

3 ESSAYS ON MARKETS, HIERARCHIES, AND MORALITY

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This dissertation is dedicated to my parents who encouraged me to follow my dreams; countless friends, colleagues, and mentors who have helped me along the way; and, most of all, my loving wife who supported me from the beginning to the end.

ABSTRACT**3 ESSAYS ON MARKETS, HIERARCHIES, AND MORALITY**

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In my dissertation, I examine issues related to markets and hierarchies, which are core conceptual building blocks for economic theories of the firm, from a moral point of view.

The first essay engages with economic theories of the firm and argues that there is a tension between the two primary metaphors – contracts and hierarchies – utilized by economists to describe the nature and purpose of the firm.

The second essay provides a moral reason for drawing the distinction between markets and firms in the first place. It argues that the principle of fair play justifies the adoption of a proposed three-part test for employee classification based on economic theories of entrepreneurship.

The third essay applies the insights from the first two chapters by arguing that stakeholder theory should pay greater attention to the contract metaphor within theories of the firm.

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ESSAY 1:

Contracts and Hierarchies: A Moral Examination of Economic Theories of the Firm

I. INTRODUCTION

What is the nature of the firm, and what is its purpose? Economic theories of the firm try to answer the questions of why firms exist and what are their boundaries (Holmstrom and Tirole 1989). However, they are not mere academic inquiries. They also have important implications for corporate governance and managerial practice because they can shape how we view relationships inside the firm and act in light of them. For instance, the economic theory of the firm as a nexus of contracts designed to overcome various forms of agency costs (e.g., Alchian and Demsetz 1972; Jensen and Meckling 1976) has had enormous influence on how we structure corporate governance relationships in both law and practice. Despite their widespread influence, however, many business ethicists have argued that economic theories of the firm fall short of our normative ideals for a variety of reasons. Some have argued that economic theories ignore morally salient features within the firm and thus contribute to unequal relations between employers and employees (Néron 2015). Others are even more skeptical of the very use of economic language to describe the firm. For some, the usage of economic language to describe the firm de-values and de-humanizes stakeholder relationships because it reduces morality within the firm to an “economic morality,” which is solely “the morality of money and power” (Hendry 2001: 225).

The aim of this article is to examine the moral values implicit within economic theories of the firm by focusing on two primary metaphors used by economists – contracts and hierarchies. Its main claim is that the contract and hierarchy metaphors are either morally incompatible or logically inconsistent with each other, at least in the way that economic theories of the firm use them. The hierarchy metaphor has been utilized since the earliest economic theories of the firm, and it forms the basis for one large tradition of economic theories that have been very influential. Within this view, the primary purpose of the firm is to minimize the costs associated with market transactions, and the nature of the firm is a hierarchy that can reduce such costs under certain circumstances (e.g., Coase 1937; Williamson 1975). The contract metaphor has also had a long history, and it presents a significant challenge to the hierarchical view. The contractarian view of the firm argues that the primary purpose of the firm is to facilitate the aims of firm participants and that the nature of the firm is a nexus of contractual relationships between them that are intended to achieve these aims (e.g., Alchian and Demsetz 1972; Easterbrook and Fischel 1991). This paper will examine the metaphors of contract and hierarchy from a moral point of view by appealing to the Kantian requirement to treat the humanity in ourselves and others as an end and not as a mere means (Kant 1785). Treating the employee as an end and not as a mere means, it will argue, requires respect for the employee's will in a way that is consistent with the contract metaphor but at odds with the economic theory of the firm as a hierarchy.

To be clear, this paper is a normative and theoretical critique of the economic theory of the firm as a hierarchy. First, it is a *normative* critique because it questions not

whether hierarchy is the dominant mode of firm organization in the real world but, instead, whether the idea of a hierarchy *should* be the dominant mode of explaining the nature and purpose of the firm. Second, it is a *theoretical* critique because it does not give a final answer to the question of whether hierarchies should be the dominant mode of firm organization in the real world. Instead, the paper is an attempt to change how academics and practitioners view the nature and purpose of the firm at a theoretical level. Even if authority relations do and should continue to pervade how we organize into firms, the claim is that we should not view the firm as a hierarchy that exists to minimize transaction costs because it would result in our viewing and treating the firm's employees as a mere means. Third, a normative and theoretical critique is different from a mere semantic dispute or an argument for arguments' sake. Whether or not we call various power relationships within the firm as hierarchies is beside the point. What matters is how we view their *purpose*. The economic theory of the firm as a hierarchy views the purpose of the firm as the minimization of transaction costs. And if our view of the power relationships within the firm rests on a mechanism for cost minimization that is at odds with respect for persons, we ought not accept such an account nor allow it to influence how we structure our economic lives. And changing our views of the purpose of the firm will have significant real-world consequences, including implications for law, corporate governance, and managerial practice. Rather than an argument for arguments' sake, the proposed shift in how we view the nature and purpose of the firm will motivate changes at these levels in addition to academic discourse.

Lastly, this paper is not an attempt to defend economic theories of the firm that have come to represent the contractarian view nor an attempt to present a comprehensive and/or a morally acceptable theory of the firm. Instead, its aims are more modest. By focusing on the moral requirements of Kantian respect within the contracts that constitute the firm, it attempts to point out a problem with understanding the firm as a cost-minimizing hierarchy if we truly take seriously the idea of voluntary contracting. Implicit within the very idea of voluntary contracting lies a moral requirement to respect the humanity of all parties involved. A firm constituted by voluntary contracts, then, requires far more from firm participants than narrow-minded self-interest that economic theories of the firm assume. Although a full moral explication of the theory of the firm built on the foundation of the contract metaphor will require greater normative examination of some other core building blocks – agency, property, etc. – the idea of truly voluntary contracts within the firm rules out certain hierarchical conceptions of the firm and paves the way toward a truly morally acceptable theory of the firm, to be developed in the future.

This paper proceeds as follows. The first section provides a historical overview of economic theories of the firm as a hierarchy. Beginning with Ronald Coase's critique of Frank Knight's theory of the firm and ending with Oliver Williamson's account of the firm as a hierarchy into which firm participants contract, this section presents the ways the metaphors of contract and hierarchy are typically evoked within economic theories of the firm. The second section begins the moral examination of economic theories of the firm by focusing on the contract metaphor. After highlighting the importance of

voluntariness to economic accounts of contracting, it draws on Kant's moral philosophy to argue that the idea of voluntariness generates an obligation to treat persons as ends and not as a mere means. A voluntary contract must respect persons in such a manner and thus refrain from contradicting or ignoring the wills of everyone involved. The third section turns to the hierarchy metaphor and argues that its usage within economic theories of the firm is incompatible with the idea of voluntary contracting. One cannot contract into a hierarchy because doing so would either treat the humanity of the employee as a mere means or undermine the very purpose of the hierarchy. The fourth section discusses the implications for the incompatibility of contracts with hierarchies. After contrasting hierarchical relationships with agency relationships, it examines the role that authority relationships play in theories of the firm and looks to the metaphor of contract to serve as a foundation for a more promising theory of the firm.

II. CONTRACTS AND HIERARCHIES

This section provides an overview of the metaphors of contract and hierarchy within economic theories of the firm and distinguishes two types of theories that emphasize one metaphor over the other. Economic theories of the firm typically begin with the baseline assumption that markets serve an important and valuable coordinating mechanism for production in society. Among other things, markets promote economic efficiency associated with resource allocation and production. Whereas firms centralize production under a manager-entrepreneur who directs the effort of his employees, markets utilize the price mechanism to coordinate production in a decentralized manner

(Coase 1937). This decentralized coordination grants the market an important advantage for resource allocation. Because each individual has localized knowledge about his or her circumstances, relying on individuals to make allocative decisions within their particular contexts leads to greater aggregate social welfare than a centralized mechanism for coordination (Hayek 1945). Moreover, markets also promote the efficiency of production by supporting the division of labor. The division of labor into specialized functions drastically increases productivity – and thus wealth and welfare – in society (Smith 1776). Without a robust market, however, economic actors would not be able to specialize in producing a particular good because they would also need to focus on producing the wide variety of goods needed for their survival. By providing avenues to trade for the diversity of goods that we need to survive, markets allow us to focus on increasing the productivity of our labor through specialization.

Given the advantages of allocating resources through markets, the question goes, why should firms exist at all? Why do firms persist in floating separately in a sea of market contracting like “butter coagulating in a pail of buttermilk” (Coase 1937: 388)? An important precursor to theories of the firm focused largely on the effect that uncertainty in the market has on the division of labor (Knight 1921). The future is riddled with both risk and uncertainty. Risk refers to the ways in which future outcomes are indeterminate in probabilistic – and thus calculable – ways. Uncertainty, on the other hand, refers to the indeterminacies in the future that cannot even be calculated. Under uncertainty, the importance of execution fades into the background, and “the primary problem or function [becomes] deciding what to do and how to do it” (Knight 1921: 268).

Because a multitude of factors on both the demand and supply side rest largely on an uncertain future, Knight argues that economic life is fraught with uncertainty. Under this theory, markets and firms both exist as successful adaptations to deal with uncertainty. The production of goods and services to a market is a useful method of dealing with the uncertainty of demand because it consolidates a large segment of potential customers who do not always know what they want in the future. Within such an arrangement, however, judgment about anticipating future demand under conditions of uncertainty become extremely important. And because there are some people who possess superior economic judgment than others, the increased importance of economic judgment confers an advantage to the centralization of production under the authority of a specialized class of manager-entrepreneurs (Langlois and Cosgel 1993). What results, then, is the rise of firms controlled by manager-entrepreneurs who believe that they can anticipate the aggregation of future demand within a market better than others.

The first major theory of the firm is a response to Knight's argument. Ronald Coase argues in his seminal essay that Knight's argument about the firm does not explain why firms exist at all (1937). If the firm exists simply because a certain class of manager-entrepreneurs who believe that they are better at others at anticipating the future, there is no reason to think that a contractual arrangement could not produce the same results. Rather than consolidating in a firm, the confident entrepreneur could simply enter into contracts with suppliers of goods and labor to profit from their abilities. A theory of the firm must explain why a firm exists in the first place and, if there are good reasons why it exists, why there isn't one giant firm. In other words, it must

provide an account of the reason for the firm's existence and its boundaries. Coase's famous argument addresses both of these points. He argues that the firm exists because a hierarchical power structure for allocating goods and labor in production for the market can be more efficient than market contracting under certain circumstances and that the boundaries of the firm can be explained by the relative difference in efficiencies. The crucial insight here is that economic activities in markets and hierarchies are subject to different types of costs. Transactions in markets have marketing costs, which include costs associated with discovering relevant prices, negotiating and executing contracts, and entering into long-term relationships in light of an uncertain future. Production in hierarchies, on the other hand, have organizing costs, which include costs associated with bureaucracy, managerial mistakes, and the loss of independence experienced by employees. Within this line of analysis, firms are hierarchies that exist when marketing costs exceed organizing costs for a particular business. In other words, the nature of the firm is a hierarchy, and its purpose is cost reduction.

It was not until the 1970s when academics began to notably challenge the traditional assumption that firms are hierarchies that exist distinctly apart from markets. In one of the earliest attempts to blur the strict distinction between firms and markets, Alchian and Demsetz emphatically argued that viewing the firm as a hierarchy is a "delusion" and that the firm "has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people" (1972: 777). Jensen and Meckling took this insight in one further direction and made the now influential claim that firms are "simply legal fictions which serve as a

nexus for a set of contracting relationships among individuals” that are employed to depict ordinary market relations as a matter of convenience (1976: 310). Depicting the firm as a nexus of contracts rather than a hierarchy had an important influence within the field of microeconomics. The traditional neoclassical economic account of the firm was a “black box” production function that unilaterally converted inputs into outputs in the market. The theory of the firm as a nexus of contracts transformed this view by bringing market principles *inside* the firm. Rather than a unilateral hierarchical relation that converted inputs into outputs, the firm was reconceived as a complex set of bilateral exchange relations among inputs to the firm, thus making it possible to apply microeconomic tools to organizational analysis (e.g., Fama and Jensen 1983a; 1983b; Gibbons 2005). Furthermore, the nexus-of-contracts view of the firm quickly began to have significant influence outside the field of economics. In law and corporate governance, for instance, scholars quickly adopted the nexus-of-contracts view and argued that corporate law should exist simply as default rules that instantiate “contract terms” that a majority of firm participants would wish to adopt (e.g., Easterbrook and Fischel 1991). And although earlier works typically argued that a majority of firm participants would wish to establish a shareholder primacy norm, later works drawing on the nexus-of-contracts tradition utilized the same contractual insight to argue that managers and Boards of Directors ought to promote the interests of all of the firm’s stakeholders rather than merely its shareholders (e.g., Blair and Stout 1999; Freeman and Evan 1990).

The success of the contractual metaphor in economics and organizational studies quickly led to the adoption of the contractual metaphor within the hierarchical theory of the firm itself. As a result, the view that a firm is a nexus of contracts is now the dominant view of the firm. Nevertheless, underneath the semantic commonality lies a crucial difference in both the nature and purpose of the firm depending on whether the metaphor of contract or hierarchy dominates. For economic theories of the firm in which the metaphor of contract dominates, the nexus of contracts is merely an *overlap* of contracts that differ in no way to market contracts. Some views within this group of theories even go as far as to argue that the firm itself is not a very helpful category for examining complex phenomena in the markets (e.g., Gulati et al. 2000). Within this view, the nature of the firm is merely an aggregation of market contracting at best, and the purpose of such an aggregation lies solely in the desires of firm participants themselves, subject only to the demands of the market for corporate governance. On the other hand, economic theories of the firm in which the metaphor of hierarchy dominates understand the nexus of contracts as a vertical power relation between contracting parties that is *separate* from the contract itself. Within these views, the firm is a nexus of contracts only to the extent that firm participants *contract into* the power relationship. The most prominent example of such a view is that of Oliver Williamson, who argues that the firm is an institutional structure in which organizing decisions are made by fiat rather than through an on-going negotiation (1975; 1985; 2002). Other views within this group of theories shift the locus of power from the manager within the firm to the Board of Directors who govern the firm (e.g., Bainbridge 2003; Blair and Stout 1999), but the

key insights are essentially the same. Within this view of the firm, the nature of the firm is a hierarchical power relationship between the manager-entrepreneur, and, as will be seen in a later section of this paper, the traditional purpose of such a power relationship is to minimize the costs associated with transacting in the market.

Given the crucial differences in economic theories of the firm as a nexus of contracts depending on whether the metaphor of contract or hierarchy dominates, a moral examination of economic theories of the firm requires disaggregating the metaphors of contract and hierarchy. Take, for instance, John Boatright's argument that the normative justification for the nexus-of-contracts theory of the firm ultimately rests on the mutual agreeability of the economic organization to all firm participants, assuming a fair bargaining process and internalization of costs to third parties (2002). By conflating theories that emphasize the element of hierarchy with those that emphasize contracts, Boatright focuses on the moral issues associated with contracting even though his discussion centered primarily on economic theories of the firm as a hierarchy. However, as the next sections will attempt to show, overlooking the importance of hierarchies within these theories can lead to a lack of attention to the ways in which the power structure of the firm can result in the treatment of employees as a mere means, even if the employee voluntarily agrees to such an arrangement *ex ante*.

III. THE IMPLICIT MORALITY OF CONTRACTS

This section begins the moral examination of economic theories of the firm by focusing on the metaphor of contract. Although lawyers refer to contracts as legal

enforcement mechanisms that must meet certain doctrinal criteria, economists have a much broader understanding of contracts since they are not as concerned with legal enforceability. For economists, contracts refer to all types of voluntary exchanges for mutual benefit (e.g., Buchanan 1975). Thus, within economic theories of the firm, a contract can refer not only to the mechanism for governing an exchange (e.g., Williamson 1979) but also to the very exchange relationship itself (e.g., Gibbons and Henderson 2012). However, as this section will argue, the requirement for *voluntariness* in economic accounts has an important yet often overlooked moral feature. By drawing on Kant's moral philosophy, this section will argue that a contract cannot contradict or ignore the will of a party to it because a truly voluntary action must respect humanity as an end and not a mere means.

When considering contracts, economists almost always invoke the concept of voluntariness as a requirement or a fundamental assumption. The reason for the importance of voluntariness in economic exchange has its roots in the ultimate moral justification of economics. Some economists explicitly appeal to a libertarian view of freedom and self-interest to support the claim that a contract must be voluntary (e.g., Friedman 1962). From this view, voluntariness is obviously crucial because coercing others into exchanges against their will would directly threaten their freedom and self-interest. For most economists, however, the appeal to voluntariness is more indirect. Despite the development of the concept of utility as a derived ordinal ranking of preferences rather than a cardinal ordering of happiness, most modern economists still implicitly rely on the concept of welfare as the ultimate value for justification (Dasgupta

2005). Voluntariness is crucial to welfare maximization within these accounts due to the impossibility of interpersonal utility comparisons. Because increases in welfare depend on each person's individualized set of preferences, it is impossible to know whether or not a non-voluntary transfer of resources will lead to a net increase in welfare. On the other hand, when individuals act on their knowledge of their own preferences to exchange with each other voluntarily, we can confidently assume that the exchange will have increased the welfare of at least one party to the exchange without harming the other. As a result, voluntariness is practically taken as a given among economists. For instance, James Buchanan, a Nobel-prize winning economist, criticizes game theory by appealing to the "mutuality of advantage from voluntary exchange," which he takes as a given to be "the most fundamental of all the understandings in economics" (2001: 29). The emphasis on voluntariness is especially strong in economic theories of the firm. Oliver Williamson, another Nobel-prize winning economist, builds on Buchanan's assumption to argue that private ordering, which entails efforts by transacting parties to *voluntarily* craft mechanisms that align their incentives, is a key to understanding the governance of economic exchanges, including the firm itself (2002). Other theorists of the firm that emphasize the metaphor of contract also emphasize the need for voluntariness in exchange (e.g., Easterbrook and Fischel 1991).

However, hidden in the requirement for voluntariness in economic theories of the firm lies a need to consider the morality of exchange. One might think that economists simply understand voluntariness in a thin, instrumental way. If voluntariness has value only as a condition to ensure that exchanges lead to increases in welfare, wouldn't it be

sufficient for exchanges to simply be consistent with the preferences of economic actors? However, even such a thin account of voluntariness requires considerations of morality. At a superficial level, an evaluation of whether an exchange is consistent with our preferences requires considerations of morality because normative concepts are embedded within our preferences (e.g., Sen 1977). If, for instance, the preferences of economic actors include the preference for fairness and respect, the requirement for voluntariness will also impose a requirement for fairness and respect within the exchange. More importantly, the consideration of preferences without reference to objective – and thus normative – standards leads to an unacceptable account of welfare and/or voluntariness. If economists allow for a purely subjective understanding of welfare, they will fail to account for the distortion of preferences that are commonplace in the market (e.g., Sen 1985). A compulsive smoker or a prisoner suffering from Stockholm syndrome may prefer the status quo, but it would be unacceptable to think that their actual welfare is enhanced by addiction or captivity. Similarly, a purely subjective account of preferences leads to an unacceptable account of voluntariness itself (Olsaretti 2004). To exclude objective considerations from the requirements of voluntary action would yield bizarre results, including the characterization of actions constrained by mistakes of fact as nonvoluntary actions. What is needed, then, is the consideration of normative standards to distinguish between preferences that should count and those that should not, even for those who place a purely instrumental value on voluntariness of exchange (Olsaretti 2006).

One possible approach to articulating the connection between morality and voluntariness is to look to Kant's argument that a voluntary action proceeds from a free will and thus requires respect for humanity as an end not a mere means (1785). For Kant, to say that an exchange is voluntary is to say that it was freely made in accordance with the will of each party. And the very idea of action that proceeds from a free will leads to a moral requirement to respect humanity as an end and not a mere means. How could this be the case? Kant argues that we can say that an action proceeds from a free will only when it is caused by the exercise of reason. For Kant, our will is free because we can exercise our reason to determine our action independently from our impulses. When we tell the truth even when we desire to tell a lie, we exercise our *freedom* in being able to will an action independently from our desires. A voluntary action, then, is an exercise of our free will only to the extent that it is caused by our reason rather than our desires. Lastly, for Kant, because the exercise of our practical rationality requires reasons for acting, we must act for a reason that exists independently from our desires if we are to act freely. The only reason that can exist apart from our desires, according to Kant, is our own rational nature. Whenever we desire something, it is a necessary feature of our rationality that we desire it for the sake of our selves. Therefore, acting freely requires acting for the sake of our rational nature, and when we interact with other rational beings, we must act for the sake of their rational nature as well. The Kantian respect for persons expressed in the moral requirement to treat the humanity in ourselves and in others as an end and not as a mere means encapsulates this requirement of the free will to act for the sake of the rational nature in ourselves and in others.

From a Kantian point of view, then, the requirement that contracts entail voluntary exchanges for mutual advantage simultaneously imposes a significant moral requirement for contracting parties to treat the humanity in themselves as ends and not as a mere means. A contract that treats humanity as a mere means is not truly voluntary, even if both parties consent to it. Voluntary contracting cannot consist of a brief moment of mutual exploitation in which one uses the other as a mere instrument to get what one wants nor be consistent with allowing one's self to be exploited. Instead, a contract must be consistent with the will of each party involved. Of course, it is unavoidable that we treat each other as a means for achieving our ends when we contract with each other. If I contract with you to buy ice cream, for instance, I am treating you as a means for getting ice cream. However, I cannot treat the humanity in you as a *mere* means when we contract with each other. To treat the humanity in myself and in others as a mere means is to relate to myself and to others as if we did not each have independent ends of our own by acting on terms that are not acceptable to everyone involved (O'Neill 1989). If, for instance, a group of farmers enter into a contract to share a plot of land despite the unwillingness of the landowner to allow them to use it, the contract is not a voluntary exchange because its terms are not acceptable to the landowner. In such a case, the farmers would be treating the humanity in the landowner as a mere means for the achievement of their own ends.

Because a contract that respects the humanity of contracting parties must be consistent with their free wills, a contract cannot contradict or ignore the wills of either contracting party. In one family of contracts, I treat the humanity in *you* as a mere means

by contradicting or ignoring your will. I contradict your will when I use a contract to achieve a purpose you did not will. If I contract with you to sell you a barrel of oil and then deliver a barrel full of water topped with a thin layer of oil, I act in a way that contradicts your will to buy a barrel of oil and thus treat you as a mere means for my own ends. I ignore your will when I effectuate an exchange unilaterally without taking your will into consideration. If I choose to leave a barrel of oil and then take money from you without knowing whether or not you consented to such an exchange, I wrong you by treating you as a vending machine for my own purposes, even if you would have consented to an exchange. In another family of contracts, I treat the humanity in *myself* as a mere means by contradicting or ignoring my own will. I contradict my own will when I act inconsistently with the very principle of willing itself. If I enter into a slavery contract, I contradict my own will by exercising my will to act as if I could not exercise my will at all (Kant 1797). A rock cannot enter into a contract because it cannot will itself to do so. Contracting to become like a rock thus contradicts the very principle of willing since it treats the idea of willing as something that negates itself. This is why the libertarian argument that slavery contracts ought to be allowed actually represents an *illiberal* position (Freeman 2001). I ignore my own will when I simply acquiesce to the will of another in a contract. I treat the humanity in myself as a mere means for you if you offer terms on a contract that I never really consider in light of my own will. A contract requires that both parties will the exchange. The absence or the contradiction of the will of either party to the exchange renders it morally impermissible.

Nevertheless, the prohibition against contradicting or ignoring the will of contracting parties does not imply that one cannot limit one's own freedom through contracts. Contracts are useful because they can help us manage the uncertainties of the future by limiting our future actions. For instance, suppose that I run a transportation business and would like to protect myself against the possibility of a prohibitive increase in the price of oil in the future. I can promote my interests in a way that is consistent with my will today by contracting with you to buy oil from you a year from now for \$50 per barrel. When we enter into such a contract, we both limit the freedom of our future selves by willing in the *present* to determine our actions in the *future*. Such a limitation of our future selves does not contradict or ignore our wills because it is an exercise of our own wills to limit our actions. When you act today to determine your actions tomorrow, *you* are the one who determines your actions. For instance, if the price of oil increases in the future, you are still obligated to sell oil to me at \$50 per barrel because *you* willed it at the time of contracting. And when I insist on performance from you in the future, I would not be treating you as a mere means because I would be respecting the exercise of your will today to determine your actions in the future. On the other hand, if you sell yourself to slavery or simply acquiesce to my will, you are exercising your will to grant *me* the right to determine your actions. In such an instance, you would be acting inconsistently with the principle of voluntary action, and I would be treating you as a mere means since I would be agreeing to value you in the future only as an instrument for my own purposes. And as the next section will explain, the very purpose of the firm in economic theories of the firm as a hierarchy is to grant the employer the unilateral right

to determine the employee's actions in the future. Therefore, it will argue, the idea of a hierarchy within such theories is inconsistent with the idea of voluntary contracting.

IV. CONTRACTING INTO A HIERARCHY

This section discusses the attempt to justify the economic theory of the firm as a hierarchy on contractual grounds and argues that it ultimately falls short. Some defenders of the hierarchical theory of the firm argue that its conception of the firm is not problematic because it presents the firm as merely an arrangement inside the firm with functionally defined roles into which economic actors contract (e.g., Boatright 2012). Within this view, the hierarchical theory of the firm is merely one variant of the theory of the firm as a nexus of contracts (Bratton 1989). Putting aside semantic commonalities and differences, however, it becomes evident that the theory of the firm as a hierarchy is inconsistent with truly voluntary contracts. Because the very reason for a hierarchy is to override the will of the employee when contracts run out, the employee cannot be said to be placing limits on her future self when she contracts into a hierarchy. Instead, she would be undermining her future capacity to exercise her free will and thus treating the humanity in herself as a mere means. Furthermore, attempting to rescue the hierarchical theory by granting the employee the right of free exit fails because it would collapse the hierarchy back into a contract. In other words, the economic theory of the firm as a hierarchy is either morally unacceptable or logical inconsistent.

Modern economic theories of the firm as a hierarchy build on the Coasian intuition about the costs of contracting by recognizing that asset specificity and bounded

rationality lead to hold-up problems that can frustrate market transactions. Asset specificity refers to the ways in which investments made in an asset within the context of a particular exchange relationship make the asset more valuable within that relationship than in other relationships (Williamson 1985). Investments that lead to asset-specificity are relationship-specific investments. For instance, suppose that it takes time to learn and perfect the skill required for a manufacturer's proprietary process of assembling widgets. The efforts that the manufacturer expends to train the employee is a relationship-specific investment. Learning this skill increases the asset-specificity of the employee to the firm because the investment required to teach the employee will make her more valuable to this particular manufacturer than to other firms. Asset specificity introduces the possibility that, once a relationship-specific investment is made, parties to an exchange relationship will engage in opportunistic behavior to appropriate the difference between the value of the asset within the relationship and the value outside the relationship. For instance, if the manufacturer values a trained worker at \$25 whereas the labor market values generic workers at \$20, an employee may contract with the manufacturer at \$19 to beat out other competitors and then hold up the manufacturer by demanding \$25 once it expends the resources to train her. The possibility of being held up can lead to parties not making relationship-specific investments, which would undermine economic efficiency, and it can even prevent parties from entering into a contract at all if the fear of being held up is large enough.

Asset-specificity would not lead to a hold-up problem if the manufacturer and the worker could sign a contract that precludes any opportunistic behavior once relationship-

specific investments have been made. Unfortunately, bounded rationality renders such contracts extremely costly and difficult, if not impossible, to make. Bounded rationality refers to the finite condition of human rationality (Simon 1955). It describes the ways in which decision making is a burden on our cognitive capacities, which leads to our inability to process the near-infinite amount of current data points to make a perfectly rational decision, let alone begin to even anticipate and process future events. The upshot of bounded rationality for contracting is that all of our contracts are necessarily incomplete (Williamson 1985). Because it is impossible to anticipate at the time of contracting all the various ways we may need to govern our exchange relationship in the future, there will inevitably arise a situation in the future that presents an opportunity for at least one party to take advantage of another party once a relationship-specific investment has been made. For instance, suppose that the manufacturer and the worker agree to a contract in which it pays her \$19 to assemble widgets in accordance with its proprietary assembly technique. To protect herself against possible exploitation in the future, the worker will not agree to any economically feasible deal unless the contract specifies which tasks she will be performing. But after some time, suppose that the manufacturer wishes to alter its specified assembly technique that will double the speed of manufacturing. Unfortunately, the new technique will require the worker to perform an action that was not specified in their contract. The need for this change could not have been foreseen at the time of contracting because both parties entered into their contract under bounded rationality. The contract they signed was incomplete with respect to the possible range of tasks that the manufacturer would want the worker to perform in the

future. As a result of the incompleteness of the contract, the worker stands in a position to extract more payment from the manufacturer in exchange for her compliance with the new manufacturing technique. In fact, the costs of the negotiation and the possible payout to the worker may even force the manufacturer to abandon the new process altogether. Lastly, because both parties know that they cannot cover all situations in the future at the time of contracting, they may be discouraged to form a contract at all because they are concerned about similar costs and difficulties in the future.

Modern economic theories of the firm as a hierarchy argue that the firm is an arrangement that can preempt opportunistic behavior and thus enable mutually beneficial exchanges and the making of relationship-specific investments to take place. Given that the hold-up problem resulting from asset specificity and bounded rationality makes market contracting inefficient, difficult, or impossible, it is in the economic interest of both parties to agree to a hierarchy when contracts “run out” ex post (e.g., Blair and Stout 1999; Williamson 2002). Within a hierarchical firm, when unanticipated circumstances arise, the incomplete nature of ex ante contracting will not raise concerns about one party holding the other hostage because the power structure of the firm will have already entitled one party – the manager-entrepreneur or the Board of Directors – to make a unilateral decision as to how to allocate productive resources. This arrangement will allow both parties to enter into economic transactions without the fear of being held up and will allow the manager-entrepreneur to make an efficient amount of relationship-specific investments in the employee once they enter into a relationship. For instance, the manufacturer in the example above does not need to worry about the worker holding up

its implementation of a new manufacturing process within a hierarchy because it entitles the manufacturer to tell the worker what to do and obligates the worker to act under the manufacturer's direction. This will allow the manufacturer to not only hire the worker in the first place but also to make an efficient amount of investment into her to make her a more productive worker for his factory.

Unfortunately, contracting into a hierarchical firm for the reasons outlined above treats the employee as a mere means because the purpose of the hierarchical firm is to impose the employer's will on the employee to compel her to perform an action that she neither willed at the time of contracting nor willed at the time of performance. Imagine that Alfred would like his employee, Betty, to perform an action today. His request and her action would respect her humanity as an end if she exercises her will to perform the action by agreeing to his request *today* or if she had previously exercised her will in the *past* by promising to perform such an action today. Yet, there would be no need for a hierarchy in either of these scenarios because a contract formed either today or in the past would be sufficient to govern their interaction. If it weren't for bounded rationality, both Alfred and Betty would be able to prevent the hold-up problem by exercising their wills at the time of contracting to completely determine the full range of possible actions. And if it weren't for Betty's unwillingness to perform today, she would agree to Alfred's request even if it falls outside the bounds of their incomplete contract. The need for a hierarchy only arises because it would be efficient for both parties to agree *ex ante* that Alfred will be able to exert his will unilaterally over and against Betty's will in circumstances where the contract governing their relationship has "run out."

Unlike contracting to limit one's freedom in the future by determining one's future actions at the time of contracting, contracting into a hierarchy to prevent hold-up problems results in a contradiction of the will. When a worker contracts to perform a service for a counterparty, she binds her future self to her current will. She never acts to give up her capacity to exercise her will because how she acts in the future will have already been determined by her will at the time of contracting. Similarly, when a worker enters into a unilateral contract with a hirer of her services, he grants her the option to perform actions that both parties anticipated and specified before she takes any action. The granting of such an option entails that both parties have willed both the possibility of her performing the specified action and of her not performing the specified action. On the other hand, when a worker contracts into a hierarchy, she agrees to an arrangement within which another person has a right to demand her to act against the will of her future self without knowing at the time of the agreement what that action will be. By giving up her capacity to govern her own actions and transferring it to someone else, she essentially agrees to become a mere instrumentality of the employer in exchange for money. In this sense, such a contract does not differ much from a contract to enter into slavery. In both cases, the subordinate is exercising her will to enter an arrangement within which she can no longer exercise her own will to determine her actions. Such an exercise of one's will contradicts the very idea of a free will and thus treats the humanity of the subordinate as a mere means by treating her as someone who did not have a free will.

At this point, defenders of the hierarchical theory of the firm may argue that employees retain their capacity to exercise their will because they never give up their

right to freely exit the relationship at any time of their choosing. However, these arguments overlook the fact that the right of exit undermines the very reason for imposing a hierarchy in the first place. Once employees are given the right of free exit, the hierarchical firm quickly collapses into a set of contracts. Again, as noted above, the hierarchical firm exists as an efficient alternative to markets because it eliminates the possibility of the employee holding up the employer in an attempt to appropriate the value that exists within their exchange relationship. The right of free exit in a hierarchy reintroduces this possibility because the very reason why the employee can hold up the employer is because the employer has already made relationship-specific investments in the employee that makes her more valuable than other potential employees. The right to quit gives the employee enough leverage to engage in opportunistic behavior, which is the very problem that the hierarchy was supposed to prevent.

As an illustration of the way the right of free exit undermines the very purpose of the hierarchical firm, suppose that Betty agrees to contract into a hierarchical arrangement within Alfred's widget-making factory. Alfred hires Betty to assemble various parts to produce widgets at Alfred's direction and pays her the going rate of an assemblyperson, which is \$25 an hour. Alfred spends a significant amount of time training Betty and teaches her his proprietary manufacturing method. Betty is a quick learner, and, after some time, she becomes a productive worker who is worth \$35 to Alfred. Assuming that the price of a replacement worker in the labor market is still \$25, the right of free exit gives Betty an opportunity to extract more money out of Alfred. He could pay her \$5 more for several months and still be better off than if he hires someone

new. The contract that Betty signed doesn't protect Alfred since it gave her the right to quit, and the hierarchy does Alfred no good since he cannot force Betty to keep working for him for \$25 once she decides that she does not want to do so anymore. In other words, Betty's right of free exit puts Alfred right back in the place where he would have been if he entered into a service contract with Betty outside of the firm. The right of exit reintroduces within the firm the very thing that the firm is intended to eliminate, i.e., the economic inefficiencies associated with opportunistic behavior after relationship-specific investments have been made. But what good is a firm if it does not differ from contracts in governing the economic relationship?

To be fair, the intended level of analysis for economic theories of the firm is organizational, where the option to exit does not exist. Most economic theories of the firm are concerned with transaction costs at the firm level, and they offer answers to questions that relate to market competition. Thus, the primary question for most applications of theories of the firm is whether a firm should acquire a supplier, as GM did with Fisher Body in 1926, or maintain a contractual relationship with it (e.g., Klein et al. 1978). And when firms purchase other firms, the purchased firm has no option to exit. At the intended level of analysis, then, economic theories of the firm do not have much of a problem with logical consistency when they argue that the purpose of the firm as a hierarchy is to prevent the hold-up problem by granting the acquirer a unilateral right to control the other party. However, insofar as theories of the firm also explain why firms exist at all, they must be able to account for the *genesis* of firms. But at the individual level of analysis, the requirement to respect the humanity of firm participants presents a

stark choice of either denying them the right to exit for the sake of economic efficiency or granting them the right and thus undermining the very purpose of the hierarchy. Once taken out of the limited context of market competition and applied to broad areas of policy, law, and morality, economic theories of the firm can offer no satisfying explanation for the nature and purpose of firms since they must look not only at the organizational level but also the individual level of analysis.

When economic theories of the firm appeal to a hierarchy, they are referring to more than just an authority relation that establishes a line of command. Instead, the idea of a hierarchy refers more specifically to a power relation within which one can override the will of the other in effectuating the allocation of resources as one sees fit without engaging in any inefficient renegotiation. Without this power for the manager/entrepreneur to override the will of the employee, the idea of the firm as a hierarchy does not offer an economic advantage over markets at all. Yet, this right to direct the employee's labor in accordance with the employer's will rather than the employee's will goes at the heart of what it means to treat her as a mere means. When the employer exercises his right to unilaterally direct the employee's labor against her wishes, she is no longer exercising her own will to determine her actions. Instead, he treats her as a mere input for his own purposes and thus as an instrumentality of his will, and the employee treats the humanity in herself as a mere means when she agrees to such an agreement *ex ante*. Moreover, if the purpose of the firm is to minimize transaction costs through the imposition of a hierarchy, the employee cannot contract into a hierarchy while retaining the option to exit it because it would eliminate the very purpose of the

hierarchy altogether. Adding the right of free exit to what seems like a hierarchical employment contract would allow economic theories of the firm to present a picture of the firm that approximates real life. Within the United States, for instance, the employment relationship is typically characterized as an at-will master-servant relationship. Unfortunately, this modification would turn the hierarchy into something else altogether. A theory of the firm as a hierarchy that is constituted by employment contracts with a right of exit is nothing more than a theory of the firm as a nexus of contracts in disguise.

V. DISCUSSION

The scope of this paper is limited to pointing out the problems with how academics and practitioners often understand the nature and purpose of the firm as a cost-minimizing hierarchy. Nevertheless, if the idea of contracting into a hierarchy to minimize transaction costs is inconsistent with the moral requirements implicit within the idea of contracting, where can we go from here? Firms are riddled with authority relationships. Many also take as a given that some type of command hierarchy is needed to effectively coordinate the allocation of resources for many types of production in the modern economy (e.g., Anderson 2008). If the economic theory of the firm as a hierarchy were correct, the seeming necessity for hierarchies would imply that we either give up the idea that participation in firms is a voluntary activity or simply tolerate an economic arrangement that undermines our free will because the perceived gains outweigh the cost. Fortunately, however, there is no need to choose between these two

options because the economic theory of the firm as a hierarchy is not correct, even at a descriptive level. As noted above, the real-life phenomenon does not match the theory at the individual level. Although firms have no right of exit, respect for human autonomy has led to accommodations that grant employees the right to exit at any time and only require those who breach contracts to pay damages rather than to perform what they promised.

One possible path forward might be to take a closer look at principles of agency within the firm. Rather than hierarchies that reduce transactions costs, authority relationships within the firm are more accurately characterized as *agency* relationships. Currently within the United States, for instance, the relationship between the corporation and its directors are governed by the legal principles of agency. Traditionally, the agency relationship between the corporation and the manager has been understood to represent an underlying agency relationship between the firm's owners and its managers (e.g., Jensen and Meckling 1976). From this point of view, managers, as agents, have a fiduciary obligation to act on behalf of the interests of their principals, the shareholders (Goodpaster 1991). But many have also argued that these agency relationships extend even further out. For instance, when stakeholder theorists appeal to *fiduciary* duties to argue that managers have a duty to a firm's stakeholders beyond just its shareholders (e.g., Freeman 1994), they implicitly draw on an understanding of authority relationships between firm participants based on the principles of agency. In fact, given the complexity of agency relationships that can exist within the firm, some have even

suggested that the firm is best described as a nexus of agency relationships (Orts 1998; 2013).

Unlike hierarchical relationships, which are characterized by the exercise of power *over* a person, agency relationships are characterized by the exercise of power that is *granted* by a person. Of course, the two can coincide when one wields power over another – legitimate authority in wielding power over another person might require that one only exercise power over someone who has granted it, for instance – but they are distinct concepts. As discussed above, economic theories of the firm argue that the authority within the hierarchical firm exists to grant the hierarch a unilateral right to exert his will over the subordinate against her will. On the other hand, agency authority only applies to actions taken by the agent that enable the principal's will. Thus, whereas hierarchical power is exercised in instances that could not have been anticipated by the contracting parties, authority in agency relationships only extends to actions that are *reasonably foreseeable* by the principal (Dalley 2011). Whereas hierarchies involve the unilateral exercise of one party's will, then, authority exercised through agency relationships stems from the will of both the principal and agent. An account of the firm that incorporates the element of reasonable foreseeability along with the right of exit, then, could go a long way toward a morally satisfactory theory of the firm.

Nevertheless, appeals to agency relationships are not sufficient to form a true theory of the firm because a true theory of the firm must explain why firms exist at all. Suppose, for instance, that egalitarians and other political philosophers who concede the necessity of authority within the firm are correct. Suppose that authority relations exist in

firms because they are somehow necessary to coordinate the complex allocation of goods and labor within the firm. From this perspective, it may seem as if the purpose of the firm is to provide a coordinating mechanism that is analogous to the price mechanism within the market. Perhaps firms offer an advantage over markets because the hierarchical authority of the manager-entrepreneur is superior than the price mechanism in certain circumstances. But recall Coase's criticism of Knight and his explanation for *why* the hierarchical firm can be more efficient than markets. Even if the manager-entrepreneur could perform as a better coordinating mechanism than the price mechanism, why couldn't those who would otherwise participate within the firm simply enter into contractual arrangements to confer the manager with sufficient authority of command to coordinate their labor? Why is a firm necessary at all? And if one were to reply that the firm is merely a convenient shorthand for these contractual relationships, why is there any need to appeal to a hierarchy? If the hierarchy does not exist to reduce transactions costs by granting the manager-entrepreneur with the power to override the will of the employee, why does it need to exist at all? The reason why a theory of the firm must explain firms exist and what are its boundaries is because a theory that avoids these answers provides no theory of the firm whatsoever. If one appeals simply to pragmatic considerations for the need for authority in allocating firm resources, one does not yet have a theory of the firm. And without a theory, one has no theoretical basis to articulate the purpose of the firm.

Yet, if the economic theory of the firm as a hierarchy does not sufficiently respect the humanity of firm participants, what, if anything, can be salvaged from nearly a

century of theorizing about the nature and purpose of the firm? This paper has examined both the metaphors of contract and hierarchy because there is still much to be reclaimed from the aspects of economic theories that look to *contracts* as constitutive elements of the firm. As noted above, the universally recognized importance of voluntariness to contracts and its connection to respect for humanity provides a strong moral foundation for constructing a theory of the firm that treats its participants as ends and not as mere means. Furthermore, it is pragmatically advisable that business ethicists continue to utilize the language of contracts when discussing the nature and purpose of the firm. The usage of the metaphor of contract is solidly entrenched not only within economics but also the study of organizational theory and corporate governance more broadly. Business ethicists face a steep uphill climb if they seek to reinvent the wheel and offer an entirely new account of the firm. Yet, once the moral implications of voluntariness in contract is made explicit, there is no need to throw out the baby with the bath water. Rather than alienating business ethics from organizational studies, both disciplines can build on a shared foundation to construct theories and yield applications that are both normatively and descriptively right and powerful.

To be clear, the reliance on the contractual metaphor cannot be the whole story. Aside from the minority of extreme theorists who claim that the very construct of a firm is harmful for understanding and governing various modes of economic production, many organizational scholars fully accept and utilize the contractual metaphor as a central building block without denying the existence of firms. The team production theory of the firm, for instance, views the firm as a distinct entity apart from markets even while

“locat[ing] the... model... within the nexus of contracts tradition” (Blair and Stout 1999: 254). One particularly promising line of thinking about the nature and purpose of the firm builds on the insight that the firm is comprised of not only complete but also incomplete contracts (e.g., Coff 1999; Zingales 2000) and argues that the firm exists as a distinct entity apart from the market because it allows for greater value to be unlocked from combining various bundles of property rights held by firm participants (Asher et al. 2005; Kim and Mahoney 2010). Although there is more work to be done to flesh out a theory of the firm that incorporates elements of property rights without undermining the freedom and equality of firm participants, such theories point to such a possibility, given the extent to which property rights are evolving and “embedded in human rights,” as some business ethicists have claimed (Donaldson and Preston 1995: 83).

Building on the contractual metaphor of intrafirm relationships can also lead to a variety of practical applications. For instance, the “master-servant” model of hierarchical control is still considered to be the distinguishing factor of the employment relationship within the law. The contractual metaphor can provide a critique to such characterizations and point to the need for new theories of employment relationships in the law that better respect the freedom and equality of employees. Furthermore, corporate governance theories still often focus primarily on the principal-agent problem between shareholders and management, both as a matter of law and practice. Because it requires that all participants in the firm treat each other as ends in themselves rather than as mere means, the contractual metaphor can provide reasons for not only including labor within the governance of the firm but also for a bilateral interpretation of shareholders,

management, and labor as all being principals and agents of each other. Lastly, viewing employees as free and equal counterparties to a contractual relationship can change managerial behavior because the manager and the employee must continually share information, negotiate, and come to a shared understanding of each other's rights and obligations. Workplace civility, for instance, might need to be improved to better reflect the equal and reciprocal relationship if intrafirm relationships were interpreted to be contractual rather than hierarchical.

Lastly, to describe intrafirm relations as contractual does not necessarily exclude considerations of efficiency in economic coordination either. There is significant reason to think that complex forms of contracting – which include not only formal but also informal and/or relational contractual relationships – can minimize, if not eliminate altogether, the inefficiencies associated with market contracting (Bernstein 1992; Gilson et al. 2009; 2010; Scott 2003). These complex forms of formal and informal contracting have also made their way into how we describe intrafirm relationships. The emphasis on informal and relational contracts between managers and employees has led to new insights within theories of the firm as a nexus of contracts on how firms can leverage intrafirm relationships to increase economic output and increase competitiveness (e.g., Baker et al. 2002; Gibbons 2005; Gibbons and Henderson 2012). To describe intrafirm relationships as informal and/or relational contracts is to deny a hierarchical characterization of the manager-employee relationship. Rather than the manager commanding the employee from above, the manager continually negotiates with the employee to structure their relationship in accordance with terms to which both parties

agree. Thus, there is no need to give up on efficiency as an important value within the firm when one incorporates the metaphor of contracts into theories of the firm because many existing theories of the firm already utilize a robust conception of contracts to construct efficient solutions to the problems of coordinated production. Again, contracts cannot tell the entire story, and there is much more work to be done on this front. But future work examining the core building blocks of the firm such as agency, property, and contracting can build a morally acceptable theory of the firm that does not ignore considerations of efficiency.

VI. CONCLUSION

Theories of the firm matter because they articulate the nature and purpose of the firm. If we view the firm as a hierarchy that exists to reduce transactions costs by giving the hierarch a unilateral right to exert his will over his employees, it becomes much easier to treat what amounts to a threat to human dignity and freedom as a mere cost of doing business. If we wish to retain the idea that market activity consists of voluntary actions taken by individuals for their own benefit, we must revisit the idea that the firm exists as a hierarchy. Unfortunately, we do not have a sufficiently developed theory of the firm that stands as an alternative to the economic theory of the firm as a hierarchy. For those who wish to retain the hierarchical element within the firm, they must be able to explain why firms exist as hierarchies and what are their boundaries. As of now, no such theory exists.

Yet, given the availability of alternative concepts like contracts, agency and property, it is unclear why we would want a theory of the firm to incorporate hierarchies at all. Why shouldn't business ethicists and organizational theorists work together to construct a new theory of the firm that looks to contracts as foundational elements that constitute the firm? By looking to agency relationships and property rights to supplement the idea that firms are constituted by contracts, we may be able to articulate a new purpose of the firm that is consistent with the dignity and freedom of all of its participants. And once a new purpose is articulated, we will be able to take the next steps in aligning our reality and practice with our new theory. We may even be able to contribute to new legal frameworks, arrangements for corporate governance, and managerial practices that are consistent with our moral intuitions about how we organize into firms to coordinate our productive activities.

ESSAY 2:

Profit and Fair Play: How Economic Theories Of Entrepreneurship Can Help Us Recognize An Employee When We See One

I. INTRODUCTION

Distinguishing employees from independent contractors and other types of workers is not an easy task.¹ Nevertheless, employee status is a necessary and important category in legal analysis in a variety of ways. First, employee status plays an important role in demarcating the tort liability of the employer. Because employees are considered to be agents of employers in ways that are mostly not the case for other types of workers and service providers, employers are often held liable for the actions of their employees even though they would not be liable for the same actions of others working on their behalf.² The primary rationale for imposing liability on employers in this way is because employees are assumed to be acting as an extension of the employer, whereas non-employees are not.³ Second, employee status subjects the employer to a variety of

¹ See, e.g., Richard R. Carlson, *Why the Law Still Can't Tell an Employee When It Sees One and How It Ought to Stop Trying*, 22 BERKELEY J. EMP. & LAB. L. 295 (2001).

² This doctrine is known as the doctrine of *respondeat superior*. See, e.g., RESTATEMENT (SECOND) OF AGENCY §219(1) (“A master is subject to liability for the torts of his servants committed while acting in the scope of their employment.”).

³ To say that employees are acting as extensions of the employer can be interpreted differently within different tort theories. For instance, corrective justice theories of tort law view employees as moral extensions of employers when *respondeat superior* applies. See, e.g., ERNEST J. WEINRIB, *THE IDEA OF PRIVATE LAW*, 187 (1995) (“Where the faulty actor is sufficiently integrated into the enterprise and where the faulty act is sufficiently close to the assigned task, the law constructs a more inclusive legal persona, the-employer-acting-through-the-employee, to whom responsibility can be ascribed.”). On the other hand, economic theories of tort law are likely to view employees as extensions of the employer as a risk-taking enterprise, at least insofar as efficient risk-taking is concerned. See, e.g., Judge Easterbrook’s opinion in *Sec’y of Labor, U.S. Dep’t of Labor v. Lauritzen*, 835 F.2d 1529, 1544 (7th Cir. 1987) (“All the details of the common law independent contractor doctrine having to do with the right to control the work are addressed to identifying the best monitor and precaution-taker.”). Regardless of the finer differences,

statutory obligations spanning virtually every aspect of the employer-employee relationship, including those pertaining to wages, hours, benefits, retirement, and taxes.⁴ Although the specific reasons for imposing a statutory obligation differs from one statute to another, the general principle that underlies most of employee protection laws is the protection of workers who are vulnerable and disadvantaged.⁵ For instance, the preamble to the National Labor Relations Act (NLRA) points to the “inequality of bargaining power between employees... and employers” and states that one of its purposes is to protect workers by “restoring equality of bargaining power between employers and employees.”⁶ Third, employee status can play an important role in delineating the employer’s rights to resources and opportunities that can be exploited for business purposes. For instance, employers have property rights over work products created by their employees whereas they do not have such rights over similar products of non-employees.⁷ Similarly, some employees have fiduciary duties to respect the business

however, the central ideas that motivate the justifications is that there is some important connection between the employer and employee that, for the most part, does not exist between a business entity and its contractual partners.

⁴ For instance, only employees are protected by many significant federal laws, including the Labor Management Relations Act of 1947, 29 U.S.C. §152(2)-(3); the National Labor Relations Act, 29 U.S.C. §158(b)(4)(i); the Employee Retirement and Income Security Act, 29 U.S.C. §1002 (5)-(6); the Fair Labor Standards Act of 1938, 29 U.S.C. §201(2); the Family Medical Leave Act of 1993, 29 U.S.C. §2611(3); the Age Discrimination in Employment Act of 1967, 29 U.S.C. §630(f); the Civil Rights Act of 1964, Title VII, 42 U.S.C. §2000e(f); and the Americans with Disabilities Act of 1990, 42 U.S.C. §1211(3).

⁵ See, e.g., Carlson *supra* note 1, at 354 (“statutory purpose nearly always leads in the same direction: broad statutory coverage of economically dependent workers”).

⁶ 29 U.S.C. §151

⁷ For instance, although ownership of a copyright typically resides in the author of the work, ownership of a work created by an employee vests in the employer. See, e.g., Natkin v. Winfrey, 111 F. Supp. 2d 1003 (N.D. Ill. 2000); 17 U.S.C. § 201(b) (“In the case of a work made for hire, the employer or other person for whom the work was prepared is considered the author for purposes of this title.”).

interests and opportunities of their employers in ways that independent contractors do not.⁸

However, despite the legal importance of distinguishing employees from other types of workers, there is a significant lack of clarity or consensus on how the law ought to do so.⁹ The control test rooted within the common law of agency is the oldest and most widely recognized legal test for determining employee status, and it largely emphasizes the control that an employer has over the employee.¹⁰ Because the doctrine of *respondeat superior* is predicated on the theory that employees are acting as an extension of their employer in some way, the focus on control is theoretically well-suited for adjudicating classification issues that pertain to tort liability. Unfortunately, the test for control does not address all the relevant issues that motivate the myriad of statutory protections for employees.¹¹ A widely accepted alternative is known as the “economic realities test,” and it emphasizes the economic dependence of employees to their

⁸ See, e.g., *Midwest Ink Co. v. Graphic Ink Sys.*, No. 98 C 7822, 2003 WL 360089 (N.D. Ill. Feb. 18, 2003) (ruling for the defendant, who argued that he did not owe any fiduciary duties to the plaintiff because he was an independent contractor rather than an employee).

⁹ See, e.g., *Richardson v. APAC-Mississippi, Inc.*, 631 So.2d 143, 150 (Miss. 1994) (“various tests to determine the type of relationship are themselves generalities which can be viewed quite differently, depending upon which judge is applying them.”).

¹⁰ See, e.g., RESTATEMENT (THIRD) OF AGENCY §7.07(3)(a) (2006) (“an employee is an agent whose principal controls or has the right to control the manner and means of the agent’s performance of work”).

¹¹ See, e.g., Stephen F. Befort, *Revisiting the Black Hole of Workplace Regulation: A Historical and Comparative Perspective of Contingent Work*, 24 BERKELEY J. EMP. & LAB. L. 153 (2003); Carlson, *supra* note 1; Nancy E. Dowd, *The Test of Employee Status: Economic Realities and Title VII*, 26 WM. & MARY L. REV. 75 (1984); Marc Linder, *Dependent and Independent Contractors in Recent U.S. Labor Law: An Ambiguous Dichotomy Rooted in Simulated Statutory Purposelessness*, 21 COMP. LAB. L. & POL’Y J. 187 (1999); Lewis L. Maltby & David C. Yamada, *Beyond “Economic Realities”: The Case for Amending Federal Employment Discrimination Laws to Include Independent Contractors*, 38 B.C. L. REV. 239 (1997).

employers.¹² Unfortunately, although economic dependence of one party to another might signify some imbalance of bargaining power that motivates many employment protection statutes in theory, the economic realities test captures neither economic reality nor economic dependence. It fails to capture economic reality because economic dependence does not really distinguish employees from other types of workers. Employers are just as likely to be economically dependent on employees, and many independent contractors are likely to be just as economically dependent on their clients as employees are to their employers.¹³ Furthermore, it fails to capture economic dependence because, in practice, the economic realities test often has no practical difference with the control test, with courts tending to focus on factors that are shared by both.¹⁴ This problem is exacerbated by the fact that both tests are too convoluted and involve so many different factors that they are very difficult to provide consistent guidance to courts, businesses, and workers.¹⁵

As an alternative to both the control test and the economic realities test, there has been a recently growing acceptance of the view that an employee is someone who is not

¹² See, e.g., *Nowlin v. Resolution Trust Corp.*, 33 F.3d 498, 505 (5th Cir. 1994) (citing *Mares v. Marsh*, 777 F.2d 1066, 1067 (5th Cir. 1985)) (the economic realities test focuses on “whether the employee realistically is dependent upon the business to which he or she renders service”).

¹³ See, e.g., Brishen Rogers, *Employment Rights in the Platform Economy: Getting Back to Basics*, 10 HARV. L. & POL’Y REV. 479, 482 (2016) (noting that “plenty of classic contractors are economically dependent upon their clients, and employers are often economically dependent upon their employees.”); Linder, *supra* note 11; Maltby & Yamada, *supra* note 11.

¹⁴ See, e.g., RESTATEMENT OF EMPLOYMENT LAW §1.01 Reporters’ Notes (noting the “lack of any sharp distinction between the common-law test... and a multifactor economic-realities test”); *Murray v. Principal Fin. Grp., Inc.*, 613 F.3d 943, 945 (9th Cir. 2010) (noting that “there is no functional difference between the three formulations” of employee status expressed by the common law agency test, the economic realities test, and a common law hybrid test).

¹⁵ See, e.g., Carlson, *supra* note 1.

an working as an entrepreneur.¹⁶ The D.C. Circuit, in particular, has embraced this “shift of emphasis to entrepreneurialism”¹⁷ by endorsing a new test that focuses on the entrepreneurial opportunities of workers.¹⁸ Under what is now known as the entrepreneurial opportunities test, the court focuses “not upon the employer's control of the means and manner of the work but instead upon whether the putative independent contractors have a significant entrepreneurial opportunity for gain or loss” to determine whether or not a worker is an employee.¹⁹ The assumption that animates this focus on entrepreneurial opportunity is that an employee is not involved with the “opportunities and risks inherent in entrepreneurialism,”²⁰ whereas an independent contractor “takes economic risk and has the corresponding opportunity to profit.”²¹ Although there is some concern that the entrepreneurial opportunities test is inconsistent with the Supreme Court precedent in *Nationwide Mutual Insurance Company v. Darden*,²² the D.C. Circuit has continued to look to it as a guidepost for other NLRA claims.²³ And other courts, even as they decline to apply the entrepreneurial opportunities test, have begun to consider the

¹⁶ See, e.g., RESTATEMENT OF EMPLOYMENT LAW §1.01(b) (“An individual renders services as an independent businessperson and not as an employee when the individual in his or her own interest exercises entrepreneurial control over important business decisions, including whether to hire and where to assign assistants, whether to purchase and where to deploy equipment, and whether and when to provide service to other customers.”).

¹⁷ *Corp. Exp. Delivery Sys. v. N.L.R.B.*, 292 F.3d 777, 780 (D.C. Cir. 2002) [hereinafter *Corporate Express Delivery Systems*].

¹⁸ The court first articulated the “entrepreneurial opportunities” test in *Corporate Express Delivery Systems* and affirmed it in *FedEx Home Delivery v. N.L.R.B.*, 563 F.3d 492 (D.C. Cir. 2009) [hereinafter *FedEx Home Delivery*].

¹⁹ *Corporate Express Delivery Systems*, at 780 (internal quotation marks omitted).

²⁰ *FedEx Home Delivery*, at 497.

²¹ *Corporate Express Delivery Systems*, at 780.

²² 503 U.S. 318 (1992). For a discussion on the inconsistency of the entrepreneurial opportunities test with Supreme Court precedent, see, e.g., Jeffrey M. Hirsch, *Employee or Entrepreneur?*, 68 WASH. & LEE L. REV. 353, 357 (2011) (noting that the test “directly contradicts Supreme Court precedent”). See also Judge Garland’s dissenting opinion in *FedEx Home Delivery*.

²³ See, e.g., *Lancaster Symphony Orchestra v. Nat’l Labor Relations Bd.*, 822 F.3d 563 (D.C. Cir. 2016).

availability of entrepreneurial opportunities as an important factor for determining employee status.²⁴

Unfortunately, what is missing from this recent focus on entrepreneurship is a theoretical understanding of what entrepreneurship actually is and why it matters. Courts often seem to rely on common sense notions of entrepreneurship as profit seeking and/or risk taking.²⁵ Scholars who look to economic theory to inform their arguments within this context only mention the entrepreneur tangentially as part of their examination of economic theories of the firm rather than as their main focus.²⁶ Neither approach has had any traction with contemporary entrepreneurship research. As a response to this lack of attention to the theoretical underpinnings of entrepreneurship, this paper looks to economic theories of entrepreneurship, which have been very influential for framing entrepreneurship research, to supply criteria for determining whether a worker is acting as an entrepreneur. In doing so, it attempts to better inform the increased attention to the element of entrepreneurship and ground it within a scholarly tradition.

²⁴ See, e.g., *N.L.R.B. v. Friendly Cab Co.*, 512 F.3d 1090, 1097 (9th Cir. 2008) (“In finding that the incidents of the relationship between Friendly and its drivers militate in favor of ‘employee’ status, we place particular significance on Friendly’s requirement that its drivers may not engage in any entrepreneurial opportunities.”). See also *Doud v. Yellow Cab of Reno, Inc.*, 96 F. Supp. 3d 1076 (D. Nev. 2015) and *Crew One Prods., Inc. v. N.L.R.B.*, 811 F.3d 1305 (11th Cir. 2016).

²⁵ See, e.g., *Corporate Express Delivery Systems*, at 780. (“The full-time cook and the executive are employees and the lawn-care provider is an independent contractor not because of the degree of supervision under which each labors but because of the degree to which each functions as an entrepreneur — that is, takes economic risk and has the corresponding opportunity to profit from working smarter, not just harder.”).

²⁶ See, e.g., Matthew T. Bodie, *Participation as a Theory of Employment*, 89 NOTRE DAME L. REV. 661 (2013). See also Julia Tomassetti, *From Hierarchies to Markets: FedEx Drivers and the Work contract as Institutional Marker*, 19 LEWIS & CLARK L. REV. 1083 (2015).

Although contemporary theories of entrepreneurship abound in a variety of ways, almost all entrepreneurship scholars build on the following three classic theories of entrepreneurship – Frank Knight’s work on risk and uncertainty²⁷, Joseph Schumpeter’s work on creative destruction²⁸, and Israel Kirzner’s work on entrepreneurial alertness²⁹. The foundational theory of entrepreneurship is that of Frank Knight. Knight argues that entrepreneurs assume ultimate responsibility for the business enterprise – a concept that this paper will refer to as *entrepreneurial responsibility*. Within Knight’s framework, entrepreneurial responsibility consists of both exercising control over the enterprise and assuming a type of risk he describes as uncertainty.³⁰ Economic uncertainty refers to the type of risk that cannot be calculated or known in advance.³¹ It exists because supply and demand in the market is unpredictable, and entrepreneurs are those who assume liability for such unpredictability. Joseph Schumpeter offers greater elaboration on the control

²⁷ See, generally, FRANK H. KNIGHT, *RISK, UNCERTAINTY, AND PROFIT* (1921) [hereinafter *RISK, UNCERTAINTY, AND PROFIT*].

²⁸ See, e.g., JOSEPH A. SCHUMPETER, *THE THEORY OF ECONOMIC DEVELOPMENT* (1934) [hereinafter *THEORY OF ECONOMIC DEVELOPMENT*]; Joseph A. Schumpeter, *The Creative Response in Economic History*, 7 *J. ECON. HIST.* 149 (1947) [hereinafter *Creative Response*]; JOSEPH A. SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY* (1942) [hereinafter *CAPITALISM, SOCIALISM AND DEMOCRACY*].

²⁹ See, e.g., ISRAEL M. KIRZNER, *COMPETITION AND ENTREPRENEURSHIP* (1973) [hereinafter *COMPETITION AND ENTREPRENEURSHIP*]; Israel M. Kirzner, *Entrepreneurial Discovery and the Competitive Market Process: An Austrian approach*, 35 *J. ECON. LIT.* 60 (1997) [hereinafter *Entrepreneurial Discovery*]; Israel M. Kirzner, *The Alert and Creative Entrepreneur: A Clarification* 32 *SMALL BUS. ECON.* 145 (2009).

³⁰ See, e.g., *RISK, UNCERTAINTY, AND PROFIT*, at 271 (“The essence of enterprise is the specialization of the function of *responsible direction* of economic life, the neglected feature of which is the inseparability of these *two* elements, *responsibility* and *control*.... Any degree of effective exercise of judgment, or making decisions, is in a free society coupled with a corresponding degree of uncertainty-bearing, of taking the responsibility for those decisions.”).

³¹ See *RISK, UNCERTAINTY, AND PROFIT*, at 233 (“To preserve the distinction... between the measurable uncertainty and an unmeasurable one we may use the term ‘risk’ to designate the former and the term ‘uncertainty’ for the latter.... The practical difference between the two categories, risk and uncertainty, is that in the former the distribution of the outcome in a group of instances is known (either through calculation a priori or from statistics of past experience), while in the case of uncertainty this is not true, the reason being in general that it is impossible to form a group of instances, because the situation dealt with is in a high degree unique.”).

element of entrepreneurial responsibility. He argues that entrepreneurship is the creative destruction of an existing economic equilibrium through the introduction of a new good, method of production, market, source of supply of materials, or organization of industry.³² Entrepreneurs are those who exercise their right to control such means of production, which is necessary for taking productive assets out of their existing usage, to allocate them for new ways of usage.³³ Israel Kirzner, on the other hand, emphasizes a different – yet ultimately complementary – view of the entrepreneur. He argues that entrepreneurship consists of bringing the market closer to equilibrium by discovering and exploiting previously overlooked opportunities to profit from an existing market inefficiency.³⁴ The Kirznerian entrepreneur is alert to potential inefficiencies and acts boldly to correct the market by buying where prices are too low and selling where prices are too high.³⁵

Taken together, the three classic theories of entrepreneurship can yield a justifiable and workable three-part test – which I will refer to as the entrepreneurial responsibilities test – for courts to determine whether or not a worker is an employee. Rather than control, economic dependence, or the existence of entrepreneurial opportunities, the entrepreneurial responsibilities test focuses on whether or not the worker assumes *entrepreneurial responsibility* for her work. Economic theories of

³² See, generally, THEORY OF ECONOMIC DEVELOPMENT.

³³ *Id.*, at 68 (“command over means of production is necessary to the carrying out of new combinations.”).

³⁴ See, generally, COMPETITION AND ENTREPRENEURSHIP.

³⁵ See, e.g., *Entrepreneurial Discovery*, at 70 (“The daring, alert entrepreneur discovers these earlier errors, buys where prices are ‘too low’ and sells where prices are ‘too high.’ In this way low prices are nudged higher, high prices are nudged lower; price discrepancies are narrowed in the equilibrative direction.”).

entrepreneurship can supply courts with three elements that are necessary for workers to assume entrepreneurial responsibility. The first element is the Knightian element, and it looks to whether or not the worker assumes liability for economic uncertainty. The second element is the Schumpeterian element, and it looks to whether or not the worker exercises control over the allocation of resources being combined to sell in the market. The third element is the Kirznerian element, and it looks to whether or not the worker participates in the market process by buying resources to sell in the market to earn a profit.

Aside from its simplicity and wide-ranging applicability, the entrepreneurial responsibilities test is superior to other existing tests for employee status because it corresponds with the principle of fair play and the very reasons why we organize our economic activities within markets and firms. The principle of fair play holds that, “when a number of persons conduct any joint enterprise according to rules and thus restrict their liberty, those who have submitted to these restrictions when required have a right to a similar submission from those who have benefited by their submission.”³⁶ Both markets and firms are such joint enterprises that offer benefits and restrictions. Markets subject economic actors to high-powered incentives, where the market actor is exposed to the entirety of full potential gains or losses that accompany a transaction. The firm is an alternative arrangement that can shield economic actors from the incentive structure of the market by offering low-powered incentives, where the firm actor, i.e., the employee,

³⁶ H. L. A. Hart, *Are There Any Natural Rights?*, 64 PHIL. REV. 175, 185 (1955). See also John Rawls, *Legal Obligation and the Duty of Fair Play*, in LAW AND PHILOSOPHY 3 (Sidney Hook, ed. 1964).

captures neither the full gains nor bears the full losses associated with her economic activity.³⁷ Within such a scheme, I will argue, the principle of fair play suggests that it would be unfair for economic actors to benefit privately by circumventing the bifurcation of work into markets and firms in our economic system, which are intended for the benefit of all participants. This principle can explain and justify a wide variety of the need for distinguishing employees from independent contractors in a parsimonious and unified way. From traditional grounds of inquiry like vicarious liability and various worker protections to other tangentially related topics like owner property rights, the entrepreneurial responsibilities test can provide a principled way for courts to distinguish those who require the protection of the law.

This paper proceeds as follows. In Part II, I outline both the control test and the economic realities test and assess the underlying rationales that animate the tests and employee status. I also discuss the entrepreneurial opportunities test as articulated by the D.C. Circuit and point to the need to examine the concept of entrepreneurship more closely and to justify it in a principled way. In Part III, I provide the theoretical underpinning of the entrepreneurial responsibilities test by describing economic theories of entrepreneurship provided by Knight, Schumpeter, and Kirzner. In Part IV, I introduce the entrepreneurial responsibilities test and connect the test's three elements

³⁷ High-powered incentives in markets can lead to costly transactions because they can encourage opportunistic behavior between transaction parties. From a transactions cost economics perspective, firms offer an advantage over markets in reducing the costs associated with opportunism by substituting out high-powered incentives for low-powered ones. For more on the relative differences in the intensity of incentives within markets and firms and how it leads to the relative advantages of each arrangement, see, e.g., OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985).

with the three theories of entrepreneurship described above. I also apply the proposed test to worker misclassification in the sharing economy by showing how it fares better than other existing tests in classifying Uber drivers differently from taxi drivers. Then, in Part V, I justify the entrepreneurial responsibilities test by describing the principle of fair play, discussing the distinction between markets and firms as alternate systems of economic organization, and connecting the structure of our economic system with the various ways in which worker misclassification can lead to unfairness. I close in Part VI.

II. EXISTING TESTS FOR EMPLOYEE STATUS

Although distinguishing employees from other types of workers is critical for determining coverage under a variety of federal and state employment statutes, most statutes do not offer a satisfactory definition of who is an employee. The Fair Labor Standards Act (FLSA)³⁸, for instance, simply defines a non-governmental employee as “any individual employed by an employer,”³⁹ an employer as “any person acting directly or indirectly in the interest of an employer in relation to an employee,”⁴⁰ and to employ as “to suffer or permit to work.”⁴¹ Other federal and state statutes have also typically followed the tactic of leaving the definitions open.⁴² As a result, courts have often looked

³⁸ 29 U.S.C. §§ 209-219

³⁹ *Id.* § 203(e)(1)

⁴⁰ *Id.* § 203(d)

⁴¹ *Id.* § 203(g)

⁴² For other federal statutes, see, e.g., Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e(f) (“The term “employee” means an individual employed by an employer”), the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1002(6) (“The term “employee” means any individual employed by an employer”), and the Americans with Disabilities Act of 1990, 42 U.S.C. § 12111(4) (“The term “employee” means an individual employed by an employer.”). For the vacuous definitions of employees in state statutes and the need for a legal test in such contexts, see, e.g., Carlson, *supra* note 1, at 296 n.5, along with *infra* notes 63, 79, 80, and accompanying texts.

to a confusing and uncertain set of common law tests to determine whether a worker is an employee or an independent contractor.⁴³

This section assesses the two most commonly used tests for determining employee status – the control test rooted within the common law of agency and the economic realities test – and introduces the entrepreneurial opportunities test, which is a more recently articulated standard under the NLRA. It will argue that the control test, while well-suited for adjudicating classification issues that pertain to tort liability, does not account for the myriad of purposes that motivate the various statutory protections for employees. Furthermore, despite its purported focus on economic dependence, it will argue that the economic realities test corresponds to neither economic reality nor economic dependence. Lastly, it will discuss the emergence of the entrepreneurial opportunities test and argue that it requires a greater examination of entrepreneurship and why it should matter for determining employee status.

A) Assessing the control test

The control test has its origins within the common law governing the master-servant relationship in England.⁴⁴ Under the English common law, “the master is answerable for the act of his servant, if done by his command, either expressly given, or

⁴³ See, e.g., *Kisner v. Jackson*, 132 So. 90, 91 (Miss. 1931) (“There have been many attempts to define precisely what is meant by the term ‘independent contractor’; but the variations in the wording of these attempts have resulted only in establishing the proposition that it is not possible within the limitations of language to lay down a concise definition that will furnish any universal formula, covering all cases.”)

⁴⁴ See, e.g., *Carlson*, *supra* note 1, at 302 (“The “master-servant” relationship... is widely regarded as the pre-industrial precursor of the “employer-employee” relationship”). See also Gerald M. Stevens, *The Test of the Employment Relation*, 38 MICH. L. R. 188 (1939).

implied.”⁴⁵ The rationale for holding the master liable for the servant’s actions stemmed from the master’s oversight of his servants. If an innkeeper’s servant robs a customer, for instance, the innkeeper is liable for the robbery because “there is a confidence reposed in him, that he will take care to provide honest servants.”⁴⁶ And despite the dramatic change in labor relationships during the Industrial Revolution, English courts continued to look to the master-servant relationship as a guide for determining whether an employer or a worker was to be held liable for the torts of the worker. And in looking to the master-servant relationship, English courts focused primarily on whether the employer exercised control over the worker’s actions.⁴⁷

The distinction between an employee and an independent contractor within the United States first became important as courts struggled to apply the common law governing the master-servant relationship within the context of worker’s compensation laws during the Industrial Revolution.⁴⁸ As a result, American jurisprudence for classifying employees also relied on the English master-servant model predicated on whether the employee was acting *under the employer’s command* to determine the

⁴⁵ WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND, 417 (1765).

⁴⁶ *Id.*

⁴⁷ See, e.g., *Sadler v. Henlock*, 119 Eng. Rep. 209, 212 (1855) (“The test here is, whether the defendant retained the power of controlling the work. No distinction can be drawn from the circumstance of the man being employed at so much a day or by the job. I think that here the relation was that of master and servant, not of contractor and contractee.”).

⁴⁸ See, e.g., *Stevens*, *supra* note 44, at 189 (“The relation of employer and employee is, of course, that formerly known under the title of master and servant. The shift to the first terminology seems to have accompanied the development of workmen’s compensation legislation, which makes clear the substantial identity of the two. And it was in determining the scope of vicarious liability under the doctrine of respondeat superior that definition of this relation became important.”).

employer's liability for the employee's actions.⁴⁹ And even today, the test for determining whether an employer ought to be liable for the employee's actions typically rests on the principles of agency, which emphasize the element of control that the principal has over the agent.⁵⁰ For instance, in *Carter v. Reynolds*, the New Jersey Supreme Court looked to the common law principles of agency to rule that an accounting firm was liable for the negligent driving of a part-time worker on her way home from work because its requirement that she drive her personal vehicle amounted to an exercise of control over her.⁵¹ Similarly, in *St. Joseph Hospital v. Wolff*, the Texas Supreme Court ruled that a surgical resident involved in a malpractice case was an employee of a health organization formed for the purpose of operating a residency program based primarily on the degree of control that the foundation had over the resident.⁵²

Given its origins, the control test intuitively seems well-suited for determining whether or not the employer should be held vicariously liable for the actions of the worker. Under the laws of agency, the employer is liable for the consequences of his

⁴⁹ See, e.g., *Pelow v. Oswego Const. Co.*, 162 A.D. 840, 841 (1916) (“an employer is made liable for personal injuries... by reason of the negligence of any person intrusted with authority to direct, control, or command any employe in the performance of the duty of such employe.”).

⁵⁰ See, e.g., RESTATEMENT (SECOND) OF AGENCY § 220(1) (“A servant is a person employed to perform services in the affairs of another and who with respect to the physical conduct in the performance of the services is subject to the other's control or right to control.”). See also RESTATEMENT (THIRD) OF AGENCY § 7.07(3)(a) (“an employee is an agent whose principal controls or has the right to control the manner and means of the agent's performance of work”).

⁵¹ *Carter v. Reynolds*, 175 N.J. 402, 416, (2003) (“When an employer requires an employee to use a personal vehicle, it exercises meaningful control over the method of the commute by compelling the employee to forswear the use of carpooling, walking, public transportation, or just being dropped off at work.”)

⁵² *St. Joseph Hosp. v. Wolff*, 94 S.W.3d 513, 541 (Tex. 2002) (“The above discussion makes clear there are a number of factors affecting whether and when vicarious liability is appropriate. Paramount among those factors, however, is whether the person being held responsible can be said to have had a right to control the activities of the wrongdoer.”).

employee's actions undertaken during the course of her employment,⁵³ whereas he is generally not liable for the actions of an independent contractor.⁵⁴ The reason for such a distinction is often thought to rest on the relative difference in the degrees of control exercised by the employer over the worker.⁵⁵ When an employer sufficiently controls the worker, it seems intuitive that it is the employer and not the worker who is responsible for mitigating the harm to others. When there is no such control, however, the worker can be thought to be acting independently from the employer and thus personally responsible for the harms caused to others. Furthermore, when a worker acts under the control of the employer, the worker can be thought to be sufficiently connected to the will of the employer so as to express the employer's will in his actions.⁵⁶ And insofar as the worker is an instrumentality of the employer, it does not seem unreasonable to treat the two parties as one composite entity for apportioning liability.⁵⁷

However, the application of the control test is no longer limited to determining whether or not the employer ought to be vicariously liable for the actions of the worker.

⁵³ RESTATEMENT (THIRD) OF AGENCY § 2.04 (“An employer is subject to liability for torts committed by employees while acting within the scope of their employment.”).

⁵⁴ RESTATEMENT (SECOND) OF TORTS § 409 (“the employer of an independent contractor is not liable for physical harm caused to another by an act or omission of the contractor or his servants.”). See also RESTATEMENT (SECOND) OF TORTS §§ 410 – 429 for exceptions to this general rule, which include various circumstances related to the wrongful actions or omissions of the employer.

⁵⁵ See, e.g., RESTATEMENT (SECOND) OF TORTS § 409 cmt b (“The explanation for it most commonly given is that, since the employer has no power of control over the manner in which the work is to be done by the contractor, it is to be regarded as the contractor's own enterprise, and he, rather than the employer, is the proper party to be charged with the responsibility of preventing the risk, and bearing and distributing it.”).

⁵⁶ See, e.g., BLACKSTONE, *supra* note 45, at 417 (“[the master's] negligence is a kind of implied consent to the robbery”).

⁵⁷ See, e.g., ERNEST J. WEINRIB, *THE IDEA OF PRIVATE LAW*, at 187 (1995). See also *Fruit v. Schreiner*, 502 P.2d 133, 141 (Alaska 1972) (“Employees' acts sufficiently connected with the enterprise are in effect considered as deeds of the enterprise itself.”).

In fact, unless otherwise specified by statute or case law, courts will typically default to the common law of agency to determine whether a worker is an employee or an independent contractor.⁵⁸ For instance, federal courts focus on thirteen factors that pertain to “the hiring party's right to control the manner and means by which the product is accomplished”⁵⁹ for the purposes of determining employee status under a variety of federal statutes, including the Employee Retirement Security Act (ERISA),⁶⁰ the Americans with Disabilities Act (ADA)⁶¹, and the NLRA.⁶² State courts have also followed suit and typically rely on the federal common law test for a wide variety of state statutes involving employee protections that mirror the federal statutes as well.⁶³

Unfortunately, the focus on the employer’s control over the worker does not make much sense when applied outside the vicarious liability context. For instance, the purpose of ERISA is, among others, to protect “the interests of participants in private

⁵⁸ See, e.g., *Cnty. for Creative Non-Violence v. Reid*, 490 U.S. 730, 739–40 (1989) (“In the past, when Congress has used the term “employee” without defining it, we have concluded that Congress intended to describe the conventional master-servant relationship as understood by common-law agency doctrine.”).

⁵⁹ *Id.*, at 751-752 (“In determining whether a hired party is an employee under the general common law of agency, we consider the hiring party's right to control the manner and means by which the product is accomplished. Among the other factors relevant to this inquiry are the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties; whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party.”) (footnotes omitted).

⁶⁰ See, e.g., *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992).

⁶¹ See, e.g., *Clackamas Gastroenterology Assocs., P. C. v. Wells*, 538 U.S. 440 (2003).

⁶² See, e.g., *N.L.R.B. v. United Insurance Co. of America*, 390 U.S. 254 (1968).

⁶³ See, e.g., *Strother v. S. California Permanente Med. Grp.*, 79 F.3d 859, 866 (9th Cir. 1996) (“we look to federal cases in those areas that have addressed whether an individual labeled as a partner can be considered an employee for the purpose of employment discrimination laws.”). See also *Frishberg v. Esprit De Corp., Inc.*, 778 F. Supp. 793, 798 (S.D.N.Y. 1991) (“Since New York law distinguishes between employees and independent contractors in a sufficiently similar manner, the court will use the federal test for both state and federal claims.”).

pension plans and their beneficiaries by improving the equitable character and the soundness of such plans.”⁶⁴ It is difficult to imagine a justifiable connection between the employer’s control over the worker and the fairness of worker retirement plans. Nevertheless, the control test allows employers to deny revoke employment benefits for a long-time worker who would have otherwise been protected under ERISA.⁶⁵ The connection between control and the aims of other statutes for which the control test is used – whether it is the elimination of discrimination against individuals with disabilities⁶⁶ or the correction of the inequalities of bargaining power between capital and labor⁶⁷ – are similarly too attenuated to justify the control test as an appropriate rule for determining employee status.

Furthermore, the very notion of control is problematic for courts attempting to distinguish employees from independent contractors. What does it mean for an employer to control an employee? Within the control test, the traditional meaning of control pertains to the employer’s supervision of the means and manner of production in addition

⁶⁴ 29 U.S.C. § 1001(c).

⁶⁵ In the events leading up to *Nationwide Mut. Ins. Co. v. Darden*, the trial court first granted summary judgment to the employer after determining that the worker did not qualify for employee status under the control test. The rationale for the holding can be found in an opinion that overturned it. *Darden v. Nationwide Mut. Ins. Co.*, 796 F.2d 701, 705 (4th Cir. 1986) (“Under such traditional common law principles, Darden most probably would not qualify as an employee.”).

⁶⁶ 42 U.S.C. § 12101(b) (“It is the purpose of this chapter--(1) to provide a clear and comprehensive national mandate for the elimination of discrimination against individuals with disabilities;(2) to provide clear, strong, consistent, enforceable standards addressing discrimination against individuals with disabilities”).

⁶⁷ 29 U.S.C. § 151 (“The inequality of bargaining power between employees... and employers... substantially burdens and affects the flow of commerce.... It is hereby declared to be the policy of the United States to eliminate the causes of certain substantial obstructions to the free flow of commerce and to mitigate and eliminate these obstructions when they have occurred by encouraging the practice and procedure of collective bargaining and by protecting the exercise by workers of full freedom of association, self-organization, and designation of representatives of their own choosing”).

to its results.⁶⁸ However, because the distinction between the means and results of a task depends on how narrowly the task is defined, control test can yield different results purely based on the definition of the worker's task.⁶⁹ Furthermore, because a narrow specification of the results of a task can lead to an effective control over the means of carrying it out, the control test allows for a great deal of manipulation by clever employers.⁷⁰ Lastly, because control can be exercised in subtle and informal ways, it is difficult for courts to determine whether or not the employer exercised control or had the right of control over the worker, particularly when control determines employee status across the board rather than within the particular context of the legal dispute.⁷¹ Given not only the misfit between the purpose of the control test and its subsequent application but also issues with taking control as a primary determining factor for employee status, then, it comes as no surprise that courts have continued to look for other options.

⁶⁸ See, e.g., *C.C. E., Inc. v. N.L.R.B.*, 60 F.3d 855, 858 (D.C. Cir. 1995) (“Although this right-to-control test requires an evaluation of all the circumstances surrounding the relationship between the company and the worker, the extent of the actual supervision exercised by a putative employer over ‘the means and manner’ of the workers' performance is the most important element to be considered. It is important, however, to distinguish such company supervision from company efforts merely to monitor, evaluate, and improve the results or ends of the worker's performance. Supervision of the means and manner of the worker's performance renders him an employee, while steps taken to monitor, evaluate, and improve the results of his work, without supervision over the means by and manner in which he does his work, indicates that the worker is an independent contractor.”) (citations, italicization, and internal quotation marks omitted).

⁶⁹ See, e.g., Carlson, *supra* note 1, at 340 (“A plumber, for example, might be a contractor if installing good plumbing is a discrete end the parties seek to achieve, and where the owner or general contractor wishes to have no involvement in the details of the plumbing. Conversely, . . . [i]f building a house is the goal, . . . there is an argument that the plumber's entire work is but a detail under the general contractor's control, and the plumber is therefore an employee.”).

⁷⁰ See, e.g., Tomassetti, *supra* note 26, at 1099 (“the means-ends standard is amenable to nearly infinite manipulation. Courts can always find some residual discretion left to the putative contractor, and they can describe the “ends” at the level of detail necessary for the employer to maintain complete control.”).

⁷¹ See, e.g., Carlson, *supra* note 1, at 340-342.

B) Assessing the economic realities test

Even while courts were frequently looking to the master-servant model and its emphasis on control, some courts were looking at a more expansive set of criteria to distinguish employees from independent contractors. In *Lehigh Valley Coal Co. v. Yensavage*, for instance, a coal mine refused to pay statutorily required compensation to its miners for work-related injuries because its miners were merely independent contractors who wholly assumed the risk of their activities.⁷² In holding that the mine owed “the duties of a master to a servant” to its miners, Judge Learned Hand looked to the economic disadvantage of the miners relative to the mine along with the purpose of the statute.⁷³ Since *Lehigh Valley*, courts have attempted at times to look to the purpose of the relevant statute to hold that the determination of employee status ought to look to the economic relationship between the employer and the worker rather than to the formal elements of control and the common law of agency, with limited success.⁷⁴

And despite the focus on the control test in the past few decades, the part of the *Lehigh Valley* approach that looks to the economic relationship between the employer

⁷² 218 F. 547 (2d Cir. 1914).

⁷³ *Id.*, at 552–53 (“the whole purpose of such statutes... are meant to protect those who are at an economic disadvantage... It is absurd to class such a miner as an independent contractor in the only sense in which that phrase is here relevant. He has no capital, no financial responsibility. He is himself as dependent upon the conditions of his employment as the company fixes them as are his helpers.”).

⁷⁴ See, e.g., *N.L.R.B. v. Hearst Publications*, 322 U.S. 111, 124 (1944) (“Whether, given the intended national uniformity, the term ‘employee’ includes such workers as these newsboys must be answered primarily from the history, terms and purposes of the legislation.”) and *United States v. Silk*, 331 U.S. 704, 713 (1947) (“We concluded that, since that end was the elimination of labor disputes and industrial strife, ‘employees’ included workers who were such as a matter of economic reality.”). Both *Hearst* and *Silk*, along with their focus on statutory purpose, were later overturned in *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318 (1992).

and the worker – now known as the economic realities test – has persisted within a narrow range of cases that arise out of FLSA’s definition of employees. As noted above, FLSA defines the verb “to employ” to include “to suffer or permit to work.”⁷⁵ Due to this expansive definition, federal courts have applied what is now known as the economic realities test to determine employee status for claims arising out of FLSA⁷⁶ and, because it utilizes FLSA’s definitions of employ and employee,⁷⁷ the Family Medical Leave Act of 1993 (FMLA).⁷⁸ Many state courts have also followed suit and applied the economic realities test for claims relevant to wage and hour protections.⁷⁹ Other states adopt the economic realities test for other claims as well.⁸⁰

The exact application of the economic realities test varies depending on jurisdiction. Some jurisdictions look to a limited set of factors such as “(1) control of a worker’s duties, (2) the payment of wages, (3) the right to hire and fire and the right to discipline, and (4) the performance of the duties as an integral part of the employer’s

⁷⁵ 29 U.S.C. § 203(g).

⁷⁶ See, e.g., *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 326 (U.S. 1992) (FLSA’s expansive definition “stretches the meaning of “employee” to cover some parties who might not qualify as such under a strict application of traditional agency law principles.”). See also *Tony & Susan Alamo Found. v. Sec’y of Labor*, 471 U.S. 290, 301 (1985) (“The test of employment under the Act is one of economic reality”) (quotations omitted).

⁷⁷ 29 U.S.C. § 2611(3) (“The terms ‘employ’, ‘employee’, and ‘State’ have the same meanings given such terms in subsections (c), (e), and (g) of section 203 of this title.”).

⁷⁸ See, e.g., *Nichols v. All Points Transp. Corp. of Michigan*, 364 F. Supp. 2d 621, 630 (E.D. Mich. 2005) (“Because the statutory definition of FMLA, unlike the definition found in ERISA, incorporates the FLSA’s broader definition of ‘employee’ and ‘employ,’ the court will continue to apply the “economic realities” test as described by the Sixth Circuit”).

⁷⁹ See, e.g., *Laborers’ Int’l Union of N. Am., AFL-CIO v. Case Farms, Inc.*, 127 N.C. App. 312, 314, (1997) (“The North Carolina Wage and Hour Act is modeled after the Fair Labor Standards Act.... Several factors used by federal jurisdictions to determine ‘employee’ status under the FLSA are equally useful in the context of the Wage and Hour Act”).

⁸⁰ See, e.g., *Fitzgerald v. Mobil Oil Corp.*, 827 F. Supp. 1301, 1303 (E.D. Mich. 1993) (“Michigan courts rely on the ‘economic realities test’ to establish the existence of an employer/employee relationship.”).

business towards the accomplishment of a common goal.”⁸¹ Other jurisdictions take a more expansive approach to cover factors such as “1) the nature and degree of the alleged employer's control as to the manner in which the work is to be performed; 2) the alleged employee's opportunity for profit or loss depending upon his managerial skill; 3) the alleged employee's investment in equipment or materials required for his task, or his employment of workers; 4) whether the service rendered requires a special skill; 5) the degree of permanency and duration of the working relationship; 6) the extent to which the service rendered is an integral part of the alleged employer's business.”⁸² Whatever the specific test, however, the general thrust of the economic realities test is intended to look beyond a formal specification of factors to determine the employee’s economic dependence on the employer.⁸³

One rationale offered to justify the economic realities test is that those who are economically dependent on their employers are particularly vulnerable in the market due to their lack of bargaining power, whereas those who have greater bargaining power would only be limited by mandatory regulation on what they can negotiate in light of their preferences.⁸⁴ For instance, low-skilled laborers are dependent on their employers

⁸¹ *Askew v. Macomber*, 398 Mich. 212, 217–18, (1976).

⁸² *Sec'y of Labor, U.S. Dep't of Labor v. Lauritzen*, 835 F.2d 1529, 1535 (7th Cir. 1987).

⁸³ See, e.g., *Dowd*, *supra* note 11, at 112-113 (“Control of employment opportunities is the linchpin of the economic realities test, viewed from the perspective of the employee's dependency on the employer and vulnerability to discriminatory conduct. This focus requires an analysis of the economic terms of particular relationships on a case-by-case basis, rather than on the basis of a catalogue of immutable factors. The flexibility of this analysis is essential to avoid the rigidity of the common law test and to accommodate the present range of employment relationships and the new patterns that may evolve in the future.”).

⁸⁴ See, e.g., *Sec'y of Labor, U.S. Dep't of Labor v. Lauritzen*, 835 F.2d 1529, 1544–45 (7th Cir. 1987) (J. Easterbrook concurring) (“Indeed, the details of independent contractor relations are fundamentally contractual. Firms can structure their dealings as ‘employment’ or ‘independent contractor’ to maximize the efficiency of incentives to work, monitor, and take precautions.... The FLSA is designed to defeat

because they lack the ability to obtain higher paying jobs elsewhere. This lack of bargaining power makes them vulnerable to an employer who wishes to maximize his profits by forcing his workers to endure long hours for little pay. Since low-skilled laborers would have no choice but to accept such an arrangement, it might be appropriate for the law to institute minimum standards out of respect for worker rights, dignity, or autonomy. A more skilled worker, on the other hand, has sufficient bargaining power to walk away from such an arrangement. If a more skilled worker agrees to work long hours for little pay, the theory goes, it must be because he enjoys the work or has other valid reasons that courts ought to respect. Mandatory standards will only frustrate the high-skilled worker's ability to negotiate for what she prefers.

In theory, a test for employee status that emphasized the economic dependence of a worker to the employer could go a long way to address a variety of purposes that animate the patchwork of labor and employment law in the United States. For instance, FLSA addresses substandard labor conditions,⁸⁵ and for reasons mentioned above, the economic dependence of a worker could be a good proxy for those who lack the bargaining power to negotiate for better working conditions. Similarly, the NLRA, which directly addresses the inequality of power between employers and workers,⁸⁶ could benefit from limiting required collective bargaining rights to those who lack the market power to demand favorable terms on their own. Even cases involving vicarious liability

rather than implement contractual arrangements.... In this sense 'economic reality' rather than contractual form is indeed dispositive. The migrant workers are selling nothing but their labor. They have no physical capital and little human capital to vend.'").

⁸⁵ 29 U.S.C. § 202.

⁸⁶ 29 U.S.C. § 151.

could benefit from a focus on the relative lack of bargaining power among workers. A worker with relatively high bargaining power could demand that the employer indemnify her for potential harms caused by her actions. The structure of the allocation of risk within such a context could depend on the particular context to lead to the most efficient outcome. A worker with little bargaining power, on the other hand, has no ability to bargain for indemnification. Since an employer would always prefer to protect himself against liability for the actions of his workers, economically dependent workers would be forced to agree to a contract that indemnifies the employer, even if it would be socially inefficient to do so. Furthermore, since workers with little bargaining power often have little resources to pay damages, victims of their torts would also have little recourse if the law allowed employers to shield themselves through such indemnification contracts.

Unfortunately, there is a significant difference between economic dependence and economic reality. Many low-wage laborers have little bargaining power but are not particularly dependent on one employer precisely because they must often go from one employer to another just to find work.⁸⁷ Contingent workers and others on the fringes of the labor market are often particularly vulnerable to abuse and exploitation, yet they would not be covered under the economic realities test because they are not dependent on any one employer either.⁸⁸ Conversely, a highly skilled independent contractor could be

⁸⁷ See, e.g., *Baker v. Flint Eng'g & Const. Co.*, 137 F.3d 1436, 1443 n.1 (10th Cir. 1998) (“For example, a low-skilled worker who regularly shifts jobs (e.g., fast food jobs) would never be dependent upon a single employer, or even a single industry, for annual subsistence. The worker would necessarily be classified as an independent contractor for purposes of the FLSA and would not be entitled to overtime pay.”)

⁸⁸ See, e.g., *Befort*, *supra* note 11.

very dependent on one employer, and an employer can come to depend significantly on a worker.⁸⁹ A supplier of a specialized part for a large manufacturer, for instance, could become economically dependent on the manufacturer if the orders are so large that he has no time or capacity for any other clients. And the manufacturer could become dependent on the supplier if there are no other substitutes immediately available. In fact, economists argue that the very purpose of integrating into a firm, i.e., to turn an independent contractor relationship into an employment relationship, is to eliminate the economic dependence of the employer on the supplier.⁹⁰

More importantly, the economic realities test does not really capture economic dependence nor economic reality. In practice, the economic realities test does not operate much differently from the control test.⁹¹ The economic realities test is almost always formalized into discrete factors for analysis. But both the control and economic realities tests tend to share similar factors for analysis. Of the six factors to be examined within the economic realities test used by federal courts, for instance, at least five of them are also considered within the thirteen-factor control test used by the federal courts as well.⁹²

⁸⁹ See *supra* note 13.

⁹⁰ Because economic relationships often require making an investment that is specific to the relationship, a worker can hold up the employer for more money once the relationship-specific investment has been made. For instance, a supplier could obtain the reliance of a large manufacturing company by undercutting competitors and then demand more money from the manufacturer at some time later once it has developed much of its manufacturing processes around the supplier. Employing the supplier as a part of the manufacturing company, i.e., to hire her as an employee, on the other hand, eliminates the risk of being held up in this way. See, e.g., OLIVER WILLIAMSON, *MARKETS AND HIERARCHIES, ANALYSIS AND ANTITRUST IMPLICATIONS: A STUDY IN THE ECONOMICS OF INTERNAL ORGANIZATION* (1975). See also Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

⁹¹ See *supra* note 16 and accompanying text.

⁹² See *supra* note 82 for the six factors of the economic realities test and *supra* note 59 for the thirteen factors of the control test. The only factor within the economic realities test arguably not covered by the control test refers to the employee's opportunity for profit or loss depending on his managerial skill. The

Furthermore, reducing the test into discrete factors has often lead to courts conducting a factor analysis without examining the facts comprehensively, thus neglecting the very point of the economic realities test, which is to look beyond formal elements of employment to capture the underlying economic relationship for each particular case.⁹³ Lastly, insofar as the economic realities test is a formal factor test, most courts continue to look to the element of managerial control as an important – and often the first – factor to be considered.⁹⁴ Given the traditional importance of the control test, inclusion of the control element can often influence courts to focus on it rather than on the broad economic dependence of the worker.⁹⁵

In general, there is a tension that is inherent within a legal test that asks judges to look beyond formalistic elements and, instead, look to some underlying economic reality of the relationship without any further guidance. On one hand, formalism can undermine the expansive aim of the economic realities test, as noted above. On the other hand, a test that asks courts to conduct a case-by-case analysis of the economic relationship without

lack of overlap is arguable because the skill required for the job is one of the thirteen factors of the control test.

⁹³ See, e.g., Linder, *supra* note 11, at 208 (“Instead of becoming the centerpiece of purpose-driven interpretation under the FLSA, this ‘economic reality of dependence’ test has itself degenerated into a disembodied laundry list of factors. Judges, regardless of whether they wish to include or exclude the workers in question, unimaginatively check off these factors without embedding the test in the act’s purpose”) (footnotes omitted). See also Sec’y of Labor, U.S. Dep’t of Labor v. Lauritzen, 835 F.2d 1529, 1543 (7th Cir. 1987) (Easterbrook, J., concurring) (“We should abandon these unfocused ‘factors’ and start again.”).

⁹⁴ See, e.g., *supra* notes 81-82 and accompanying text. See also Hopkins v. Cornerstone Am., 545 F.3d 338, 343 (5th Cir. 2008) (“To aid us in this inquiry, we consider five non-exhaustive factors: (1) the degree of control exercised by the alleged employer”).

⁹⁵ See, e.g., Dowd, *supra* note 11, at 110 (“The court’s elevation of the control factor to a position of critical importance, however, suggests that this analysis easily could be oversimplified to an examination of this factor alone, thus overshadowing the court’s effort to suggest a broader framework of analysis.”).

any reliance on formal guidance risks increasing the levels of unpredictability and variation across jurisdictions. Both the control and the economic realities tests are already bloated with too many factors, and they have led to significant uncertainty over how a judge will actually adjudicate a particular case.⁹⁶ If a test for employee status is to strike the balance between economic reality and formal guidance, it must rely on simple criteria that reflect the actual economic reality of employee relationships.

C) The emergence of the entrepreneurial opportunities test

One recent response to the limitations of the control and economic realities tests discussed above has been an increased focus on entrepreneurship as a litmus test for employee status. To be sure, courts have looked to entrepreneurship as a guidepost for employee classification for as long as there has been a need for employee classification.⁹⁷ But these cases almost always understood the entrepreneurial element as a proxy for employer control. For instance, *The Restatement of Employment Law* interprets the element of employer control as important to distinguish employees from independent contractors because it precludes the worker from being able to exercise *entrepreneurial control* to further her interests.⁹⁸ Under this formulation, entrepreneurial control pertains

⁹⁶ See, e.g., Carlson, *supra* note 1.

⁹⁷ See, e.g., Barnes v. Indian Ref. Co., 280 Ky. 811, 134 S.W.2d 620, 624 (1939) (noting that the lack of employer control over the worker indicated that he was “to all intents and purposes an entrepreneur”); N.L.R.B. v. Hearst Publications, 322 U.S. 111, 121 (1944) (“Few problems in the law have given greater variety of application and conflict in results than the cases arising in the borderland between what is clearly an employer-employee relationship and what is clearly one of independent entrepreneurial dealing.”).

⁹⁸ RESTATEMENT OF EMPLOYMENT LAW § 1.01 cmt d (“the employer's power to control the manner and means by which an individual renders services is sufficient to make the service provider an employee. Where the employer exercises such power, the service provider generally cannot further his or her economic interest by exercising entrepreneurial authority”).

to the typical employer's control over his business, "including whether to hire and where to assign assistants, whether to purchase and where to deploy equipment, and whether and when to provide service to other customers."⁹⁹ As a result, much of the attention to entrepreneurship had, until recently, been on the element of employer control and the ways in which it impacted workers.¹⁰⁰

However, a recent line of employee classification cases within the D.C. Circuit has resulted in what has come to be known as the entrepreneurial opportunities test. Under this inquiry, the focus is placed on whether or not the worker has an entrepreneurial opportunity to profit. An entrepreneurial opportunity refers to a worker's "opportunity to profit from working smarter, not just harder" by taking on economic risk.¹⁰¹ An opportunity arises from a realistic right to exercise discretion for potential profit, and the actual exercise of the right is irrelevant to the inquiry of whether the opportunity exists.¹⁰² Thus, the D.C. circuit found that delivery drivers for FedEx Home Delivery were independent contractors "by evidence of entrepreneurial opportunity" because they possessed the contractual right to hire drivers for their routes and sell their routes, despite the fact that only a few drivers actually ever did so.¹⁰³ On the other hand,

⁹⁹ RESTATEMENT OF EMPLOYMENT LAW § 1.01(b).

¹⁰⁰ See, e.g., RESTATEMENT OF EMPLOYMENT LAW § 1.01 Reporters' Notes ("The requirement that the employment relationship effectively prevent the employee from rendering services as part of an independent business ties the entrepreneurial-control test to the right-to-control test.").

¹⁰¹ *Corporate Express Delivery Systems*, at 780.

¹⁰² *FedEx Home Delivery*, at 502 (noting that "the failure to take advantage of an opportunity is beside the point."). See also *C.C. E., Inc. v. N.L.R.B.*, 60 F.3d 855, 860 (D.C. Cir. 1995) ("Likewise it is the worker's retention of the right to engage in entrepreneurial activity rather than his regular exercise of that right that is most relevant for the purpose of determining whether he is an independent contractor.").

¹⁰³ *FedEx Home Delivery*, at 504. Of the 36 drivers working for the two terminals in *FedEx Home Delivery*, only three drivers had multiple routes, and there have ever been two sales of routes. See *FedEx Home Delivery*, Brief for the National Labor Relations Board, 2008 WL 4425831 (C.A.D.C.), at 6 and 21.

the court ruled that drivers in a different context “lacked all entrepreneurial opportunity” and were thus employees because, although they owned their vehicles, they were not permitted to hire other drivers or use their vehicles for others jobs.¹⁰⁴

On its face, the entrepreneurial opportunities test is a “subtle refinement” of the traditional control test rooted in the common law of agency.¹⁰⁵ Under the test, “all the considerations at common law remain in play,” and it is only “in cases where some factors cut one way and some the other” that entrepreneurial opportunities provide “an important animating principle by which to evaluate those factors.”¹⁰⁶ However, since almost all cases will involve some factors cutting one way and some the other, the entrepreneurial opportunities test effectively constitutes a significant departure from the control test rather than a mere refinement. Previous explicit inclusions of the element of entrepreneurship in the control test, to the extent that it was included at all, was as one among many factors to interpret the facts in light of the test’s overall emphasis on employer control.¹⁰⁷ On the other hand, the entrepreneurial opportunities test treats the element of entrepreneurship as the primary theoretical lens itself through which courts should interpret all of the common law factors.¹⁰⁸ In other words, the entrepreneurial

¹⁰⁴ *Corporate Express Delivery Systems*, at 780-781.

¹⁰⁵ *FedEx Home Delivery*, at 497.

¹⁰⁶ *Id.*

¹⁰⁷ See, e.g., *Merchants Home Delivery Serv., Inc. v. N.L.R.B.*, 580 F.2d 966, 972–73 (9th Cir. 1978) (“In distinguishing between employees and independent contractors, the Board and the courts apply general agency principles.... Other factors which this court has considered are the entrepreneurial aspects of the individual’s business”). See also *N.L.R.B. v. Associated Diamond Cabs, Inc.*, 702 F.2d 912, 919–20 (11th Cir. 1983) (“Stated somewhat differently, whether agents are employees or independent contractors requires application of a control test which takes into account the degree of supervision, the entrepreneurial interests of the agent and any other relevant factors.”).

¹⁰⁸ See, e.g., Judge Garland’s dissent in *FedEx Home Delivery*, at 508-509 (J. Garland dissenting) (“My colleagues cite only one case from this (or any) Circuit, our 2002 opinion in *Corporate Express*, for the

opportunities test effectively abandons control as the primary focus of the test for employee status and looks to the element of entrepreneurship as a replacement for control.¹⁰⁹

Yet, despite this recent interest in entrepreneurship, there has been very little discussion about what entrepreneurship is and why it ought to matter for employee status. The D.C. Circuit seems to understand entrepreneurship as economic risk taking, where the entrepreneur assumes both the potential profits and losses associated with running a business.¹¹⁰ But risk taking cannot be the sole defining characteristic of an entrepreneur because all economic activity involves risk. All investors take economic risk and stand to profit or suffer losses from their investment, but to call every person who makes investments for a living an entrepreneur would dilute the term into uselessness. Even more importantly, virtually all workers take economic risks regularly. A worker takes a risk when making a bold proposal to his employer. He stands to gain from his actions in the way of a promotion and/or a raise if his proposal is a good one, and he will suffer losses in the form of a pay cut or company discipline if his proposal turns out to be a dud. Since the very question the courts must answer is whether a worker is an employee or an

proposition that entrepreneurial opportunity has... become the emphasis of the independent contractor test.... I do not dispute that theirs is one fair reading of that opinion.... But Corporate Express did not purport to overrule Supreme Court, Circuit, and Board precedent.... Corporate Express can also be read as merely holding that the Board was reasonable in determining that entrepreneurial opportunity tipped the balance in that case.... There was certainly nothing in the NLRB's opinion in Corporate Express to suggest that entrepreneurial opportunity had become the focus of the Board's own analysis. To the contrary, the Board simply followed its traditional approach of examining the common-law factors.”).

¹⁰⁹ See, e.g., *FedEx Home Delivery*, at 497 (“In other words, ‘control’ was close to what we were trying to capture, but it wasn't a perfect concurrence. It was as if the sheet music just didn't quite match the tune.”).

¹¹⁰ See, e.g., *supra* note 25.

independent contractor, how is the court to distinguish whether an economic risk involves profits and losses or raises and pay cuts? Without more elaboration on what kind of economic risk counts and why, the simple evocation of economic risk taking cannot distinguish independent contractors from employees.

What is needed, then, is an examination of the concept of entrepreneurship itself along with what, if anything, can be gained from its use in employee classification. Luckily, there is a century's worth of material that examines the concept of entrepreneurship. The next section will draw on these theories of entrepreneurship to sharpen the understanding of what constitutes entrepreneurship. Once the concept of entrepreneurship is clarified, we will be in a better position to assess its usefulness for employee classification.

III. ECONOMIC THEORIES OF ENTREPRENEURSHIP

This section links together three classic economic theories of entrepreneurship to show their potential for informing legal tests for employee status. The overarching framework is provided by Frank Knight's theory that entrepreneurship refers to a specialized economic function that bears entrepreneurial responsibility, which refers to the entrepreneur's ultimate responsibility for a business enterprise in light of economic uncertainty. Unlike other types of risk, economic uncertainty refers to the risks associated with future supply and demand in the market, which is not knowable in any probable sense. In a world full of uncertainty, the entrepreneur is someone who possesses superior confidence and/or knowledge about market conditions and exposes

himself to potential losses in the market so that he may be in a position to realize a pure profit from his risk-taking.

From this overall view of the entrepreneur, three insights can be gleaned from the economic theories of entrepreneurship provided by Knight, Joseph Schumpeter, and Israel Kirzner. First, an important insight from Knight's account of economic uncertainty is that the entrepreneur provides a guarantee to others for potential losses associated with the business enterprise. Whereas laborers and investors forgo the opportunity to earn a pure profit by accepting a fixed wage and a market-determined return on investment, respectively, entrepreneurs expose themselves to potential losses in pursuit of profit. Second, Schumpeter's account of the entrepreneur emphasizes the control element of assuming entrepreneurial responsibility. The entrepreneur within the Schumpeterian account disrupts the status quo by carrying on new combinations of resources. And because control over resources is necessary to combine them in new ways, the Schumpeterian entrepreneur must exercise control over the allocation of resources being combined to sell in the market. Third, Kirzner argues that entrepreneurs bring the market closer to equilibrium by discovering and exploiting potential opportunities for arbitrage. Within this view, the entrepreneurial function consists of exposing a previously unnoticed potential for a more efficient allocation of resources by buying resources to sell in the market in the pursuit of profits.

A) Knight and uncertainty

Despite the importance of and frequent references to the entrepreneur in economics and economic history in the nineteenth and twentieth centuries, there were no notable contributions in economic theory about the entrepreneur until Frank Knight and Joseph Schumpeter in the early 20th Century.¹¹¹ Knight's work on the entrepreneur was concerned primarily with what he calls "the problem of profit."¹¹² Economic theory postulates that competition should have the tendency to bring the allocation of resources to an equilibrium, i.e., a condition where the value of resources is equal to their cost, and thus bring profits to zero. Nevertheless, Knight recognized that profit never disappeared in real life. Why do entrepreneurs continue to profit from their activity when economic theory postulates that they should not?

One important aspect of the problem of profit is how it is defined.¹¹³ Profit is often used to describe the residual between the total revenues and costs of a business. This, however, is accounting profit, and its existence does not necessarily pose a problem for economists because it can encompass not only profit but also the entrepreneur's

¹¹¹ See, e.g., William J. Baumol, *Entrepreneurship in Economic Theory*, 58 AM. ECON. R. 64, 64 (1968) ("The entrepreneur is at the same time one of the most intriguing and one of the most elusive characters in the cast that constitutes the subject of economic analysis.... Only Schumpeter and, to some degree, Professor Knight succeeded in infusing him with life and in assigning to him a specific area of activity to any extent commensurate with his acknowledged importance."). See also James H. Soltow, *The Entrepreneur in Economic History*, 58 AM. ECON. R. 84, 84 (1968) ("Economic historians of the late nineteenth and early twentieth centuries devoted considerable attention to businessmen and firms.... But they did not attempt to define explicitly the role of the entrepreneur in economic change, although they appear to have implicitly assumed that he was an important agent.").

¹¹² RISK, UNCERTAINTY, AND PROFIT, at 18-19.

¹¹³ For more on Knight's distinction between accounting profit and pure profit within the context of his discussion on the problem of profit and entrepreneurship, see, Frank H. Knight, *Profit and Entrepreneurial Functions*, 2 J. ECON. HIST. 126 (1942). See, more generally, RISK, UNCERTAINTY, AND PROFIT.

wages and the return on the entrepreneur's capital investment. An entrepreneur's wage is the rate of compensation set ex ante by the market for the cost of the entrepreneur's services. The return on capital investment is the cost of capital that is set by the market. For instance, suppose that you made a \$1,000,000 investment in your own business last year. In the past year, the total revenues for your business reached \$2,000,000, you paid \$1,800,000 in expenses, and the depreciation on your assets were \$100,000. In such a scenario, you would have realized \$100,000 in accounting profit. However, the \$100,000 that is left over to you is commingled with your own wages and return on capital. Suppose that, when you started your business, the expected rate of return for a \$1,000,000 investment was \$50,000. Suppose further that the yearly salary for someone with your skillset was \$80,000 when you started your business. In such an instance, by running your own business, you *lost* \$30,000 since you could have earned \$130,000 by investing your money elsewhere and working for someone else. The problem of profit arises from the existence of *pure profit*, which is a portion of accounting profit that cannot be attributed to the entrepreneur's wages or return on capital. For instance, if the total revenues of your business reached \$2,500,000 rather than \$2,000,000, your accounting profit would have been \$600,000, with \$470,000 in pure profits. The problem of profit, then, is explaining why the market allows for the extra \$470,000 because the margin implies an inefficiency in the market for allocating capital and/or labor. Why are workers and/or investors unable to demand higher compensation until pure profits reach zero if there is competition among entrepreneurs for labor and/or capital?

Knight's answer to the problem of profit was that competition in the real market is imperfect due to a limitation of human knowledge stemming from economic uncertainty.¹¹⁴ Economic uncertainty refers to a special type of risk in the market. Normal risk follows a known distribution of potential outcomes and thus can be insured against. The risk of a fire in one's warehouse, for instance, is a normal risk, and the compensation that an insurance company receives from taking on the risk of a warehouse fire consists of a return on the capital it has available to pay out claims for warehouse fires and is not a form of pure profit. Uncertainty, on the other hand, refers to risks associated with circumstances for which there is no known distribution of potential outcomes. Economic uncertainty refers to the risks associated with the need to plan *ex ante* for a production process aimed to satisfy future demand in the market.¹¹⁵ Knight argued that a market devoid of economic uncertainty would result in no pure profit since the probable losses associated with anticipating future supply and demand could be quantified into known fixed costs that others can use to bring the costs of the entrepreneur's wages and investment into equilibrium with the rest of the market. Under uncertainty, however, there can be no known cost of anticipating future supply and demand in the market. As a result, the market cannot accurately price the wages and

¹¹⁴ See, generally, RISK, UNCERTAINTY, AND PROFIT. For a detailed discussion of risk and uncertainty, see Chapters VII and VIII.

¹¹⁵ *Id.*, at 237-238 ("At the bottom of the uncertainty problem in economics is the forward-looking character of the economic process itself. Goods are produced to satisfy wants; the production of goods requires time, and two elements of uncertainty are introduced, corresponding to two different kinds of foresight which must be exercised.... The producer, then, must estimate (1) the future demand which he is striving to satisfy and (2) the future results of his operations in attempting to satisfy that demand.").

investment of the entrepreneur,¹¹⁶ and the entrepreneur has a chance to earn pure profit by taking on the responsibility of anticipating future supply and demand.

Under Knight's theory, the entrepreneur is someone who attempts to earn a pure profit by assuming the responsibility for economic uncertainty. If the markets were absent of uncertainty, even workers who help to anticipate future supply and demand by allocating capital and labor would only be considered laborers – and not entrepreneurs – since they would only be earning a wage for their work. The existence of economic uncertainty, however, makes unknowable what will be the efficient allocation of resources for future consumption. Under such conditions, there will be some who, for reasons of superior knowledge, judgment, and/or confidence, are willing to assume the responsibility of forecasting future demand in the pursuit of pure profit. The resulting arrangement will be a “system under which the confident and venturesome ‘assume the risk’ or ‘insure’ the doubtful and timid by guaranteeing to the latter a specified income in return for an assignment of the actual results.”¹¹⁷ Those in the former group, according to Knight, are known as entrepreneurs, and they assume the responsibility for confronting economic uncertainty by guaranteeing others a specified return for their investment or effort. And by providing such a guarantee, the entrepreneur stands to gain pure profits when market conditions are more favorable than anticipated and to suffer financial losses when market conditions are less favorable than anticipated.

¹¹⁶ *Id.*, at 284 (noting that pure profit is “a margin of error in calculation on the part of the non-entrepreneurs and entrepreneurs who do not force the successful entrepreneurs to pay as much for productive services as they could be forced to pay.”).

¹¹⁷ *Id.*, at 269-270.

B) Schumpeter and creative destruction

While Knight was examining the entrepreneur through the lens of uncertainty and profit, Joseph Schumpeter was concurrently examining the entrepreneur as part of his inquiry into economic development.¹¹⁸ If the market process consists of reaching an equilibrium of efficient resource allocation, how and why does the economy undergo development and change?¹¹⁹ Schumpeter criticized existing economic theory as static and only capable of analyzing what he called the circular flow of economic life.¹²⁰ Within the circular flow, the market adjusts to new information and tends to bring resource allocation to an equilibrium. What static theories do not capture, though, is the element of dynamism within economic development. Economic development consists of a disruption to the existing circular flow by the adjustment of the very channels of the circular flow itself. When cars change lanes to adjust to an accident on a highway, for instance, they are adjusting to changes in information within the circular flow of traffic. Similarly, the circular flow in the economy adjusts to changing conditions of supply and demand. Economic development, on the other hand, is akin to a change in the highway itself, and it proceeds by what Schumpeter famously described later as an ongoing

¹¹⁸ THEORY OF ECONOMIC DEVELOPMENT was first published in German in 1911 and translated into English in 1934. RISK, UNCERTAINTY AND PROFIT was published in 1921. Schumpeter's work on the entrepreneur continued through CAPITALISM, SOCIALISM, AND DEMOCRACY (published in 1942), the *Creative Response* (published in 1947), and others.

¹¹⁹ See, e.g., THEORY OF ECONOMIC DEVELOPMENT, at 64 (“Development in our sense is a distinct phenomenon, entirely foreign to what may be observed in the circular flow or in the tendency to equilibrium. It is spontaneous and discontinuous change in the channels of the flow, disturbance of equilibrium, which forever alters and displaces the equilibrium state previously existing.”).

¹²⁰ See, e.g., *id.*, at 66 (Arguing that existing theory “describes economic life from the standpoint of the economic system's tendency towards an equilibrium position...and may be described as an adaptation to data existing at any time... These tools only fail...where economic life itself changes its own data by fits and starts.”).

process of creative destruction, where the existing circular flow is disrupted and then replaced with a new circular flow.¹²¹

For Schumpeter, the central player within economic development is the entrepreneur. The entrepreneur's unique role within the process of economic development is to disrupt the existing circular flow and replace it with a new one by the *carrying out of new combinations of resources*.¹²² All economic production, according to Schumpeter, consists of combining resources,¹²³ and the carrying out of new combinations can consist of a variety of activities, including the introduction of goods or methods, the exploitation of new resources, or creating/organizing a market or an industry.¹²⁴ By innovatively carrying out new combinations, the entrepreneur drives economic development through a process of creative destruction. Thus, Schumpeter's definition of the entrepreneur is functional. An entrepreneur is defined not by who a person is but by *what a person does*, and the mere possession of a right or the opportunity to carry out new combination does not make one an entrepreneur.¹²⁵ Furthermore, the

¹²¹ See, e.g., CAPITALISM, SOCIALISM, AND DEMOCRACY at 83 (“The opening up of new markets, foreign or domestic, and the organizational development from the craft shop to such concerns as U.S. Steel illustrate the same process of industrial mutation—if I may use that biological term—that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism”).

¹²² See, e.g., THEORY OF ECONOMIC DEVELOPMENT, at 74 (“The carrying out of new combinations we call ‘enterprise’; the individuals whose function it is to carry them out we call ‘entrepreneurs.’”). Schumpeter also defines entrepreneurs in a slightly different way in *Creative Response*, at 151 (“Seen in this light, the entrepreneur and his function are not difficult to conceptualize: the defining characteristic is simply the doing of new things or the doing of things that are already being done in a new way”). But since all economic production consists of carrying out combinations, the entrepreneur, at least within the context of the production process, can be understood to simply be someone who carries out new combinations.

¹²³ See, e.g., THEORY OF ECONOMIC DEVELOPMENT, at 73 (“To produce means to combine materials and forces within our reach.”).

¹²⁴ *Id.*, at 66.

¹²⁵ See, e.g., *id.*, at 74 (noting that his definition of the entrepreneur is both broader and narrower than traditional ones “because in the first place we call entrepreneurs not only those ‘independent’ business in an

entrepreneurial function is contextual. An action is entrepreneurial only as part of the overall context of economic development. The same action that was entrepreneurial at the onset of the process of creative destruction can cease to be entrepreneurial once a new circular flow is established. Lastly, entrepreneurship is often commingled with other economic functions in real life. When one starts one's own business, for instance, he often acts not only as an entrepreneur but also as a manager, an investor, and an inventor. Nevertheless, the entrepreneurial function is distinct from all of these other roles and should be considered separately from them.¹²⁶

Upon first glance, Schumpeter seems to disagree with Knight on what makes someone an entrepreneur. Knight's entrepreneur is responsible for economic uncertainty, and many interpreters of Knight assume that responsibility for economic uncertainty must come in the form of ownership.¹²⁷ The entrepreneur, according to this view, is one who owns the means of production and stands exposed to potential gains and losses associated with their investment. On the other hand, Schumpeter argued that the entrepreneurial function of carrying out new combinations did not need ownership of the means of production at all. All that was needed was control.¹²⁸ Only by exercising his command

exchange economy who are usually so designated, but all who actually fulfil the function by which we define the concept... [and] narrower than the traditional one in that it does not include all heads of firms or managers or industrialists who merely may operate an established business, but only those who actually perform that function." See also *id.*, at 78 ("everyone is an entrepreneur only when he actually 'carries out new combinations,' and loses that character as soon as he has built up his business, when he settles down to running it as other people run their businesses.").

¹²⁶ See, e.g., *Creative Response*, at 151-152.

¹²⁷ See, e.g., Richard N. Langlois and Metin M. Cosgel, *Frank Knight on Risk, Uncertainty, and the Firm: A New Interpretation*, 31 *ECON. INQUIRY* 456 (1993).

¹²⁸ *THEORY OF ECONOMIC DEVELOPMENT*, at 68 ("The next step in our argument is also self-evident: command over means of production is necessary to the carrying out of new combinations.").

over productive resources can the entrepreneur take them out of their current use within the circular flow – or take them out of their non-use – and re-allocate them for new combination. Furthermore, Schumpeter argued that financiers, not entrepreneurs, bear the risks associated with entrepreneurship and that although the capitalist and entrepreneur functions are usually commingled in real life, they are distinct and can be separated.¹²⁹ What some interpreters assume, then, is that Knight’s entrepreneur is a capitalist whereas Schumpeter’s entrepreneur is someone who borrows credit from the capitalist to carry out new combinations.

However, these differences are superficial, and Knight and Schumpeter do not fundamentally disagree. Once one recognizes that Schumpeter uses the term ‘risk’ in different ways and that Knight’s conception of responsibility encompasses more than capital investment, it becomes easy to reconcile both views as emphasizing different aspects of the same economic function. First, Schumpeter uses the term risk to refer both to normal risk and economic uncertainty. Like Knight, Schumpeter argues that profit is distinct from wages and return on capital and that an entrepreneur is someone who earns a profit.¹³⁰ Furthermore, he argues that whereas income for assuming risk entails a return on capital rather than profit, profit and loss *do* have their source in risks when they are

¹²⁹ *Id.*, at 75 and 137.

¹³⁰ See, e.g., *id.*, at 153 (“Entrepreneurial profit is not a rent...; nor is it a return to capital... We want finally to emphasize that profit is also not wages...; it is the expression of the value of what the entrepreneur contributes to production in exactly the same sense that wages are the value expression of what the worker ‘produces.’ However, while wages are determined according to the marginal productivity of labor, profit is a striking exception to this law: the problem of profit lies precisely in the fact that the laws of cost and of marginal productivity seem to exclude it.”).

“not foreseen or at any rate are not taken account of in the economic plan.”¹³¹ When he refers to financiers as bearers of risk, then, he has in mind someone who earns an income from her capital by assuming responsibility for a risk that is different from the kind of risk that leads to profits. In other words, he views the capitalist function as bearing normal risk and the entrepreneur as being responsible for economic uncertainty. Second, Knight does not argue that responsibility requires capital investment. He is clear that although the vast majority of entrepreneurship entails at least a partial investment of capital, it is possible “[i]n some instances, though perhaps a relatively small proportion of real enterprises and those probably of small average size, [that] the independent entrepreneur may have no property investment in his business, furnishing labor services only.”¹³² Furthermore, Knight argues that “the rare and improbable case of a man who owns nothing in a particular business and contributes nothing to it but responsibility” is nevertheless an instance of a “pure form” of entrepreneurship.¹³³ What matters is assuming *entrepreneurial responsibility*. Of course, the entrepreneur in this case still stands to suffer a financial loss from his activity since he will need to borrow the resources necessary to conduct his business and will need to repay to the extent that he is able to do so.¹³⁴ But so does the Schumpeterian entrepreneur. What matters for Knight is

¹³¹ *Id.*, at 33.

¹³² RISK, UNCERTAINTY, AND PROFIT, at 306.

¹³³ *Id.*, at 299.

¹³⁴ Given the current structure of limited liability and our bankruptcy laws, then, responsibility for economic uncertainty is diffused within the organization between shareholders and managers. Knight argues that such a diffusion of responsibility is common within modern enterprises and locates the entrepreneurial function widely across the organization. See, e.g., RISK, UNCERTAINTY, AND PROFIT, at 300 (“The natural result is a complicated division or diffusion of entrepreneurship, distributed in the typical modern business organization by a hierarchy of security issues carrying every conceivable gradation and combination of rights to control and to freedom from uncertainty as to income and vested capital.”). See

that the entrepreneur expose himself to potential loss, and what matters for Schumpeter is that the entrepreneur carry out new combinations. Both of these elements are complementary and can be subsumed under Knight's broad conception of entrepreneurial responsibility.

C) Kirzner and alertness

As was the case with Knight and Schumpeter, Israel Kirzner's examination of the entrepreneur was also grounded in a critique of existing economic theory about markets, prices, and equilibrium. For Kirzner, existing economic theories placed too much importance on the conditions for equilibrium.¹³⁵ Existing notions of perfect competition and general equilibrium rely on the assumption of perfect information. But since knowledge and competition are imperfect in the real world, economics must supply an account of *how* the market "supplies new information to the participants."¹³⁶ Kirzner provides such an account by highlighting what he calls the *market process*. Rather than understanding the market as a place where economic exchanges take place, Kirzner argues that the market is a process that consists of "a series of systematic changes in the interconnected network of market decisions... generated by the flow of market information released by market participation."¹³⁷ As economic actors participate in the

infra Section IV.D for a discussion on such a diffusion leading to the conclusion that there is often no entrepreneur but the firm itself in a modern economy.

¹³⁵ See, e.g., COMPETITION AND ENTREPRENEURSHIP, at 26 (The failure of the dominant approach... seems a direct implication of its stress on equilibrium situations and its view of price theory as explaining the conditions for equilibrium.").

¹³⁶ *Id.*, at 38.

¹³⁷ *Id.*, at 10.

market process, they scan and process existing information in an attempt to bid or offer better opportunities than their competitors. The discovery and exploitation of such opportunities drives the market process and helps to bring it closer to the theoretical equilibrium.

For Kirzner, entrepreneurship is an economic function that plays a central role in driving the market process. Entrepreneurs help to bring the market closer to equilibrium by *discovering* new opportunities for arbitrage in the market. An opportunity exists when market participants are ignorant of the fact that sellers are willing to sell for less and/or buyers are willing to buy for more than the existing price.¹³⁸ Entrepreneurs exploit such opportunities by discovering buyers to whom they can sell for slightly more than the existing price and/or sellers from whom they can buy for slightly less than the existing price.¹³⁹ Thus, unlike standard economic actors who maximize their preferences while taking the price and/or output data as a given, entrepreneurs act on their discovered opportunities to *change* the price and/or output data to profit from them.¹⁴⁰ And in the process of changing price and/or output data, entrepreneurs help to bring the market closer to equilibrium by exposing the previous ignorance among market participants of opportunities to allocate resources more efficiently.

¹³⁸ See, e.g., *id.*, at 14-15.

¹³⁹ See, e.g., *id.*, at 41 (noting that pure entrepreneurship consists of a decision-maker who needs nothing except “to discover where buyers have been paying too much and where sellers have been receiving too little and to bridge the gap by offering to buy for a little more and to sell for a little less.”).

¹⁴⁰ See, e.g., *Entrepreneurial Discovery*, at 70 (“Whereas each neoclassical decision maker operates in a world of given price and output data, the Austrian entrepreneur operates to change price/output data.”).

Key to the ability to discover previously unrecognized opportunities for market arbitrage is the element of entrepreneurial *alertness*. Entrepreneurial alertness refers to “an attitude of receptiveness to available (but hitherto overlooked) opportunities.”¹⁴¹ Alertness is similar to – yet ultimately different from – knowledge. Rather than knowledge of market information, alertness refers to the knowledge of where to look for knowledge.¹⁴² Knowledge of market information is a resource and can be purchased in the factor market. For instance, if I would like to set up a fast food franchise in St. Louis, I can hire someone who is knowledgeable about the industry and the specific location that I am considering. If the knowledge about the Saint Louis fast food market were the key aspect of knowledge required for entrepreneurship, the person I would hire could be the entrepreneur herself rather than work for me. According to Kirzner, assuming that the opportunity for profit truly exists, the fact that the knowledgeable worker would be willing to work for me rather than pursue the opportunity for entrepreneurial profit for herself shows that she lacks the alertness to the opportunity for market arbitrage, even if she possesses deep knowledge of the market.¹⁴³ Because I am the one who recognizes the opportunity for profit and exploits it by hiring someone who does not recognize it, the ultimate knowledge of market conditions, at least in the sense that matters for bringing

¹⁴¹ *Id.*, at 72.

¹⁴² See, e.g., COMPETITION AND ENTREPRENEURSHIP, at 68 (“Ultimately, then, the kind of ‘knowledge’ required for entrepreneurship is ‘knowing where to look for knowledge’ rather than knowledge of substantive market information. The word which captures most closely this kind of ‘knowledge’ seems to be alertness.”).

¹⁴³ *Id.* (“The entrepreneur is the person who hires the services of factors of production. Among these factors may be persons with superior knowledge of market information, but the very fact that these hired possessors of information have not *themselves* exploited it shows that, in perhaps the truest sense, their knowledge is possessed not by them but by the one who is hiring them.”).

the market closer to equilibrium, resides with me and my alertness to the opportunity. In other words, entrepreneurial alertness refers to not knowledge of market conditions itself but rather a higher-order knowledge that can recognize market opportunities and exploit them by obtaining the appropriate resources to do so.

Kirzner's account of the entrepreneur has generated considerable debate as to whether he agrees or disagrees with Schumpeter. One interpretation of Kirzner argues that he offers a competing perspective to Schumpeter's view.¹⁴⁴ Whereas the Schumpeterian entrepreneur disrupts the market *out* of equilibrium, the thinking goes, the Kirznerian entrepreneur brings the market *to* equilibrium. However, these contrasts between Kirzner and Schumpeter are overblown. Even in his early work, Kirzner saw his account of the entrepreneur to describe the same economic actor as Schumpeter with only a different *emphasis* in relation to the entrepreneur's impact on economic equilibrium.¹⁴⁵ Later on, Kirzner explicitly subsumed the Schumpeterian entrepreneur within his model by arguing that the creative destruction unleashed by the entrepreneur is a response to an opportunity for arbitrage that entrepreneurial alertness discovers.¹⁴⁶ As a result most

¹⁴⁴ For modern scholars who assume that Kirzner and Schumpeter represent competing and/or irreconcilable positions, see, e.g., Brian J. Loasby, *The Entrepreneur in Economic Theory*, 29 SCOTTISH J. POL. ECON. 235 (1982), and Luke Pittaway, *Philosophies in Entrepreneurship: A Focus On Economic Theories*, 11 INT'L J. ENTREPRENEURIAL BEHAV. & RES. 201 (2005).

¹⁴⁵ See, e.g., COMPETITION AND ENTREPRENEURSHIP, at 72-73 (noting that "Schumpeter's entrepreneur and the one developed here can be recognized – and let me add, reassuringly recognized – as the same individual. But there is one important aspect – if only in emphasis – in which Schumpeter's treatment differs from my own. Schumpeter's entrepreneur acts to disturb an existing equilibrium situation.... By contrast my own treatment of the entrepreneur emphasizes the equilibrating aspects of his role.").

¹⁴⁶ See, e.g., Israel M. Kirzner, *The Alert and Creative Entrepreneur: A Clarification*, 32 SMALL BUS. ECON. 145 (2009) ("It is not merely the case that Schumpeterian creativity can be comfortably subsumed under the category of alertness.... It can be suggested, I will maintain, that a focus on the 'alertness' aspect of (all) entrepreneurship can help us understand how public policy may help promote that very

modern scholars view the Kirznerian and Schumpeterian accounts of the entrepreneur as complementary or even identical.¹⁴⁷

In addition to Schumpeter, Kirzner also saw a great deal of consistency between Knight's account of the entrepreneur and his own.¹⁴⁸ In his earlier work, Kirzner argues that Knight's focus on economic uncertainty masks the extent to which the entrepreneur discovers an actual opportunity that exists, regardless of the uncertainty associated with it.¹⁴⁹ In other words, Kirzner and Knight disagree on the ontology of entrepreneurial opportunity. Whereas the Knightian opportunity is uncertain and something to be grasped only *ex post*, the Kirznerian opportunity is real and can be discovered with certainty *ex ante*. Nevertheless, even early on, Kirzner agreed with almost everything else that Knight observed about the entrepreneur. For instance, Kirzner writes that "his identification of where entrepreneurship is located is superb"¹⁵⁰ and that Knight's conception of responsibility for economic uncertainty "is immediately identifiable with [his] own notion of 'ultimate knowledge' – that is, with entrepreneurial alertness."¹⁵¹

Schumpeterian creativity (which I certainly do acknowledge must be the major component of future dramatic leaps in economic development).")

¹⁴⁷ See, e.g., ROBERT F. HEBERT and ALBERT N. LINK, *THE ENTREPRENEUR, MAINSTREAM VIEWS AND RADICAL CRITIQUES* (1982), and Young Back Choi, *The Entrepreneur: Schumpeter vs. Kirzner*, In PETER J. BOETTKE and MARIO J. RIZZO (eds.), *ADVANCES IN AUSTRIAN ECONOMICS*, Vol. 2 (Part A) 55 (1995).

¹⁴⁸ See, e.g., *Entrepreneurial Discovery*, at 70 (After connecting his view of entrepreneurship within the larger context of Austrian economics, Kirzner notes that, "[i]n focusing upon the entrepreneurial decision in a Knight-uncertain world, Austrian theory thus diverges sharply from the notion of the individual decision that constitutes the analytical building block of neoclassical microtheory.").

¹⁴⁹ See, e.g., *COMPETITION AND ENTREPRENEURSHIP*, at 83 ("What does not come through in the Knightian exposition is the active, alert, searching role of entrepreneurial activity. Treating profit as a residual fails to disclose that from the point of view of the prospective entrepreneur the profit opportunity is, with all its uncertainty, *there*.").

¹⁵⁰ *Id.*

¹⁵¹ *Id.*, at 84.

And in his later work, Kirzner explicitly saw himself as working from within the tradition started by Knight that emphasizes the central importance of economic uncertainty in entrepreneurship.¹⁵²

Thus, although the three classic theories of Knight, Schumpeter, and Knight seem to identify different aspects of entrepreneurship as a central defining characteristic, many entrepreneurship scholars now see them as merely emphasizing different aspects of the same entrepreneurial process. Overall, many see Schumpeter and Kirzner's theories as providing complementary views that elaborate on Knight's fundamental assertion that entrepreneurs assume the risks associated with economic uncertainty.¹⁵³ As will be seen in the next section, the entrepreneurial responsibilities test follows the same line of interpretation and looks to the three different accounts of entrepreneurship provided by Knight, Schumpeter, and Kirzner as giving an account of the same phenomenon of entrepreneurship, with three different emphases. Furthermore, it will look to the Knightian emphasis on the entrepreneur's assumption of entrepreneurial responsibility as

¹⁵² See, e.g., Israel M. Kirzner, *Creativity and/or Alertness: A Reconsideration of the Schumpeterian Entrepreneur*, 11 REV. AUSTRIAN ECON. 5, 12 (1998) ("Were we to be able to imagine a world without uncertainty in regard to the future, we would... be unable to find scope in that world for pure entrepreneurship").

¹⁵³ See, e.g., Jeffery S. McMullen and Dean A. Shepherd, *Entrepreneurial Action and the Role of Uncertainty in the Theory of the Entrepreneur*, 31 ACAD. MGMT. REV. 132, 133 (2006) (noting that "it is no surprise that uncertainty constitutes a conceptual cornerstone for most theories of the entrepreneur" and arguing that research streams that emphasize a Kirznerian understanding of entrepreneurship and those that emphasize a Schumpeterian understanding "merely emphasizes a different aspect of the uncertainty experienced in the decision to act entrepreneurially. Therefore, each conceptualization of uncertainty is representative of a construct that is not only reconcilable with its counterpart but also necessary for further theorizing about entrepreneurial action.").

the lens through which courts should assess the extent to which workers act in ways that correspond to the three different points of emphasis.

IV. THE ENTREPRENEURIAL RESPONSIBILITIES TEST

The entrepreneurial responsibilities test draws from the classic theories of entrepreneurship discussed above to define the entrepreneur as *someone who assumes entrepreneurial responsibility*. It can be seen as a modification of the entrepreneurial opportunities test in that it considers whether or not a worker is an independent contractor by looking to whether she is an entrepreneur. Like all tests for employee status discussed above and for reasons that will be discussed in the next section, the entrepreneurial responsibilities test also operates within the binary dichotomy between independent contractors and employees. Thus, under the proposed test, courts should look to the worker's assumption of entrepreneurial responsibility for her work to determine whether she is working as an entrepreneur. And unless the court determines that the worker is working as an entrepreneur, she should be considered an employee.

But what does it mean for workers to assume entrepreneurial responsibility? The entrepreneurial responsibilities test draws on economic theories of entrepreneurship to provide three elements that workers must meet to be considered an entrepreneur. The first element is the Knightian element, and it looks to whether or not the worker assumes liability for economic uncertainty in the pursuit of profit. The second element is the Schumpeterian element, and it looks to whether or not the worker exercises control over the allocation of resources being combined to sell in the market. The third element is the

Kirznerian element, and it looks to whether or not the worker participates in the market discovery process by buying resources to sell in the market in the pursuit of profit. The entrepreneurial responsibilities test classifies a worker as an employee unless her work responsibilities satisfy all three elements of the test.

A) Assumption of liability for economic uncertainty

The first element of the entrepreneurial responsibilities test draws from Knight's theory of entrepreneurship and considers whether or not the worker assumes liability for economic uncertainty in the pursuit of profit. As noted above, the Knightian entrepreneur provides a guarantee to other workers for the economic uncertainty associated with the business enterprise by assuming liability for potential financial losses.¹⁵⁴ However, the assumption of liability in the entrepreneurial sense is different from the assumption of liability in general. An indemnification agreement that only shifts tort liability to the employer, for instance, has no bearing on the entrepreneurial responsibilities test because the assumed risk pertains to harms caused to others. Such risk is merely normal risk, and it can be insured against. Economic uncertainty, on the other hand, pertains to the risks associated with market conditions. The only type of risk that the entrepreneurial function assumes is that of economic uncertainty, i.e., the risk that accompanies forecasting future supply or demand in the market.

The assumption of liability for economic uncertainty will typically involve ownership of the means of production involved within the enterprise. When a worker

¹⁵⁴ See *supra* Part III.A.

makes a capital investment in resources required for the job, she assumes some responsibility for economic uncertainty associated with the investment. If I purchase a car to use as a driver for Uber, for instance, I may find myself with a potential loss if automation significantly reduces the demand for Uber drivers in the near future. Thus, existing tests do capture some entrepreneurial element to the extent that they look to the ownership of or investment in tools and materials required for the work.¹⁵⁵

However, as discussed above,¹⁵⁶ ownership of the means of production is not necessary to assume liability for economic uncertainty. Imagine, for instance, a car dealer who sells delivery trucks to several different drivers but grants the buyers an option to sell the trucks back to him at a set price. In such a scenario, the fact that the drivers own the trucks would not have any bearing on whether or not they assume entrepreneurial responsibility because their purchase would not assume any liability for economic uncertainty. It is the car dealer who provides the ultimate guarantee for potential downturns in market conditions, and he should be considered the entrepreneur within the overall enterprise. To the extent that there are pure profits to be made from this enterprise, they would accrue to the car dealer in the form of a premium he charges the drivers for the option. Any profits that drivers earn would be a form of wages for their labor and/or a return on their investment in the cars, not pure profit.

¹⁵⁵ The federal control test typically takes the provision of tools and materials as one of the factors for consideration. See, e.g., *supra* note 59. The economic realities test often takes into consideration ownership of equipment and materials required for the job. See, e.g., *supra* note 82.

¹⁵⁶ See *supra* Part III.B.

Lastly, the assumption of liability for economic uncertainty must be connected with an entrepreneurial pursuit of profit. Mere exposure to potential loss for a financial decision made for reasons other than the pursuit of pure profit does not qualify one as an entrepreneur. Imagine, for instance, a homeowner who begins to rent out her spare bedroom on AirBnB after having owned her home for forty years. Although she owns the most critical resource needed for operating her enterprise, it cannot be said that her actions entail assuming liability for economic uncertainty because her investment in the home was not made in pursuit of profits related to a forecasted future demand for AirBnB rentals. Of course, most financial decisions are made with multiple motivations, so the extent to which the entrepreneurial element is present in a worker's situation will depend on the extent to which the worker stands exposed to potential loss associated with her pursuit of profit. Thus, investments in education will help determine independent contractor status only to the extent that the investment was made for profit-seeking reasons. The employer of an enterprising individual who obtains a student loan to attend plumbing school should be able to argue that the worker should be classified as an independent contractor, whereas an employer of an individual with student loans from her liberal arts college degree should have a difficult case to make. Of course, if the employer offers any tuition assistance for continuing education, it is the employer and not the worker who assumes liability for the economic uncertainty associated with the investment in human capital.

B) Allocative control over resource combination

The second element draws from Schumpeter's theory of entrepreneurship and considers whether or not the worker exercises control over the allocation of resources being combined to sell in the market. Allocative control of resource combination differs from the traditional indicators of control within tests for employee status in a variety of ways. First, the allocative control factor looks at the *worker's* relationship to the resources required for the business. Thus, the controlling person is the worker, whereas the traditional control and the economic realities tests attempt to determine whether or not the *employer* exercises control over the work and/or the worker.¹⁵⁷ Second, the allocative control element looks at control over the allocation of resources for the *carrying on of new combinations*. Thus, what is crucial is whether or not the worker exercises control over the *allocation of resources* being combined for sale in the market and not just the resources themselves. Also, since the control must be exercised over the allocation of resources, it is not enough that a worker exercises control over just some of the resources. Instead, the worker must be able to control the allocation of the *entire range of resources* that are being combined. Third, the allocative control element looks to whether or not the worker *actually exercises* control over the combination of resources. The Schumpeterian entrepreneur is defined by her actions rather than her rights.¹⁵⁸ The right of control does not turn a worker into an entrepreneur unless it is exercised to carry

¹⁵⁷ The control test looks to the employer's control over the worker by examining a variety of factors, including whether the employer has the right to assign additional projects to the hired party. See *supra* note 59. The economic realities test also considers the employer's control of a worker's duties or the manner of performance. See *supra* notes 81 and 82.

¹⁵⁸ See *supra* note 125 and accompanying text.

out new combinations. Thus, an owner of an enterprise who might have the right to control the allocation and combination of resources within the business will still not be acting as an entrepreneur as if she defers to an employee to control her enterprise.

Within a corporate environment, it will typically be the case that a key signpost for whether or not the worker exercises allocative control will be the exercise of *managerial responsibility* over the enterprise. For instance, the manager of a factory acts as an entrepreneur when she exercises control over how resources are to be allocated and how materials and labor are to be combined for assembly. On the other hand, if the manager of the factory defers to the foreman's judgment about allocation and combination, it would be the foreman rather than the manager who would be acting as an entrepreneur within the enterprise. Nevertheless, it would be nearly impossible for a line worker within the factory to exercise allocative control since entrepreneurial control within a factory pertains to control over the allocation of the entire range of resources that are being combined within the factory.

As is implied with the factory example above, whether or not the worker exercises allocative control will depend significantly on how one defines the level at which the resource combination is being carried out. Imagine, for instance, that a farmer delivers wheat to a bread factory. Whether or not the farmer exercises allocative control over resource combination will depend on whether or not the relevant level of resource combination within his work is bread baking or wheat growing. At the bread baking level, wheat is one among many resources being combined to bake and sell bread, and the

farmer has no allocative control over the range of resources being combined. At the wheat growing level, on the other hand, wheat is the final product being delivered to a customer, and the farmer has allocative control over land, water, and other resources that are combined to grow and deliver wheat.

Because the entrepreneur assumes entrepreneurial responsibility by participating in the market,¹⁵⁹ the relevant level of resource combination should be the level at which the market transaction occurs. The entrepreneurial exercise of allocative control over resources occurs up until the result of resource combination is sold to a buyer. If a resource is purchased for use in a new combination, it is the purchaser of the resource rather than its seller who exercises allocative control over how the purchased resource will be used. For instance, in the wheat farmer example above, the farmer's allocative control over resources occurs until the wheat is sold to the bread factory. Once the factory purchases wheat, it exercises allocative control over wheat, along with other resources, to produce bread for sale. On the other hand, if there is no market transaction for the wheat, it will be the factory rather than the farmer who exercises allocative control over wheat growing. Thus, if the factory hired the farmer to grow its wheat for them, the farmer would not be acting as an entrepreneur since the factory is paying for his labor rather than purchasing the wheat from him. Furthermore, as will be seen with the third element of the entrepreneurial responsibilities test, the fact that the transaction occurs within the *market* context matters quite a bit as well. If the factory enters into an

¹⁵⁹ See, e.g., *supra* Part III.C and *infra* Part IV.C.

exclusive contract with the farmer to purchase wheat from him in such a way that the farmer could not meaningfully engage in the market to sell his wheat, the farmer would not be considered an entrepreneur either.

C) Buying to sell for profit

The third element draws from Kirzner's theory of entrepreneurship and considers whether or not the worker buys resources to sell in the market in the pursuit of profits. As noted above, the Kirznerian entrepreneur is alert to opportunities for bringing the market closer to equilibrium.¹⁶⁰ Market disequilibrium exists when there are opportunities to allocate resources more efficiently. Since the market comes to an equilibrium once all resources are allocated to their highest valued use, a market in disequilibrium contains within it at least some type of an imbalance between supply and demand. Markets utilize the price mechanism to correct such imbalances. When there are more potential sellers than buyers, prices should drop, and prices should rise when there are more potential buyers than sellers. However, the movement in prices is not a mechanical response to underlying market conditions. Neither do prices adjust magically on their own. Instead, it is the entrepreneur who recognizes the imbalance and helps to correct the market by buying from the surplus of sellers for a little less than the market price to sell to potential buyers at the market price and/or buying from sellers at the market price to sell to the surplus of buyers for a little more than the market price.

¹⁶⁰ See *supra* Part III.C.

When examining the buying and selling activities of the worker under the entrepreneurial responsibilities test, it is important to connect these activities to the worker's pursuit of profits. After all, all workers need to buy resources to support their work in some way, and they often participate in the labor market as sellers of labor. But whereas normal workers sell their labor to obtain a wage and buy resources to sustain their capacity to live and work, entrepreneurs look to earn a pure profit by *buying to sell*. As noted above, pure profit refers to the remainder of an enterprise that cannot be attributed to wages or a return on investment.¹⁶¹ By definition, what a worker earns as compensation for her labor does not constitute a profit. Furthermore, within Kirzner's theory, profit arises only when there is a discrepancy between the market price and underlying market conditions due to the mismatch in supply and demand.¹⁶² The entrepreneur can be identified by his buying resources for the purposes of attempting to sell them – as they are or as part of a new combination – for a profit. Thus, even if it were the case that compensation for labor could somehow count as a profit, the typical worker is not buying resources in an attempt to combine them with her labor for a higher price. And to the extent that a worker purchases resources to sell in the market, she will likely be acting as an entrepreneur.

¹⁶¹ For more on pure profit, see *supra* note 113 and accompanying text.

¹⁶² See, e.g., *COMPETITION AND ENTREPRENEURSHIP*, at 48 (“The pure entrepreneur... proceeds by his alertness to discover and exploit situations in which he is able to sell for high prices that which he can buy for low prices. Pure entrepreneurial profit is the difference between the two sets of prices. It is not yielded by exchanging something the entrepreneur values less for something he values more highly. It comes from discovering sellers and buyers of something for which the latter will pay more than the former demand.”).

To illustrate the buying-to-sell-for-profit element, imagine three different examples. The first example is a worker who uses the TaskRabbit platform to sell his services for interested buyers. He also optimizes his time by shopping for his own groceries when he runs an errand for a TaskRabbit customer to pick up the customer's groceries. Although this individual is engaged in both buying and selling, he would likely not be considered an entrepreneur under the entrepreneurial responsibilities test because he is not buying groceries to sell them or to combine them into a product to sell. The buying of his own groceries has the purpose of consumption, not sale. Furthermore, as discussed above, compensation for his sale of labor will result in wages, not profit.

The second example is a manager of a local outpost of a national grocery store chain. This individual likely purchases goods directly from the national chain. Suppose, for the sake of the argument, that his purchases also constitute a buy-for-sale activity. Yet, even if the grocery store manager buys goods from the chain to sell to customers, he would still likely not be considered an entrepreneur under the entrepreneurial responsibilities test because the difference between the prices that he pays and the prices that he charges will not yield him any profits. He does not realize any gains from the buying and selling, except perhaps a bonus for a job well done. If anyone realizes a profit, it will be the owner of the grocery store.

The third example is the owner-operator of a small, independent convenience store. The store owner would likely be considered as an entrepreneur under the entrepreneurial responsibilities test because he purchases goods from suppliers in an attempt to sell them to his local customers for a profit. His business operations are likely the result of his recognition that there was a mismatch between

supply and demand within the particular location he serves. Perhaps he recognized that there were not enough convenience stores to provide goods to the local population, or perhaps he felt that he could offer lower prices and/or better products than other stores in the area. In recognizing the opportunity, he exercised entrepreneurial alertness to the potential for profit. And he is attempting to exploit the opportunity by setting up shop where he did.

The example of the grocery store owner above also illustrates the importance of market engagement within the entrepreneur's buy-to-sell-for-profit activities. Kirznerian entrepreneurship requires profit-seeking through *engagement with the market process*. The entrepreneur exploits previously undiscovered opportunities for arbitrage in the market by discovering buyers and sellers,¹⁶³ and he can only discover buyers and sellers through a learning process generated by the unfolding experience of market activity.¹⁶⁴ As a result, a worker acts as an entrepreneur only by engaging with the market process as both a buyer *and* a seller. For instance, the grocery store manager may engage with the market on the demand side by selling purchased goods to customers, but he does not engage with the market with his buying because he is not free to choose another supplier from whom he wishes to buy his items. Without the freedom to evaluate his purchasing

¹⁶³ See, e.g., COMPETITION AND ENTREPRENEURSHIP, at 48 ("Pure entrepreneurial profit... comes from discovering sellers and buyers of something for which the latter will pay more than the former demand."). See also *id.*, at 44 ("This absence of coordination will express itself in price differences.... The profit opportunities represented by such price differences open up a dimension for purely entrepreneurial activity which... will consist *exclusively* in buying resources and selling products.").

¹⁶⁴ *Id.*, at 36 ("[O]nce we become sensitive to the decision-makers' alertness to new possibly worthwhile ends and newly available means, it may be possible to explain the pattern of change in an individual's decisions as the outcome of a learning process generated by the unfolding experience of the decisions themselves.").

options, he has no ability to bring the market closer to equilibrium because he has no ability to change the way the market allocates resources. On the other hand, if the owner of a small independent grocery store chooses suppliers from whom he will purchase his inventory, he engages in the market process even if he cannot change the prices at which he purchases the items. Even if he lacks the ability to negotiate for a discount, he influences the allocation of resources in the market by choosing his supplier. This influence will lead to a change in prices in the overall market. Other suppliers, for instance, may decide to lower prices to compete with the chosen supplier. Or prices for goods may increase for the grocery store's owners because his purchases decrease the supply of goods for others. In the same way, an entrepreneur in a highly-regulated industry where the government sets prices for goods engages with the market process by choosing his customers. His discovery of customers and the act of selling, even without the ability to change prices, nevertheless influences the allocation of goods within the regulated market and thus influences how the price mechanism responds to his activity.

D) Applying the test

The entrepreneurial responsibilities test can provide guidance for courts even in controversial and/or new fact patterns that would lead to uncertainty under other tests. Rather than applying a wide array of factors that can cut a variety of ways, the entrepreneurial responsibilities test simplifies the inquiry into three discrete elements that are necessary for a worker to act as an entrepreneur. Under the test, only when a worker's responsibilities meet all three elements will the worker be considered an

entrepreneur. For reasons provided in the next section, the entrepreneurial responsibilities test also treats all non-entrepreneur workers as employees. Thus, a worker would be considered an employee under the proposed test unless her work responsibilities meet all of its three elements.

Take, for instance, fact patterns involving platform companies in the new sharing economy. The most prominent example of controversial worker classification concerns Uber and its drivers. In employment law cases, Uber has typically maintained that it is merely a technology provider that helps to connect drivers working as independent contractors with customers looking for a ride.¹⁶⁵ And under the control, economic realities, and entrepreneurial opportunities tests, there is considerable uncertainty as to whether Uber has an employment relationship with its drivers. Under the thirteen-factor Federal control test, four factors support the existence of an employment relationship, six factors support Uber's case, and three factors are unclear.¹⁶⁶ Things are even murkier under the economic realities test. Under the narrower test, two of the four factors are unclear, with one factor in favor of each side.¹⁶⁷ The same goes for the more expansive

¹⁶⁵ See, e.g., *O'Connor v. Uber Techs., Inc.*, 82 F. Supp. 3d 1133, 1141 (N.D. Cal. 2015) (“Uber passes itself off as merely a technological intermediary between potential riders and potential drivers.”).

¹⁶⁶ See *supra* note 59 for the thirteen factors. Driving for Uber requires little skill, makes assistants superfluous, and is a part of Uber's regular business as a business. However, drivers are free to choose where, when, and how long to work, and they often have short and temporary relationships with Uber. Uber also lacks the ability to assign additional projects to its drivers, takes a percentage of the driver's profits rather than paying them wages, and treats drivers as independent contractors. What is unclear are the other three factors. Uber can control the manner and means of work, but only indirectly. Although drivers provide their own cars, Uber provides the app, which is an arguable even more valuable tool. And although Uber doesn't pay any benefits, it provides insurance and conducts background checks.

¹⁶⁷ See *supra* note 81 and accompanying text for the four-factor economic realities test. Although driving is an integral part of Uber's business, Uber does not pay its drivers wages. The extent of Uber's control over its drivers and its right to discipline its workers are unclear.⁵⁹

test, where three factors are unclear, with a mix of factors supporting each side.¹⁶⁸ The same uncertainty extends to the entrepreneurial opportunities test. Although Uber drivers have an opportunity to earn more or less based on when and how they work, it is not clear whether this opportunity is the same kind of opportunity possessed by FedEx drivers who have the right to hire drivers for their routes and even sell their routes.¹⁶⁹

Under the entrepreneurial opportunities test, on the other hand, determining the employee status of Uber drivers is simpler and more predictable. The first element counts in Uber's favor. Uber drivers assume at least some liability for economic uncertainty, since they own or lease their own vehicles and often spend gas and put wear on their vehicles driving to places where they anticipate can bring them larger fares. The second element counts against Uber if courts take Uber's position at face value, i.e., that it is merely a third party service provider in a transaction between the driver and the rider.¹⁷⁰ As noted above¹⁷¹, the level at which allocative control is exercised occurs at the level of the transaction, and within the Uber driver context, the relevant transaction occurs between the rider and the driver. Yet, when the rider purchases driving services through Uber, the transaction involves not just the ride but also the smooth efficiency with which the ride is provided, including the driver-rider match, directions over the route of the ride, the means of payment, etc. It is Uber, not the driver, that controls the

¹⁶⁸ See *supra* note 82 and accompanying text for the six-factor economic realities test. Again, although driving is an integral part of Uber's business, it requires little skill, and the Uber-driver relationship is impermanent. What is unclear is the nature of Uber's control over its drivers, the driver's investment in tools and equipment, and the driver's opportunity for profit and loss depending on his managerial skill.

¹⁶⁹ See *supra* Part II.C for a discussion of the entrepreneurial opportunities test.

¹⁷⁰ See *supra* note 165 and accompanying text.

¹⁷¹ See *supra* Part IV.B.

allocation of various technological resources required to combine the Uber ride experience into a single product. Although the Uber driver controls, to a certain extent, his hours and his vehicle, he does not exercise allocative control over much of the relevant resources that go into selling the Uber ride to the rider.¹⁷² Lastly, the third element definitively counts against Uber. Although Uber drivers engage the market to purchase a vehicle and other equipment related to their work, they do not engage the market to sell their services. It is Uber's app, not the driver, that discovers drivers willing to sell their services and riders willing to buy their services at prices that Uber sets. Thus, drivers engage the Uber app rather than the market to sell their services. The market actor that performs the entrepreneurial function of bringing the market closer to equilibrium by discovering buyers and sellers, then, is Uber and not the driver.

A comparison of Uber drivers with taxi drivers helps to accentuate the nuanced economic logic that the entrepreneurial opportunities test can bring to worker classification. On their face, taxi drivers seem to be performing similar services as Uber drivers. But outside of those who rely on a dispatcher to find a majority of their customers, taxi drivers will often be classified as independent contractors under the entrepreneurial opportunities test. Like Uber drivers, most taxi drivers assume liability for economic uncertainty by leasing their vehicles along with their medallions. And

¹⁷² Interestingly enough, the second element becomes a more difficult question if courts do not accept Uber's account at face value. If it were the case that Uber functions as an intermediary that purchases driver services and sells them to riders, it can make a plausible case that its drivers do exercise allocative control over the sale of their services to Uber. Of course, this element will not be dispositive in the Uber case because the driver also fails to meet the third element.

unlike an Uber ride, the transaction for a taxi ride usually consists of not much more than the combination of the driver's resources and labor, albeit often strictly regulated environment. And lastly, the absence of an intermediary interface like Uber requires that drivers discover buyers of their services on their own. By exercising their alertness to profit opportunities by making their own judgments about when, where, and for whom to work based on their anticipation of supply and demand, taxi drivers engage in the market for ride services and influence the allocation of rides within the market, even if price regulation prevents them from setting their own prices.

Lastly, as the Uber example shows, most applications of the entrepreneurial responsibilities test involving firms involving multiple workers will yield what seems like a counter-intuitive conclusion for some: there is no entrepreneur except the firm itself. However, the attribution of the entrepreneurial role to the firm rather than to any individual worker is the natural result of viewing entrepreneurship as an economic function within the context of the modern economy. All three economic theories discussed above view the entrepreneur as the embodiment of an economic function rather than a class or type of individual.¹⁷³ The identification of the entrepreneur within these theories is thus a theoretical exercise intended to isolate the entrepreneurial element within a given action for the purposes of economic analysis.¹⁷⁴ The same individual

¹⁷³ See, e.g., *Creative Response*, at 151 (noting that "the entrepreneur and his function are not difficult to conceptualize.... It is but natural, and in fact it is an advantage, that such a definition does not draw any sharp line between what is and what is not 'enterprise.' For actual life itself knows no such sharp division, though it shows up the type well enough.").

¹⁷⁴ See, e.g., *COMPETITION AND ENTREPRENEURSHIP*, at 43 (noting that "although each human being acts in a wholly integrated manner which we *analyze* into two separate components..., it is analytically expedient

carrying on an economic task in the real world will typically be performing several functions at once, and the entrepreneurial function will also typically be distributed among a wide group of individuals in a business enterprise.¹⁷⁵ When a worker is acting on her own behalf or as part of a sole-proprietorship, she may reasonably be viewed as assuming the entrepreneurial function all on her own. Similarly, a high-level executive in small to medium-sized firms with a significant equity stake and direct managerial responsibilities over the firm's resource allocation and buying and selling activities may also function as an entrepreneur. But as firms increase in size and complexity, its entrepreneurial function will often be dispersed across a wide range of actors, and the only entrepreneur available to identify in such instances may be the legal person of the firm.¹⁷⁶

V. JUSTIFYING THE ENTREPRENEURIAL RESPONSIBILITIES TEST

The bifurcation of workers into two main categories – independent contractors and employees – is widely established in U.S. law and also frequently criticized. Many scholars have argued that the current framework excludes from legal protection a wide

to treat him as if he represented two entirely separate decision-makers, one a passive economizer, the other a pure entrepreneur.”).

¹⁷⁵ See, e.g., RISK, UNCERTAINTY, AND PROFIT, at 299-300 (“It is impossible for entrepreneurship to be completely specialized or exist in a pure form.... The natural result is a complicated division or diffusion of entrepreneurship, distributed in the typical modern business organization”).

¹⁷⁶ In fact, it will sometimes be the case that the entrepreneurial function is dispersed over *groups* of firms. When the conditions for production can benefit from the dispersion of the entrepreneurial elements of responsibility and control among groups of firms, what will result is a variety of ‘hybrid’ forms of economic organization that straddle the traditional bifurcation of markets and firms. See, e.g., Claude Ménard, *Hybrid Modes of Organization: Alliances, Joint Ventures, Networks, and Other Strange Animals*, in ROBERT GIBBONS and JOHN ROBERTS (eds.), *THE HANDBOOK OF ORGANIZATIONAL ECONOMICS* 1066 (2012).

variety of atypical and/or contingent workers who do not fit neatly into either category.¹⁷⁷

A popular recommendation for reform has been to create new categories of workers that are not covered under the current framework.¹⁷⁸ However, what these scholars often overlook is the fact that the current dichotomy in the law correctly – even if accidentally – reflects the efficient division of work into markets and firms within our economic system.

This section argues that the entrepreneurial responsibilities test should be adopted because it corresponds to the principle of fair play and the organization of our economic activities into firms and markets for the benefit of all participants. The principle of fair play imposes an obligation on participants of a cooperative enterprise to abide by the rules of the enterprise in exchange for receiving its benefits. Our economic system is a cooperative enterprise within which we organize our economic activity into markets and firms so that we can all benefit from an efficient allocation of resources. Entrepreneurs participate in the markets under the high-powered incentives of the price mechanism to facilitate the efficient allocation of resources. Entrepreneurs then organize other workers,

¹⁷⁷ See, e.g., Befort, *supra* note 11; Gillian Lester, *Careers and Contingency*, 51 STAN. L. REV. 73 (1998); Linder, *supra* note 11; and Katherine V.W. Stone, *Legal Protections for Atypical Employees: Employment Law for Workers without Workplaces and Employees without Employers*, 27 BERKELEY J. EMP. & LAB. L. 251 (2006).

¹⁷⁸ Several have argued that the U.S. might benefit from adopting Canada's dependent contractor category. See, e.g., Brian A. Langille and Guy Davidov, *Beyond Employees and Independent Contractors: A View from Canada*, 21 COMP. LAB. L. & POL'Y J. 7 (1999); Guy Davidov, *The Three Axes of Employment Relationships: A Characterization of Workers in Need of Protection*, 52 U. TORONTO L.J. 357 (2002); Elizabeth Kennedy, Comment, *Freedom from Independence: Collective Bargaining Rights for "Dependent Contractors"*, 26 BERKELEY J. EMP. & LAB. L. 143 (2005).

A more recent proposal is to create a new category called the independent worker. See Seth D. Harris and Alan B. Krueger, *A Proposal for Modernizing Labor Laws for Twenty-First-Century Work: The "Independent Worker"*, HAMILTON PROJ. (Dec. 2015).

i.e., employees, into firms to avoid the costs of transacting in markets. Benefiting from participating in our economic system, this section will argue, creates an obligation to maintain the calibration of prices at socially optimal levels and ensuring that employees are not exposed to the high-powered incentives in the market. This is what the entrepreneurial responsibilities test helps to do.

A) The principle of fair play

The principle of fair play is typically evoked within discussions of political obligations between political philosophers. The principle was introduced by H.L.A. Hart, who argued that “when a number of persons conduct any joint enterprise according to rules and thus restrict their liberty, those who have submitted to these restrictions when required have a right to a similar submission from those who have benefited by their submission.”¹⁷⁹ For Hart, political obligations arise from a “mutuality of restrictions” within such a joint enterprise between cooperating members of a society.¹⁸⁰ John Rawls drew on a similar principle of the same name by arguing that the moral obligation to obey the law can be grounded within the duty of fair play, subject to several conditions and modifications.¹⁸¹ In both cases, the main intuition at play is that a free rider within a

¹⁷⁹ Hart, *supra* note 36.

¹⁸⁰ *Id.*

¹⁸¹ Rawls, *supra* note 36, at 9 (“If one thinks of the constitution as a fundamental part of the scheme of social cooperation, then one can say that if the constitution is just, and if one has accepted the benefits of its working and intends to continue doing so, and if the rule enacted is within certain limits, then one has an obligation, based on the principle of fair play, to obey it when it comes one’s turn.”). It is worth noting, however, that Rawls later changed his views on the principle of fair play and developed a much more developed – and influential – account of justice as fairness. See JOHN RAWLS, A THEORY OF JUSTICE, at 97 and 308 (1972).

cooperative scheme wrongs others who also participate within the scheme and do their part in following its rules.

The principle of fair play has been met with both criticism and support among political philosophers. M.B.E. Smith criticizes the principle by arguing that obligations of fair play disappear when the scale and complexity of the cooperative enterprise become large enough. If other members of the enterprise do not benefit from one's compliance with the rules and/or they are not harmed by one's non-compliance, the unfairness of non-compliance would appear to apply only to the group and not to any individual, which Smith finds impossible.¹⁸² Defenders of the principle respond by arguing that non-compliance within a cooperative enterprise wrongs other participants even if it does not harm the participants or the enterprise.¹⁸³ Robert Nozick criticizes the principle by arguing that merely conferring a benefit on someone does not then create a right to impose on the beneficiary an obligation to make a contribution.¹⁸⁴ The argument that one has an obligation to obey the rules of a cooperative scheme merely because one benefits from it is flawed, he argues, because it ignores the element of consent. Just as one may not give someone a book and just grab money from the person for compensation, a government cannot confer benefits on its members to create a "general floating debt which [it] can collect and use as it will."¹⁸⁵ A. John Simmons provides a response to Nozick's criticism by arguing that one can not only receive but also *accept*

¹⁸² M.B.E. Smith, *Is There a Prima Facie Obligation to Obey the Law?*, 82 YALE L. J. 950, 956 (1973).

¹⁸³ See, e.g., RICHARD DAGGER, *CIVIC VIRTUES: RIGHTS, CITIZENSHIP, AND REPUBLICAN LIBERALISM* (1997), at 71.

¹⁸⁴ ROBERT NOZICK, *ANARCHY, STATE, AND UTOPIA* (1974), at 93-95.

¹⁸⁵ *Id.*, at 95.

benefits without consent, and he and others have argued that mere reception of a benefit does not make someone a *participant* within a cooperative enterprise.¹⁸⁶ Nevertheless, Simmons criticizes the principle of fair play by arguing that not many people would meet the conditions for the acceptance of benefits in most political societies. Because acceptance of a benefit requires either that someone try and succeed in obtaining it or that one take it willingly and knowingly, Simmons argues, the principle of fair play would not apply to the vast majority of a country's citizens since they either do not recognize the benefits of political membership and/or view the benefits as being purchased from government rather than the outcome of social cooperation.¹⁸⁷ Defenders of the principle respond to Simmons by arguing that participation can occur without full awareness¹⁸⁸ and/or that acceptance is not necessary to incur an obligation to cooperate.¹⁸⁹

Regardless of its applicability for political obligations in general, however, the principle of fair play does not raise any similar concerns within the employer and worker context. Smith's concerns about the consequences of compliance and non-compliance do not apply because economic free-riding has a real impact on other economic actors. If employers externalize the costs of their enterprise to their employees who lack the leverage to demand anything else, they would directly harm their workers in the form of lower wages and also indirectly harm other market participants by taking an inefficient

¹⁸⁶ See, e.g., A. John Simmons, *The Principle of Fair Play*, 8 PHIL. & PUB. AFF. 307 (1979) and DAGGER, *supra* note 183.

¹⁸⁷ Simmons, *supra* note 186.

¹⁸⁸ See, e.g., SAMANTHA BESSON, *THE MORALITY OF CONFLICT: REASONABLE DISAGREEMENT AND THE LAW* (2005), at 487-489.

¹⁸⁹ See, e.g., GEORGE KLOSKO, *THE PRINCIPLE OF FAIRNESS AND POLITICAL OBLIGATION* (1992).

amount of risk. Nozick's concerns about consent do not apply because the very nature of hiring and working requires participation within the economic system. Nozick's argument might hold some weight against taxing non-working members of society on the basis of the benefits they receive from the economic system. But employers and workers are not bystanders to the scheme of economic cooperation. Rather than passively receiving the benefits of the market, they actively participate within the system to earn wages and/or profits. Thus, Simmons' argument also does not apply. Employers and workers clearly accept the benefits of participating in the economic system because they are trying to gain a benefit through their participation. Although there are various "open" benefits that members cannot avoid receiving in a society with a functioning economic system, wages and profits are "readily available" benefits that can be easily avoided by refraining from working at all.¹⁹⁰ As a result, there aren't likely any good reasons to deny the validity of the principle of fair play in articulating a rule that enforces the division of work within markets and firms within the U.S.

B) Markets and firms

We organize our economic activity within markets and firms because they help us to efficiently allocate resources for the benefit of all in society. At their best, markets enable us to coordinate our aggregate response to the scarcity of resources by putting them to their highest valued use. Essential to the functioning of the market is the price

¹⁹⁰ Simmons defines open benefits as those like security and clean air that cannot be avoided without considerable inconvenience. Readily available benefits, on the other hand, can be avoided without inconvenience. For more on the distinction, see, e.g., Simmons, *supra* note 186, at 327-329.

mechanism, which centralizes and translates the disparate and complex bits of information into a signal about local supply and demand across the entire market.¹⁹¹ The utilization of the price mechanism in the market incentivizes us with the potential to profit from making individual resource allocation decisions that correspond with overall supply and demand for resources in society. When the supply of limes drops due to agricultural issues in Mexico, for instance, the price system helps us to collectively respond to the shortage by presenting to all of us an opportunity to profit from consuming limes less and selling them to those who need or desire them more.

The opportunity to profit from changing prices in the market provides what is known as a high-powered incentive for market participants. An incentive for an action is high-powered when the consequences of the action accrue directly to the actor.¹⁹² If a lime cost \$1 yesterday but now costs \$2 today, my incentive to sell the lime in the market is high-powered since I would realize the entire \$1 gain from selling the lime. On the flipside, if I purchased a lime for \$2 yesterday and can only sell it for \$1 today, I would bear the entirety of the \$1 loss under a high-powered incentive system. In order for us all to benefit from participating in the market, high-powered market incentives must be calibrated accurately to reflect the “true” cost of the activity, i.e., the price at which a given market activity would lead to an optimal allocation of resources within the market. If I can realize a 100% gain if the relative supply of limes drops by half but stand to lose

¹⁹¹ See, e.g., F. A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945); JOSEPH HEATH, MORALITY, COMPETITION, AND THE FIRM: THE MARKET FAILURES APPROACH TO BUSINESS ETHICS, at 205-229 (2014).

¹⁹² See *supra* note 37.

only 25% of my investment if the relative demand of limes drops by half, market incentives would be over-powered since I would be incentivized to buy and sell more limes than I should. Rather than efficiently allocating limes for the benefit of all, over-powered incentives would lead to an overconsumption of limes in society and lead to a shortage. Thus, taxes and other costs of doing business imposed by the law are supposed to calibrate the incentives of market activity at the socially-optimal level. Rather than distorting the high-powered incentives of the market, they help us to keep them in calibration by attributing the social costs of an economic activity to the actor.

Yet, despite the advantages of markets, we also need to organize some of our economic activities in firms if we are to benefit from an efficient allocation of resources in society. Economists typically view the firm as “islands of conscious power” within the ocean of unconscious market coordination, “like lumps of butter coagulating in a pail of buttermilk.”¹⁹³ Rather than relying on the price mechanism, resource allocation within firms proceeds through managerial direction. As mentioned above,¹⁹⁴ leaving it up to the manager to decide how to allocate resources within the firm can have an efficiency advantage over the price mechanism in the market because there are a variety of costs associated with transacting in the market. Central to these transactions costs is the ways in which the high-powered incentives of the market distort and prevent the making of enterprise-specific investments that would lead to a more efficient allocation of resources. When one makes an investment in the market to support one’s business, the resources

¹⁹³ Coase, *supra* note 90, at 388, citing D. H. ROBERTSON, *THE CONTROL OF INDUSTRY*, 85 (1923).

¹⁹⁴ See *supra* note 90 and accompanying text.

into which the investment is made become more valuable to the investor than other similar resources in the market. If an employer makes an investment in a worker by providing additional training specific to the employer's business, for instance, the worker becomes more valuable to the employer after the investment than other potential workers in the market. However, the investor has no incentive to make such enterprise-specific investments if the recipient of the investment can hold up the investor afterwards to extract the benefits of investment. If an employer anticipates that a worker will refuse to cooperate with managerial direction unless the firm confers the benefits of the investment to the worker, the employer will not make an investment in the worker, even if it would lead to a better allocation of resources – and thus the benefit of all – if the employer were to make the investment.

From the point of view of social efficiency, then, firms help to calibrate incentives in the market by eliminating the possibility for workers inside the firm to profit from exploiting their position over the firm's resources. When a firm's workers follow managerial direction in allocating resources inside the firm, the firm realizes the potential gains and assumes the full costs associated with its workers' activities. Workers may benefit indirectly in the form of higher wages or other type of compensation, but the incentives of the price mechanism do not motivate them in the same way it would if they were operating directly in the market. In other words, firms substitute the high-powered incentives of the market with low-powered incentives. An incentive for an action is low-powered when the consequences of the action do not accrue directly to the actor. When a worker in a firm helps to combine resources to create a new product for the firm to sell on

the market, for instance, he works under low-powered incentives since the economic results of his actions will not accrue directly to him. He is motivated, instead, by the prospect of internal discipline and other non-market-oriented factors to perform his resource allocation activities. The substitution of high-powered incentives for low-powered incentives help to encourage employers to make socially efficient levels of investment in labor and the means of production since the firm's workers will not have the same incentive to profit from exploiting their position in the enterprise to extract the benefits of investment for themselves.

The organization of our economic activity into markets and firms thus represents a joint enterprise where we all benefit from efficient resource allocation by accurately calibrating the high-powered incentives of the market and eliminating them altogether for certain types of activities by organizing them in firms. This bifurcation of our economic activity results in a bifurcation of two different types of workers. The first is the entrepreneur. As seen above, entrepreneurs are essential to the functioning of the market and the price mechanism because they are the ones acting in markets based on the signals provided by the price mechanism to allocate resources and drive economic development.¹⁹⁵ By assuming entrepreneurial responsibility for their economic activity, entrepreneurs operate under the high-powered incentives of the market, exposing themselves to financial liability for their activities, carrying out new combinations of

¹⁹⁵ See, e.g., RISK, UNCERTAINTY, AND PROFIT, at 271 ("Under the enterprise system, a special social class, the business men, direct economic activity; they are in the strict sense the producers, while the great mass of the population merely furnish them with productive services, placing their persons and their property at the disposal of this class; the entrepreneurs also guarantee to those who furnish productive services a fixed remuneration.").

resources, and bringing the market closer to equilibrium in the pursuit of profits.¹⁹⁶ The second is the employee. By giving up entrepreneurial responsibility for their economic activity, employees operate under the low-powered incentives of the firm. As Knight notes, employees essentially insure themselves against the high stakes of market activity by forgoing participation in the market altogether and, instead, choosing to enter into a contractual agreement with entrepreneurs to provide services in exchange for a fixed amount of compensation.¹⁹⁷

C) Profit and fair play

The principle of fair play limits the ways in which economic actors pursue profit in society. Our economic system is a cooperative enterprise through which everyone benefits from an efficient allocation of resources. As seen above, the benefits of cooperation depend on entrepreneurs responding to well-calibrated incentives in the market and on shielding other workers from the high-powered incentives of the price mechanism. The principle of fair play suggests that participants within our economic system have an obligation to act consistently with such an arrangement. Entrepreneurs who are able to distort the prices of resources for their own advantage will wrong other participants in our economic system by interfering with the market's resource allocation process. Conversely, workers who are able to pursue individual profit opportunities while shielding themselves from the full risks and costs associated with market activity

¹⁹⁶ See, e.g., *Entrepreneurial Discovery*, at 73 (“The competitive process is an entrepreneurial one in that it depends crucially on the incentives provided by the possibility of pure entrepreneurial profit.”).

¹⁹⁷ RISK, UNCERTAINTY, AND PROFIT, at 269-270.

will wrong other participants in our economic system by making resource allocation inside the firm costlier than it should be. The entrepreneurial responsibilities test helps to prevent unfairness in our economic system by eliminating opportunities for circumventing the terms of cooperation through worker misclassification.

One potential area for worker misclassification pertains to apportioning tort liability. Employers often attempt to benefit from the current legal framework by classifying their workers as independent contractors to avoid liability for damages attributable to their enterprise. For example, in *Doe v. Uber Techs., Inc.*, two plaintiffs sued Uber under the theory of *respondeat superior* for sexual assault allegedly suffered at the hands of Uber drivers.¹⁹⁸ In response, Uber moved for summary judgment on account of its position that no employment relationship exists between it and its drivers as a matter of law.¹⁹⁹ And because it has a plausible claim that no employment exists under existing tests for employee status,²⁰⁰ Uber has the opportunity to benefit by distorting the price of ridesharing in our economic system by forcing its drivers (who would almost never have enough assets to cover for significant damages) and victims to bear the costs that should be built into its prices in the market.

Under the entrepreneurial responsibilities test, Uber would be found as an employer of its drivers²⁰¹ and thus held liable for the harms caused by its drivers, provided that other elements of the claim are met. The principle of holding employers

¹⁹⁸ 184 F. Supp. 3d 774 (N.D. Cal. 2016).

¹⁹⁹ See, e.g., *supra* note 165 and accompanying text.

²⁰⁰ See *supra* Part IV.D.

²⁰¹ See *supra* Part IV.D.

vicariously liable lies “in a deeply rooted sentiment that a business enterprise cannot justly disclaim responsibility for accidents which may fairly be said to be characteristic of its activities.”²⁰² And although the risks associated with accidents are not the risks associated with economic uncertainty, the entrepreneurial responsibilities test nevertheless yields results that are consistent with this principle by helping to prevent employers from acting unfairly. Uber should bear the costs associated with connecting drivers with riders because it – and not the drivers – is entitled to potential pure profits associated with the activity. Within this framework, Uber has the responsibility to manage the costs associated with screening drivers and providing the infrastructure to prevent sexual assaults by its drivers. These costs will likely be passed on to both riders in the form of higher prices and to drivers in the form of lower compensation, but these costs should nevertheless be managed by the enterprise that is ultimately responsible for the market consequences of the drivers’ activities. Uber’s attempt to earn the profits associated with ridesharing services while circumventing the price mechanism’s function of forcing it to internalize the costs of ridesharing services wrongs other market participants by interfering with the efficient allocation of resources in society.

Employers also frequently misclassify workers in an attempt to avoid compliance with a variety of federal and state statutory obligations associated with an employment relationship. For example, FedEx was able to avoid compliance with the N.L.R.A. and prevent its workers from exercising their collective bargaining rights in *FedEx Home*

²⁰² *Ira S. Bushey & Sons, Inc. v. United States*, 398 F.2d 167, 171 (2d Cir. 1968)

Delivery because the D.C. Circuit ruled that its drivers were independent contractors rather than employees.²⁰³ The D.C. Circuit ruling thus allowed FedEx to manipulate the means-ends distinction the law over worker control and thus import and expose its drivers to the high-powered incentives of the market.²⁰⁴ If entrepreneurs are able to expose their employees to the risks associated with market participation while retaining the opportunity to profit from their enterprise, they wrong not only their employees but the rest of society by contributing to the misallocation of resources. The entrepreneurial responsibilities test can prevent such an outcome by identifying the entrepreneur for all different types of regulatory purposes.

As noted above, the government regulates the employment relationship for a wide variety of reasons. And although some criticize courts for not paying enough attention to the purpose behind each statutory protection,²⁰⁵ instituting a variety of tests for employee status for each statutory purpose can lead to a confusing array of potential tests to navigate. The entrepreneurial responsibilities test, on the other hand, can provide a single rationale for the wide variety of governmental regulation over the employment relationship. The principle of fair play and the bifurcation of economic activity into markets and firms suggest that regulating the employment relationship should be motivated by the goal of shielding employees from the high-powered incentives of market participation and calibrating market incentives to the socially optimal level.

²⁰³ See *supra* Part II.C.

²⁰⁴ See, e.g., Tomassetti, *supra* note 26. For more on the ambiguity of the means-ends distinction in employment relationships, see also Julia Tomassetti, *The Contracting/Producing Ambiguity and the Collapse of the Means/Ends Distinction in Employment*, 66 S. C. L. REV. 315 (2014).

²⁰⁵ See, e.g., Linder, *supra* note 11.

Because the discipline of market participation will lead to employers attempting to extract as many concessions as possible from workers, allowing the high-powered incentives of the labor market to govern negotiations between employers and potential employees will result in terms of employment where workers bear the down-side costs of market participation without any opportunity to pursue entrepreneurial profits. In essence, the incentives of the market are *too* powerful without statutory protections for employees, and the lack of employee protections will undermine the purpose of organizing some economic activity in firms. Regulations that restrict the ability of employers to extract concessions regarding wages, hours, collective bargaining rights, and discriminatory practices help to calibrate the incentives of the labor market to a more socially efficient level by ensuring that employees can bargain to shield themselves inside the firm from the high-powered incentives of the market. Taxes, retirement benefits, and other financial obligations incurred by the employer and independent contractors also should be motivated by the goal of calibrating the incentives of the market to ensure that entrepreneurs operate under a socially optimal cost structure.

Lastly, worker misclassification can lead to the interference with the entrepreneur's allocative control over productive resources. One common area of concern pertains to property rights over work products. For instance, in *Natkin v. Winfrey*, two photographers sued their employer after their photos were published in a book without their permission.²⁰⁶ Although the employer claimed that the photographers

²⁰⁶ 111 F. Supp. 2d 1003 (N.D. Ill. 2000).

were its employees over whom they exercised significant control, the court applied the thirteen factor Federal control test to hold that the photographers had rights over the photographs because they were independent contractors. Among other things, property rights over productive resources grants the right holder to extract additional concessions from the user of the resources.

The entrepreneurial responsibilities test provides a rationale for determining property rights over productive resources by ensuring that the entrepreneur be given the right to exercise allocative control over them. In the case of *Winfrey*, the court's ruling gave the photographers a right over the photographs that could be used to extract additional compensation for their use by the employer. However, it is important that only entrepreneurs be granted this right because it would otherwise privilege employees to partake in the profit opportunities of the market. If employees were granted property rights over resources over which the entrepreneur exercises allocative control, they could disrupt the entrepreneurial process by appropriating some of the entrepreneur's profits as compensation that cannot be attributed to the costs of their labor. Such an arrangement would not only harm the entrepreneur but also interfere with the efficient allocation of resources by hindering the necessary movement and combination of resources in the market.

VI. CONCLUSION

Despite its flaws, the central insight of the entrepreneurial opportunities test – that workers should be afforded the legal protection of employee status unless they have an opportunity to profit from their work – is sound. What the D.C. Circuit has gotten wrong is what constitutes an entrepreneur. A worker with a mere opportunity to profit by working smarter is not an entrepreneur. What the classic three economic theories of entrepreneurship show is that the entrepreneur perform an economic function of assuming *entrepreneurial responsibility* for their economic activity. The three markers of entrepreneurial responsibility are: (1) the assumption of liability for economic uncertainty, (2) the exercise of allocative control over productive resources, and (3) the buying of resources to sell in the market for a profit. Only when a worker's responsibilities correspond with all three markers should courts consider her an entrepreneur. Otherwise, courts may contribute to perpetuating inefficiencies in society by allowing some parties to exploit opportunities to engage in worker misclassification in order to extract resources for themselves at the cost of everyone else in society.

ESSAY 3:**Spontaneous Orders and Stakeholder Value Creation: Toward an Equilibration Model of Managing for Stakeholders****I. INTRODUCTION**

Stakeholder theory operates on descriptive, instrumental, and normative levels (Donaldson and Preston 1995). At the instrumental level, stakeholder theorists have long argued that managing for stakeholders is not only ethical but also conducive for firm success (e.g., Berman et al. 1999; Freeman 1984; Freeman et al. 2010; Hillman and Keim 2001; Jones 1995). A recent area of focus on this link between ethics and firm success has been the *process* of stakeholder management, typically described as the “managing-for-stakeholders approach” (Freeman et al. 2007). The managing-for-stakeholders approach emphasizes the responsibility of the manager/entrepreneur to *create value* for all of the firm’s stakeholders (Freeman 2010). Within this view, stakeholder value is understood broadly as utility or happiness (Harrison and Wicks 2013; Jones and Felps 2013), and value creation is thus implicitly understood as an increase in stakeholder utility/happiness. As such, the managing-for-stakeholders approach argues that managers can help the firm succeed by intentionally increasing the utility/happiness of all stakeholders involved. Some have operationalized this insight by focusing on how the manager can directly create value for stakeholders by taking actions that increase their utility/happiness. By drawing on an often overlooked aspect of stakeholder theory that the firm is an equilibrating mechanism (Venkataraman 2002), this paper argues that the

managing-for-stakeholders approach should also focus on managing the process by which *stakeholders create value for themselves*.

By emphasizing the managerial responsibility to increase the utility/happiness of stakeholders, the managing-for-stakeholders approach implicitly assumes three distinct necessary conditions for managerial knowledge within the process of stakeholder value creation. First, the manager must know what are the stakeholder interests. Second, the manager must know how his actions will actually advance the interests of his stakeholders and thus create value for them. Third, the manager must know how to advance the interests of various stakeholder groups simultaneously without resorting to tradeoffs. Unfortunately, most of the focus of the managing-for-stakeholders approach has been only on the third condition, with little attention having been paid to the first and second conditions. Despite well-worn criticisms from shareholder-centric theorists (e.g., Jensen 2002; Sundaram and Inkpen 2004), stakeholder theorists have long emphasized that creating value for all stakeholders does not necessarily mean that shareholders will benefit less than they would under the traditional shareholder primacy approach. Since stakeholder interests are joint rather than opposed to each other, stakeholder theorists argue, managers can and should create value for all stakeholders without resorting to tradeoffs (Freeman 2010; Porter and Kramer 2011). The recent focus on stakeholder utility functions builds on this insight by arguing that synergy in stakeholder value creation is possible due to the multi-attribute nature of stakeholder utility functions (Tantalo and Priem 2016). However, little attention has been paid to how much managers can actually access stakeholder utility functions and, even if they have

adequate knowledge of them, how they can know that their actions will actually increase the utility of *any* of their stakeholders, let alone all or most of them.

This paper presents an approach to stakeholder management rooted within the theory of spontaneous order – what I will call the stakeholder-equilibration model – that addresses the first and second necessary conditions of managerial knowledge for stakeholder value creation. To the extent that it recognizes the issue at all, the existing model of stakeholder management that asks managers to act in light of their knowledge of stakeholder utility functions to create stakeholder value – what this paper will call the top-down-stakeholder-utility-function model – is limited by the problem of managerial knowledge. The stakeholder-equilibration model, on the other hand, involves managers attending to and reinforcing the conditions that allow stakeholders to create value for themselves. The theory of spontaneous order (Hayek 1973) can explain why stakeholders pursuing their own interests can create stakeholder value in ways that can supplement – and sometimes limit – managerial efforts to directly create value for them. Rather than interfering with the spontaneous ordering of stakeholder interactions within the firm, managers can reinforce the conditions of stakeholder value creation by focusing on identifying and refining organizational norms, which can lead not only to stakeholder value creation but also to a sustainable competitive advantage for the firm.

The paper is organized as follows. First, I argue that the problems associated with localized knowledge, interpersonal comparison of utility, and bounded rationality impose significant limits on the top-down-stakeholder-utility-function model. Managers do not know enough nor process the knowledge that they possess to create as much stakeholder

value as possible. Second, I present the theory of spontaneous order as an approach to overcome some of these limitations to managerial knowledge by relying on decentralized decision-making. And because firms are riddled with spontaneous orders of stakeholder interactions, managers can look to them as sources of stakeholder value creation in addition to their own knowledge of stakeholder utility functions. Third, I apply the insight of spontaneous ordering within firms to present a managerial approach to stakeholder value creation – the stakeholder-equilibration approach – that leverages the power of spontaneous orders. By focusing on identifying and refining organizational norms, managers can encourage spontaneous ordering of stakeholder interactions, which can lead to a sustainable competitive advantage for the firm because it will help stakeholders create value for themselves, help achieve strategic fit, and foster the development of a valuable resource.

II. THE PROBLEM OF MANAGERIAL KNOWLEDGE

Managers who accept the managing-for-stakeholders approach attempt to create as much value as possible for stakeholders without resorting to tradeoffs. But in order to create value for stakeholders, a manager must know what are the stakeholder interests and how his actions will advance them. This section argues that the top-down-stakeholder-utility-function model has significant limitations because it overlooks the problems of localized knowledge, interpersonal comparison of utility, and bounded rationality.

A) Limitations with the Stakeholder Utility Function Approach

The top-down-stakeholder-utility-function model frames the issue of managerial knowledge to consist only of managerial access to multi-variate stakeholder utility functions (Harrison et al. 2010; Tantalo and Priem 2016). Stakeholder utility functions represent the preferences of stakeholder groups with respect to a comprehensive set of goods, services, and other factors. Within this view, managers gain access to stakeholder utility functions – and thus gain knowledge of what are the stakeholder interests – through two different mechanisms. First, managers gain nuanced access to stakeholder utility functions by creating trust between the firm and its stakeholders, which induces stakeholders to reveal information about their preference orderings (Harrison et al. 2010). Second, managers discover the factors that drive stakeholder utility through the exercise of entrepreneurial judgment by continually and actively attending to the demands of stakeholder groups (Tantalo and Priem 2016). Both of these accounts assume that managers will be able to translate their knowledge of the drivers of stakeholder utility into decisions that will actually create value for stakeholders and supply the firm with a competitive advantage.

Unfortunately, the top-down-stakeholder-utility-function model has significant limitations due to the problems of localized knowledge, interpersonal comparison of utility, and bounded rationality. Firstly, the problem of localized knowledge refers generally to the fact that the information needed for rational resource allocation resides in the “dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess” (Hayek 1945: 519). Because stakeholder utility functions

reside within the mind of each stakeholder, managers face an enormous challenge of obtaining the information needed to perform the calculations associated with creating value for stakeholders.

Secondly, even if managers somehow gain access to the knowledge needed for stakeholder value creation, they have an impossible task of aggregating the knowledge into a coherent whole due to the problem of interpersonal comparison of utility. The problem of interpersonal comparison of utility arises from the fact that modern theories of utility only represent an individual's index of ordinal preference rankings (Binmore 2009; Von Neumann and Morgenstern 1944). Since an individual's utility function refers only to one's preference orderings, it does not have any relation to the utility function of another person. As a result, it becomes extremely difficult, if not impossible, to compare the utility of different individuals in any meaningful way (Elster and Roemer 1991; Hausman 1995). Managers who attempt to create value for stakeholders without tradeoffs by acting on their knowledge of stakeholder utility functions are likely to face serious problems because acting on their knowledge of stakeholder utility functions to increase stakeholder utility implicitly entails comparing the utility of different stakeholders to avoid tradeoffs and to know when value has been created.

Lastly, even if it were somehow possible to obtain access to and make meaningful comparisons between stakeholder utility functions, attempts to process the information into actionable insights will be significantly limited by the problem of bounded rationality. Bounded rationality refers to the fact that economic actors have limited cognitive resources and abilities (Simon 1955). Managers are human and are subject to

the same limitations that constrain the rest of us, and it is simply asking too much of them to simultaneously process countless relevant variables associated with even simple stakeholder utility functions in ways that can lead to decisions that will optimally satisfy a maximal number of stakeholders at once.

Taken together, the problems of localized knowledge, interpersonal comparison of utility, and bounded rationality create significant limitations to the efficacy of the top-down-stakeholder-utility-function model. The knowledge that managers need to create value for stakeholders is not only of local conditions, which theoretically could be obtained through third party observation, but also of incomplete and highly unstable subjective orderings of preferred states that reside only within the minds of individual stakeholders. Furthermore, stakeholder analysis is necessarily a dynamic exercise (Windsor 2010). Stakeholder utility functions are multi-attribute, extremely complex, and constantly under revision, and stakeholder groups are comprised of a diverse and often constantly changing flux of individuals and firms with varying interests. It is practically impossible for managers to gain access to this information, aggregate or compare them in any meaningful way, and then evaluate a particular action in light of the effect that it would have on the utility of *any* stakeholder, let alone many of them at once. Instead, the practical implementation of the utility-function approach typically entails relying significantly on an implicit cognitive model where managers make intuitive judgments about what actions they feel will lead to greater value for stakeholders.

Even a cursory example of a cartoonish simplification illustrates the difficulty of managers creating value for stakeholders based on any rational calculation of stakeholder

utility functions. Suppose that stakeholders reveal their preferences to managers because they trust the firm. Since stakeholder utility functions are multi-variate and extraordinarily complex, no stakeholder will be able to reveal his utility function in full. Instead, he will provide small insights about simple preferences. For instance, Employee A may reveal that he is willing to trade off a slightly lower salary for a modern office space. On the other hand, Employee B may reveal that she prefers an increase in salary over a more generous work-life balance. How will the manager have any idea how a modern office space might impact the utility of Employee B or how a more rigorous schedule might impact the utility of Employee A? What happens if Employee A changes his mind? What if learning about Employee B's salary makes Employee A jealous and decreases his utility? What if Employee A's preference for a modern office space is interrelated with firm prestige, which will decrease with lower salaries? What happens if the manager hires Employee C after making changes, only to find out that Employee C prefers more flexible hours and is indifferent about the office space? The problems for the manager are potentially never-ending, and one must also consider the decrease in the manager's own utility as a result of attempting to juggle multiple demands at once.

B) The Inadequacy of Stakeholder Group Utility Functions

At this point, some stakeholder theorists might respond to the problems outlined above by arguing that top-down-stakeholder-utility-function model entails responsiveness to stakeholder *groups* rather than individual stakeholders (e.g., Jones and Felps 2013). But even after assuming that it is actually possible to segment stakeholders into

meaningful groupings, formulating an aggregation of individual stakeholder utility functions into a single stakeholder group function is bound to be just as difficult as attempting to work with individual stakeholder utility functions, if not more so. Any attempt to formulate a group utility function in an informed manner will necessarily entail collecting and processing the underlying utility functions of individual stakeholders. As a result, grouping stakeholder utility functions cannot avoid the problems outlined above. Managers will still need access to the same localized and dispersed information about individual stakeholder utility functions, and utility will still need to be interpersonally comparable if individual utility functions are to be aggregated into a single group function. And although it may require slightly less processing power for managers to calculate the effects on stakeholder utility functions in batches, doing so would also create additional layers of calculation that are likely to introduce serious problems, particularly since there is likely a high level of interactivity between various stakeholder interests.

Alternatively, if the managing-for-stakeholders approach entails making reasonable assumptions about stakeholder groups in order to simplify the problem at hand, managers will run the risk of divorcing their decision-making from reality and thus undermining the very core of the managing-for-stakeholders approach. Recognizing the impossibility of aggregating individual utility functions, welfare economists turn to a construct known as a social welfare function. Although social welfare functions represent the preferences of society at large, they are actually abstractions that have very little to do with the actual utility of individuals in society. Rather than reflecting

underlying conditions, social welfare functions merely reflect the theorist's own ethical judgment about distributive concerns (Hammond 1991). Managerial attempts to formulate a single utility function for each stakeholder group would be a similar analogue to the formulation of social welfare functions. And as is the case with social welfare functions, the managerial formulation of stakeholder group utility functions also would be abstracted away from what individual stakeholders actually want.

Regardless of whether or not a significant amount of abstraction poses a problem for welfare economics, it is certainly a significant problem for the managing-for-stakeholders approach, which emphasizes the importance and efficacy of *intentionally overinvesting* in stakeholders, i.e., allocating resources to various stakeholders at a level that goes beyond what is necessary to ensure their willful participation (Freeman et al. 2007; Harrison et al. 2010). First, divorcing stakeholder utility functions from reality would nullify the very reason for overinvestment in stakeholders since there would no longer be a need for managers to gain access to stakeholder utility functions. Rather than overinvesting to engender trust, managers would feel free to make decisions based on what they think stakeholder preferences should be rather than overinvesting in stakeholders to find out what they actually prefer. Second, divorcing stakeholder utility functions from reality would eliminate the competitive advantage associated with stakeholder overinvestment since making reasonable assumptions about what stakeholders want as a group can be done just as easily by managers who attempt to extract as much value as possible from stakeholders as those who overinvest in them. In fact, holding the ability to anticipate stakeholder demands as constant, managers who

overinvest in stakeholders will be at a competitive disadvantage since they would use more resources than managers who invest in stakeholders minimally without being able to meet stakeholder needs any better. Third, divorcing stakeholder utility functions from reality would undermine the ethical core of stakeholder theory. Stakeholder theory rests on a normative core comprised of a convergence of ethical positions that highlight the concern for others in addition to self-interest (Jones et al. 2007). However, once managers unilaterally determine what stakeholders should want as a group rather than attempting to find out what they actually want, the focus shifts away from this other-regarding normative core. Rather than focusing on the interests of stakeholders, managers would be focusing – perhaps narcissistically – on their own ethical judgments about stakeholder interests instead.

III. SPONTANEOUS ORDERING WITHIN THE FIRM

Managers can begin to address the problems of localized knowledge, interpersonal comparison of utility, and bounded rationality by turning to the theory of spontaneous order. A spontaneous order is “the result of human action but not the execution of human design” (Ferguson 1767: 122). Leveraging the power of spontaneous orders can provide managers with a way to cope with limits to their knowledge because spontaneous orders create value for everyone within the system through decentralized decision-making. This section argues that, although there are ways in which the firm is constituted by intentional design, there are also important aspects of the firm that reflect a spontaneous ordering of stakeholder relations. Recognizing the spontaneous ordering of

stakeholders within the firm can enable managers to overcome the problems associated with managerial knowledge and supplement the top-down-stakeholder-utility-function model with a bottom-up model of stakeholder value creation within the firm.

A) The Theory of Spontaneous Order

A spontaneous order refers to a stable state of affairs at the macro-level that emerge through the aggregation of micro-level responses to a coordinating mechanism. Unlike *made* orders, which are organized around directives issued by a particular individual or institution that aim at a particular context with a particular purpose, *spontaneous* orders are organized around coordinating mechanisms that were not designed by anyone, are abstract, and are without purpose (Hayek 1960). Take, for instance, the traditionally understood difference between the allocation of goods within firms and markets. Hayek considers the firm to be a made order because it allocates resources internally through a central decision-making process (1973). After evaluating the firm's strategic position, management will issue directives to employees on how to allocate the firm's resources to achieve its intended goals. Such activity within firms is thus organized around a centralized decision-making body that issues directives aimed at a particular context with a specific purpose in mind. Markets, on the other hand, represent a paradigmatic example of a spontaneous order. Within markets, the social allocation of goods is achieved through a price system that coordinates individuals acting in accordance with their self-interest. There is no one who created the price system. Instead, it is a mode for communicating localized information across society that

humanity only “stumbled upon... without understanding it” (Hayek 1945: 528). The price system is also abstract, i.e., it functions in accordance with generalizable rules rather than context-specific facts. The price for a good will increase if its demand outpaces its supply, regardless of what kind of a good it is and what the reasons may be for its shortage. Lastly, the price system acts without purpose. The purposes held by most market participants deal with their individual goals and not the overall social effects of their decision-making. Of course, the aggregation of actions taken to achieve individual purposes serves a social function of coordinating the use of dispersed and localized knowledge in a wide, complex network to allocate goods and services. However, although this *function* can be recognized by those who aim to leverage it for their own purposes, it cannot be said to be a *purpose* that is inherent within the price system since no one enacted the system with an intention to bring about its desirable results. Nor can anyone manipulate the price system intentionally to achieve an intended outcome at the systemic level.

Because spontaneous orders involve dispersed actors utilizing their localized knowledge in response to a coordinating mechanism to allocate resources and achieve stability, they do not depend on any centralized decision-maker. This *decentralization* of decision-making allows them to avoid the pitfalls of knowledge that place limitations on the top-down-stakeholder-utility-function model. The avoidance of central decision-making helps to alleviate the problem of localized knowledge because individual stakeholders already know their own preferences better than anyone else. It also alleviates the problem of interpersonal comparison of utility because there is no one who

is making any utility comparisons at all. Lastly, it drastically reduces the problem of bounded rationality because actors within a spontaneous order act only need to respond to a coordinating mechanism to guide their action. For instance, the price mechanism can achieve an efficient allocation of a scarce resource even if market actors do not perform any calculation of social welfare relative to the known supply and demand for the resource. All they need to do is to respond to the price mechanism in accordance with their self-interest by producing more of the resource and/or consuming less of it (Hayek 1945).

The decentralization of decision-making through a central coordination mechanism within spontaneous orders can lead to greater welfare – and thus more value that is created – for those within the system than through central decision-making. As noted above, spontaneous orders are more efficient in coordinating the use of knowledge to allocate scarce resources under changing circumstances. Capitalism, for instance, has long been justified as a superior alternative to socialism because it relies on a decentralized means of resource allocation, which allows for greater innovation and adaptation in meeting consumer demand (Boettke 1998; Land et al. 1994; Smith 1776; Van Parijs 1995; Von Mises 1922). Moreover, spontaneous orders can lead to greater welfare within the system because they are more efficient in the way they govern exchange relationships. Legal scholars, for instance, have long found that informal coordinating mechanisms around which individuals organize within spontaneous orders are typically cheaper and more effective enforcement mechanisms than formal mechanisms (Bernstein 1992; Scott 2003). Lastly, and perhaps most importantly if

liberty is a value in and of itself, spontaneous orders can lead to greater welfare within the system by preserving and promoting the liberty of its participants. Spontaneous orders are consistent with liberty because they are constituted by individuals acting in accordance with their own wills rather than through the directives of a centralized authority (Hayek 1973). In addition to possibly being a value in and of itself, liberty can also lead to greater progress and thus greater welfare because it “leaves room for the unforeseeable and unpredictable” (Hayek 1960: 29). Rather than relying on human design to maximize value based on what is foreseeable at the time, preserving liberty for those within the system leaves room for the entrepreneurial element to discover *new* opportunities for value creation based on localized knowledge of changing circumstances (Kirzner 1973).

B) Relational Contracts and Spontaneous Orders Within Firms

Despite Hayek’s categorization of the firm as a made order, there is a long tradition of scholarship within organizational studies that have uncovered spontaneous ordering as a central feature of firms. The insight began with the idea that the firm can be thought of as a nexus of contracts (Alchian and Demsetz 1972). Since its introduction, the nexus-of-contracts view has become the dominant paradigm for theories of the firm. Even stakeholder theorists have largely embraced this view, with only minor modifications to challenge the norm of shareholder primacy that many nexus-of-contracts theories of the firm assume (Blair and Stout 1999; Freeman and Evan 1990). The nexus-of-contracts approach to the firm brings spontaneous ordering inside the firm by arguing

that the firm is constituted by a similar process as the market process, which is the paradigmatic example of spontaneous ordering. In one of the classic articulations of the nexus-of-contracts firm, for instance, Jensen and Meckling argue that the firm is like the market in that it is the outcome of a complex process within which “the conflicting objectives of individuals... are brought into equilibrium within a framework of contractual relations” (1976: 311). Within this view, the firm is an aggregation of decentralized actions taken by firm participants in pursuit of their own interests, just as the market is. As will be explained below, the primary difference between spontaneous ordering within markets and firms is the usage of alternative coordinating mechanisms. Whereas spontaneous ordering is coordinated by the price system within markets, it is coordinated by organizational culture within firms.

Although it may seem upon first glance as if the nexus-of-contracts approach to the firm overstates the decentralization of stakeholder relations within the firm, it becomes clear that spontaneous orders are prevalent within the firm once relational contracts are disaggregated from formal contracts. Modern theorists of the firm have recognized that firms are riddled with not only formal contracts but relational contracts as well (Baker et al. 2002; Gibbons 2005). In fact, many modern theories now understand the firm as a nexus of relational contracts in addition to formal contracts (Coff 1999; Kim and Mahoney 2005; Zingales 2000). Economists distinguish formal and relational contracts by asking whether the terms of an economic exchange are specified *ex ante* in such a way that they can be verified and enforced *ex post* by a third party (Gibbons 2005). A formal contract is an economic exchange that specifies the terms of the

agreement in a way that can be enforced by a third party in the future. A contract to deliver a good on a certain day in exchange for a certain price, for instance, is a formal contract because it is easy for a third party, e.g., a court, to determine whether each party fulfilled its end of the bargain and to enforce its terms. Relational contracts, on the other hand, cannot be enforced in such a way. Rather than specifying the terms of the agreement *ex ante* as formal contracts do, they leave the nature of the bargain open-ended. The ambiguity and flexibility built into relational contracts allow contracting parties to take advantage of new information and adapt to changing circumstances (Baker et al. 2002). Unfortunately, these same features also render third-party enforcement very difficult and expensive, if not impossible, because there is never any clear specification of contract terms to enforce. As a result, relational contracts are “sustained by the shadow of the future” rather than the threat of enforcement by a third party (Gibbons and Henderson 2012: 1350).

The spontaneous ordering of formal contracts within the firm is difficult to recognize because they are the result of both intentional and spontaneous processes. Because formal contracts reflect an attempt by stakeholders to govern their economic exchange *ex ante*, they involve a significant amount of intentional design. The formal contracts that constitute the firm have particular intentionality because they represent an effort to replace the spontaneous ordering of the market with an intentionally designed transaction that aims to reduce transaction costs and align interests (Williamson 1991). The decision to allocate more labor within a particular department, for instance, is a managerial decision that is made with a particular purpose for a particular context.

Nevertheless, there is still a fair amount of spontaneous ordering in the way that formal contracts aggregate into the firm itself. The nexus-of-contracts view of the firm envisions firm participants bargaining in light of their self-interests without any ex ante regard for the system as a whole (Easterbrook and Fischel 1991). Within this view, there is no predetermined design for intrafirm relationships. Instead, the firm is shaped through the self-regarding wishes of its participants that are mediated through a bargaining process within the context of the broader market for labor and corporate governance. As a result, both the exact shape and nature of each formal contract and the overall shape of the constellation of formal contracts that results from this process will include elements that are beyond the intentions of management or the firm's founders. Furthermore, the level of complexity within most organizations can lead to decisions that were not intended by any particular individual and thus are attributable to only the organization itself (Pettit 2007). When multiple individuals are responsible for the execution of these contracts, for instance, the resulting nexus of formal contracts will not reflect the intentional design of any particular individual. Instead, it will be ordered in accordance with a firm's decision-making procedure that can only be attributed to the firm itself.

Regardless of how much spontaneous ordering there is of formal contracts within the firm, however, spontaneous orders are prevalent within the firm because the vast majority of the relationships between stakeholders are governed by relational contracts rather than formal contracts. Typically, stakeholders only enter into formal contracts with the firm itself rather than with other stakeholders. Take, for instance, a simple case of a manager and a junior employee within a firm. Aside from any potential collective

bargaining arrangements, the manager will have a formal contract with the firm that governs his employment in a way that could be enforced by courts in the event of a breach or a dispute, and the junior employee will have the same. The relationship between the manager and the junior employee, on the other hand, is not governed by any formal contract. For instance, there is no formal remedy for the junior employee if the manager decides to skip a scheduled meeting with her without informing her of his plans. A violation of most of the rights and obligations implicit within their working relationship must be addressed directly between the manager and the junior employee within the context of their relationship. Even if a third party, e.g., the HR department, gets involved in the dispute through an escalation policy, the outcome of any resolution to the dispute will have nothing to do with the contract that the employee signed with the firm. Intrafirm relationships, for the most part, are governed through an informal relational process rather than a formal one. As a result, although formal contracts constitute an important backdrop within the context of stakeholder interaction, much of the contractual relationships within the firm are relational, not formal.

And unlike formal contracts, relational contracts within the firm are almost entirely ordered spontaneously. Hayek argued that a large-scale society, e.g., the social order within many modern communities, is a spontaneous order because it emerges from an evolutionary process within which individuals in society each go about their activity *in accordance with rules within society* that are not intentionally designed by anyone (1973). Relational contracts create a spontaneous order within the firm in an analogous way. Just as social norms coordinate individual action within societies, organizational

culture, defined here as “a complex set of values, beliefs, assumptions, and symbols that define the way in which a firm conducts its business” (Barney 1986: 657), coordinates the spontaneous ordering of relational contracts within the firm. Relational contracts come into existence and evolve through an iterated process during which stakeholders respond to each other’s behavior in light of their shared knowledge about their tasks and about each other (Gibbons and Henderson 2012). Organizational culture shapes the shared knowledge base among stakeholders by providing them with a shared frame for interpreting their interactions and with informal incentives/pressures that send signals for how they ought to relate with each other. Just as a spontaneous order emerges from interactions between those who live within a large scale society as they follow the rules in society, a spontaneous order emerges within the firm through the relational contracts between stakeholders as they interact with each other within the context of their organization’s culture.

Lastly, like the price system and rules in society, organizational culture shares the characteristics of coordinating mechanisms that lead to a spontaneous ordering of micro-level processes. As a coordinating mechanism, organizational culture shares many of the characteristics of other coordinating mechanisms for other kinds of spontaneous orders. Culture emerges from a dispersed collection of interactions rather through intentional design. Even though others may try to manipulate it, as some do to the price system, its overall function in response to the aggregation of individual interactions cannot be predicted or controlled. Moreover, organizational culture is abstract. Rather than a rule that may govern a particular aspect of a specific kind of interaction, organizational

culture acts at a general level to shape all aspects of stakeholder interactions. Lastly, because it is emergent rather than planned, there is no purpose embedded within organizational culture. Although managers may attempt to leverage or even modify aspects of the culture to achieve their goals, the multiplicity of cultures within an organization, along with its interactivity and complexity (Barney 1986; Gregory 1983; Smircich 1983), will result in only a partial infusion of purpose within the culture, at best. The broad pattern of the nexus of relational contracts within the firm as they are shaped and governed by its culture, then, exhibit all the signs that other types of spontaneous orders exhibit. And given the prevalence of relational contracts within the firm, it is not difficult to see that there is a significant presence of spontaneous orders within firms.

IV. THE STAKEHOLDER EQUILIBRATION MODEL

The prevalence of spontaneous orders within the firm paves the way for managers to leverage the advantages of spontaneous ordering to create value for stakeholders. This section argues that stakeholder theory already has resources within it to take advantage of spontaneous ordering within the firm because it envisions the firm as an equilibrating mechanism rather than as a governance mechanism. Because norms within an organization shape and reflect its culture, managers can reinforce the conditions under which stakeholders can create value for themselves by identifying and refining the constellation of organizational norms within the firm as they adjudicate stakeholder interests. This approach to stakeholder management – what I will call the stakeholder-equilibration model – allows managers to translate the process of stakeholder value

creation into a sustainable competitive advantage because it will create more value for stakeholders, help achieve strategic fit, and foster the development of a valuable firm resource.

A) Stakeholder Equilibration

The stakeholder-equilibration model builds on the claim that stakeholder theory views the firm as an equilibrating mechanism rather than a governance mechanism (Venkataraman 2002). The manager of a firm as a governance mechanism engages in a logic of *control* to create value for the firm and/or its shareholders. For instance, modern theories of the firm often view the distinguishing feature of firms to be the residual rights of control established by contract or property rights that the manager/entrepreneur can exercise to govern relations with other firm participants (e.g., Grossman and Hart 1986; Williamson 1975). Within this view, the value provided by labor and other productive inputs is to be carefully managed and extracted so as to enable maximal economic returns for the firm and/or its shareholders. On the other hand, the manager of a firm as an equilibration mechanism engages in a logic of *adjudication* to align and reinforce stakeholder interests as *they create value for themselves* within the context of the firm. This alternative account views the firm as a nexus of formal and relational contracts that serves as an equilibrium point for stakeholders who pursue their own monetary and non-monetary interests. Within this view, value is co-created and captured by the firm's stakeholders through contractual processes (Prahalad and Ramaswamy 2004; Priem

2007; Ramirez 1999), with no stakeholder group receiving prima facie priority over others.

In both the top-down-stakeholder-utility-function and stakeholder-equilibration models, managers play a central role in allocating resources within the firm. However, resource allocation is not synonymous with the stakeholder idea of creating value for stakeholders without resorting to tradeoffs. For instance, managers who pay employees above their market rates may create more value for these employees. The impact on this action on other stakeholders, however, can often lead a corresponding decrease in value for them. Suppliers or shareholders may have to be paid less, and customers may have to pay more. In fact, increasing stakeholder value on one dimension often leads to a decrease in value in another dimension (Grant et al. 2007). Higher employee compensation, for instance, could lead to decreases in value for these very employees if they have to work harder, longer, or in otherwise more challenging social, emotional, or technical working conditions. As a result, unilateral actions such as an employee pay increase is often not so much an act of stakeholder value creation as much as it is an act of stakeholder value *redistribution*. Value *creation* for stakeholders within the firm requires a greater focus on the quality and nature of the relationships between stakeholders rather than on decisions that pertain merely to resource allocation.

The source of value creation within the stakeholder-equilibration model lies within the spontaneous ordering of formal and informal contractual processes within the firm. Within the model, the primary managerial role is to support the contractual processes by which each stakeholder applies her localized knowledge of her immediate

context and of her own subjective preferences to create value for herself. Stakeholders interact with each other through formal and relational contractual processes because it advances their interests to do so (Freeman 2010). As a result, the contractual processes through which stakeholders pursue their interests can constitute significant opportunities for stakeholders to create value for themselves. And because stakeholders have greater knowledge of their set of preferences and their local context than managers do, they have opportunities to create value for themselves within the spontaneous ordering of stakeholder interactions in ways that managers cannot know within the top-down-stakeholder-utility-function model.

When managers make resource allocation decisions, then, the stakeholder equilibration model implies that managers ought to do so differently. As is the case between the managing-for-stakeholders approach and the traditional approach to business (Freeman et al. 2007), the crucial difference between the stakeholder-equilibration model and the traditional model of management control is *intent*. Rather than seeing himself as an architect of the organization's culture and the value creation process within it, the stakeholder equilibration model envisions the manager seeing himself as one stakeholder among many others, each of whom participates within the stakeholder value creation process through formal and relational contractual relations. As far as value creation is concerned, the manager acts to help stakeholders create value for themselves.

Because the stakeholder-equilibration model focuses on value creation within the spontaneous ordering of stakeholder relationships, there is a tension between it and the top-down-stakeholder-utility-function model. The top-down model implies a certain

amount of direct managerial action taken to create stakeholder value. The stakeholder-equilibration mode, on the other hand, not only emphasizes *indirect* ways of creating stakeholder value but also places *limits* on what kinds of direct actions should be taken. As noted above, a spontaneous order functions as “a system of interdependent actions determined by information and guided by purposes known only to the several acting persons but not to the directing authority” (Hayek 1973: 51). Because such interdependence and complexity cannot be fully anticipated and controlled under conditions of bounded rationality, interference with the spontaneous ordering process can destroy the fragile balance within the system by distorting and otherwise interfering with decision-making at the individual level. As a result, those who are tasked with maintaining the order must be careful to not interfere with it – *what they refrain from doing is just as important as what they do*. Specifically, they must refrain from issuing centralized directives aimed at improving the spontaneous order directly but, instead, act “only indirectly by enforcing and improving... the formation of a spontaneous order” (Hayek 1973: 51). Thus, the stakeholder-equilibration model requires that special care must be taken to not interfere with the established spontaneous order of stakeholder relations within the firm, even as managers act to create stakeholder value through the top-down-stakeholder-utility-function model.

Nevertheless, the stakeholder-equilibration model does not imply managerial inaction nor a diminishment of the managerial role in stakeholder value creation. The manager plays an important role within such an approach because each stakeholder will likely pursue her own interests if largely left alone, even at the expense of other

stakeholders and regardless of power imbalances that may exist between them. If managers were to simply take a laissez-faire approach to stakeholder interactions, the business enterprise is likely to suffer – or perhaps even dissolve – due to high political costs associated with negotiations among various stakeholders with distinct sets of interests (e.g., Hansmann 1988). Stakeholders who lack leverage may also choose to leave the business enterprise in favor of other firms rather than engage in negotiations with stakeholders who have much more leverage. Lastly, firm performance may suffer because certain stakeholders with leverage may capture all the value that is available before it can be converted by the firm into future value-creating resources and opportunities (Coff 1999). As a result, managers must take an active role in supporting and reinforcing the institutional context within which all stakeholders can further create value for themselves within the firm.

B) Stakeholder Equilibration and Organizational Norms

Managers can take an active role within the stakeholder-equilibration model by identifying and refining the organizational norms within the firm. According to Hayek, the rules around which individual elements within a large-scale society interact to constitute a spontaneous order are identified and refined primarily by judges who adjudicate cases in accordance with the common law (1973). Common law refers to rules that are articulated and refined through a judicial process rather than a legislative process. For instance, common law jurisdictions like the United Kingdom and the United States have a set of elaborate rules that have evolved over centuries as generations of

judges have looked to previous adjudications of similar cases to identify a consistent set of rules that can be applied to a new pattern of facts. For Hayek, judges who identify the rules in society according to which individuals act and adjudicate disputes in ways that articulate and reinforce these rules play a crucial role in maintaining the spontaneous order within society and thus preserve liberty and increase welfare within it. Judges and legislators who attempt to create new set of rules through a centralized decision-making process, on the other hand, risk upsetting the equilibrium that is reached through the spontaneous ordering process and will likely undermine the welfare and liberty of those within society.

Just as common law judges identify and refine rules within society to maintain its spontaneous order, managers can analogously identify and refine relevant rules within the firm to maintain *its* spontaneous order. As noted above, spontaneous orders within the firm emerge out of stakeholder interactions organized around the firm's culture. Leveraging the value creation potential of the spontaneous ordering of stakeholder interactions entails managers strengthening the firm's culture and making it as predictable and stable as possible. Although organizational culture can be a nebulous concept that is difficult to manage or manipulate, an organization's norms are a manageable gateway into its culture. Norms are "understood rules for accepted and expected behavior" (Cialdini et al. 1999: 196). As such, they shape the values and behavior within an organization to create and reinforce its culture (Cooke and Rousseau 1988; O'Reilly et al. 1991; Ouchi 1980). By identifying norms within the organization around which stakeholders interact, finding ways to integrate them when they conflict,

and clarifying them as they are applied to particular facts, managers can act like common law judges interpreting a tradition of rules that give rise to a spontaneous order.

Managers who act like common law judges look backwards to make decisions in the present. The managing-for-stakeholders approach argues that managers ought to adjudicate stakeholder conflicts as best as they can, looking for synergies and searching for creative solutions that will avoid tradeoffs or, when tradeoffs are unavoidable, making the tradeoff and then immediately searching for ways to align stakeholder interests once again (Freeman et al. 2007). Managerial adjudication of stakeholder interests that proceeds in a similar way as common law adjudication is one in which managers resolve stakeholder conflicts in accordance with organizational norms that can be identified through how stakeholder interests have been adjudicated in the past. Just as judges identify and refine rules through a series of past decisions, managers can look backward to how the adjudication of similar conflicts between stakeholders within the organization can point to an organizational norm that can help them with their decision in the present. And just as common law judging is a highly fact and context specific affair, managers can focus on the relevant factors for their particular decision at hand to know which norms are relevant and when norms need to change or evolve.

However, unlike common law judges, managers need not only be backward-looking. In addition to adjudicating stakeholder conflicts, managers can also act preemptively by enacting practices and policies that communicate, reinforce, and align with widely shared organizational norms. One example of how managers can manage an organization's norms to reinforce a desirable culture around which stakeholders can

create value for themselves is Charles O'Reilly's framework for creating strong cultures (1989). O'Reilly argues that managers can discern a firm's values and norms by focusing on the firm's incentives systems, the stories that are told by stakeholders, and the values embodied by leaders among stakeholder groups. After sifting through these norms, he argues that managers ought to implement a variety of mechanisms for reinforcing desirable norms such as encouraging stakeholder participation, taking symbolic action to communicate the firm's values, encouraging organizational consensus through team-building activities, and enacting comprehensive reward systems. By paying attention to the norms around which stakeholder relationships organize themselves into a spontaneous order, managers can help stakeholders create as much value as possible for themselves without allowing the firm to descend into anarchy or instability.

C) Stakeholder Equilibration and Competitive Advantage

The managing-for-stakeholders approach argues that creating value for stakeholders will also lead to a competitive advantage for the firm for a variety of reasons. First, creating value for stakeholders is advantageous for the firm because it increases demand for the firm and its offerings, which allows the firm to command higher prices and/or higher quality inputs (Harrison et al. 2010; Harrison and Wicks 2013). Second, it can increase valuable assets within the firm because it leads to improved stakeholder relationships and other effects of moral capital (e.g., Berman et al. 1999; Godfrey 2005; Hillman and Keim 2001; Jones 1995). Third, it can reduce costs by reducing the potential for stakeholder retaliation, e.g., lawsuits, boycotts, strikes, and

adverse governmental action (Harrison and St. John 1996; Spicer 1978; Steadman et al. 1995). Lastly, it can increase organizational flexibility by making the business enterprise more sensitive to stakeholder demands, thus allowing it to plan and adapt as stakeholder demands change over time (Freeman and Evan 1990).

The stakeholder-equilibration model adds to this discussion by outlining a way that the firm can increase *more* demand for it and its products, accumulate *more* assets, reduce *more* costs, and increase its flexibility *even more*. First, because the stakeholder-equilibration model allows stakeholders to freely respond to localized circumstances in accordance with their knowledge of their own utility functions, it will help stakeholders to identify offerings and opportunities that are better suited for their particular circumstance and preferences than if their options were limited only to what the management team presents based on its limited knowledge. The greater level of personalization and context-specificity will help drive even greater demand for the firm and its offerings. Second, the ability to create more value for stakeholders will lead to increased goodwill and other intangible assets associated with a reputation for stakeholder satisfaction. Not only are spontaneous orders efficient, a focus on organizational norms can open up more opportunities for stakeholder value creation because, as research on the common law system and economic development shows, having strong and predictable rules that govern spontaneous orders tends to increase value within the order itself (Hayek 1960; 1973; Mahoney 2001). Third, because the stakeholder-equilibration model seeks to reinforce the firm's culture, it can lead to a *stronger* culture and *higher* stakeholder commitment (O'Reilly 1989). Combined with an

active management that encourages internal escalation of conflicts for managerial adjudication, managerial attempts at strengthening firm culture and increasing stakeholder commitment will reduce the potential for dissatisfied stakeholders who may increase costs for the firm. Lastly, the stakeholder-equilibration model can lead to greater organizational flexibility because it grants more autonomy for stakeholders to utilize their localized knowledge to adapt to changing circumstances. Spontaneous orders within the firm are the result of relational contracts through which stakeholders “utilize their detailed knowledge of their specific situation and... adapt to new information as it becomes available” (Baker et al. 2002: 40). As a result, leveraging the power of spontaneous orders rather than through centralized decision-making will allow the firm to collect, process, and implement knowledge of changing circumstances more efficiently.

Moreover, the stakeholder-equilibration model goes beyond existing insights within the top-down-stakeholder-utility-function model by connecting stakeholder theory with competitive advantages described by two prominent theories of strategic management. First, the stakeholder-equilibration model can lead to better *strategic fit* within the firm. Strategic fit refers to the degree to which a set of factors match or are aligned to each other (Drazin and Van de Ven 1985; Venkatraman and Prescott 1990; Zajac et al. 2000). Achieving fit between different internal aspects of the firm can be critical to firm success because it allows the firm to create a unique and valuable strategic position (Porter 1996). By aligning and refining organizational norms, the stakeholder-equilibration model helps to achieve fit between the various norms within the firm. Moreover, achieving fit between organizational norms can lead to a strategic fit between

the various stakeholder interactions within the firm since stakeholder relationships are shaped by organizational norms. And the alignment of stakeholder interactions will help create a more aligned set of positions that are consistent with greater stakeholder value creation within the firm. Second, by refraining from directly interfering with the spontaneous ordering of stakeholder relations within the firm, the stakeholder-equilibration model fosters the development of a *valuable resource* within the firm. Within the resource-based view of the firm, the strategic position of the firm depends primarily on its bundle of assets or resources (Dierickx and Cool 1989; Wernerfelt 1984). Firms can sustain a competitive advantage when they have resources that are valuable, rare, imperfectly imitable, and non-substitutable (Barney 1991). By encouraging the ongoing development of relational contracts within the firm, the stakeholder-equilibration model can lead to an accumulation of a thick set of transactional and relational knowledge developed through relational contracting (Gibbons and Henderson 2012). This transactional and relational knowledge is valuable and rare because it pertains to contextual knowledge that is relevant for stakeholder value creation, and it is imperfectly imitable and non-substitutable because it concerns tacit knowledge that cannot be easily articulated, let alone transmitted. As a result, the stakeholder-equilibration model can lead to a sustainable competitive advantage for firms.

V. CONCLUSION

The power of stakeholder theory lies in the convergence of ethical management and firm success. Taken by itself, the top-down-stakeholder-utility-function model has

the potential to undermine this power by envisioning the manager only as a central decision-maker who acts in light of his knowledge of stakeholder utility functions. A manager who attempts to control the firm in such a way will be putting himself at a disadvantage because he does not know what stakeholders value and how his actions will lead to stakeholder value creation. Rather than only controlling stakeholder interactions, it is better to look *also* to equilibrating stakeholder interactions and to refrain from interfering with the organization's culture and norms. The stakeholder-equilibration model argues that empowering stakeholders and allowing the firm to be shaped directly by its stakeholders can be an important component of the managing-for-stakeholders approach because it leverages the power of spontaneous ordering within the firm. Since a more democratic organization led by managers who focus on organizational culture is also a more successful one, managers might benefit from focusing less on controlling and more on equilibrating.

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