporations Act (2001)* require managers to act in the interests of the company as a whole. This reflects a long and distinguished precedent in common law countries (e.g. the pre-eminent UK decision of *Percival v Wright*) that a director's duties are owed to the company as a whole and not to individual stockholders. The meaning of the phrase "company as a whole", however, is not self-evident and has been the subject of extensive debate, including two lengthy Australian Parliamentary reviews that reported their findings in 2006. The reviews considered whether directors and managers were obligated to act in the interests of stockholders. They concluded that the "interests of the company as a whole" meant more than just stockholders' interests and that directors were able to take other stakeholder interests into account.

4.31 The committee considers that this interpretation [i.e. shareholders' interests being paramount], like ***the shareholders' restrictive interpretation*** *and the short term interests interpretation**, is too constrained**. In addition,* ***... the committee does not agree that acting in the best interests of the corporation and***

acting in the best interests of the shareholders inevitably amounts to the same thing. *Consequently, the committee is not attracted to this interpretation.* [emphasis added]

The legislation that formed the basis of this investigation is mirrored in most other common law countries (for instance, legislation such as the UK's Companies Act 2006 and USA's Delaware Code Title 8) and interpreted by courts in broadly the same way. In the US, the Delaware courts have stated that the board has "a fundamental duty and obligation to protect the corporate enterprise, which includes stockholders" (*Unocal Corp. v Mesa Petroleum Co)*. The language of the Delaware courts makes clear that the company and stockholders are not synonymous and includes "creditors, customers, employees and perhaps even the community generally" (p. 955). Further, landmark US rulings on the business judgment rule make this clear (e.g. Citran v Fairchild Camera & Instrument Corp; also the provisions of company charters such as Digital Equipment (DEC) (Reder, 1989)).

In civil law systems, the codified nature of the relationship between stockholders and managers is more clearly defined. For instance, under Japanese Law there are formal rights for stockholders but few mechanisms that ensure that their interests are represented (Yamamura and Streeck, 2001). German law does not define an exclusive stockholder-management relationship, but rather constitutionalizes the representation of multiple stakeholders. In all cases, directors' fiduciary duties are clearly not owed exclusively to stockholders (Yamamura and Streeck, 2001) but rather to the corporation as whole (i.e. the separate legal entity).

Board of directors is Sui Generis

Since stockholders are not owners and directors must act in the interests of the company as a whole, boards cannot be correctly characterized as an agent (or representative) of stockholders. Recent, alternative contractarian theories (e.g. Bainbridge, 2003; Blair & Stout, 1999) have emerged to highlight that instead boards are *sui generis* – a legal body entirely separate from stockholders, serving the interests of the company as a whole (Aglietta 2008). Directors act as if they own the corporation (*Manson v Curtis*) and possess the right to make decisions for the corporation and act, for all intents and purposes as the mind of the corporation. This is an important and fundamental shift in our understanding of the role of directors specified in a traditional agency theory approach. It means that there is no underlying imperative to maximize shareholder wealth but instead maximize the welfare of the company as a whole through the pursuit of the company's objectives.

RECASTING THE AGENCY RELATIONSHIP: STAKEHOLDERS, STOCKHOLDERS, TEAM PRODUCTION AND IMPLICIT CONTRACTING.

Since boards are not acting as agents of stockholders, new approaches must address the way in which the board (as principal) determines its goals and the nature of the relationship between stockholders and the firm. Both team production theory (Blair & Stout 1999; Kaufman & Englander, 2005) and director primacy theory (Bainbridge 2003) can provide important starting points in analyzing these relationships as they recognize the legal position of the board as *sui generis*.

Team production theory and director primacy theory have their genesis in Coase's (1937) theory of the nature of the firm, a history shared with agency theory. All three theories are based on the concept that bringing together various factors of production increases output. Coase argued that the boundary of the firm exists where the costs of market transactions (and/or government intervention) are larger than the inefficiencies produced under the hierarchy (command and control structure) of the firm. Alchain and

Demsetz (1972) extended this transaction cost approach by representing the firm as a bundle of contracts between the factors of production. Their key insight was that in a team production environment there are information costs; it is difficult to tell who is exactly responsible for the outcome and shirking is possible. In the team production model, the entrepreneur (or owner or employer) contracts and monitors with all the factors to control information costs and claim the residual income. Agency theory extended this argument by highlighting that the contracting party in the modern corporation (i.e. manager) is now one of the factors of production and not the residual claimant (e.g. Jensen & Meckling 1976; Fama 1980).

Team production theory (Blair & Stout 1999) and director primacy theory (Bainbridge 2003) are more recent extensions of the team production approach. They both posit the board, rather than stockholders, as the contracting party in the relationship. Furthermore, the role of the board is not to claim the residual (Alchain & Demsetz 1972) but to act as a mediating hierarchy that distributes any residual rent (or surplus profit) across the factors of production (Bainbridge 2003; Blair & Stout 1999). The role of a stockholder is no longer as the key contracting party, but rather a factor of production with whom the board contracts. The board, as the mediating hierarchy, establishes a minimum set of contracts for each of the parties (obviously within the constraints of relevant markets) and then is charged with dividing any rents earned by the firm between the various factors of production (Hart & Moore 1990). If a firm makes a large profit, it is the board that decides what proportion of the excess return (or rent) should be given as bonuses to senior executives, paid to employees (either directly as incentives or indirectly through improved working conditions), paid as dividends, employed to improve supplier conditions or payments and so on. It is not given for granted that the residual will be given to the shareholders (Coff, 1999).

Thus, team production theory simultaneously overcomes the uncertainty involved in ex ante contracting in the firm and reflects the legal position that the board is *sui generis* owing its duty to the company as a whole (Blair & Stout 1999). In economic terms, the board is the ultimate decision maker in the firm and the last body to which a factor of production can "appeal" for a better deal. Legally, directors who form the mediating hierarchy are not acting in their own interests, but rather in the interests of the company as a whole. Thus, the courts will also uphold a board's decisions except where there is self-interested behavior or egregious negligence that calls into question their fiduciary duties to the company as a whole,[ii] a position that even ardent supporters of the shareholder wealth maximization recognize (e.g. Bainbridge, 2005; Baxt, 2009).

This approach, however, requires a reassessment of the goals or purpose of the corporation. Agency theory assumes the goals of the corporation originate with the principal (Eisenhardt 1989) even where the principal cannot specify their goal(s) (Hendry 2002). As a result of the predominance of agency theory, maximizing stockholder wealth remaining largely unchallenged as the goal of corporations, particularly in for-profit corporations (e.g. Roe 2001). This is in spite of theoretically different agency costs in different types of companies (e.g. closely held versus public companies (Easterbrook & Fischel 1986) and the complexity that we know exists in measuring and articulating what stockholder wealth means. For instance different classes of investors appear to favor different innovation strategies (Hoskisson, Hitt, Johnson, & Grossman 2002), international diversification strategies (Tihanyi, Johnson, Hoskisson, & Hitt 2003) and different time horizons (e.g. Sanders & Carpenter 2003). Thus, an important potential problem arising from agency theory (goal misspecification) is ignored by the current approach to agency theory in corporate governance research and instead focuses on a singular, unquestioned goal.

Rather than focusing on stockholder wealth maximization, team production theory suggests the goal of the firm is wealth maximization (Blair & Stout 1999). This is a subtle but important shift from the most widely held, though not universal, view that the role of the firm is to maximize stockholder value (Friedman 1970). Some classes of investors and firms (e.g. ethical investors; family-owned companies) and segments of society clearly establish that they do not subscribe to the strict expectation of stockholder wealth maximization and history suggests that the dominance of shareholder wealth maximization norm is cyclical (Sundram and Inkpen, 2004). Over the past 40 years, stockholder wealth maximization has become the default goal of companies, largely driven by a board's bounded rationality (March & Simon, 1958) and the almost unquestioned, universal adoption and teaching of agency theory (Ghoshal 2005).

Importantly, the default shareholder wealth maximization position does not reflect economic or legal constraints, but rather an implicit contract held by a particular kind of investor. In contrast, wealth maximization maintains economic efficiency as a key corporate goal but allows the board the flexibility to share the economic rents with the factors of production most responsible for its creation. It can, therefore, be viewed as more efficient than a pure stockholder wealth model as it allows the board to reward firm-specific investments (Barney, Wright, & Ketchen 2001) that contribute to competitive advantage. This focus on wealth maximization is also a more realistic representation of a corporation's goals. For instance, mining companies deal with multiple important factors of production whose support is essential - local communities, environmental groups, and, often, indigenous communities. Despite the rhetoric of stockholder value, there are clear signs that these firms take part in complex and expensive processes designed to engage the factors in the production process, often at the expense of stockholder value, at least in the short term. Measures of agency costs that rely on stockholder value are therefore only suitable in certain contexts, particularly in moderately dispersed shareholdings where the key stockholders hold this position (e.g. listed corporations where institutional investors hold strong positions) and the factors of production subscribe to this schema or have little relative bargaining power with the firm.

Viewing the board as a mediating hierarchy with a goal of wealth maximization repositions the firm as a fluid set of agreements comprising both legal and implicit contracts. It builds on the extant transaction cost literature (Alchain & Demsetz 1972; Blair & Stout 1999; Coase 1937; Easterbrook & Fischel 1986) by introducing the concept of implicit contracting. Implicit contacting uses a social exchange approach (Homans 1958) to examine the stockholder-board-management relationship and provides more insight compared with a traditional agency approach. It recognizes "the public corporation is as much a political adaptation as an economic or technological necessity" (Roe 1991: 10). However, it breaks from the traditional approach to studying boards of directors that concentrates almost exclusively on the internal struggle for power in a corporation. Instead, it provides a framework for understanding both the internal and external politics at work (e.g. see Davis & Thompson 1994; Huse, 2009; Pettigrew, 1992). In this way, the approach can be viewed as a bridge that allows research into how external factors affect the internal decision-making of the corporation.

General research into agency theory often indicates that a social exchange approach explains outcomes better than a traditional agency approach (Bottom, Holloway, Miller, Mislin, & Whitford 2006). For instance, social control mechanisms such as firm interdependence have been found to have "much greater predictive ability" than agency theory (O'Donnell 2000:525). Similarly, social exchange theory has proven superior in explaining extra-role behaviors (Deckop, Mangel, & Cirka 1999), variations in incentive intensity effects (Zenger & Marshall 2000) and why mechanisms designed to reduce agency costs (e.g. options) may actually increase self-serving behavior (Deya-Tortella, Gomez-Meija, De Castro, & Wiseman 2005). At the least, it may be a helpful approach in explaining the "diminishing behavioral returns to increases in monitoring and incentives" in senior executives (Zajac & Westphal 1994: 121).

Social exchange is based on implicit contracting. By implicit contracting I do not mean contracting in a strictly legal sense but rather "the attributions that people not party to the contract (i.e. outsiders) make regarding its terms, acceptance, and mutuality" (Rousseau 1995: 11). These expectations or contracts can take place (1) between an individual and a firm, (2) between a group or groups and a firm; and (3) between firms and the members of a society.

Psychological contract is the term used to describe an individual's implicit contract with a firm and is much studied in the employment literature (e.g. see Ho and Levesque, 2005; Rousseau and Schalk 2000). Specifically, psychological contracts are the "beliefs that individuals hold regarding promises made, accepted and relied on between themselves and another (employee, client, manager, organization)" (Rousseau 1995: 9). At their core, they "deal with the promises … organizations have made…" (Dulac, Coyle-Shapiro, Henderson, & Wayne 2008: 1079).

Evidence of different expectations between shareholders and shareholding groups suggests that psychological contracting is applicable to the stockholder-firm relationship. For instance, Ramsay and Noakes (2005) have documented that small, tightly held companies are the most likely to have actions to lift the corporate veil, suggestive of a clash of expectations for the company between different individual shareholders. Similarly, Schulze, Lubatkin, & Dino (2003) provide evidence of differences in expectations between stockholders who are members of a founding family and other stockholders. Different stockholder expectations may help explain why research has failed to identify consistent patterns between stock ownership patterns and firm performance (Dalton, Daily, Certo, & Roengpitya 2003). The "patterns" vary with the individual expectations of the various stockholders. Taken together, this evidence suggests that stockholders each have individual, unstated expectations and objectives (for instance regarding ethical conduct or time horizons) about their investment. These differences in expectations would make up an investor's psychological contract with the firm and, if violated, may lead them to react negatively[iii].

Normative contracts share the implicit nature of psychological contracts but instead describe the implicit contract between two groups. More formally, a normative contract is "the shared psychological contract that emerges when members of a social group (e.g. church group), organization (e.g. US Army, Xerox, United Way), or work unit (e.g. the trauma team at a community hospital) hold common beliefs" (Rousseau 1995: 9). While individual stockholders will have psychological contracts with the firm, there will also be a set of normative contracts surrounding different classes of stockholders. For instance, institutional stockholders may have a set of expectations for their investments that differs from other classes of stockholders such as Mom and Pop investors. Empirically, family dominated companies appear to favor different restructuring strategies to foreign investors (Chung & Luo, 2008) and there appear to be interactions between founding-family representation on the board and independent directors, suggestive of a conflict between these classes of shareholder groups (Anderson & Reeb, 2004). Similarly, Sanders and Carpenter (2003) along with Hoskisson, Hitt and colleagues (Hoskisson, et al. 2002; Tihanyi et al. 2003) highlight differences across stockholding groups due to divergent expectations and interests.

Finally, social contracts set out the expectations of society for companies. More formally, a social contract is "cultural, based on shared, collective beliefs regarding appropriate behavior in a society" (Rousseau 1995: 13). Where firms breach the social contract, they will often find themselves in the midst of public relations and political activity[iv]. Differences in social contract occur both between national systems and over time within a given system, but are most evident between different nations. For instance, Japanese firms have unique shareholding patterns, employment and culture (specifically, lower levels of individualism and higher levels of power distance) that are thought to impact on the mix of motives and incentives in corporations (Lee & O'Neill 2003). These differences have been shown to affect the transfer of financial resources between firms indicating "the need to account for both economic incentives and social context in corporate governance research" (Gedajlovic & Shapiro 2002: 565) in much the same way as Brass, Butterfield and Skagg (1998) propose that social embeddedness affects ethical behavior.

In summary, I contend that stockholders are not owners and that there is no legal duty owed by directors to maximize stockholder wealth. Therefore, agency theory is often misapplied in the field of corporate governance. Instead of focusing on a single relationship between the stockholders and the firm, a more general model can be developed by recognizing the nature of the board as a separate body that makes contracts on behalf of the firm and that implicit contracting plays a crucial role in determining the actions of the firm.

Implicit Contracting and the Nature of Board Decisions

Figure 1 provides an overview of the foundations of my propositions. The axes represent the various factors of production (Alchain & Demsetz 1972; Blair & Stout 1999), disaggregated into stockholders (on the x-axis) and other factors (on the y-axis). This separation reflects the special decision rights given to stockholders (Bainbridge 2005). In most Western jurisdictions (particularly common law systems), the firm's various factors of production have legal recourse if the firm does not behave in a minimally suitable way. For example, there are laws governing employment practices, the use of credit, payment of suppliers, monopoly power, and so on. The key factor of production that is not well protected is the stockholders, particularly as their position is that of residual claimants; they will only gain once all the other factors of production have had their contractual obligations met (Bainbridge 2003).

Insert Figure 1 about here

To remedy their economic and legal position, stockholders are given the little-used protective mechanism of electing and removing the board of directors. As the last factor of production paid, there is an economic imperative to provide stockholders the ability to sanction the board based on its adherence to the terms of the implicit contracts (Williamson 1983). There is also a strong legal imperative as a key feature of the corporate structure is the inability of a stockholder to sue the firm (see the rule in *Foss v Harbottle*[v]). To protect against these disadvantages, stockholders are provided with the mechanism to remove the people making the decisions with which they disagree.

A stockholder's ability to execute this protective mechanism is, however, contingent on the mobilization of a majority of the stockholder body. Consequently, the nature of the relationship between the stockholders and the firm will vary with the dispersion of shareholdings. The more concentrated the shareholdings, the easier it will be for each stockholder to articulate their desires and to summon the necessary voting power to make the changes required to bring those desires to fruition. In Tilly's (1978) terminology, the stockholders require the interest, social infrastructure and mobilization forces to effect change. In the extreme example of a single stockholding, that stockholder's objectives are easily identified and the threat of appointment and removal of directors is very real. At the other extreme, in a very widely dispersed shareholding the objectives of individual stockholders are likely to be highly variable such that there is little likelihood of that stockholder or group effecting change in the board room (Black 1990; Davis & Thompson 1994; Karpoff 2001) as mobilization is difficult. Instead, it is only when the board has transgressed a societal-wide stockholder expectation that change will follow. In this case, the breaching of the minimum societal expectations of stockholders will result in the requisite political action by stockholders to effect change due to the commonality of interest and the broadly supportive social infrastructure absent from individual interests.

Emerging evidence suggests that management does respond to stakeholder, particularly stockholder views. Westphal & Bednar (2008) found CEOs and top management teams use personal influence strategies such as ingratiation behavior and persuasion to influence institutional investors. Similarly, Westphal & Clement (2008) have demonstrated the positive and negative top management team behaviors towards security analysts that either recommend or criticize their decisions respectively. Thus, I would propose that:

P1: The dispersion of stockholdings is related to the nature of implicit contracting undertaken by the board of directors; specifically:

P1a: Boards of firms with concentrated stockholdings engage in psychological contracting with individual stockholders;

P1b: Boards of firms with moderately concentrated stockholdings engage in normative contracting with groups of stockholders; and

P1c: Boards of firms with dispersed stockholdings engage in social contracting that reflects broad market expectations.

The y-axis represents the *number* of other factors of production that have a strong influence on the firm's performance. This could include specialized labor, management, strategic suppliers, government co-operation and so on. It is important to differentiate between this construct (number of factors with influence) and the strength of influence of the various factors. For instance, Porter (1998) identifies the bargaining strength of suppliers as a key factor in his seminal five-forces model. While I acknowledge that the influence of each factor of production on a firm's outcomes will vary with context (Porter 1998; Sirmon, Hitt, & Ireland 2007), the proposed model differentiates on the *number* of factors on which a firm is reliant,[vi] not the power of the individual factors.

The number of factors with influence, just like the concentration of stockholdings, will substantially change the nature of the contracting. If there is a single key factor (or supplier) with power, then the ability of that factor to articulate its desires and its relative bargaining power will lead the board to engage in psychological contracting. The greater the board's ability to comprehend and respond to the objectives of the single important strategic supplier, the more likely they will be to secure the resources necessary for success.

Implicit contracting with the factors of production is more likely to reflect individual preferences in cases where the firm is faced with mostly perfectly competitive markets (e.g. low skilled labor, commodity inputs, competitive financing options, etc.). Somewhat counter-intuitively, the greater the number of factor markets that resemble perfect competition, the more likely that the board will be engaged in normative and, ultimately, psychological contracting[vii] because the relative bargaining power of the few critical factors will lead to their greater influence on the implicit bargaining process. As the number of factors with substantial influence increases, I contend that bounded rationality (March & Simon 1958; Simon 1982) makes psychological contracting (from both the firm's and the factors' perspectives) more and more difficult. Instead, a series of normative contracts will emerge with a variety of factors coalescing around shared expectations of what the corporation should do (Bainbridge 2005). There is a qualitative difference, for instance, between a single essential supplier (a monopsony situation (Robson 2004)) and a number of essential suppliers. If there are a significant number of essential factors, each will recognize the relative importance of the other and so their expectations will revert to social norms. They will recognize it is not feasible for a board to develop psychological contracts with each factor, particularly where the goals of each prevent normative contracting. Figure 1 highlights that as the number of important factors increases, the nature of board contracting expands from psychological to normative to social contracts and I would propose that:

P2: The number of influential factors of production is related to the nature of implicit contracting undertaken by the board of directors; specifically:

P2a: Boards of firms with few influential factors of production engage in psychological contracting with those individual factors;

P2b: Boards of firms with moderate numbers of influential factors of production engage in normative contracting based on groupings of those factors; and

P2c: Boards of firms with many influential factors of production engage in social contracting.

The proposition that boards respond to their external environment and set their goals based primarily on the operating environment is reflected in the literature on board symbolic action. For instance, Westphal & Zajac (1998: 127) demonstrated that "the stock market reacts favorably to specific governance mechanisms that convey the alignment of CEO and shareholder interests...even if such plans are not actually implemented". Rather than demonstrating the generalizable effect of an agency relationship, their findings are broadly indicative of the board managing the expectations of a key constituency through symbolic action. Such behavior and effects are to be expected under the model presented and contradict the general agency position where stockholders would ensure that espoused actions are implemented. This highlights how the traditional approach to agency theory in the firm may even be a reflection of the problem associated with bringing traditional economic (market) thinking to bear on resource allocation decisions within the firm; these are fundamentally different problems (Rumelt, Schendel, & Teece 1991).

RECASTING THE EXPECTED AGENCY RELATIONSHIP

A team production approach changes the application of agency theory in corporate governance research. The board of directors, not the stockholders, is most appropriately classified as the principal. This reflects the true nature of relationships at the apex of the company, namely it is the board that has the power and responsibility to (1) hire and fire management, (2) set the company's objectives and strategy and (3) review and alter the company's progress towards that strategy (*AWA Ltd v Daniels*; Delaware Corporations and Business Entity Laws §3.02(a)). As the esteemed UK jurist, Lord Denning, pronounced, the board is the mind of the corporation and management the hands and so a focus on understanding agency costs must shift from stockholder-management (Eisenhardt 1989) or board-stockholder misalignment (Black 1992) to board-management misalignment.

Research into the role of the board in strategy setting (Carpenter & Westphal 2001; Golden & Zajac 2001; Hendry & Kiel 2004; Jensen & Zajac 2004; Westphal & Fredrickson 2001) and key decision making (Forbes & Milliken 1999; McDonald, Westphal, & Graebner 2008; Pound 1995) can play a key role in understanding the agency costs that arise as a result of board-management misalignment. Importantly, if a board is the principal and a key problem in the agency relationship is the articulation of the principal's goals (Hendry 2002), the board's involvement in strategy will be directly related to agency costs. Involvement in strategic decision making will also allow the board to more closely monitor for moral hazard, more correctly articulate and monitor their risk position and lower the chances of honest incompetence (Eisenhardt 1989). Thus, I propose that:

P3: Involvement of the board of directors in setting the goals and direction of the corporation is inversely related to a corporation's agency costs.

Information asymmetry is a major cause of agency costs within any agency relationship (Eisenhardt 1989). In the context of the corporate governance research, this has most often been expressed as an information gap between management and the stockholders. When the stockholder is cast in the principal role, legal constraints (such as insider trading rules and continuous disclosure requirements) limit information provided to stockholders to publicly available information such as financial statements. Under a recast agency theory approach, however, both principals and agents have access to the corporation's internal information systems. Boards, under both models, have a right to all management information systems and any other internal sources, such as commercially sensitive data. Thus, agency costs arising from information asymmetry are reduced when compared with the traditional conceptualization of the agency relationship. While the legal rights of directors to access information may be quite clear, the degree of reduction in information asymmetry is moderated by two key factors, (1) the board's composition and (2) the board-management power structure.

In terms of composition, insiders are full time employees and so are thought to have a detailed working knowledge of the firm (Donaldson & Davis 1991). Outside directors are often recruited to fulfill legitimacy concerns, such as institutional pressures on a corporation to comply with best practice (Westphal & Zajac 1998), for instance to fulfill independence requirements. Even if these outsiders have similar access to information as inside directors, they will quite likely know less about the industry and firm and not be able to interpret the information as readily as an inside director. Therefore, the greater the number of insiders on the board, the lower the information asymmetry facing the board (Donaldson 1990).

Inside directors, however, also have an opportunity to act self-interestedly (Jensen & Meckling 1976). There are many high profile cases of such self-interested behavior where insiders consciously act in their own interests rather than those of the company (e.g. Enron, Worldcom, etc.) either consciously or unconsciously. Insiders, for instance, may be predisposed to take safer decisions than some risk-seeking factors of production, such as stockholders. Self-interest is, therefore, a countervailing force to information asymmetry and we could expect that either extreme (i.e. insider dominated or outsider dominated boards) would be sub-optimal. Outsider dominated boards are likely to suffer from information asymmetry whereas insider dominated boards are more likely to suffer from opportunism or subconscious bias. More formally I would expect that:

P4: There is a parabolic (U-shaped) relationship between inside/outside dominated boards and the presence of agency costs such that:

P4a: Insider dominated boards are more likely to suffer from agency costs brought about by opportunism and subconscious bias.

P4b: Outsider dominated boards are more likely to suffer from agency costs associated with information asymmetry.

The influence of board composition does not, however, take account of the firm's information architecture. Given a board's information flow will directly influence information discrepancies

between inside and outside directors, I expect that a firm's information systems moderate the relationship between board composition and agency costs and so I propose:
P5: The relationships between board composition and agency costs are moderated by the corporation's internal information architecture.

DISCUSSION

This paper is based on a bold assertion: decades of research have been based on the misapplication of a theory (agency theory) that has been central to the corporate governance research agenda. This claim is based on the strong legal precedent that establishes boards are a separate decision making body, not agents of stockholders nor a stockholder monitoring device (Bainbridge 2003; Blair & Stout 1999; Kaufman & Englander, 2005). Instead, I propose that the board enters into implicit contracts with the factors of production and the nature of these contracts (psychological, normative or social) vary with the number of factors that have strong bargaining power and the concentration of stockholders. Consequently, the predominant espoused goal of corporations, stockholder wealth maximization, is a specific contextual interpretation of the generic goal of corporations, wealth maximization. Finally, I provide a recasting of the agency relationship that aims to advance the corporate governance research agenda through examining the nature of the relationship between the stockholders, board and management of the modern corporation.

Implications for research

The implications of this recast of the relationship are potentially profound. While I have attempted to develop a limited series of propositions based on the relationship, I recognize that there will be many more avenues of enquiry than have been identified in the constraints of this paper. In fact, this approach to the agency problem opens up at least six fields of research that are focused on understanding the changed nature of the agency relationship.

First, a stream of research relating to the perceptions of board members as to their roles would appear to hold promise. Do boards who perceive their duty as being to stockholders act differently to those that see their duty to the company as a whole? How does this affect corporate decision-making, particularly surrounding stakeholder conflicts (real and perceived) and ethical dilemmas facing corporations? What are the constraints or contingent conditions that affect the ability of the board to exercise this freedom of decision? Measuring such perceptions may be possible through archival data coding (e.g. reviewing public statements of the board of directors in documents such as the Annual Report) or through direct measurement of director perceptions. There are numerous streams of research (e.g. the board and strategy (Hendry, Kiel & Nicholson, 2010; Zahra 1990), the board and monitoring (Rutherford, Buchholtz, & Brown 2007), executive remuneration (Conyon & Peck 1998)) where these director perceptions may provide new and exciting avenues of research. For instance, do boards that perceive themselves as acting for the company rather than stockholders engage in strategy more or less than those who see themselves acting for stockholders? And what are the effects on corporate performance, both financial and non-financial (e.g. ethical performance (Verschoor 1998))?

Second, an examination of the relationship between corporation context and the types of implicit contracting and goal setting undertaken by boards would hold promise for understanding the contingent nature of the work of the board. For instance, what are the goals that are set by boards of firms with highly concentrated ownership structures and how does this differ from moderately or widely dispersed ownership structures? How does a firm's relative bargaining strength affect its espoused goals? Are there better survival rates for firms with an implicit contracting position contingent with the model presented in Figure 1? Researchers could investigate these questions (and many others) using a number of methodologies. While stockholder concentration is relatively straightforward to measure, careful case analysis may be necessary to lay the foundation for the development of measures for factor concentration. Certainly corporate diversification and industry would appear to be initial points of departure for generalizing about factor of production concentration. Similarly, understanding a board's implicit contracting approach may require qualitative, survey or archival data analysis to isolate how a board approaches setting its goals, depending on the type of company under study.

Third, there are important implications for the research of internal governance structures of corporations. The predominant practitioner and academic focus on the role of the board in establishing goal congruence between managers and stockholders has provided at best mixed results (e.g. Dalton, Daily, Ellstrand & Johnson, 1998). If this pattern of results is due to the incorrect assumption that stockholders are the principals, the model presents a series of avenues for investigation with a correctly specified relationship. Research could investigate internal company governance processes, structures and policies that reduce information asymmetry and honest incompetence. There are also likely to be substantial differences in possible board configurations and information systems when the board is considered the principal, rather than a channel of communication to the stockholders. As a result, we need to better understand the role of executive and nonexecutive directors given these substantial changes in role of the board. Many of these structures and processes are identifiable through public documents (e.g. board structure, committee structure, board meeting attendance, board evaluation processes and so on) making the implementation of this element of the research agenda an exciting opportunity open to many approaches.

Fourth, this analysis highlights the importance of specifying the cause of the agency cost under study. Agency costs due to each source (i.e. opportunism, differences in risk preference, adverse selection and honest incompetence) are likely to occur under quite different circumstances and have quite distinct outcomes. We need to better understand these sources and consequences if we are to advance the research agenda. While this area may provide challenges, there are distinct bodies of the literature that appear to seek to better understand different elements of the agency costs.

Fifth, the concept of the board as *sui generis* offers a way of reconciling the potentially different perspectives of stewardship theory and agency theory. Both stewardship and agency theories are based on different conceptualizations of the stakeholder-corporate manager relationship (Preston 1998). Importantly, Preston notes that challenges of the widespread adoption of agency theory or stewardship theory relates to underlying assumptions. Either the principal must be "in a position to generate even virtual agency contracts" or the stakeholders involved must "be recognized as relevant clients by corporate "stewards" " (1998: 9). In the model proposed here, this assumption is removed and I suggest the criteria on which the recognition of factors of production occurs. Further work is required to understand what conditions may enable changes in social, normative and psychological contracts. For instance, social movement theory (Davis & Thompson 1994) may provide valuable insights into the legal and social structures and events that are necessary for such a major change in context to occur.

Finally, the suggested approach has potential benefit for researchers interested in understanding ethics and stakeholder approaches to corporate behavior. To date stakeholder approaches to governance and board decision making have concentrated on either an instrumental ethics approach (e.g. Kotter & Heskett 1992) that sees an organization taking stakeholders into account through enlightened self interest (Jensen 2002) or the "vague and poorly focused" duties to stakeholders generated by normative ethical reasoning (Quinn & Jones 1995: 23). Instead, I offer a reasoned argument that the moral duties of directors are their own to define as they owe their duties to the company, not any specific stakeholder group, including shareholders. With this foundation, scholars are justified in pursuing new forms of argument and enquiry to investigate ethical behavior of firms and the treatment of stakeholders.

Implications for practice

Just as the recasting of the board-management relationship provides fertile ground for research, there are several important implications for practice and public policy. The behavior of boards and their advisors during the global financial crisis derives in large part from the normative view of the board-stockholder relationship. A fundamental rethink of the relationship provides the opportunity to review how a board can execute its fiduciary duties.

The first key implication is that governance practitioners need to ensure their boards have sufficient time and resources to set the strategic direction of the corporations they govern. It is not a new conclusion to call for a greater understanding of the board's role in strategy (e.g. Zahra & Pearce 1989). However, the importance of defining strategic direction as a means of reducing the agency costs associated with the principal's problems (Hendry 2002) is a new insight. The theoretical rationale provides a focus for practitioners and public policy makers on what a board should do – clarify the direction and purpose of the company. It can provide a way for practitioners to differentiate between direction setting and implementation that clarifies the respective roles of directors and managers not necessarily evident in agency theory's definitions of decision control. The focus also highlights the importance of monitoring the company for strategic alignment with that direction and the ultimate decision control envisaged by both Fama & Jensen (1983a) and Pound (1995).

Second, understanding that the board is the principal should cause practitioners and public policy makers to think about board composition. Rather than being some form of agency cost reducing monitoring system (Eisenhardt 1989), the model outlines a far broader role that includes ethical and strategic overtones and provides guidance on the mix of board composition that is contrary to current market norms. Importantly, it highlights the need for a company's board to reflect its context, to have a greater capacity to engage in direction setting and strategic thinking and to balance the benefits of inside and outside directors.

Another important public policy implication of this approach is that regulators charged with ensuring the integrity of the corporate sector need to concentrate on ensuring the board (rather than investors) receive adequate information. Investors owe no duties to the other factors of production – in fact they are likely to be in competition with those factors for economic rents and so likely to make decisions in their interests rather than the interests of the corporate entity. The decision-makers best able to make determinations about interests of the entity are the board. To do so, it requires sufficient power and freedom. Regulators need to reflect on extant legal authority and enforce this ability to take stakeholders into account. Questions of market efficiency and equity are different from (though not necessarily less important than) agency costs; they are largely issues of transparency and reliability, not ones involving fiduciary relationships and need to be thought of in that light.

Finally, an explicit recognition of the various factors of production provides useful ways for practitioners to understand ethical decision-making. Given the model's links to the exercise of power, particularly the bargaining power of the various factors of production, it provides an interesting frame for understanding which kinds of company are likely to face pressures to change decisions.

CONCLUSION

We commenced this article with the aim of reviewing the application of agency theory in the corporate governance arena and to highlight that researchers and managers have paid little attention to the true nature of the relationship between stockholders, boards and management. As stockholders are not truly "owners" of the corporation but rather residual claimants (Blair & Stout 1999), any application of agency theory that equates stockholders with principals is a misspecification of any true agency relationship. Instead, we offer a conceptualization of the agency relationship with the board as *sui generis* principals to the management/agents. This recasting opens up exciting opportunities for the study of boards and the role they play in ensuring our companies are well run.

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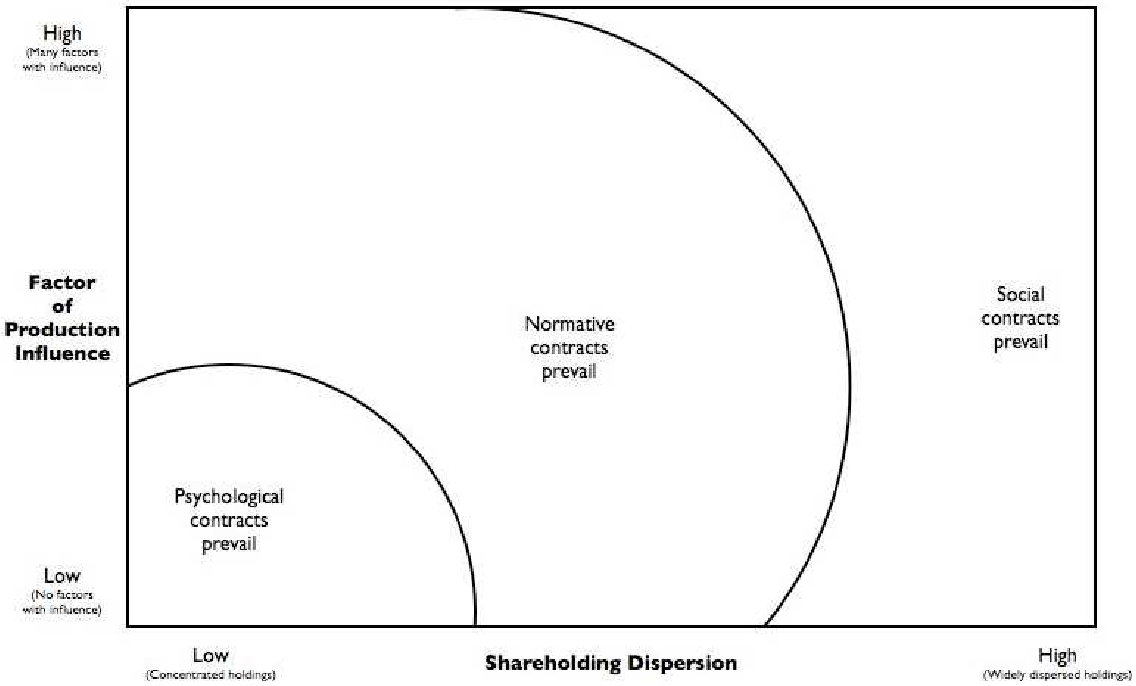

Figure 1: Implicit contracting and the firm's factors of production

Endnotes

[i] This is the general structure of corporations but can be varied with the reservation of powers to the stockholders in general meeting. This is rarely the case and would be highly idiosyncratic in a listed entity.

[ii] Of course, they will also intervene if there are specific legislated duties, but these are beyond the scope of this discussion.

[iii] The reaction could vary with context and the individual's position and may range from exit (selling their shares) to voice (raising issues through official channels such as the company's annual general meeting).

[iv] For instance, when James Hardie moved their legal structure offshore and avoided liability for asbestos-related injuries they had caused to both employees and customers, there was a widespread public backlash. The resulting Royal Commission found that while the actions of the company were entirely legal, they were not moral and the state government to threatened retrospective legislation to force the company to take responsibility for the liabilities.

[v] I acknowledge that this general position has been moderated by statute in various jurisdictions. However, the amendments to the rule in *Foss v Harbottle* still make very onerous requirements of stockholders wishing to directly take action when compared with the other factors of production.

[vi] A shorthand way of thinking of reliance is the nature of the market for the factor. If the market resembles perfect competition, there is little influence of the factor. The more it resembles a monopoly (from the target firm's perspective), the more likely we would classify the factor as having influence.

[vii] Unless all factors of production resemble perfect competition, in which case the key factor affecting the nature of board contracting will be shareholding concentration.