

# **Mutual Trust: A Critical Linkage Between Value Appropriation and Value Maximization\***

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## **Abstract**

Although value appropriation and value maximization are fundamental for any firm's economic activities, previous research has tended to treat them separately and to focus on each issue while taking the other for granted. This paper suggests that the two processes, i.e., value appropriation and value maximization, are not separate; rather, they are highly interrelated and reinforce each other through mutual trust among major stakeholders, a crucial linkage between the two processes. Specifically, this paper presents that fair value appropriation - i.e., appropriating value to the stakeholders in proportion to their stakes in the firm - contributes to the development of trust from the stakeholders, not only directly, but also indirectly through strengthening moral obligations of internal organizational members, particularly managers, to the stakeholders. The present paper also shows how mutual trust with the stakeholders leads to value maximization. After examining the reinforcing effects of value maximization on value appropriation, this paper concludes with some discussion about social legitimacy of a firm and the roles of managers.

## **1. Introduction**

A firm faces two central issues: 1) how to maximize the value of the firm's outputs, i.e., *value maximization*; and 2) how to

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divide up the value produced by the firm among its various stakeholders, i.e., *value appropriation*. Although the two issues are fundamental for any firm's economic activities, previous research has tended to treat them distinctly and to focus on each issue separately, taking the other issue for granted.

Of the two issues, value appropriation has attracted substantial attention from both mass media (e.g., *The Economist*, 1996) and academics. Most previous studies, particularly in economics and strategic management, have perceived the maximization of "profit" or "shareholder value" as a firm's objective. These studies recognize that the basic source of profit or shareholder value is the creation of value for the customer. However, they also acknowledge that the value created by the firm is potential profit, not actual profit, and is distributed among the stakeholders by competition or bargaining power. By focusing on "profit" and "shareholder value" maximization, these studies tend to be more interested in the issue of how to maximize the *value which is appropriable by the firm or shareholders*, than in the issue of how to maximize the value perceived by the customer.

Some other studies have examined the value maximization of a firm's outputs, not the maximization of profit or shareholder value. Particularly, a recent study (Moran & Ghoshal, 1996) maintains that competition should be dedicated, not to value appropriation, but to value creation through the innovative combinations of firms' existing resources. Arguing that value creation is the major source of institutional legitimacy of firms, this study examines the detailed processes of value creation by firms.

This article presents that the processes of value appropriation and value maximization are not separate, but highly interrelated with each other, suggesting "*mutual trust*" among major stakeholders as a linkage between the two processes. This article first reviews the ways of appropriating value proposed in existing theories, identifying the fundamental differences between value maximization and profit or shareholder value maximization. The next section of this article then examines how the ways of appropriating value among the stakeholders affect the development of trust from them. Specifically, this article presents that fair value appropriation contributes to the development of trust

from stakeholders, not only directly, but also indirectly through strengthening moral obligations to the stakeholders of internal organizational members, particularly managers. The following section articulates how mutual trust with the stakeholders leads to the maximization of the value of the firm's outputs. After examining the reinforcing effects of value maximization on value appropriation, the final section concludes with some discussion about social legitimacy of a firm and the roles of managers.

## **2. Value Appropriation**

This section first identifies different types of value that each stakeholder, as resource providers, contribute to the final value of the firm's outputs. This section then argues that profit or shareholder value maximization may be simply a way of appropriating value, not necessarily a way of maximizing the value perceived by the customer, reviewing the value appropriation suggested in existing theories.

### **2.1 Value Components**

The resource-based view perceives a firm as a bundle of resources (Penrose, 1959; Wernerfelt, 1984). The firm produces its outputs by employing a bundle of the resources provided by various resource contributors such as employees, suppliers, investors, and even customers. Broadly speaking, the value of the firm's outputs consists of three components: 1) the intrinsic value of the resources used for its outputs, 2) the firm-specific value of the resources, and 3) the synergetic value, i.e., the value created by the combinations of the resources. Each resource provider or stakeholder is thus perceived to contribute to the final value of the firm's outputs: (1) by providing the intrinsic value of the resource held by the resource contributor, (2) by making investments in developing the firm-specific value of the resource, and (3) by cooperating to efficiently and effectively combine with other resources the resource possessed by the resource holder, which creates synergetic value from the combinations.

*The intrinsic value of resources and Ricardian rents*

The intrinsic value of a resource refers to the value of the resource which is independent of firms using it. According to Ricardo (1821), land varies in fertility. When demand is higher than the supply provided by fertile land, it becomes economic to grow corn on less fertile land. If this is the case, the farmer who owns more fertile land earns a profit, i.e., the productivity difference between the farmer's land and marginal land. This extra profit is called "Ricardian rents." It is noted that the intrinsic value of fertile (or less fertile) land remains constant regardless of who owns it. Therefore, Ricardian rents can be viewed as the difference between the intrinsic value of a particular resource possessed by a firm and the intrinsic value of the same type, but marginally productive resources.

Ricardian rents from a resource require two conditions. First, the resource should be *intrinsically* superior in efficiency (e.g., more fertile land) to other resources (e.g., less fertile land) and scarce (Mahoney & Pandian, 1992; Peteraf, 1993). Firms endowed with the intrinsically superior resource are able to produce more efficiently or better satisfy customer needs; thus, the customer value of the outputs is higher than that of the outputs produced by firms with inferior resources. However, if intrinsically superior resources are sufficient enough to satisfy demand (i.e., if inferior resources are not employed for production), firms cannot earn rents. Therefore, the intrinsically superior resource should be scarce to fully satisfy demand for its service, so that inferior resources are brought into production as well (Peteraf, 1993).

Secondly, to earn Ricardian rents, a firm must not simply employ intrinsically superior and scarce resources, but must also own them. If the market for a resource is perfect so that its market value reflects its intrinsic value, the firm has to pay the market value for the use of the resource which is equal to its intrinsic value. Otherwise, the owner of the resource will not stay in the firm, leaving for other potential users who are willing to pay the market value. Therefore, a firm can achieve Ricardian rents from a resource only when the firm already has *owned*<sup>1)</sup>

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1) May want to explain that prior ownership only leads to Ricardian rents only

the resource that has become scarce and superior to other resources. Examples of such resources include the *ownership* of valuable land, locational advantages, and efficient plants.

A firm may achieve competitive advantages by owning rare and intrinsically superior resources, since the ownership enables the firm to earn Ricardian rents. In practice, however, firms do not possess the permanent ownership of all the rare and intrinsically superior resources required for their economic activities. Most resources, perhaps the more valuable resources, cannot be permanently owned, partly because of the very nature of the resources (e.g., human resources). These resources are temporarily owned or used, not permanently owned, by the firm. As long as the "strategic factor markets" (Barney, 1986) are efficient, firms cannot enjoy Ricardian rents from the resources not permanently owned by them.

Firms may secure the permanent ownership of some other resources (e.g., inputs from suppliers) by acquiring the resource providers. But again, if the strategic factor markets for those resources are efficient, and thus, their market value reflects their intrinsic value, firms cannot achieve Ricardian rents from the resources; thus, the firms do not need to acquire these resources.

According to Barney (1986), a firm may achieve Ricardian rents from a particular resource under two conditions, both of which should be met. Firstly, the market for the resource is not efficient so that different firms have different expectations about the future value of the resource. Secondly, the firm has better insights into the future value of the resource than other firms, or better fortune or luck, so that the firm can pay for the resource significantly less than its intrinsic economic value.

Whatever the reasons are, the reality is that firms possess the permanent ownership of only a few resources required for their economic activities. Other, perhaps more valuable, resources are simply used or temporarily owned by the firms. Thus, if the strategic factor markets are efficient, firms may not earn Ricardian rents from those valuable, non-possessed resources.

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if the prior price paid did not reflect future scarcity & superiority.(assuming perfect capital markets) I.e. the perceived intrinsic price of ownership did not equal the true intrinsic price of ownership.

*The firm-specific value of resources and quasi-rents*

The value of firm outputs reflects not only the intrinsic values of input factors, but also their values improved by various firm-specific factors. These improved values may come from the firm's better use of the input factors (Penrose, 1959, Mahoney & Pandian, 1992), such as assigning employees to the tasks that better suit them (Prescott & Visscher, 1980; Tomer, 1987) or by making better allocations of financial resources toward high yield uses (Bower, 1970; Williamson, 1975).

This firm-specific value of a resource is thus distinguished from its intrinsic value in that the former becomes negligible outside the firm while the latter remains constant across different firms. If the resource is so immobile or idiosyncratic that it has no other use outside the firm (Rumelt, 1982; Williamson, 1979), its intrinsic value is zero since it cannot add any value outside the firm. The value of this completely idiosyncratic resource consists entirely of the firm-specific value.<sup>2)</sup> Some resources are imperfectly mobile, that is, they are tradeable but more valuable within the current firm than in other firms. These types of resources have the same intrinsic value across different firms, which is lower than their value in the current firm. Therefore, the firm-specific value of a resource indicates the difference between the value of the resource within the firm and its value outside the firm or its intrinsic value. This firm-specific value of a resource represents "quasi-rents" or "Pareto rents" which are often defined as the excess of a resource's value over either its salvage value or its value in its next best use (Klein, Crawford, & Alchian, 1978; Peteraf, 1993).

*The synergetic value and Schumpeterian rents*

A firm can also add value to its outputs through new combinations of available resources (Moran & Ghoshal, 1996; Penrose, 1959; Schumpeter, 1934). These new combinations enable the firm to produce its outputs more efficiently and/or produce new outputs that better satisfy customer needs and tastes than existing outputs. Schumpeter perceived innovation as "the carrying out of new combinations" which indicates "to

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2) Not necessarily true. (resource could have synergetic values as well)

produce other things or the same things by a different method [or to] combine these materials and forces differently" (Schumpeter, 1934: 65-66; Moran & Ghoshal, 1996). That is, innovation of the economic system consists largely of a "recombination of conceptual and physical materials that were previously in existence" (Nelson & Winter, 1982: 130). This new and additional value created by this type of innovation or by the new combinations of available resources is called "Schumpeterian rents."

The importance of the synergetic value of resources or the new and additional value from resource combinations is also recognized by the resource-based perspective, which emphasizes the firm's "new combinations of resources" (Penrose, 1959: 85) as a means of achieving sustainable competitive advantages (Ghemawat, 1986; Mahoney & Pandian, 1992). In a diversified or multi-business firm, the value created by resource combinations, also called synergies or economies of scope, is treated as the economic justification for the existence of the diversified firm (Wernerfelt & Montgomery, 1986).

The synergetic value of resources is related to the firm-specific value in that the latter also requires combinations with other resources available to the firm. The subtle difference between the two types of value, however, is that whereas the firm-specific value arises from the resource combinations which are highly firm-specific, the synergetic value comes from the resource combinations which are possible, but neither recognized nor executed, in other firms. Therefore, the primary source of the synergetic value is the creativity of an entrepreneur who has recognized the value of the new ways of combining the resources that are available, not only to a particular firm, but also to other firms.

## 2.2 Value Appropriation in Existing Theories

### *Value maximization and profit or shareholder value maximization*

A firm produces its outputs by utilizing the resources provided by various resource holders. The value created by a firm is the difference between the value perceived by the customer of its outputs and the value of the resources provided by the resource holders (i.e., the intrinsic value of the resources). The value created by the firm, which consists of both firm-specific value

and synergetic value, is then distributed among many resource providers largely through the pricing mechanism or bargaining power over the resource providers. The higher the bargaining power of the firm over its customer (e.g., the higher demand over the supply of the firm's outputs), the higher the price of the outputs, and then the higher the proportion of the value appropriated to the firm ("producer surplus") and the lower the proportion of the value appropriated to the customer ("consumer surplus"). Likewise, the higher the bargaining power of the firm over its resource providers, the lower the costs of the resources, the higher the proportion of the value appropriated by the firm, and the lower the value appropriated for the resource providers. In this sense, the value created by the firm is quite different from profit or shareholder value. That is, profit is value appropriated by the firm from the total value created by the firm, whereas shareholder value is value appropriated for the shareholders, one of the major resource providers.

#### *Value appropriation in existing theories*

The ways of appropriating value differ across different theories. Assuming perfect market competition where end customers have the maximum bargaining power, neoclassical economics views the end customers as those who appropriate most value or "economic rents" in the system. In this perspective, all the other stakeholders or resource providers receive only "normal profits."

Theories in industrial organization economics and the resource-based view perceive profit maximization as the firm's objective. This requires the firm to appropriate as much value as possible from its stakeholders, by *actively* pursuing and exploiting the power differentials between the firm and its stakeholders. Industrial organization economics, for example, suggest that for competitive advantages, a firm should focus on increasing the relative bargaining power over its stakeholders by raising entry barriers (Bain, 1956) or mobility barriers (Caves & Porter, 1977). By limiting competition or by restricting the alternative uses of the resources held by stakeholders within an industry or a strategic group, entry or mobility barriers lower even the market value of the resources. The firm thus attempts to appropriate not only the firm-specific value, but also the



intrinsic value of the resources held by the stakeholders. The resource-based view of the firm (Penrose, 1959; Wernerfelt, 1984) also suggests that a firm appropriate as much value as possible from the resource holders, emphasizing high "immobility" of resources for competitive advantage.

Agency theory argues that the contract structures of most organizational forms limit the risks undertaken by most agents by specifying either fixed promised payoffs or incentive payoffs tied to specific measures of performance. The residual risk - i.e., the risk of difference between stochastic cash inflows and promised payments to agents - is borne by those who contracted for the rights to net cash flows. Calling these agents the residual claimants or residual risk bearers, the theory continues to assert that the contracts of most agents contain the implicit or explicit provision that, in exchange for the specified payoff, the agent agrees that resources he/she provides can be used to satisfy the interests of residual claimants (Fama & Jensen, 1983). Therefore, most value should be appropriated for the shareholders who are the residual claimants.

### 3. Value Appropriation and Trust

This section presents how the ways of appropriating value among major stakeholders affect the development of mutual trust with them. After briefly describing the concepts of trust used in this study, this section will show how detrimental the value appropriation proposed in existing theories is to the formulation of trust among the stakeholders, and then introduce *fair value appropriation* as an effective mechanism for producing trust among them.

#### 3.1 The Concepts of Trust

In the trust literature, there are two perspectives on trust: the instrumental, or rational, perspective and the non-instrumental perspective. According to the instrumental perspective, people's willingness to cooperate is based on a belief or expectation that others will reciprocate the cooperation (Brann & Foddy, 1988; Kramer, 1991; Messick, et al., 1983; Tyler & Kramer, 1996).

Assume that a particular individual cooperates while the other parties involved in the cooperative relationship do not cooperate. Then, the individual's isolated cooperation will not lead to much impact on the cooperative outcomes, and will be costly for the individual as he/she assumes all the costs associated with that cooperation while the other parties enjoy the benefits. Therefore, in the absence of expectations that the other parties will reciprocate, it will be difficult for an individual to cooperate (Kramer, Brewer, & Hanna, 1996). There is widespread evidence for this instrumental perspective of trust (e.g., Brann & Foddy, 1988; Brewer & Kramer, 1986; Komorita, Chan, & Parks, 1993; Messick et al., 1983; Tyler & Degoe, 1996).

The non-instrumental perspective of trust views trust as an "orientation toward society and toward others that has social meaning beyond rational calculations" (Tyler & Kramer, 1996: 5). In this perspective, people help or trust others, not only because they expect that others will reciprocate, but also because "they feel it is the morally appropriate action" (Tyler & Kramer, 1996: 5). That is, people trust when they have internalized positive orientation toward others, or have moral duty or obligation to others.

When people have moral obligation to others, they, through psychological transformation (Kelly, 1979), tend to: have more positive perception of others' actions; reduce the perceived social distance with others and the distinction of their outcomes with others, and increase affective satisfaction through their trust behavior (Kramer, Brewer, & Hanna, 1996). Therefore, even when objective expectation about an event is negative, the individual's *subjective* belief in the event becomes positive through cognitive, motivational, and affective psychological transformations of the event.

The two perspectives, instrumental and non-instrumental, suggest that the definition of trust needs to incorporate both instrumental and non-instrumental aspects. In addition, a decision to trust is made in risky situations where there are ambiguous courses of action in the future, where outcomes depend on the behavior of others, and where the strength of the harmful event is greater than that of the beneficial event (Deutsch, 1960). This means that trust is necessary in situations where those being trusted have opportunities for malfeasance

(Granovetter, 1985; Lewis & Weigert, 1985).

In this paper, trust is defined as “subjective and positive belief in the consequences of another’s action with respect to oneself in uncertain environmental states.” This definition contains both the instrumental and non-instrumental aspects of trust, together with situational parameters. “Positive” in this definition represents the instrumental aspect of trust, i.e., another’s action will be beneficial rather than detrimental (Gambetta, 1988; Creed & Miles, 1996). “Subjective” indicates the non-instrumental aspect of trust that the expectation about the consequences of another’s actions is psychologically transformed (Kelly, 1979) by moral obligation to others. Finally, trust is not simply expectation, but “belief” in the face of highly uncertain settings. Now, how do the ways of appropriating value affect trust of stakeholders in the firm?

### **3.2 Value Appropriation and Trust**

#### *Value appropriation in existing theories and trust*

The traditional agency theory argues that since the residual risk is borne by shareholders, most value should be appropriated to the shareholders. However, the risk taken by other stakeholders may be higher than the residual risk borne by the shareholders. If markets are efficient and adjust quickly to new circumstances as traditional agency theory assumes, an individual stakeholder may minimize risks by adjusting to changing market conditions either through fixed promised payoffs or through incentive payoffs tied to specific measure of performance.

Markets, however, are changing all the time due to either the process of creative destruction triggered by innovation (Schumpeter, 1942) or due to exogenous macro-environmental trends, such as demographics, sociopolitical factors, and macroeconomic change. That is, as Austrian economists argue, there is continuous and permanent disequilibrium in the markets (Jacobson, 1992). Once market conditions have changed, it is difficult for stakeholders to make new fair contracts reflecting their contributions to the firm, due to their investments in firm-specific assets. Firm-specific assets means the assets that cannot be deployed to alternative use without a loss of value

(Williamson, 1985). Once a stakeholder has made significant investments in such assets, the stakeholder cannot leave the firm without bearing substantial loss due to these firm-specific investments, leading to significant power differentials between the firm and its stakeholders. These power differentials make it difficult for the stakeholder to write a new contract reflecting the stakeholder's fair contributions, i.e., his/her firm-specific investments, to the firm. Therefore, the firm-specific investments by stakeholders become "appropriable quasi-rents" (Klein, Crawford, & Alchian, 1978). In this sense, the stakeholders who have made significant firm-specific investments may take higher risk in the firm than the shareholders who take residual risk, but make little firm-specific investments.

Quasi-rents that are appropriated to the firm or only to shareholders, not to the stakeholders who have made the firm-specific investments for the quasi-rents, are therefore highly destructive with regard to securing trust from the stakeholders. When a stakeholder invests in firm-specific assets, the stakeholder makes an implicit contract where the stakeholder expects payoffs in exchange for his/her firm-specific investments. If the payoffs that are expected are not made to the stakeholder, the stakeholder's confidence or trust in the firm will be severely damaged. If, as the agency theory suggests, a firm appropriates most of the value, particularly quasi-rents, only for shareholders, all the other stakeholders who have made substantial investments in firm-specific assets will lose any positive confidence or trust in the firm. Therefore, the way of appropriating value proposed by the traditional agency theory destroys trust of the stakeholders.

The prescriptions of industrial organization economics and the resource-based view are more damaging to obtaining trust from stakeholders. These views suggest that the firm should appropriate not only the firm-specific value, but also the intrinsic value of the resources held by the stakeholders by limiting competition through entry or mobility barriers or through isolating mechanisms.

#### *Fair value appropriation and trust*

The agency theory views a firm as the nexus of implicit and explicit contracts among resource holders or stakeholders (Fama

& Jensen, 1983; Jensen & Meckling, 1976). These contracts, or internal "rules of the game," specify the rights of each resource holder, performance criteria on which resource holders are evaluated, and the payoff functions they face (Fama & Jensen, 1983).

The theory defines an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. Agency theory then holds that, in the agency relationship, the agent as a utility maximizer does not always act in the best interests of the principal. Such agency problems occur when (1) conflicts of interests arise: agents and principals have different interests and when (2) information asymmetries arise: principals do not control the information necessary to verify that agents are acting in the principals' interests (Abrahamson & Park, 1994; Eisenhardt, 1989).

While agency theorists have been primarily interested in the agency problem between the stockholders and managers of a firm, the agency problem is quite general and, thus, exists "in all organizations and in all cooperative efforts-at every level of management in firms." (Jensen & Meckling, 1976: 309). Agency theory may be thus used to explain the nature of the implicit and explicit contractual relationships between all stakeholders of the firm (Hill & Jones, 1992).

Stakeholders refer to groups of constituents who have a legitimate claim on the firm, including stockholders, managers, employees, buyers, and suppliers (Freeman, 1984). Each of these groups can be seen as engaging in implicit and explicit contractual relationships where each group provides the firm with critical resources ("contribution") and in exchange each expects its interests to be satisfied ("inducement") (March & Simon, 1958; Hill & Jones, 1992). For example, stockholders supply the firm with capital. In exchange, they expect the firm maximizes the risk-adjusted return on their investment. Employees provide the firm with time, skills, and human capital commitments. In exchange, they expect fair income and adequate working conditions. Suppliers provide the firm with inputs and expect fair prices and dependable buyers in exchange. Customers supply the firm with revenues and expect value in

exchange for money. In this sense, a firm may be viewed as a nexus of implicit and explicit contracts between all stakeholders.

Compared to the contracts of other stakeholders, the contracts of managers is somewhat complex and unique (Hill & Jones, 1992). Being positioned at the center of the nexus of contracts, managers are the only group of stakeholders who enter into a contractual relationship with all other stakeholders. In addition, managers are also the only group of stakeholders with direct control over the decision-making apparatus of the firm. That is, managers are the only group of stakeholders with abilities to make strategic decisions and allocate resources so that the claims of all the other stakeholder groups can be fairly satisfied (Hill & Jones, 1992).

The abovementioned unique nature of the contract with managers has significant implications for the role of managers in the firm. Engaging in multiple contracts with all the other stakeholders and possessing direct control over strategic decisions and resources, managers in the contracts are expected to satisfy the *claims of all stakeholder groups, not just the claims of the shareholders*.

Furthermore, while having a responsibility to satisfy the claims of all the other stakeholder groups, the managers as one of the firm's major stakeholder groups also expect their claims to be satisfied. Like employees, the managers also expect fair income and adequate working conditions in exchange for their contribution. The managers however have direct control over decisions and resources to satisfy their own claims as well as the claims of other stakeholder groups. As a consequence, the agency problems exist *not just between the managers and shareholders, but between the managers and all the other stakeholders*.

A firm can secure a minimum level of trust (instrumental trust) from stakeholders when the stakeholders expect the firm to reciprocate their contributions. Firm-specific assets cannot be deployed to alternative use without a loss of value (Williamson, 1985). Therefore, compared to stakeholders with low stakes, stakeholders with high stakes expect more value appropriation in exchange for their high firm-specific investments. Here, fairness in value appropriation thus means *appropriating value according to each actor's stake in the firm*, which is a function of

the actor's investments in firm-specific assets (Williamson, 1984; Hill & Jones, 1992).

In order to secure the minimum level of trust, i.e., instrumental trust, the firm should thus appropriate more value for the stakeholders with higher stakes than for the stakeholders with lower stake in the firm. Otherwise, the firm will not be able to maintain even the minimum level of trust from the involved stakeholders because their expectations are violated. Therefore,

**Proposition 1:** *The fairer the value appropriation by a firm among its stakeholders, the higher the instrumental trust of the stakeholders in the firm.*

Fair value appropriation is critical to building non-instrumental trust as well as instrumental trust. Fair value appropriation provides internal organizational members, particularly managers, with good opportunities to strengthen their moral obligation to others and their identification with others, the primary mechanisms for building non-instrumental trust (Lewicki & Bunker, 1996; Kramer & Brewer, 1984; Tyler & Kramer, 1996; Zucker, 1986). That is, while working for other stakeholders through fair value appropriation, managers tend to internalize a moral obligation to these stakeholders, together with a strong identification with them. When the other stakeholders perceive the managers as having strong moral obligation and identification with respect to them, they are also likely to build strong identification with the managers, resulting in strong subjective as well as objective confidence in the consequences of the managers' actions that affect the stakeholders. Thus, through the process of fair value appropriation, the firm can obtain strong non-instrumental trust as well as instrumental trust.

Assume that fair value appropriation is effected for *internal stakeholders*, e.g., employees, by managers. Fair value appropriation requires the managers to suppress their own interests in the interest of employees. While the managers suppress their own interests for the employees, the managers begin to take it for granted that they work for their employees. In the process, that is, the managers are more likely to believe that it is morally appropriate to sacrifice their own interests for the employees.

When the employees believe that the managers possess strong moral obligation to and identification with the employees, they are also likely to be convinced that it is morally right to sacrifice their own interests, leading to strong trust in the managers.

When fair value appropriation is made for external stakeholders by internal organizational members, the effects are the same. While working for the external stakeholders, the internal organizational members build strong identification with and moral obligations to the external stakeholders. In turn, the external stakeholders will also build strong identification with these internal organization and the firm as a whole.

One diversified firm has actively pursued fair value appropriation for external stakeholders as well as for internal stakeholders. As one of such activities, the firm has promoted a campaign, "One Group Company, One Mountain." In the campaign, each group company of the diversified firm is required to take care of an actual, specific mountain assigned to that company; this includes the protection of the mountain from environmental contamination. One executive of the company said,

"We are promoting this campaign not just to get more favorable evaluation and reputation from our customers or the public in general, but also to provide opportunities for our employees to strengthen their humanism and morality and, thus, moral obligation to others. If our employees have built strong moral obligation to the public in general, they will have much stronger moral obligation to and identification with more immediate stakeholders, such as buyers, suppliers and shareholders. Moral obligation to or identification among internal organizational members would be even stronger."

Finally, fair value appropriation and the development of organizational members with strong moral obligation to and identification with other stakeholders are highly interdependent and reinforcing with each. That is, fair value appropriation enables the organizational members to strengthen their moral obligation to and identification with the other stakeholders. At the same time, when the organizational members have developed strong moral obligation to and identification with other stakeholders, they may be better able to appropriate value fairly



among the other stakeholders. Therefore, the two processes are highly interrelated and reinforcing. Since moral obligation to and identification with others are the major mechanisms for developing non-instrumental trust, it is proposed that:

**Proposition 2:** *Fair value appropriation for stakeholders and non-instrumental trust of the stakeholders will be highly interrelated and reinforce each other.*

#### **4. Mutual Trust and Value Maximization**

How does trust among major stakeholders contribute to the value maximization? Most studies in economics and organization theory emphasize trust as a mechanism for value appropriation. Viewing other governance mechanisms, e.g., formalization through explicit contracts, as necessary only when trust is disrupted or too costly to build (Evan, 1963; Geertz, 1978; Macaulay, 1963), these studies suggest that trust is the most efficient mechanism for governing transactions (e.g., Arrow, 1970, 1974; Ouchi, 1980) and, thus, the most efficient mechanism for maximizing the appropriation of value by firms. The position of this article is that trust is not merely an efficient mechanism for value appropriation by firms, but an effective mechanism for value maximization.

##### **4.1 Mutual Trust and Intrinsic Value**

Building mutual trust with resource holders, i.e., major stakeholders, is one of the most effective ways of acquiring, developing and retaining resources with high intrinsic value. Mutual trust enables a firm to acquire valuable resources and retain them by creating "mutual attractiveness" between the firm and the resource holders (Ghoshal, Moran, & Bartlett, 1996). Unlike less valuable resource holders (e.g., employees and suppliers) who often lack self-competence, and thus, are highly passive and dependent, valuable resource holders are highly competent, self-directed and motivated, and independent. Those valuable resource holders are thus more highly attracted to a firm that has developed a reputation of trusting its stakeholders,

so that they can enjoy self-accomplishment from their jobs, which is also beneficial for the firm. Therefore, through this trust-based mutual attractiveness, the firm can better attract resources with high intrinsic value and retain them within the firm.

Trust also allows the firm to retain resources with high intrinsic value through "mutual affection" between the firm and the resource holders. When the involved parties have developed a high level of trust, i.e., non-instrumental trust, each party understands and identifies with the other party's needs, desires and preferences. Mutual affection from this strong identification between the firm and the resource providers makes it difficult for the resource providers to leave the firm.

Furthermore, non-instrumental trust also permits the firm to enhance the intrinsic value of existing resources through "mutual sacrifice" among the resource holders. As Ghoshal et al. (1996) noted, internal training to increase the intrinsic value of a particular resource requires the investment of other resource holders with high intrinsic value (e.g., in-house training by seniors for juniors). When the resource holders have developed non-instrumental trust and, thus, share the others' desires and needs, each resource holder is willing to sacrifice for other resource holders. Therefore, for example, seniors are willing to invest their time and efforts in raising the intrinsic value of juniors. In sum, mutual trust enables the firm to acquire, develop, and retain resources with high intrinsic value, through mutual attractiveness, mutual affection, and mutual sacrifice. Therefore,

**Proposition 3:** *The higher mutual trust of a firm with its stakeholders, the higher intrinsic value of the resources in the firm.*

*The criticalness of intrinsic value to firm-specific value and synergetic value*

As defined earlier, the intrinsic value of a resource is the value which is independent of the resource users. Whoever uses the resource, the resource produces the same amount of intrinsic value. If the market for the resource is efficient, or firms have the same expectations about the future value of the resource

(Barney, 1986), the intrinsic value of the resource is equal to its market value. Unless the firm permanently owns the resource, the firm has to pay for the resource at least equal to or more than the intrinsic value of the resource. Otherwise, the resource provider will leave the firm for other firms that are willing to pay more than what the current firm is paying. Therefore, Ricardian rents from this resource are always zero or negative.

Although a firm cannot appropriate any rents from the intrinsic value of resources, retaining superior resources with high intrinsic value is critical to the firm's competitive advantage for the following two reasons. Firstly, the firm-specific value of or quasi-rents from a resource may not be significant when the resource has low intrinsic value. The firm-specific value of the resource is created largely by the resource holder recognizing the value of firm-specific knowledge, assimilating it, and exploiting it. This ability of the resource holders to recognize the value of firm-specific knowledge, assimilate the firm-specific knowledge, and exploit it, i.e., "absorptive capacity," is determined by prior related knowledge of the resource holders (Cohen & Levinthal, 1990). By definition, the intrinsic value of the resource is tradeable, and thus, broadly applicable. Therefore, the high intrinsic value of the resource thus indicates that existing knowledge of the resource holder is highly fungible or flexible (Chatterjee & Wernerfelt, 1991), and thus, his/her absorptive capacity is broader. When the intrinsic value of the resource is high, therefore, the firm is in a better position to create high firm-specific value of the resource than when the intrinsic value of the resource is low.

Secondly, resources with high intrinsic value are important for Schumpeterian rents as well as for quasi-rents. Like firm-specific value, the synergetic value or Schumpeterian rents can be acquired when each resource holder possesses high absorptive capacity, which makes it easier for the resource holder to acquire knowledge from other available resources; this thus enables resources to be more effectively and efficiently combined with each other.

Resources with high intrinsic value further facilitate the creation of Schumpeterian rents by reducing the amount of trial-and-error search involved in new resource combinations. Nelson & Winter (1982) imply that an effective new resource

combination usually requires a significant amount of trial-and-error search. Through the trial-and-error search, a firm detects, diagnoses, and solves obstacles to effective performance of the new combination. Resources with high intrinsic value are likely to be more reliable, and thus, to contribute less to the problems arising from the new resource combination, reducing the amount of the trial-and-error search.

The high intrinsic value of resources also contributes to Schumpeterian rents by lowering the “operational ambiguity” (Nelson & Winter, 1982: 88) of the resources. The operational ambiguity is defined as “predictive uncertainty as to what a particular individual who possesses ‘the skill’ can actually accomplish in an attempt to exercise that skill under particular circumstances” (Nelson & Winter, 1982: 88). The high operational ambiguity of resources leads to significant difficulties in the designs of the new combination. Of course, some of the operational ambiguity can be eliminated by clarifying quality differentials among resource holders and task characteristics. However, neither of these sorts of clarification is costless, and neither can be totally effective (Nelson & Winter, 1982). Therefore, reliable resources with high intrinsic value increases the potential for the firm to create high synergetic value. As Nelson & Winter (1982) suggested, success on the innovative frontier may depend on the quality of the support from the “civilized” regions of existing resources.

Retaining existing resources with high intrinsic value is also important because the loss of the resources is highly costly to the firm. It is costly because the firm might have already invested in the improvement of the resource’s intrinsic value for more firm-specific tasks in the form of various trainings in general skills. If the resource has contributed to synergetic value through combinations with other resources, the cost of its loss will be even higher.

In sum, acquiring and retaining resources with high intrinsic value are critical for a firm to achieve competitive advantage since those resources can make significant contributions to both quasi-rents and Schumpeterian rents.

## 4.2 Mutual Trust and Firm-Specific Value

It has been widely recognized that firm-specific value is one of the most important sources for competitive advantages. Therefore, it is important that resource providers make investments in the development of the firm-specific value of their resources. Unlike investments in the intrinsic value, however, investments in the firm-specific value create “appropriable” quasi-rents (Klein, Crawford, & Alchian, 1978) and thus increase the potential for the opportunism of the firm. Therefore, investments in the firm-specific value require the resource providers either to have assurance that the firm will not behave opportunistically and attempt to appropriate those quasi-rents from the investments or to be emotionally willing to sacrifice for the firm.

Instrumental trust increases the resource providers' expectations that the firm will reciprocate their investments in the firm-specific value, i.e., that the firm will not behave opportunistically or attempt to appropriate the quasi-rents from the investments. With non-instrumental trust, the resource providers are not concerned about the possibility of the firm's opportunistic behavior because the resource providers identify with the firm's interests and desires, allowing the resource providers to be willing to sacrifice for the firm by making firm-specific investments. Therefore,

**Proposition 4:** *The higher mutual trust of a firm with its stakeholders, the higher firm-specific value of the resources in the firm.*

## 4.3 Mutual Trust and Synergetic Value

The primary sources of synergetic value are resource sharing and knowledge transfer. Resource sharing involves the combination and rationalization of some of the operating, tangible resources available to different parties of the firm, due to their functional and performance similarity. Such resource sharing increases a firm's competitive advantages by lowering costs through economies of scale or economies of scope, or by

enhancing differentiation through increasing the uniqueness of the shared activity (Porter, 1985).

Resource sharing, however, involves significant transaction costs (Williamson, 1985). As Porter (1985) identified, resource sharing requires the design or performance of the resource to be compromised, which may not be optimal for either of the parties involved. In addition, sharing the resource among different parties makes it difficult to respond quickly to environmental changes since responding to the changes in one party may reduce the value of interrelationship for the other party involved. Since resource sharing requires compromise and inflexibility from the involved parties, it increases the possibility of the involved party's opportunistic behavior and, thus, potential transaction costs.

Mutual trust reduces the transaction costs associated with resource sharing, such as contracting costs, monitoring costs, and enforcement costs (Hennart, 1993; Williamson, 1985). Contracting costs indicate the costs associated with negotiating and writing an agreement, for example, about scheduling, setting priorities, and resolving problems. Under conditions of trust, the parties involved in resource sharing have a strong belief that the other party will reciprocate their efforts and that fair adjustments thus will be made as future conditions change. Therefore, the parties do not need to engage in the complex negotiation and writing of a contract about all future contingencies to prevent the other party's opportunistic behavior.

Mutual trust also reduces the monitoring costs that refer to the costs associated with monitoring the contract to ensure that each involved party fulfills the predetermined set of obligations. Mishra (1996: 265) identified four dimensions or components of trust, defining trust as "one party's willingness to be vulnerable to another party based on the belief that the latter party is (a) competent, (b) open, (c) concerned, and (d) reliable." Because the parties in the trust relationships believe that the other party is, not only willing (i.e., "open", "concerned" and "reliable") to, but also able (i.e., "competent") to fulfill the obligations, the parties do not need to engage in intensive monitoring.

Finally, mutual trust among the parties involved in resource sharing reduces enforcement costs, the costs associated with ex post haggling and sanctioning the party that does not perform

according to predetermined agreement. When the parties trust each other, each party is "concerned" about the other party's interests (Mishra, 1996) and attributes the consequences of the other party's behavior more positively. Therefore, the involved parties do not engage in severe ex post bargaining and haggling over the results.

Instead of building mutual trust, firms can also devise organizational mechanisms, such as organizational structure, systems, and processes, to reduce the transaction costs associated with resource sharing (Galbraith, 1973; Gupta & Govindarajan, 1986; Hage, Aiken, & Marrett, 1971; Van de Ven, Delbecq & Koenig, 1976; Williamson, 1985). However, such organizational solutions also incur significant costs on firms (Nayyar, 1992).

Even when a resource cannot be shared directly, it may be utilized in the form of knowledge transfer. It has been well recognized that knowledge transfer both within a firm and outside the firm is critical to the firm's innovative capabilities, or its ability to create synergetic value from resource combinations (Cohen & Levinthal, 1990; Mansfield, 1968; March & Simon, 1958). While knowledge transfer has been well known as a crucial source of a firm's competitive advantages, the difficulties in knowledge transfer have been also noted by many researchers (Jemison & Sitkin, 1986; Porter, 1985; Park, 1995). As major sources of the difficulties in knowledge transfer, this article presents two fundamental characteristics of knowledge: *tacitness and stickiness*.

The most common dimension of knowledge classification is "tacitness" (Nonaka, 1994; Polyani, 1966; Winter, 1987). Whereas articulated knowledge refers to explicit, formal and codified knowledge, tacit knowledge is defined as implicit and highly personal, people-embedded knowledge that is difficult to codify or communicate. The difficulty to communicate or transfer tacit knowledge comes largely from its causal ambiguity, i.e., ambiguity about the relationships between actions and results (Lippman & Rumelt, 1982). Therefore, the possessor of this tacit knowledge is not fully aware of the details of the knowledge and finds it difficult or impossible to articulate a full account of those details (Nelson & Winter, 1982). This causal ambiguity inherent in tacit knowledge often acts as a powerful barrier to both imitation and factor mobility (Lippman & Rumelt, 1982) and,

thus, is an effective source of competitive advantages.

Due to causal ambiguity, therefore, the effective transfer of tacit knowledge requires a firm to have high "absorptive capacity," i.e., the ability to recognize the value of new knowledge, assimilate it and apply it to commercial ends (Cohen & Levinthal, 1990). Since a firm's absorptive capacity is largely a function of the level of prior related knowledge, it is difficult for the firm to acquire knowledge from novel domains. Without diverse internal knowledge structure, the firm's learning tends to be highly incremental, domain-specific, and path- or history-dependent (Cohen & Levinthal, 1990; March, 1991).

A firm's absorptive capacity depends not only on the ability to acquire knowledge from outside the firm (i.e., "outward-looking" absorptive capacity), but also on the ability to transfer knowledge across and within subunits of the firm (i.e., "inward-looking" absorptive capacity) (Cohen & Levinthal, 1990). While outward-looking absorptive capacity necessitates diverse internal knowledge to tap into diverse external knowledge sources, inward-looking absorptive capacity requires highly overlapping and related knowledge structure for efficient internal communications. Due to this trade-off between inward-looking versus outward-looking absorptive capacity, the firm is forced to make choice between the two or to compromise them, as neither of them is optimal for the firm's innovations.

Mutual trust with stakeholders improves both outward-looking and inward-looking absorptive capacity and, thereby, overcomes a considerable portion of impediments associated with transferring tacit knowledge. Like human perception (Barr, Stimpert, & Huff, 1992; Daft & Weick, 1984; Starbuck & Milliken, 1988; Schwenk, 1984), a firm's existing knowledge may affect its ability to recognize the value of new knowledge and assimilate it, through the following two processes : scanning, through which the existing knowledge directs or limits attention to a limited range of new knowledge that are highly related to the existing knowledge; and interpretation, through which the new knowledge that gained attention is first understood with respect to the existing knowledge and then given meanings.

Consider interorganizational knowledge transfer where new knowledge is not related to existing knowledge. If the source of the new knowledge is one of the stakeholders that a firm trusts,



the firm with strong concern about and interests in the stakeholder will not ignore the new knowledge in the scanning process although the new knowledge is not related to its existing knowledge. Therefore, the firm is better able to recognize the value of the new knowledge from the trustful stakeholder than the value of new knowledge from other firms.

Furthermore, in the interpretation process, the new knowledge that gained attention will be understood and given meaning, not with respect to the firm's existing knowledge, but with respect to the other's standpoint. Thus, the firm is better able to assimilate the new knowledge from the stakeholder than from other firms that the firm does not trust. It follows that mutual trust among stakeholders increase a firm's outward-looking absorptive capacity of new knowledge from the stakeholders.

At the same time, the knowledge-transferring stakeholder with trust in the firm is better able to identify the knowledge needed by the firm and to help the firm with assimilating the knowledge by better understanding difficulties facing the firm in assimilating the knowledge. For the same reason, mutual trust enhances inward-looking absorptive capacity. By enhancing both inward-looking and outward-looking absorptive capacity, trust overcomes many impediments to the transfer of tacit knowledge among stakeholders.

Another characteristic of knowledge as an impediment to knowledge transfer is "stickiness." Although many researchers have defined stickiness as inseparability of an asset or knowledge, this paper uses the term of stickiness as referring to *inseparability of knowledge due to motivational impediments*. More specifically, knowledge is sticky in the sense that even if the parties involved in knowledge transfer are able to acquire new knowledge from external environments and to efficiently transfer the knowledge internally, they may not be *willing* to actively participate in the knowledge transfer. That is, although the involved parties have the "ability" to transfer knowledge, they may not have the "motivation" for the knowledge transfer. Therefore, while difficulties from the tacitness of knowledge depend on the firm's ability in knowledge transfer (e.g., absorptive capacity), difficulties from the stickiness of knowledge depend on the involved parties' motivation for the knowledge transfer.

Various factors contribute to the stickiness of knowledge, or

the unwillingness for knowledge transfer. Knowledge-receiving parties may resist accepting new outside knowledge due simply to the "Not-Invented-Here" (NIH) syndrome, i.e., the resistance of the knowledge-receiving parties to ideas or solutions that have been generated elsewhere and not by them (Allen, 1977; Bartlett & Ghoshal, 1989). Knowledge-transferring parties may be also reluctant to the knowledge transfer due to the importance of the skilled personnel required for the transfer in their businesses and to the risk that highly proprietary knowledge will leak out and will be used opportunistically (Porter, 1985). Since the stickiness of knowledge makes it difficult for articulated knowledge as well as tacit knowledge to be effectively transferred, it is extremely important for a firm to overcome the stickiness of knowledge.

When a firm has developed high mutual trust with its stakeholders (i.e., non-instrumental trust), each stakeholder feels strong identification with each other. NIH syndrome is thus much lower among these stakeholders. In addition, mutual sacrifice inherent in non-instrumental trust and the belief that the other party will not behave opportunistically also enable the firm to overcome the knowledge transferring party's reluctance to the knowledge. As a result, mutual trust significantly reduces motivational impediments arising from the stickiness of knowledge.

Since mutual trust lowers impediments to resource sharing and knowledge transfer which are the major sources of synergies, mutual trust increases the synergetic value of the resources. Therefore,

**Proposition 5:** *The higher mutual trust of a firm with its stakeholders, the higher synergetic value of the resources in the firm.*

Finally, value maximization is also likely to facilitate fair value appropriation. An increase in value to be appropriated among stakeholders enables the firm to better satisfy the stakeholders' expectations through fair value appropriation. Therefore,

**Proposition 6:** *The higher value of a firm's outputs, the fairer value appropriation by the firm.*

In summary, mutual trust among stakeholders is critical to value maximization because: it is one of the most effective means of acquiring, developing and retaining resources with high intrinsic value that is important for high firm-specific and synergetic value of the resources; it also increases the firm-specific value of each resource by facilitating firm-specific investments by the resource holder; and it increases the synergetic value of the resources by reducing impediments to resource sharing and knowledge transfer. Finally, value maximization also facilitates fair value appropriation. As a result, value appropriation and value maximization are highly interrelated and reinforcing with each other through mutual trust as a key linkage between the two processes.

## **5. Discussion and Conclusion**

Thus far, we have seen the relationships between value appropriation and value maximization and the critical roles played by mutual trust in these relationships. At this point, it may be worthwhile to discuss the roles of a firm in the economy.

### **5.1 Social Legitimacy of a Firm**

In this article, the value of a firm's outputs consists of three components: the intrinsic value of the resources used for the outputs, the firm-specific value of the resources, and the synergetic value of the resources. A firm acquires resources with a certain intrinsic value from the market. In this sense, a market may be perceived as a mechanism to exchange the *given* intrinsic value of resources which have been created else where. That is, a market is a mechanism for *value exchange*.

Acquiring resources with given intrinsic value from the market, a firm creates value: (1) by enhancing the given intrinsic value of the resources; (2) by producing their firm-specific value through resource holders' firm-specific investments; and (3) by maximizing the synergetic value from the combinations of resources available to the firm, aided by resource holders' voluntary cooperation. The final outputs of the firm are again exchanged in the market as a resource with a specific, given

amount of intrinsic value that is equivalent to the sum of: the initial intrinsic value of the resources used in the firm, an increase in the intrinsic value within the firm, the firm-specific value of the resources, and their synergetic value. Therefore, a firm may be a mechanism for value creation, not simply for value exchange, whereas a market is a mechanism for value exchange.

For value exchange that is a major role of a market, "efficiency" may be critical. Market mechanisms are highly efficient for most value exchanges. For some value exchanges, however, the market mechanisms may not be so efficient due to high uncertainty and asset specificity inherent in those exchanges (Williamson, 1985). For such value exchanges, as transaction cost economics argues, a hierarchy may be more efficient than the market. However, a hierarchy is simply one type of market mechanisms in the sense that it is a mechanism for value exchange. In other words, like other market mechanisms, a hierarchy is a mechanism which may be more efficient for certain value exchanges that involve high uncertainty and high asset specificity.

If a firm is viewed as a mechanism for value creation, not for value exchange, the firm should not be a simple hierarchy which may be useful to increase "efficiency" in certain value exchanges. The firm may need some other mechanisms, systems, processes, etc., not to enhance efficiency for value exchange, but to maximize value creation which is the major source of institutional legitimacy of the firm (Moran & Ghoshal, 1996).

Whereas efficiency may be important for value exchange, what is crucial for value maximization? In this article, a firm creates value by enhancing the given, initial intrinsic value of resources acquired from the market and by maximizing their firm-specific and synergetic value. These value creating activities may require mutual attractiveness, mutual sacrifice, and mutual affection arising from *mutual trust among the resource providers*, whereas value exchange activities in the market require efficiency.

Critical to a firm's social legitimacy and sustainable competitive advantage is thus the question of how to generate "mutual trust" among stakeholders, not the question of how to increase "efficiency" in the intrafirm-exchange of resources with certain intrinsic value. In this sense, a firm needs to be more cautious

about the adoption of such market mechanisms as performance-based payments, market-based employment, profit-centers, autonomous management, etc., which aim at enhancing efficiency in value exchange. Instead, the firm should place more attention on developing mechanisms for generating mutual trust among stakeholders to maximize value creation. This article suggests fair value appropriation as one such mechanism.

## 5.2 Appropriability of “Appropriable Quasi-rents”

Fair value appropriation in this article is the appropriation of value in proportion to the stake of each actor in the firm, which is a function of the actor's investments in firm-specific assets. In fair value appropriation, therefore, it is crucial that quasi-rents in particular are fairly appropriated among the stakeholders. In other words, quasi-rents are no longer “appropriable.”

Quasi-rents may be appropriable (Klein, Crawford, & Alchian, 1978) through “unfair” value appropriation in the short-term, not in the long-term. The stakeholders are ones with a stake in the firm, which is a function of the stakeholders' investments in firm-specific assets. By definition, therefore, the stakeholders have made firm-specific investments to create firm-specific value or quasi-rents for the firm. In exchange, the stakeholders expect that the firm will reciprocate their firm-specific investments by appropriating the quasi-rents according to their stakes or their firm-specific investments. If the firm does not appropriate the quasi-rents for the stakeholders depending on their stakes, it violates the expectations of the stakeholders and thus, destroys trust in the firm. When the stakeholders do not have trust in the firm, they will no longer actively make firm-specific investments any more to create quasi-rents. In the long-term, therefore, there will be little quasi-rents to appropriate by the firm. It follows that quasi-rents may not be appropriable, *regardless of whether the firm fairly appropriates value or not.*

Difficulties facing the firm then may be to determine the magnitude of the fair stake of each stakeholder. Since managers engage in multiple contracts with all the other stakeholders and possess the direct control over strategic decisions and resources, the managers determine the magnitude of the fair stakes of the resource providers, including themselves. Determining the fair

stakes of the multiple resource providers and appropriating value according to the stakes are challenging, particularly when the managers are also one party of the resource providers with their own stake. These issues may be managerial challenges, and thus, managers may matter for these reasons.

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