Corporate Stakeholders and Corporate Finance

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I. Introduction

The modern theory of the firm dates to Coase's [4] fundamental insight that firms exist as a substitute for more expensive modes of transacting. According to Coase, transaction costs in negotiating, contracting, coordinating, enforcing, and discharging rights and obligations under a set of contracts can be reduced by creating a firm that serves as a middleman between the consumer and the suppliers of inputs.

Coase's insight has been extended by Alchian and Demsetz [1], Jensen and Meckling [13], Williamson [30], Klein, Crawford, and Alchian [16], and Fama and Jensen [7, 8, 9], among others. Their contribution has been to view the firm as a set of interrelated con-

tracts among the various factor input suppliers and the purchasers of the final outputs. From this perspective, the firm's claimants go beyond stockholders and bondholders to include customers, suppliers, providers of complementary services and products, distributors, and employees.

Despite this view of the firm as a contractual coalition that includes both investor and non-investor stakeholders, the traditional emphasis of corporate finance has been on the firm's investors, and their evaluation of and response to the firm's changing economic circumstances. It is our belief that stakeholders other than investors and management play an important role in financial policy and constitute a vital link between corporate strategy and corporate finance. One purpose of this paper is to suggest several ways in which the inclusion of additional stakeholders leads to new interpretations of classic problems in finance.

A second focus of our paper is the distinction between explicit contractual claims that firms issue to non-investor stakeholders, such as wage contracts and
product warranties, and implicit claims, such as the
promise of continuing service to customers and job
security to employees. The distinguishing feature of
implicit claims, as we define them, is that they are too
nebulous and state contingent to reduce to writing at a
reasonable cost. For this reason implicit claims have
little legal standing. Typically, the firm can default on
its implicit promises without going bankrupt or
liquidating.

The distinction between the implicit and explicit
claims of stakeholders has yet to receive adequate atten-
tion in the finance literature. If only explicit claims
are considered, then stakeholders will not play an im-
portant role in the financial policy of most firms be-
cause their explicit claims are generally senior to those
of stockholders and bondholders. As long as the prob-
ability of financial distress is small, the explicit claims
of stakeholders are essentially risk free and, therefore,
cannot explain variation in the value of the firm. Thus,
when Titman [28] and Chung and Smith [3] study the
manager-stakeholder relation, they do so in the context
of models in which bankruptcy is a distinct possibility,
making the unstated assumption that if there is no
chance of bankruptcy, then stakeholder claims are un-
important. This view must be broadened when implicit
claims are considered. There are numerous examples
of firms defaulting on implicit claims, such as North-
ern Telecom’s sale in 1985 of digital switches that
were plagued by software and hardware problems and
lengthy delivery delays, without the firm being in fi-
nancial distress. One of the implicit claims that North-
ern Telecom sells is the promise that its equipment will
be free of glitches. Another is that it will deliver its
switches on time.

Because the payoffs on the implicit claims held by
stakeholders are uncertain, even when the possibility
of bankruptcy is remote, the value of these claims will
be sensitive to information about the firm’s financial
condition. Since the market value of the firm depends
on the price at which implicit, as well as explicit,
claims can be sold, management must take account of
the manner in which this information affects the prices
of implicit claims.

The remainder of the paper is organized as follows.
Section II further defines what we mean by implicit
claims and shows how these claims might be included
in an extended balance sheet. Section III addresses the
issue of how implicit claims are valued. In section IV,
we discuss some of the implications for corporate fi-
nancial policy of stakeholders’ implicit claims. The
final section summarizes the conclusions and presents
possible extensions of the analysis.

II. Stakeholders’ Claims and
the Extended Balance Sheet

Implicit claims are best illustrated by a simple ex-
ample. When Apple Computer company introduced the
Macintosh computer in January 1984, the company
promised that a file server, which is a fast hard disk
that can be connected to several machines, would be
available in the near future. Because the disk was not
yet fully developed, the costs to Apple of explicitly
stating what future characteristics the disk would
have were very high. Consequently, Macintosh customers
were sold an implicit claim that a competitive file
server would soon be available, but the exact nature of
the claim was never specified. For example, Macin-
tosh customers were not told exactly when the disk
would be ready for delivery, how it would be priced,
how many machines could be connected to it, or how
fast it would run.

A. Key Characteristics of
Stakeholders’ Claims

The example illustrates two key characteristics of
implicit claims. First, they are too nebulous and state
contingent to reduce to written contracts at reasonable
cost. Second, because implicit claims cannot be re-
duced to writing, they cannot be unbundled and traded
independently from the goods and services the firm
buys and sells. For example, while a Macintosh buyer
could choose to purchase an extended warranty, no
similar contract could be purchased ensuring the avail-
ability of a file server. Instead, the implicit claim that a
file server would be available was bundled with the
machine and sold as a package. Similarly, the manu-
facturer of a car, a pump, or a refrigerator implicitly
is committed to supplying parts and service as long as the
article lasts.

Implicit claims are purchased by other corporate
stakeholders as well as customers. When a firm hires a
new employee, he or she frequently receives promises
about the work environment, the evaluation process
and the opportunity for advancement, as well as an
explicit employment contract. Similarly, managers
typically have no formal employment contract, but
they often perceive an implicit contract that guarantees
lifetime jobs in exchange for competence, honesty,
loyalty, and hard work. Before deciding to carry a line of machines, a computer retailer frequently receives promises from the manufacturer about advertising and future products and enhancements. In a similar fashion, implicit claims are also sold to stakeholders, such as suppliers and independent firms that provide repair services and manufacture supporting products. One can think of these claims as a part of the compensation stakeholders receive for choosing to invest in firm-specific human and physical capital. In this context, stakeholders also receive an implicit promise that they will not be subject to opportunistic behavior by the firm.\(^2\)

The fact that implicit claims cannot be unbundled and sold apart from the firm’s other business dealings has two important implications. First, the risk associated with holding these claims is difficult to diversify. For example, an employee who receives an implicit claim from the firm that he will not be terminated except under extraordinary circumstances can neither market that claim nor buy similar implicit claims from other firms to protect him in case the company does default. Second, because the risk associated with holding implicit claims is difficult to diversify, total risk, measured by the variance of the firm’s real cash flow, plays an intriguing role in our model: it can alter the value of the firm without affecting required returns.\(^3\)

To illustrate how this occurs assume that the capital asset pricing model holds and the risk-free rate is zero. Under these circumstances, the value of the firm should not change if it undertakes an investment that increases the total risk of the firm and that has an expected return of zero, as long as the return on the investment is uncorrelated with the return on the market portfolio. In our model, however, undertaking such an investment causes the value of the firm to fall.\(^4\)

\(^2\)See Klein, Crawford, and Alchian [16] for a further analysis of this issue.

\(^3\)This is the same conclusion as that of Shapiro and Titman [27].

\(^4\)Shapiro and Titman [27] provide a detailed discussion of the effect of total risk on cash flow and explain how companies are likely to respond when designing financial and other policies.
gives a more realistic picture of the firm’s assets and liabilities. Organizational capital, OC, equals the current market value of all future implicit claims the firm expects to sell. Organizational liabilities, OL, equal the expected costs, from the firm’s standpoint, of honoring both current and future implicit claims. In this context the firm creates value by selling implicit claims at an average price that exceeds the average cost of honoring them.

Though it is a handy tool, the extended balance sheet masks two key issues. As defined, organizational capital and liabilities are clearly interrelated. The price at which the firm can sell implicit claims depends on the payoffs stakeholders expect to receive on their claims. The payoffs, in turn, are related to the firm’s expected costs of honoring the claims. The problem is complicated by the fact that managers and stakeholders may have different information. For example, the price at which Apple Computer can sell its promise to supply a file server depends on what customers expect of the new product. Those expectations may be based on different information than that available to Apple engineers or to the investment community. Though a formal model for the valuation of implicit claims is beyond the scope of this paper, the issue is analyzed further in section three.

The extended balance sheet also fails to address the question of how shareholders capture the value of the net organizational capital, OC – OL. Is it simply a return on past investment in reputation and organizational structure? Though this is an interesting problem, it is not the focus of this paper. Therefore, we assume that at time zero firms differ in their net organizational capital for some exogenously determined reason(s). Our goal is to explore the implications of these differences for corporate finance.

To highlight the role of organizational capital, we assume in the remainder of the paper that the sale of implicit claims is the firm’s only ex ante source of positive net present value projects. That is, we assume that every firm has access to the same production technology, and that the products produced by each firm would be judged to be functionally identical by an expert who studied them. This ensures that the excess of the market value of equity over its book value equals the firm’s net organizational capital.

III. The Valuation of Implicit Claims

The issues involved in the valuation of implicit claims are enormously complex. The example of IBM's PCjr illustrates some of these issues. The price at which IBM sold the PCjr included both the price of the hardware and the prices of the implicit claims for future support, software, product enhancements, and the like. As it became clear that PCjr’s success in the market was limited, IBM faced a difficult decision. If the company chose to discontinue the product line it would clearly lessen the organizational liabilities connected with PCjr. On the other hand, discontinuing the product reduces the payout on implicit claims previously issued by the company, which in turn reduces the firm’s organizational capital by causing the prices of future implicit claims to fall.

If the value of the implicit claims that IBM could sell with future PCjrs were less than its estimated cost of honoring those claims, IBM would clearly choose to discontinue the PCjr as long as there was no spillover effect on the prices at which IBM could sell the implicit claims bundled with its other products. Unfortunately, there is no guarantee that the spillover effect will be small. Even if a company sells vastly different products, many of the implicit claims bundled with those products, such as promises of timely delivery, continuing service and parts, and future enhancements, are similar. The failure to deliver the expected payoff on the implicit claims sold with one product will lead stakeholders to doubt whether other implicit claims will be honored. For firms such as IBM that choose to identify all their products with the company name, the spillover effect is likely to be particularly strong.

Of course, a company does not have to choose between making the expected payments on implicit claims or cutting payoffs to zero. Instead, there is a continuum of possible payoffs and the company will choose the level of payment that maximizes the current value of its net organizational capital. In the case of

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5Prescott and Vischer [22] define organizational capital as the quantity of information about employee and task characteristics possessed by the firm. Such information clearly affects the firm's ability to market implicit claims, but its value need not equal the present value of the future proceeds from the sale of implicit claims. Thus, their definition of organizational capital differs from ours.

6The problem of optimal investment in reputation is examined by numerous authors including Dybvig and Spatt [5], Klein and Lefler [17], Kreps and Wilson [18], and Shapiro [25, 26].

7It is interesting to note that by U.S. law domestic vodkas must be identical in taste. Despite this, vodka prices are widely dispersed by brand.

8One implicit claim the company sells is a promise to continue producing the product, since the stream of service, support, and repairs current owners can expect depends on future production.
IBM, the company chose to discontinue the production of the PCjr, but it also undertook a major advertising campaign to let PCjr owners, and other stakeholders, know that “If you own a PCjr you can be sure it is still a well-cared for member of the IBM PC family.” Specifically, IBM promised to provide parts, service, and support for five years. By contrast, when Exxon’s office systems division performed poorly, Exxon chose to eliminate the entire division and provided minimal support for customers and other stakeholders of that division. One explanation for this decision is that the spillover effect was less for Exxon, since office products are not related to its main line of business.

No matter what IBM initially planned to pay on the implicit claims it sold with PCjr, the amount it decides to pay _ex post_ will be chosen to maximize the current value of net organizational capital. In addition, rational stakeholders will recognize that it is in IBM’s interest to act opportunistically _ex post_. As a result, the price stakeholders pay for the implicit claims IBM sells with PCjr will fall as new information reveals that it is in IBM’s interest to reduce the payoff to those claims. This is one explanation for the decline in the price of PCjr relative to competing microcomputers as market problems with the PCjr became apparent.

The primary implications of this example may be summarized as follows. First, the price stakeholders will pay for implicit claims depends on their expectations of future payouts. In forming those expectations stakeholders recognize that it is in the firm’s interest to maximize net organizational capital _ex post_. Thus, if stakeholders have no information about any firm, they would expect every firm to promise the maximum payout _ex ante_, but only to deliver the amount that maximizes the _ex post_ value of net organizational capital.9

Recognizing the position of stakeholders, firms anticipating that it will be in their interest to make high payouts _ex post_ will want to certify themselves _ex ante_.10 This would be a relatively easy signalling problem were it not for the fact that the amount firms decide to pay _ex post_ depends on the impact that their decision has on stakeholders’ expectations. For example, if IBM believed that halting production of PCjr would have a significant impact on prices of the implicit claims it sells with its other machines for an extended period, the company would still be making PCjr.

In a dynamic world opportunism is not the only problem that complicates the flow of information between managers and stakeholders regarding future payoffs on implicit claims. It is possible that some firms will incorrectly conclude that it will be in their interest to make high future payouts on implicit claims and thereby choose to bear the current certification expenses. For example, Apple’s management may believe that the costs of developing a high speed file server are going to be low when in fact they are high. This “incompetence” distorts the certification procedure by making signals more noisy.

The value of implicit claims also depends on the incentive stakeholders have to do their own research. The buyer of a mainframe computer system will invest more resources to determine the probable payoff on the implicit claims bundled with the machine than the buyer of a home computer. In addition, different classes of stakeholders typically have different incentives. In the case of a shipbuilder, for instance, the incentive of individual employees to gather information about the payoffs on the implicit claims they purchase is less than that of the customers.

Stakeholder incentives to gather information in turn affect the certification procedure the firm chooses. Ongoing negotiations are possible if the firm has only a few large stakeholders of any one type, such as defense contractors. The situation is quite different for firms, such as Proctor and Gamble, which sell implicit claims with small expected payoffs to millions of stakeholders.

Finally, the certification process will be affected by regulation. When the government regulates a utility it simultaneously guarantees the implicit claims of stakeholders, such as customers and suppliers. For this reason one would expect utilities, and other regulated firms, to invest fewer resources to certify themselves.

### IV. Predictions for Corporate Finance

From the standpoint of corporate finance, stakeholder theory allows us to make several interesting cross-sectional predictions. First, the manner in which the prices of the firm’s securities respond to new information is likely to depend on the firm’s net organizational capital and on the nature of its stakeholders. Second, as we noted in the previous section, firms that expect to provide high payoffs on implicit claims will attempt to distinguish themselves _ex ante_. Under some circumstances, this can be done by choosing the appro-

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9 This conclusion is a variant of Akerlof’s [2] lemons model.

10 Note that the firm cannot postpone the sale of implicit claims until stakeholders have more complete information because the claims are bundled with the goods and services the firm buys and sells.
appropriate dividend payout rate or financial structure. It follows, therefore, that financial structure may also depend on a firm’s net organizational capital and on the nature of its stakeholders.11

A. Response of Security Prices to New Information

Announcements of earnings, dividends, stock splits, ratings changes, and the like provide information to both investors and other stakeholders. If investors are rational, the response of stock prices to this news should reflect investors’ assessments of the reaction of other stakeholders to the information.

In the context of our model, two related factors affect the manner in which security prices respond to information. The first is the amount of the firm’s net organizational capital. The second is the extent to which the information is “news” to stakeholders. It is important to note that the same information may be news to some stakeholders but not to investors. Since many stakeholders do not have the incentive to become as well informed as investors, stock prices may respond to events — such as stock splits, ratings changes, exchange listings, and name changes — which, ignoring the role of stakeholders, might otherwise be predicted to have no impact on value.12

Consider, for example, the case of stock splits and stock dividends. In a comprehensive study Grinblatt, Masulis and Titman [10] find that announcements of both stock splits and stock dividends are accompanied by positive abnormal returns. One possible explanation is what they refer to as the “attention hypothesis.” That is, stock dividends and splits call attention to the firm, triggering reassessments of the firm’s prospects by market analysts. While underpriced firms find such reassessments in their interest, overpriced firms do not.

The problem with applying the attention hypothesis to analysts is that it seems implausible that professionals require such an expensive and indirect signal to take a closer look at a company. The same is not true of many stakeholders, however. A company with

500,000 diverse stakeholders may find a split or a stock dividend the most cost effective way to attract attention.

The fact that stock splits and dividends tend to follow a significant increase in the company’s stock price is typically attributed to management’s desire to keep the price of their shares within a customary trading range. Stakeholder theory offers a second explanation. When times are good, managers want to convey that information to stakeholders in order to increase the price at which they can sell implicit claims. A split is a particularly effective way to do this because the financial press will discuss the company’s recent history when reporting the announcement of the split. Thus, not only does the company receive free publicity, but also the story of its recent success is reported as news, backed by the reputation of the financial press.

The stock price response to such announcements should depend both on the firm’s net organizational capital and on the nature of its stakeholders. For example, the prices of regulated utilities should respond less to announcements of stock dividends and splits than typical manufacturing companies. In addition, the abnormal return is likely to be a decreasing function of firm size, since the benefit of free publicity should not exceed the cost of directly disseminating the information.13

Under normal circumstances implicit claims have components that are analogous to bonds in that the maximum payoff is fixed. In our PCjr example, for instance, the payoff on implicit claims provided by IBM is unlikely to increase much beyond the company’s initial promises no matter how successful the product. Similarly, a firm that typically delivers reliable products on schedule is unlikely to significantly improve its performance when earnings are high. On the downside, however, stakeholders face significant risk. If a company runs into financial difficulty the payouts on implicit claims may be cut substantially.

This asymmetry provides an explanation for Holtzhausen and Leftwich’s [11] findings that bond rating downgrades are associated with statistically significant declines in stock prices, but that upgrades do not cause a significant increase in price. Although both investors and bond rating agencies have similar information,

11Following Fama [6], a firm’s financial structure includes all contracts calling for payments to stakeholders, not just contracts calling for payments to investors.

12A recent paper by Karpoff and Rankine [15] reports significant stock price increases following name changes. Furthermore, the evidence indicates that the magnitude of the increase is related to the firm’s net organizational capital.

13It should be stressed though that the benefit will exceed the cost of simply placing an advertisement in the newspaper which reproduces what a news story would say, because the ad is not backed by the reputation of the press.
investors are not able to predict exactly if, or when, a rating change will occur. In addition, stakeholders may not be as well informed as investors and bond raters, so a drop in the bond rating will cause a decline in the payoff stakeholders expect to receive. As a result, the prices at which implicit claims can be sold, and thus corporate cash flow, will be expected to drop, and investors will bid down the price of the stock. The bond rating effect is much weaker for upgrades because of the asymmetry in the payoffs to implicit claims. Finally, stakeholder theory predicts that the stock-price response to ratings changes will depend upon the nature of the firm’s stakeholders, on its stock of net organizational capital, and on the extent to which any ratings change is publicized in the financial press.

B. Signalling Models

One problem that occurs when applying signalling theory to finance is that managers must be given an incentive to signal now rather than waiting for information to filter out to investors and the stock price to reach equilibrium. Ross [24] solves this problem by assuming that managerial compensation depends on the current stock price. More recently, Miller and Rock [20] and John and Williams [14] assume that managers maximize a weighted average of current and future stock prices to protect the interest of shareholders who choose to sell during this period. In all these models, however, it is taken for granted that managers are trying to provide information to investors; rather than to non-investor stakeholders.

Signalling models can also be developed within the framework of stakeholder theory. In this context the fact that implicit claims are bundled with the goods and services a company buys and sells provides a natural motive for signalling. Current cash flow is tied to stakeholder information through the prices of implicit claims. Thus, losses due to misinformation on the part of stakeholders are permanent, even if the prices of implicit claims eventually adjust after the information is disseminated.

With minor modifications the Miller-Rock [20] approach can be used to develop a stakeholder signalling model. The simplest case is that in which managers are the sole owners of the firm and customers are the only stakeholders. Managers signal their ability to make high payoffs on implicit claims by paying larger net dividends. Since the cost of paying such dividends is forgone investment, only those firms that know it is in their interest to make large payoffs on implicit claims will choose to signal. The benefit derived from signalling is higher cash flow via higher prices for implicit claims.

This interpretation of dividend signalling leads to a number of new cross-sectional predictions. For instance, the more diverse and less informed a company’s stakeholders are, the more the stock price should respond to dividend announcements. In addition, the asymmetry in the pricing of implicit claims implies that dividend cuts should be associated with larger absolute price changes rather than dividend increases. Finally, it is worth noting that the stakeholder approach contradicts conventional wisdom on the impact of dividend changes on the prices of utility stocks. Investment bankers frequently assert that since utility stocks are bought for their dividends, the reaction of utility stock prices to dividend cuts will be particularly large. 14 Stakeholder theory, on the other hand, predicts that the utility stock price response to these cuts may well be smaller than average, because the value of implicit claims issued by utilities is less dependent on the financial performance of the firm. 15

C. Capital Structure

Firms that expect it will be in their interest to make large payouts on implicit claims in the future have an incentive to bond themselves in order to sell implicit claims at high prices today. The problem is to assure stakeholders that the firm’s best future decision will involve large payouts on implicit claims. We assume, of course, that contractual solutions to this problem are prohibitively expensive; otherwise, the implicit claims could be made explicit.

There are a wide variety of things the firm can do to bond its payouts on implicit claims. Along the lines suggested by Klein and Leffler [17], the firm can make specialized investments whose value is tied to the payouts on implicit claims. In the case of the Macintosh file server, for example, the payout that Apple customers expect to receive tomorrow will depend

14 See, for example, the comments of John Childs, Vice President, Kidder Peabody, "A Discussion of Corporate Dividend Policy," Chase Financial Quarterly, Vol. 1, Winter 1982, p. 51: "If you take the dividends out of utilities today, you'll never sell another share of stock ... small investors would lose faith in the utility industry and that would finish the sales of utility stock."

15 Here we are holding constant the motives for the cut which Wooldridge and Gosh [31] show have an important impact on the price response.
upon the investments they see Apple making in disk research and disk production facilities today.

Another way for a firm to back its promise of high payouts on implicit claims is to alter the firm’s financial structure so as to reduce the future opportunity costs of making such payments. For example, if the firm invests in “excess” cash and marketable securities this period, it will lower its opportunity cost of funds next period because the returns on marketable securities are doubly taxed.16

With some additional structure the stakeholder approach leads to predictions about the cross-sectional variation of financial structure. Consider three major financing sources in Myers17 [21] pecking order: internal funds, issuing debt, and issuing equity. Assuming that information and transaction costs make it more expensive to use financing sources at the top of the pecking order, the firm faces an intertemporal trade off. If sources low on the pecking order are used this period, current financing costs will appear to be low, but the firm faces the hidden opportunity cost of being pushed up the pecking order. On the other hand, if new equity is issued this period and the funds are held as cash, current costs are high, but by moving down the pecking order the firm will have a cheap source of funds in the future. For this reason, firms that are attempting to bond their implicit claims should be observed to be lower on the pecking order. That is, they should be predominantly equity financed and hold relatively large cash balances.

The foregoing seems to imply that firms with large amounts of net organizational capital will tend to be at the bottom of the pecking order, but this is not necessarily the case. The problem is that organizational capital itself functions as a performance bond. Firms such as IBM are reluctant to reduce the payout on implicit claims because of the impact it will have on the prices at which the company can sell future implicit claims.

The model predicts, therefore, that firms which rely on the sale of implicit claims, but which have not yet developed a large stock of organizational capital, will be lowest on the pecking order. As these firms mature and develop a reputation, they should be observed to issue increasing amounts of debt. Thus debt ratios should be observed to increase over time for successful firms, although they will still be lower than the debt ratios of firms of similar age that have less organizational capital. Unfortunately, this factor muddies cross-sectional predictions. Firms in the same industry may be observed to have widely different debt-equity ratios, depending on the reputation each company has established with its stakeholders.17

D. The Costs of Financial Distress

To the extent that the value of the firm depends on its ability to sell implicit claims, financial distress is likely to be particularly costly, even in cases where bankruptcy remains a remote possibility. If stakeholders suspect that financial problems will lead the firm to reduce its payouts on implicit claims, the prices of these claims will fall. In some cases, stakeholders may refuse to buy implicit claims at all so that explicit contracts will have to be written at substantially higher cost.

The importance of implicit claims in this context is illustrated by the Texaco-Pennzoil litigation. On November 19, 1985 a Houston jury found that Texaco had improperly interfered with Pennzoil’s plan to buy Getty Oil and directed Texaco to pay Pennzoil $11.1 billion in damages plus interest. In the seven trading days following the verdict the market value of Texaco dropped by $1.8 billion, while the market value of Pennzoil rose only $600 million. After the judge upheld the award, Pennzoil stock rose further, and Texaco slumped. From November 19 through December 11, the first day of trading following the judge’s decision (the decision was announced on December 10 after the market had closed), Texaco had lost $2.58 billion in market value, while Pennzoil’s market value had risen by just $780 million. Overall, for every dollar that the market value of Pennzoil rose, the market value of Texaco fell $3.31.

The asymmetry can be attributed, in part, to the role of implicit claims. Assuming that receipt of a windfall was not expected to alter the payout on Pennzoil’s implicit claims, one explanation for the $1.8 billion dollar wedge is the decline in the value of Texaco’s implicit claims. Customers, suppliers, and business partners were no longer willing to do business with Texaco on the same terms. For example, Atlantic

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16 In this context Apple again provides an interesting example. When the company terminated its Apple III and Lisa products and fired its chairman in succession, there was a good deal of speculation in the financial press about the company’s future and its ability to support its products (i.e., honor its implicit claims). In response, Apple’s president repeatedly pointed to the firm’s large cash holdings as evidence that the company would continue to honor its claims.

17 This means that empirical studies, like Titman and Wessels [29], which attempt to correlate stakeholders’ claims and capital structure in a cross-sectional analysis may not find significant results even if the relationship between a firm and its stakeholders is one of the prime determinants of capital structure.
Richfield Co., which both buys and sells crude oil and refined products with Texaco, sent a letter to its staff in early December urging them to use "prudence" in doing business with Texaco. "The basic message was that we'll continue doing business with Texaco, but if we can make the same transaction with someone of less risk, then we should choose someone else," according to William C. Rusnick, Arco's senior vice president of marketing and employee relations. 18, 19

This interpretation is also supported by the work of Jarrell and Peltzman [12], who find that the drop in shareholder wealth accompanying drug and auto recalls is much greater than the direct costs of the recall, including public relations expenses. In the case of drug recalls, Jarrell and Peltzman report that the decline in shareholder wealth is 12 times the size of the direct costs on average. These findings are consistent with our model because drug companies are selling a variety of implicit claims, perhaps the most important of which is quality control, along with the medicine. If a recall reduces the price at which these claims can be sold, shareholder wealth will decline.

In summary, stakeholder theory implies that shocks, such as product recalls, production delays, litigation and the like, will have a larger negative impact on the value of the firm than is indicated by the actual cash outlays involved. In such cases, the prices of implicit claims fall and stakeholders may even require that tacit "understandings" be replaced by explicit contracts.

V. Summary and Conclusions

This paper suggests some of the ways in which corporate financial policy depends on the role of non-investor stakeholders. A key concept in the analysis is the distinction between explicit contracts and implicit claims. If only explicit claims are considered, then stakeholders will not play an important role in the financial policy of most firms because their explicit claims are generally senior to those of stockholders and bondholders. However, many of the claims issued by management to non-investor stakeholders take the form of tacit promises of continuing supply, timely delivery, product enhancement, and job security. Since the payouts on these implicit claims are not set, the prices stakeholders pay for such claims depend on the condition of the firm, including its financial policy.

Among the implications of the stakeholder approach for financial economics are the following. First, the response of stock prices to announcements depends on the extent to which the announcement conveys information to non-investor stakeholders as well as investors. Second, management may choose financial policies in order to signal their intent to make payments on implicit claims or to bond promised payouts on implicit claims. Finally, the stakeholder approach suggests that the costs of financial problems are likely to be larger than the direct cash drain indicates, because they make it difficult for the firm to sell implicit claims.

Cross-sectional tests of the theory, such as those outlined in this paper, should be conducted. The main difficulty in carrying out such tests will be attempting to measure a firm's net organizational capital and to assess the nature of the information possessed by the firm's stakeholders. Nevertheless, the stakeholder approach appears to provide an avenue for understanding the relation of finance to other corporate functions such as marketing, organizational design and logistics, all of which deal with the problem of selling implicit claims to non-investor stakeholders.

References


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19The stock market reaction to favorable news for Texaco is also consistent with the predictions of stakeholder theory. On December 18, 1985, Texaco won a temporary federal court order preventing Penzoil from attaching liens on most Texaco assets pending final resolution of the $11.1 billion judgment against Texaco. The effect of that ruling was to reduce the specter of bankruptcy hanging over the company. Texaco stock jumped $480 million the day the news of the ruling was released, far outstripping the $150 million decrease in the value of Penzoil stock. Overall, Texaco stockholders gained $3.20 for every dollar lost by Penzoil stockholders. This suggests that much of the gain to Texaco's stockholders came in the form of reduced costs of doing business. Since Penzoil stockholders had previously received no benefits from Texaco's added costs of doing business, they lost nothing when these costs were reduced. Hence, only that portion of Texaco's gains that reflected the reduction in its expected cash payment came at the expense of Penzoil stockholders.