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Agency Theory, Institutional Sensitivity, and Inductive Reasoning: Towards a Legal Perspective

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ABSTRACT Making agency theory institutionally sensitive is a reasonable suggestion, as far as normal science stands. However, we argue that such a move has already been taking place, that it cannot address important problems with agency theory, and that the time is ripe for a critical re-examination of this theory. We suggest that inductive studies can not only be more sensitive to institutional features than deductive studies, but they can also offer deeper understanding of governance practices in specific contexts, as well as the potential for analytical or moderatum generalizations. Drawing from legal theory, we offer an alternative conception of the principal, and of the role and status of the board of directors. We contend that this reformulated agency theory has a greater potential of being institutionally sensitive because it recognizes various stakeholders as team members, rather than just adding specific institutional features as variables to the dominant conception of agency theory.

Keywords: abduction, agency theory, board of directors, induction, legal perspective

INTRODUCTION

Wiseman et al. (2012) suggest that if institutional features are taken into account as formal variables, in studies that retain the key assumptions and structure of agency theory, within a deductive research model, the applicability of agency theory to a variety of settings can be enhanced. In this manner, they aim to respond to critics of agency theory who noted that the theory is not applicable to institutional contexts other than the Anglo-American one. In advocating a deductive research approach, they also criticize inductive research, claiming that through its emphasis on context-specific issues, it is unable to offer generalizable propositions that can be applied across institutional settings.

Wiseman et al.'s (2012) call for making agency theory institutionally sensitive is a reasonable suggestion as far as normal science stands, within the current paradigm (Kuhn, 1962). However, we argue that such a move cannot address important and fundamental problems with agency theory, and that the time is ripe for a critical re-examination of this theory and the development of alternative conceptualizations.

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Drawing from legal theory, we offer an alternative conception of the principal, and of the role and status of the board of directors. In addition to being more in line with the legal context as well as with stakeholder expectations, we contend that this reformulated, legal agency theory has a greater potential of being institutionally sensitive because it recognizes various stakeholders as team members, and encourages in-depth, inductive research of actual decision processes in context, rather than just taking account of specific institutional features as variables within the dominant conception of agency theory and a deductive research approach, as Wiseman et al. (2012) argue.

We further argue that inductive studies are not only more sensitive to institutional features than deductive studies, but they offer a deeper understanding of governance practices in specific contexts, as well as analytical or moderatum generalizations with respect to corporate governance theory. Further, a recognition of the nature of firms as team production processes involving a variety of stakeholders, and the role of boards as mediators, within an inductive approach, encourages research which can lead to in-depth understanding of corporate governance systems in context.

THE NEED TO CHALLENGE THE NORMAL SCIENCE VIEW OF AGENCY THEORY

As far as normal science goes, Wiseman et al.'s (2012) call to make agency theory institutionally sensitive is reasonable. Indeed, their principal recommendation that institutional factors should be taken into account in studies adopting an agency theory lens, has already been implemented. Studies of Japanese corporate governance employing an agency theory perspective, for example, have shown how the national institutional context leads to selective appropriation and adaptation of the Anglo-American model of corporate governance and results in governance innovation and a diversity of corporate governance practices (Aoki et al., 2007; Yoshikawa and McGuire, 2008; Yoshikawa et al., 2007). Indeed, several empirical studies in a variety of institutional contexts have been conducted which incorporate institutional factors within an agency theory perspective (Aguilera and Jackson, 2010). Further, theoretical developments of how institutional factors may be taken into account within an agency theory framework to explain variations in corporate governance systems, have also been proposed (Aguilera and Jackson, 2003).

Wiseman et al.'s (2012) vision of the future of agency theory, in insisting that the basic features of the theory remain intact, would serve to accumulate evidence in support of the dominant paradigm, increase its influence, and safeguard root assumptions from challenge (Kuhn, 1962). By root assumptions we do not simply mean the propositions that interests of agents and principals may diverge, or that agents can pursue their own interests at the expense of the principal, both of which are valid. Rather, we refer to a need to question more fundamental assumptions, such as who should be the principal in the first place; and what is the status and role of the board of directors in the context of the agency relationship.

Wiseman et al. (2012) offer a prime example of good reasoning, albeit within a conditioned, instrumental rationality (Nozick, 1993). They focus on critiques of agency theory that can easily be countered because these assumptions involve ideal types, in a Weberian sense (e.g. the reductionist assumptions of atomistic, utilitarian, self-interested

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agents). They ignore critiques that are harder to respond to, such as, for example, the legally and theoretically questionable view of shareholders as the owners of the corporation (Learmount and Roberts, 2006); or the debatable conception of shareholders as principals, and of directors as agents of shareholders and monitors of managers (Lan and Heracleous, 2010).

Wiseman et al. (2012) thus propose an incremental extension intended to increase agency theory's applicability but without questioning its basic structure. Traditional agency theory masquerades in terms of economic rationality, and presents itself as universal, possessing objective, tight and unassailable logic, rather than as being the contingent product of a specific socio-historical moment; and Wiseman et al.'s (2012) suggestions are consistent with, and serve to buttress this. In this context we should distinguish between the agency problem, and agency theory. The agency problem is indeed real and universal, once a certain set of assumptions hold. That is, that there is someone (the principal) who asks someone else (the agent) to manage their investments or assets, in return for compensation, where their interests may or may not diverge, and there is information asymmetry. How these concepts and relationships are understood and analysed, however (agency theory rather than the agency problem), is not universal but historically and paradigmatically contingent.

Within a context of substantive rationality therefore, what is needed is an examination of the current state of agency theory that is capable of questioning its root assumptions. There are several reasons pointing to the desirability of such a challenge to agency theory. First, meta-analyses of empirical research do not clearly support the means suggested by agency theory to mitigate the agency problem (director independence, equity ownership, and the market for corporate control) (Dalton et al., 2007). Further, several scholars have questioned the control and self-interest oriented assumptions of agency theory (Davis, 2005; Ghoshal, 2005; Mizruchi, 1988), which are arguably more applicable to agency relationships in the Anglo-American model of governance rather than alternative models such as the Continental one. As such, agency theory assumptions are not entirely consistent with corporate governance systems characterized by collaborative behaviours (Sundaramurthy and Lewis, 2003) or situated in different contexts than mature market oriented economies, where other theories may have higher explanatory power (McCarthy and Puffer, 2008; Young et al., 2008). Further, these assumptions offer limited understanding of the complexities of real-world organizations, and in their focus on economic self-interests are inconsistent with the behavioural assumptions of agents as viewed in most theories of organization (Lubatkin, 2005). Finally, a legal perspective severely questions the idea that shareholders are the owners of the firm, and directors are their agents and monitors of managers (Lan and Heracleous, 2010). It is for these reasons that we must look beyond normal science and engage in new ways of examining agency theory as a foundational theory of corporate governance, as urged by scholars such as Daily et al. (2003) and Ghoshal (2005).

What is at stake here is not just conceptual understandings of agency theory, but also the influence of these understandings on practice, such as on actual decisions of directors. These can often be morally questionable, because directors, wedded to traditional agency theory assumptions, believe that they have to do everything in their power, with little or no leeway, to maximize shareholder returns (Heracleous and Lan, 2010). The

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vast majority of Fortune 500 directors surveyed cited this (mistaken) understanding when they said they would fell mature forests for profit, and release poisonous chemicals in the atmosphere if they are unregulated, to avoid the cost of investing in technology that would render these emissions safe (Rose, 2007).

INSTITUTIONAL SENSITIVITY AND THE ROLE OF INDUCTIVE STUDIES

Wiseman et al. (2012) propose a very specific way of understanding institutional diversity; incorporating specific institutional features as variables within deductive studies within a traditional agency theory perspective. Clinging to a vision of positivist science and its entailment of ever-expanding accumulation of additive knowledge, they propose that this approach can produce (statistical) generalizations that can hold cross-culturally, and in the process of making this argumentation they disparage inductive studies for being unable to produce such generalizations; going on to suggest that a comparative inductive approach 'misses the subtle differences within each setting'. Wiseman et al.'s (2012) vision reflects a machine metaphor of science (Heracleous and Jacobs, 2008) where each part has a clear, stable, and identifiable role to play in the great scheme of things, and assumes that knowledge is out there; all we have to do is discover it and link the pieces of the great puzzle together.

In criticizing inductive studies for being unable to offer statistical generalizations within their positivist view of science, and as liable to miss subtle features of institutional contexts, Wiseman et al. (2012) either misunderstand or choose to ignore the valuable role of inductive studies in being able to deliver rich, in-depth understanding of social (including governance) practices in ways that deductive studies cannot. Further, while inductive studies could produce analytical or moderatum generalizations (Payne and Williams, 2005), which could be used to inform further deductive studies, Wiseman et al. (2012) criticizing them for not being able to produce statistical generalizations is like criticizing elephants for being grey. It is not in their nature to be another colour, and they don't aspire to it either. In criticizing inductive studies for failing 'to yield a useful theory of agency' that can be universally applicable, Wiseman et al. (2012) evaluate all work though the procrustean bed of positivist science as well as traditional, economics, and finance-inspired agency theory.

An exclusive focus on the deductive model as the way to advance science ignores the interrelation and contributions of deductive, inductive, and abductive reasoning in knowledge generation (Burks, 1946), as well as the possibilities of theory building when researchers are confronted with doubts, mysteries, and surprises that they try to resolve (Alvesson and Karreman, 2007; Locke et al., 2008). Science progresses not just by deduction, but by a combination of these three types of reasoning, seen by Pierce as different stages of inquiry (Burks, 1946, p. 303). Deduction can only deliver knowledge along dimensions that are already included or assumed in the premises. Induction can offer analytical generalizations to the whole based on in-depth observations of a sample. Fundamentally new perspectives or insights however could be offered by abduction, a process of discovering new hypotheses which may involve instinct or a leap of logic, allowing for new understandings to emerge (Burks, 1946). Recent methodological work

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on the advance of organizational knowledge has built on Pierce's views on scientific discovery as the process of confronting surprising situations and resolving doubt through abduction (Locke et al., 2008).

FROM SHAREHOLDER PRIMACY TO DIRECTOR PRIMACY

Having noted that traditional agency theory (like all theories) is contingent on particular circumstances and theoretical understandings, in this section we briefly note the theoretical antecedents of agency theory in terms of shareholder primacy as well as the move towards director primacy.

Wiseman et al. (2012) accept that institutions matter, but in their scheme they matter only in a very specific way, only in as far as they influence the concerns of traditional agency theory (such as moral hazard, opportunism, and the design of contracts and other mechanisms to control opportunism). Institutional environments however should not (and cannot) be reduced to 'contextual antecedents', as Wiseman et al. (2012) suggest, mere attachments to the mighty agency theory. Institutions matter, more substantively, because they lead to a diversity of legitimate corporate governance systems, which could, but do not necessarily have to be seen in terms of traditional agency theory. In this sense, Wiseman et al.'s vision does not go far enough, remaining at the level of normal science rather than asking harder questions that challenge the foundations of agency theory.

Shareholder Primacy

Agency theory is not as universal in its nature, nor as universally applicable, as supposed. It is based on a historically contingent set of understandings and on specific theoretical streams, such as the shareholder primacy model in legal theory. Although the extent of global convergence of corporate governance systems around the shareholder primacy model is a matter for debate (e.g. Bainbridge, 2002b; Branson, 2001; Hansmann and Kraakman, 2001), this is the model currently in vogue in most common law countries such as the United States, United Kingdom, and Australia (Coffee, 1999).

Shareholder primacy is itself based on contractual theory (Phillips, 1994); if the firm is made up of contracts, the shareholders, as the principals of the contracts should have ultimate control. Management employed by the shareholders under contract is thus not in a privileged role, and as agents should be accountable to shareholders. The consequence of this arrangement is that management's overriding purpose should be to maximize shareholders' wealth, and as such should not engage in activities that are not financially beneficial to shareholders or overly risky.

The ideal corporate governance structure under the shareholder primacy model would create incentives to minimize agency costs and maximize shareholders' wealth. The primary function of the board in this view is to monitor the self-interested actions of the professional managers, as agents of shareholders, but the real control would still lie with shareholders (Eisenberg, 1976). Under the shareholder primacy model, corporate law should only focus on the welfare of shareholders, where all shareholders, including minority ones, are treated equally (Millon, 1990). Other corporate constituencies, such as

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creditors, consumers, employees, or suppliers, are advised to look elsewhere for protection of their interests, for example in contracts or statutes (Hansmann and Kraakman, 2001).

A specific legal ruling has been mistakenly held as support of this shareholder primacy model. In 1919, the Supreme Court of Michigan State in *Dodge v Ford Motor Co.* (170 N.W. 668, Mich. 1919) noted that management must conduct corporate affairs primarily for the benefit of shareholders, when it rejected Ford Motor's reasons for not paying a special $10 million dividend to shareholders. These reasons were an intention to plough back the funds, so as to increase production and employment, and ultimately to enhance stakeholder wealth. This case, however, which is most often used in law schools to suggest that directors' primary responsibility is to maximize shareholder wealth, has been called a wrong judgment, bad law that is both out of date as well as inconsistent with several other legal doctrines, and ignored by the courts, having been cited once as legal precedent in the last 30 years (and in that one time the citation was about the safeguarding of minority shareholder interests rather than the maximization of shareholder wealth) (Stout, 2008).

Director Primacy

Despite the tight logic of the shareholder primacy model, it has been observed that control over the corporation's assets and outputs does not in fact lie with the shareholders as principals, in terms of either corporate law or corporate practice (Bainbridge, 2002b; Stout, 2002). The shareholders of corporations with broadly dispersed shareholdings are generally passive, as originally pointed out by Berle and Means (1932). Further, corporate law in most Anglo-Saxon countries still confers complete management power in the hands of directors, not managers (Ferran, 1999; Welling, 1991). Although the law allows shareholders the powers to change the firm's corporate charters or constitutive documents, shareholders of most public corporations do not take advantage of these powers. Further, laws on shareholder voting power and derivative actions remain relatively weak, resulting in insufficient scope for shareholders to influence the corporation.

Legal scholars have recently explicitly argued that the shareholder primacy model is faulty and that empirical evidence has far from supported its accuracy (Stout, 2002, 2003); an argument consistent with a number of meta-analyses of empirical findings in the management field (Dalton et al., 1998, 1999, 2003). This argument prompted legal theorists to go beyond the 'standard model' (Hansmann and Kraakman, 2001) of shareholder primacy, leading to the development of the director primacy model, addressing the status and role of directors, as well as a re-conceptualization of who is the principal (Bainbridge, 2002a, 2002b, 2002c; Blair and Stout, 2001a).

Stout (2003) provocatively argued that contrary to the popular belief that shareholders may be the victims of opportunistic executives who could act to further their self-interest using corporate resources, as agency theory assumes (Fama, 1980; Fama and Jensen, 1983a, 1983b; Jensen and Meckling, 1976; Shleifer and Vishny, 1997), shareholders can in fact be exploiters of corporate resources as well (Stout, 2003, p. 677). Stout suggests that the relationship between shareholders and directors in a public corporation is not one of involuntary reliance on directors for want of a better alternative model to exercise

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control, but rather a voluntary relinquishing of power by shareholders, that is ultimately in their benefit. Stout likens the situation to the Roman mythology of Ulysses (the equivalent of Greek Odysseus): '[j]ust as the legendary Ulysses served his own interests by binding himself to the mast of his ship, investors may be serving their own interests by binding themselves to boards' (Stout, 2003, p. 669).

There are two variants of the director primacy model with respect to economic analysis: one based on the traditional nexus of contracts theory and the other on team production theory (Alchian and Demsetz, 1972; O'Connor, 1995). Bainbridge (2002a, 2002b, 2002c), the main advocate of the first variant, relies on the institutionalist version of the nexus of contracts theory to argue that in a public corporation, an authority-based decision making system is needed rather than one based on consensus to overcome the collective action problems faced by shareholders. A central decision maker with 'largely unreviewable authority' (Bainbridge, 2002b, p. 204) who has the power to effect adaptive responses to changing conditions due to asset specificity, bounded rationality and opportunism is an essential attribute of the firm. This central decision maker is the *nexus* of the firm and should in fact be the board of directors (Bainbridge, 2002b, pp. 203–4). As we note later, directors here are not seen as agents of shareholders who monitor managers, in the sense that the concept of agent has been conventionally understood in agency theory; but as 'autonomous fiduciaries' (Clark, 1985; Ferran, 1999), a term we explain further below.

Blair and Stout (2001a), proponents of the second variant, focus on the function of the board as a mediator rather than a monitor. In this variant, shareholders are not the only residual claimants of the firm (Easterbrook and Fischel, 1991), but other parties such as creditors, employees, managers, and local government make contributions in order for an enterprise to succeed, just like in a team production (Kaufman and Englander, 2005; Stout, 2002). Team production, according to Blair and Stout (2001a), is a complex productive activity involving several parties where the resulting output is neither separable nor individually attributable. The assets contributed are generally firm-specific and once committed to team production cannot be withdrawn and sold elsewhere for their full value.

Therefore, contrary to the economic assumption that parties are always free to negotiate the best deal that protects their interests in a contractual arrangement, contracts in the 'team production' setting are difficult to design so as to provide adequate incentives for each team member to make optimal contributions to the team (Blair and Stout, 2001a, p. 419). In consequence all parties willingly subject themselves to an independent body, a 'mediating hierarch' in the form of the board of directors, who will monitor their efforts and determine how each can best be rewarded. Corporate governance from this perspective thus aims to provide a structure that can maximize the sum of the risk-adjusted returns of parties in the team production process though the mediating function of the board of directors located at the top of the hierarchy (Blair and Stout, 1999, p. 264).

In the director primacy model of corporate governance therefore the board of directors is the central decision making body of the firm (Bainbridge, 2002a, 2002c, p. 204; Stout, 2002, p. 1199) and plays a mediating role, serving as a 'mediating hierarch' (Blair and Stout, 2001a, p. 404) among the various groups that bear residual risk and have

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residual claims on the firm where there is a conflict among corporate constituents (Stout, 2002, 2003).

TOWARDS A LEGAL PERSPECTIVE ON AGENCY THEORY

Having briefly noted the contingent nature of traditional agency theory, and its theoretical antecedents, in this section we draw from legal theory and precedent to present an alternative conceptualization of the principal, as well as of the status and role of the board of directors. We show that the legal systems of the United States and United Kingdom do not in fact support the traditional conceptualization of the shareholders as principals, pointing to the corporation instead. Further, directors are not seen as agents of the shareholders, but as autonomous fiduciaries; and not as managers' monitors, but as mediating hierarchs, balancing competing stakeholder claims on the corporation's resources. This conception not only challenges Wiseman et al.'s (2012) discussion, but also traditional agency theory on which their discussion is based. With regard to the particular issue of institutional sensitivity, we contend that this reformulated agency theory has a greater potential to be institutionally sensitive because it recognizes various stakeholders as team members, rather than just adding specific institutional features as variables to the dominant conception of agency theory.

The Corporation as Principal

The personification principle (the status of the corporation as an autonomous legal person) (Mark, 1987) means that the corporation is liable for its own debts, and can hold property, participate in commercial transactions, and engage in legal proceedings in its own name without engaging the shareholders (Farrar and Hannigan, 1998; Ferran, 1999; Welling, 1991). While shareholders own the shares and voting rights, they do not own the corporation, which is an autonomous legal person; the status that allows it to engage in commerce and that grants limited liability to shareholders in the first place. If shareholders were legally the owners of the corporation (rather than owners of the shares and associated voting rights), limited liability would not apply and they would be personally liable for the corporation's actions, something that would make commerce unworkable.

Under the law, and in contrast to traditional agency theory, boards of directors are accordingly expected to act on behalf of the interests of the *whole corporation*, rather than just those of shareholders. What is in the best interests of a corporation is now commonly judged by not only what advances the welfare of shareholders, but also its employees, customers, creditors, and communities. This is particularly apparent, for example, in the UK Companies Act 2006, section 172, which clearly requires a director to act in the way they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in the long term, as well as the effects on various stakeholders such as employees, suppliers, customers, and community. In the USA, although the legal position is not as clear as that in the UK, there has been a gradual shift in approach in recent years by some state statutes and judgments from a shareholder-oriented approach to one that requires the board to consider the interests of

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other stakeholders. This has been particularly apparent, for example, in takeover cases (Bamonte, 1995; Johnson and Millon, 1989; Mitchell, 1992) where boards can decide to accept lower offers if they believe that the interests of employees would be better protected (see, for example, *Norfolk Southern Corp. v Conrail Inc.*, 1996).

From a legal perspective therefore, the argument of classic agency theory that shareholders are the only important principals and should thus enjoy primacy over other stakeholders (Jensen and Chew, 2000; Jensen and Meckling, 1976) can be seen as too narrow as well as out of touch with legal developments. In this sense, the legal position is consistent with the view that a firm focusing solely on profit maximization but ignoring the interests of the other stakeholders can suffer long-term repercussions that may eventually lead to corporate failure (Cascio, 2002; Nixon et al., 2004). A legal perspective suggests therefore that agency theory should be redefined so as to recognize the corporation itself rather than the shareholders as the principal.

Directors as Autonomous Fiduciaries

As noted above, the shareholder primacy model, agency theory, and related governance research encompass the assumptions that boards are, and should be, subservient to the shareholders–principals; and that boards exist to act as primary agents of shareholders and to monitor managers. Directors' independence from management and the alignment of board equity interests with those of shareholders are therefore seen as paramount to mitigating the agency problem (Fama, 1980; Jensen and Meckling, 1976); a proposition that has received mixed empirical support (e.g. Bhagat and Black, 2002; Coles et al., 2001; Dalton et al., 1998, 2007).

Crucially, however, within the director primacy model (Bainbridge, 2002a, 2002b, 2002c; Blair and Stout, 2001a; Stout, 2002, 2003) the status of directors is one of 'autonomous fiduciaries', not merely 'agents' (Clark, 1985; Ferran, 1999). In law, a fiduciary individual is someone who is entrusted with the management of property or with the power to act on behalf of and for the benefit of another. One key feature of a fiduciary is their internalized trustworthiness (Mitchell, 1995, 1999), which sets a fiduciary relationship apart from a contractual one (Blair and Stout, 2001b). A person who accepts the role of fiduciary in law must single-mindedly pursue the interests of their beneficiary, in this case the corporation (Model Business Corporation Act § 8.30), even when the latter cannot monitor or control the fiduciary's behaviour (Blair and Stout, 2001b; Clark, 1985).

Most legal scholars and judges agree that the relation between a director and the corporation is unlike that between the normal agent and principal (as seen in agency theory) but is rather *sui generis* (a unique relationship in any type of corporate setting) (Bainbridge, 2002c; Clark, 1985; *Enyart v Merrick*, 1934; Harvard Law Review Association, 1941; *Regal (Hasting) Ltd v Gulliver*, 1942). This is because while directors are generally elected by the shareholders, once appointed they should be able to manage the corporation freely without frequent interference by the shareholders (Frankel, 1983) unless they are removed in accordance with the articles or the issue falls within the purview of the shareholders as mandated by the articles. To ensure success of the corporate enterprise, the directors must be able to make risky business decisions without

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fear of their decisions being second-guessed *ex post* (Marchesani, 2007). The emphasis that directors must be presumed to exercise independent judgment even if it may place the shareholders' interests below those of other stakeholders under the requirements of the law (for example, under section 173 of the UK Companies Act 2006 and under the American business judgment rule as well as by exculpation and indemnity rules) reinforces the directors' role as autonomous fiduciaries.

The director primacy model sheds some light on the wide discretion that the law offers to directors, the restricted rights of shareholders in bringing derivative suits, and the limited role played by shareholder voting (Bainbridge, 2002b; Blair and Stout, 2001a).

The Board as Mediating Hierarchs

As noted above, from the perspective of team production theory within the director primacy model, the public corporation is not a 'nexus of contracts (explicit or implicit)' but a 'nexus of firm-specific investments' (Blair and Stout, 1999, p. 275) and shareholders are not the only residual claimants of the firm. Given concerns of mutual opportunism, parties will be reluctant to invest in a team production without any mechanisms to safeguard their investment so they cede control over their investments to an independent third party in the form of the board, acting as a mediating hierarch. By doing so, they aim to reduce dependency between the members, reduce uncertainty, and avoid the transaction costs they would otherwise incur in having to negotiate *ex ante* more complete contracts to protect themselves from shirking by the other team members. In addition, they can also minimize the losses that would result from the reduced incentives to commit firm-specific resources by the various stakeholders if only one class of stakeholders, that is shareholders, is assigned the exclusive rights to the surplus while the rest of the stakeholders have limited rights to claim for their opportunity costs.

Whereas the concept of mediating hierarch has been noted in the management literature on corporate governance (Daily et al., 2003, p. 379), it has not been extensively developed or applied in this literature (for an exception, see Frey and Osterloh, 2005). Since the role of corporate governance here is to provide a structure that will maximize the sum of risk-adjusted returns enjoyed by all stakeholder groups participating in the firm, the challenge would be to devise a system of prioritization to assist directors in making choices among competing interests (Callahan et al., 2002). Lan and Heracleous (2010) suggest three criteria in this prioritization process: first, drawing from team production theory, the team-specificity of investment of each stakeholder (the higher the specificity the higher the claim); second, drawing from the behavioural theory of the firm, satisficing returns – that is, delivering returns that keep stakeholders content enough so that they sustain their support and contribution to the firm; and third, drawing from the contingency theory of intra-organizational power, the ability of stakeholders to help the firm cope with uncertainty, and their centrality and substitutability (Hickson et al., 1971).

For such a mediating role to work effectively, the board would need to be free from extralegal and political pressures to favour the demands of some constituencies over others (Millon, 2000, p. 1027). This would be more likely in a public corporation with dispersed shareholdings as compared to a closely-held firm where the major shareholders would be able to exert control over the board (Brioschi et al., 1989; Fama and Jensen,

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Table I. Outline of legal perspective on agency theory

	Traditional agency theory	*Legal perspective on agency theory*
Nature of the firm and unit of analysis	Firm is a nexus of contracts voluntarily negotiated among agents who are rationally selfish and individualist. Principal–agent relationships have to be configured so agency costs are minimized. Unit of analysis is the contract between principals and agents and minimization of agency costs.	Firm is a nexus of firm-specific investments involving team production. It is a complex productive activity where resulting output is not separable or individually attributable to specific team members. Unit of analysis is the firm-specific investment by each team member, and the mediation process.
Ownership of the firm	Shareholders, as owners of the shares and voting rights, also own the firm. This is what makes them principals, and entitles them to firm surpluses to the exclusion of other stakeholders.	The firm is an autonomous legal person, which is what allows it to engage in transactions, bear debt, and own property. While shareholders own the shares and voting rights, they do not own the corporation. The personification of the corporation is what grants shareholders limited liability in the first place, whereas directors have potentially unlimited liability.
Relationships among actors and nature of the principal	Shareholders are the principals, with management as their agents, and boards as monitors of management to ensure management decisions maximize shareholder returns. Assumption of goal conflict between principals and agents.	Corporation is the principal and board is a mediating hierarch. Other corporate stakeholders are team members, contributing in various ways and to different levels in team production process. Assumption of goal alignment among team members and between team members and board.
Status of directors	Directors are shareholders' first-order agents, monitoring managers who are second-order agents, to ensure maximization of shareholders' returns.	Directors are not agents in the traditional sense; their power and status under the law is *sui generis*; they are autonomous fiduciaries, entrusted to act in the interests of the whole corporation, to exercise independent judgment in doing so, and are afforded substantial autonomy by courts.

1983b; Leech, 1987). In other words, the mediating role of the board presupposes that the board acts as an autonomous fiduciary. The paramount consideration should still be acting in the interests of the firm as a whole, treating the whole corporation as principal rather than simply aiming for shareholder value maximization. Table I summarizes the above discussion.

DISCUSSION AND CONCLUSION

In this article we considered Wiseman et al.'s (2012) vision of the future of agency theory, which holds that if institutional features are taken into account as formal variables, in

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studies that retain the key assumptions and structure of agency theory, within a deductive research model, agency theory can become more applicable to various settings. This is an extension of an earlier position, where Gomez-Mejia et al. (2005) argued that 'the absence of an explicit recognition of context gives agency theory broad generalizability' (Gomez-Mejia et al., 2005, p. 1511). In advocating a deductive research approach, Wiseman et al. (2012) also criticize inductive research, claiming that because it emphasizes context-specific issues, it cannot offer generalizable propositions that can be universally applied.

We argued that Wiseman et al.'s (2012) suggestions remain within normal science and the current paradigm (Kuhn, 1962) of traditional agency theory studied within a positivist model. In this manner, important and fundamental problems of agency theory remain unaddressed, making the time ripe for a critical re-examination of this theory and the development of alternative conceptions. We drew from legal theory and precedent to offer an alternative conception of the principal, and of the role and status of the board of directors.

Our redefinition of agency theory not only aligns the theory more closely with the prevailing legal context but also strengthens its relevance to current thinking on the societal role of the corporation (Agle et al., 2008). Director primacy, and the status of directors as autonomous fiduciaries, shifts attention away from structural aspects such as board composition, towards such substantive aspects as director characteristics or board decision processes (Eisenhardt and Zbaracki, 1992). It encourages debate to go beyond such issues as the independent vs. dependent mix, or the nature of the resources directors may bring to the board, to include issues such as trust, integrity, ethical values, and personal cost to a particular director in the event of abuse of power, as major criteria in selecting appropriate candidates for board seats (Blair and Stout, 2001b; Schwartz et al., 2005).

Further, director primacy assumes that the social norms of careful and loyal behaviour sanctioned by law can be internalized by directors and form the basis for their internalized trustworthiness (Blair and Stout, 2001b). In this sense, the director primacy model is aligned with stewardship theory which assumes that agents are trustworthy, with intrinsic motivation and oriented to serving the collectivity rather than themselves (Davis et al., 1997; Mayer et al., 1995). This view implies that it would be more important to appoint directors who inspire trust, as 'a psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behavior of another' (Rousseau et al., 1998, p. 395) rather than merely based on structural criteria, or on simplistic concepts of independence.

Further, director primacy is consistent with stakeholder theory (Donaldson and Preston, 1995), in recognizing that constituencies other than shareholders have legitimate concerns and claims on the corporation. A stakeholder's level of importance to the corporation varies at different times, depending on the corporation's needs and contingencies, and the effectiveness of stakeholders to address them (Jawahar and Mclaughlin, 2001). This poses the challenge of prioritizing stakeholders, and in this respect we proposed three criteria to help directors address this challenge: stakeholders' team specificity of investment, satisficing returns, and stakeholders' ability to help the organization address critical contingencies (Lan and Heracleous, 2010).

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Having said that, corporate priorities are not necessarily a zero-sum game, as research finding positive correlations between a broader stakeholder corporate view of success, and higher financial returns to shareholders shows (Ruf et al., 2001; Waddock and Graves, 1997). As Jensen recently noted, 'stockholder value maximization has been wrong from the social viewpoint from the start . . . maximizing the value of a firm's equity will not produce maximum value of the firm as a whole . . . Maximizing total firm value will get us to the efficient frontier for society' (Jensen, 2008, p. 167).

In addition to being more in line with the legal context as well as with stakeholder expectations, our reformulated agency theory from a legal perspective can be institutionally sensitive to a more substantial degree because it incorporates various stakeholders as team members, rather than just taking account of specific institutional features as variables within a deductive research model. Careful study of board decision processes, for example, which could include mediation processes between various stakeholders, would not only provide access to an understanding of how boards in different contexts operate, but also to the importance and demands of different stakeholder groups in such contexts. Further, study of features of corporate governance in specific institutional contexts, such as principal–principal conflicts (Young et al., 2008) and how boards address these (or not), can shed light not only on board processes but also on how these processes are influenced by, and enact, institutional features.

Such studies could result in analytical generalizations based on induction or abduction, which could possibly then be taken up by deductive studies for operationalization and testing in various settings. Such analytical generalizations, for example, could relate to the types of decision criteria employed by boards when engaged in mediation processes, as well as the relative weights of these criteria. It is important to note that such criteria would need to be developed inductively or abductively through careful observation of actual board decision processes, rather than pre-assumed, as would be the model of a deductive research approach aiming to test such criteria. Pre-assuming these criteria would likely lead to inaccurate theory and wasted efforts to test it.

This is why, in response to Wiseman et al.'s (2012) strong support of an exclusively deductive research model and critique of the inductive model, we argued that a deductive model is unlikely to offer any new insights; firstly because of its reliance on knowledge and assumptions already assumed in its premises. Secondly, a deductive reasoning model that does not interact with inductive and abductive types of reasoning utilizes only a limited part of the scientific arsenal.

Analytical generalization, deriving from inductive or abductive reasoning is context-specific; i.e. a statement that applies within certain contextual and institutional conditions. While not satisfying the criterion of universal generalization and applicability, we argue that universal generalizability, a criterion derived from natural science, is not appropriate to social science given its subject matter (Burrell and Morgan, 1979), and has served more as a hindrance rather than an enabler to the development of organizational knowledge (Morgan and Smircich, 1980). The employment of inductive and abductive reasoning and research approaches encourages attention to what the data can tell us with respect to the subject matter under investigation and generation of hypotheses, rather than an imposition of preconceived assumptions on the nature of the variables and interrelationships among them. Such approaches are not only more sensitive to

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institutional features than deductive studies, but they can also offer a more in-depth understanding of governance practices in specific contexts, as well as analytical or moderatum generalizations with respect to corporate governance theory.

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