

CORPORATE SOCIAL RESPONSIBILITY AND CORPORATE GOVERNANCE

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ABSTRACT

Corporate social responsibility (CSR) is a model of corporate governance (CG) extending fiduciary duties from fulfillment of responsibilities towards the firm's owners to fulfillment of analogous fiduciary duties towards all the firm's stakeholders. After considering the place of CSR in the debate about alternative CG modes, a full-fledged social contract foundation of the multi-stakeholder and multi-fiduciary model is present. The paper shows that CSR is a social norm that would endogenously emerge from the stakeholders' social contract seen as the first move in an equilibrium selection process that reaches the equilibrium state of a CG institution. The social contract provides a model of the impartial mediating reasoning performed by a board of directors striving to balance different claims of stakeholders. It also allows deducing the multi-stakeholder objective function that socially responsible firms maximize, and then provides a specification of the particular fiduciary duties owed to each stakeholder according to its position.

1. INTRODUCTION

In the last decades, the agency model has gained acceptance among corporate governance (CG) scholars and practitioners. The agency model does not acknowledge any basic responsibility of managers or directors towards any stakeholder beyond shareholders. It is based on shareholders primacy. Corporate social responsibility (CSR), however, involves at least some corporate responsibility towards stakeholders other than shareholders. Not surprisingly, the agency model of CG does not reserve any major role to CSR within CG, even though it does not exclude an instrumental use of CSR as far as it may function as a tool practical to shareholder value maximization.

The agency model is by no means the only view of CG. A second prominent view sees the board of directors as a largely autonomous body aimed at providing an impartial balance among the different corporate stakeholders and playing the role of a mediating hierarchy. While some suggest this model is a faithful interpretation of American corporate

law, there are also CG institutions that cannot be interpreted according to the shareholder primacy doctrine in Japan, Germany, and most continental European countries.

The purpose of this chapter is to provide a theory of CSR as an extended model of corporate governance whereby entrepreneurs, directors, managers, and owners (as far as they have direct influence on corporate decisions) have fiduciary duties owed to both non-controlling stakeholders and shareholders. This model understands CSR as a social norm making sense of both existing legal orderings and social reform movements aimed at designing CG so that employees and managers' specific investment in human capital is safeguarded no less than financial capital investments. Moreover, the chapter provides a social contract foundation of the multi-fiduciary and multi-stakeholder model of CG along two distinct but convergent lines of argumentation. First, the role that social norms play in the emergence of different CG institutions – a point accepted by both the competing views of CG considered – is taken into account. The social contract is the best potential explanation of how a social norm may at first be shared by a group of agents and then evolve until the equilibrium state of an institution is established. The model of reasoning consisting in an impartial acceptance under a 'veil of ignorance' therefore explains the starting point in the equilibrium selection process of social norms. Accordingly, CSR would endogenously emerge as a social norm from the corporate stakeholders' social contract understood as an equilibrium selection mechanism. The social contract would not explain or predict other CG models as an endogenously emergent institution.

Second, the main criticisms raised from a normative view point against the stakeholder approach to CG are addressed. In fact, the social contract answers all of them. In particular, it furnishes the impartial mode of reasoning that the mediating hierarch should implement in seeking a fair balancing among different legitimate stakeholders' claims. Moreover, it gives a mathematical uniquely defined objective function that the mediating hierarch should strive to maximize.

Finally, multiple fiduciary duties owed to both controlling and non controlling stakeholders emerge naturally from a two step social contract on the firm's constitution. Thus, the CSR model permits specifying the fiduciary duties owed to each category of stakeholders, granting each of them a proper area of fiduciary privilege.

The remainder of this chapter has the following organization. Section 1 provides an account of the place reserved to CSR in the debate between alternative CG views. Section 2 presents the definition of CSR as extended multi-fiduciary CG model. Section 3 introduces the idea that an economic institution is a summary representation (through a shared mental model) of the equilibrium regularity played in a given domain of interaction and the idea of a social norm as starting point of an equilibrium selection process. Section 4 applies the Binmore-Rawls social contract theory to the prediction that a CSR social norm would emerge from strong and weak stakeholders' interactions, and derives its basic egalitarian principle of fair stakeholder treatment. Section 5 shows that the same social contract model justifies the CSR model of corporate governance and helps deriving multiple fiduciary duties and the objective-function of the corporation governed according to CSR. The last section summarizes and concludes.

2. THE PLACE OF CSR IN THE CORPORATE GOVERNANCE DEBATE

This section provides a discussion of the place reserved to CSR in the debate between alternative CG views. After presenting the two major competing theories of CG – agency theory and the mediating hierarchy model - these are confronted with evolving CG legal frameworks worldwide. Different stakeholder-oriented frameworks are interpreted as institutionally consistent solutions based on complementarity between various degree of ownership dispersion and the level of labor contract security. Then CSR is introduced as a globally emerging social norm driving institutional frameworks to reach locally optimal equilibrium states.

2.1 The Agency Model of Corporate Governance

One prominent view of corporate governance sees it as a system of contracts, rules, norms, and institutions (legal and social) aimed at assuring the accomplishment of promises that corporate managers implicitly undertake with the investors of financial capital in a corporation, i.e., its shareholders. According to this position, Macey (2008, p. 1) notes:

the purpose of corporate governance is to persuade, induce, compel, and otherwise motivate corporate managers to keep the promise they make to investors. Another way to say this is that corporate governance is about reducing deviance by corporation where deviance is defined as any actions by management or directors that are at odds with the legitimate, investment-backed expectations of investors. Good corporate governance, then, is simply about keeping promises. Bad governance (corporate deviance) is defined as promise breaking behavior.

This is a typical statement in the agency view of corporate governance. CG is seen as a game played by two main players linked to each other by a special kind of (agency) contract. The agent is the manager who is in charge of running the corporation on behalf of the principals within the limits set by contracts and legal regulations linking the corporation with all the other stakeholders.

The principal is conceived as a representative player who stands for all the shareholders. Principals delegate to managers the task of running the firm according to their interests (e.g., value maximization), but they cannot control managerial behavior in any detail because of the asymmetry of information that characterizes the principal/agent relationship. In agency theory, the principal/agent asymmetry of information is inherent because ownership is dispersed across many shareholders. Further, no single shareholder has the time, resources, knowledge or the will to be completely informed about corporate management in which he holds a share. Dispersed and uninformed shareholders consequently lack direct influence on corporate management because of the separation of ownership and control. Thus, rules or incentives that constrain agents to act according to their principals' best interests, preventing agents from behaving opportunistically, are the focus of CG.

Asymmetry of information in the agency model results from both individual and collective causes. At the individual level, the principal may simply lack information on actions performed by the agent because these are unobservable, and he may be confined to observing their

outcomes, which are only probabilistically linked to actions. Collectively, shareholders face what economists call a 'collective choice problem.' Each shareholder holds too small a fraction of the overall amount of corporate shares to be individually motivated to undertake the cost of becoming sufficiently informed about the company's management. In fact, his individual level of influence on the management would not justify the effort required. If a sufficiently large coalition of shareholders was prepared to actively supervise corporate management, an individual shareholder could profit by free riding their positive surveillance efforts without bearing the cost of doing it on his own.

According to the nexus of contract view of the firm, owing to ex ante and ex post imperfections in bilateral long-term contracts, the entrepreneur or manager centralizes all the contracts with the various categories of stakeholders on the company that he runs, the purpose being to design incentives that minimize contract costs (Alchian and Demestez, 1972; Hansmann 1999). The agency approach to CG, however, contends that many stakeholders are related to the company by concrete and quite well-specified contracts that are self-contained and do not require a specific governance structure to protect their parties beyond contract law. By contrast, shareholders are residual claimants that may profit from their financial investment only after the firm has complied with other more concrete contracts, which makes their investments an inherently risky matter. But contractual commitments with shareholders are so indefinite, and the possibility that shareholders can verify respect of those commitments and attainment of their goals is so remote, that they warrant special protection (Jensen and Meckling, 1976; Easterbrook and Fischel, 1991; Tirole, 2000).

Thus, CG only concerns a set of rules providing for the following:

- protection of shareholders against managerial abuse of the discretion that the separation between ownership and control grants to managers;
- allocation of ownership and residual control rights;
- delegation by shareholders to a board of directors of control to be exercised on their behalf;

- fiduciary duties of due care, and no conflicts of interest, so that directors do not abuse the gaps in the fiduciary relation linking them to shareholders;
- remuneration and incentive schemes whereby the board may induce managers to act according to the shareholders' best interests; and
- mergers and acquisitions that align the management's preferences with those of the shareholders by means of the threat that a new entrepreneur who succeeds in taking over the company may fire the incumbent management.

From an economist's viewpoint, what is peculiar about this line of thought is how it oversimplifies the main point of economic analysis of the firm of . Coase (1937) and also Williamson (1975, 1986). According to this analysis, the firm is a transaction-governance institution substituting a hierarchical organization for atomistic spot market contracts whereby the incompleteness of all contracts with stakeholders is filled by authority relations (Coase, 1937; Williamson, 1975, 1986, Grossman and Hart, 1986; Hart and Moore, 1990). But the agency model reduces governance to the rules that only fill the gaps in the shareholder/management relations. CG thus focuses only on providing a mechanism with which to ensure that promises implicitly made by managers to shareholders are kept.

Unsurprisingly, this view has no room for corporate social responsibility (CSR) insofar as it concerns at least a set of responsibilities and obligations that those with authority in the company owe not just to shareholders but also to other stakeholders within the scope of their legitimate discretion. In fact, according to the agency view of CG, there are by definition no further obligations that may complement those owed to shareholders and that could therefore introduce further and perhaps dissimilar constraints on the managers' and directors' exercise of discretion beyond the responsibility of running the firm in the best interest of the shareholders.

2.2 The Mediating Hierarchy Model of CG

The foregoing agency and promissory views do not assign any major role to CSR in defining the firm's objective-function and the principles and goals of CG. This is not true, however, for the mediating hierarchy model of CG.

A second prominent view of CG is that corporate law does not guarantee and does not intend to secure shareholders' absolute priority in defining CG aims and corporate strategies. Instead, boards of directors are granted primacy because they are endowed with broad autonomy based on the 'business judgment doctrine' that insulates them against shareholders' self-interested claims to maximize their share value (Blair and Stout, 1999; Elhauge, 2005; Stout, 2011b). The board is relatively free to frame the corporation's strategy according to its views of the corporation's interests, development, and success, and also to exercise freedom in its decisions about dividends distribution and shareholders' compensation policies, assuming that the corporate interest results from the balance among different stakeholders' claims. A good theory of CG should make sense of this management autonomy, which is characteristic of the corporate form as an institution with a legal personality distinct from the natural persons involved in it (Aoki, 2010).

What the agency view regards as inefficiency in the current U.S. CG system and a deviation from its main goal – keeping the promise to protect the shareholders' investments against managers' opportunism – is in this second perspective regarded as empirical proof of the enduring non-shareholder-oriented nature of U.S. corporate law. Consider the historical fact that many states enacted stakeholder-oriented bills during the 1980s allowing the managers of targeted corporations to adopt defensive tactics in order to resist adversarial takeovers. This is cited as evidence that U.S. corporate law incorporates interests that extend well beyond those of shareholders when deciding a change in the corporation ownership and control structure that might be prejudicial to non-controlling stakeholders such as workers, suppliers, and local communities (Branson, 2001; Stout 2011b).

Blair and Stout (1999, 2006) defend this view of CG by contending that the board of directors is a 'mediating hierarchy' whose goal is to mediate among the different stakeholders' claims in order to pursue the corporation's overall success. This view is distinctive because it is based on an economic analysis of the firm as 'team production.' Thus, the mediating hierarchy view forestalls the accusation that it is too detached from the economic goal of the firm typically raised by theorists in the agency model tradition against 'progressive views' of CG. In a

productive team, different stakeholders – not just financial capital investors but also and mainly human capital investors – undertake specific investments. Because of incompleteness of contracts, due not only to asymmetric information but also to bounded rationality and unforeseen events, these investments can be subjected to hold up by other stakeholders. This happens especially when these stakeholders have control over decisional variables that are essential for accomplishment of the transactions in relation to which the investments were undertaken. Being afraid that the expected value of their investments will be expropriated, they do not invest at an efficient level (Williamson 1975; Grossman and Hart, 1986; Hart and Moore, 1990; Rajan and Zingales, 1998). Since specific investments are multiple, this may happen for any allocation of residual control, and hence abuse of authority is always a latent risk (Sacconi, 1999, 2000). Therefore, the main goal of the board of directors as a mediating hierarchy is to prevent opportunistic behavior within the team and abuse of residual control rights, and to allow each stakeholder to profit from its participation in team production.

Not surprisingly, therefore, the mediating hierarchy theory of CG is much more akin and sympathetic to CSR than agency theory. CSR may be seen as the ‘value’ or ‘fairness principle’ directing the board members’ discretion in exercising their mediating function.

2.3 Diversity of CG Legal Frameworks Regarding the Place Reserved for Stakeholders

The debate between the promissory and the mediating hierarchy views of CG and the role of the board of directors in particular is both normative and descriptive. In this latter respect, it concerns the true nature or goal of corporate law in the United States. However, as far as description is concerned, supporters of the two views may disagree about this point while agreeing that, at an international level, CG systems other than the agency model focus on the protection of a set of interests broader than that of shareholders alone. Macey (2008, p. 11) states the following:

In many places, particularly Germany and Japan, the fundamental premise behind corporation is not the notion of a promise to maximize value for shareholders. Instead the fundamental corporate promise is that the corporation is a creation of the state whose goals are to serve myriad and often conflicting societal interests.

Macey (2008, p. 35) also acknowledges the following (also see Allen and Dale 2000):

In Germany 82.7 percent of senior managers thought their company belonged to all the stakeholders. France was not much different with 77 percent of top manager “giving” the corporation to the stakeholders. In Japan an astonishing 97 percent of managers thought that the company belonged to all stakeholders.

These opinions of managers are complementary to the mandatory labor regulations in many European countries that grant broad protection against arbitrary dismissals.

Moreover, the German co-determination model provides for the active representation of at least one of the main non-owner stakeholders (i.e., employees) in the CG structure.

In the supervisory board, which is superordinate to the managerial board, unions are represented in a proportion that may equal 50 percent of seats, not including the chairman of the company (Osterloch, Frey, and Zeitoun, 2010).

Japan is another well-known anomaly with respect to the agency model of CG. Aoki (2010) notes a major change occurred in the Japanese CG landscape during the past two decades. Specifically, this change is the decline of the traditional role of national banks in both providing financial capital for large corporations and exercising a supervisory and control function on the internal CG and organization structures. Although many large corporations such as Toyota and Canon now resort to the financial market for their capitalization so that ownership has been dispersed among many shareholders, the emerging model still does not resemble a variant of the agency model. As in the past, the primary orientation of managers was to increase profitability by keeping the corporation’s commitment to value human capital investments and to keep the promise of continuity of long-life employment relations with the key skilled employees. What seems to emerge is a hybrid CG model based on the coexistence of dispersed shareholder external ownership and indirect control, and internal governance largely concentrated on making the alliance among the essential cognitive human assets held in the company by managers and core employees maximally profitable and mutually advantageous. Japanese managers discharge a mediating hierarchy function devoted to promoting organizational cooperation among managers’ and workers’ human cognitive assets, while also being accountable to the surveillance role performed by institutional investors’ representatives

intended to ensure that cooperation does not degenerate into opportunistic collusion detrimental to financial capital investors (Aoki, 1984, 2010).

Returning to the differences between the United States and Europe, the U.S. perspective on CG seemingly gives priority to shareholders while the continental European perspective assigns more weight to stakeholders' claims. This interpretation may be inaccurate. On the contrary, such differences may stem from different internally consistent answers to the same problem of preventing hold up of human capital investments in teams (Deakin and Rebeiroux, 2008; Gelter 2009). Thus, the crux of the comparison between the United States and Europe is how much direct influence shareholders have in the two contexts according to their dispersion throughout the financial capital market, and hence the level of autonomy enjoyed by managers. In the United States, a wide dispersion of ownership tightly constrains the direct influence of shareholders on corporate decisions. On the contrary, in Europe, a higher concentration of ownership increases the direct influence of owners – sometimes a single family or a small coalition of investors. This enables the board of directors to function as a mediating hierarchy in the United States, while it entails that a stronger legal protection must have emerged to protect non-controlling stakeholders (especially workers) and their specific investments in continental Europe. Such legal protection may take the form of strong labor laws protecting workers against arbitrary dismissals. This gives unions information rights and the possibility to bargain on lay-offs and the restructuring of companies and, especially in Germany, the formal proviso of participatory decision rights for unions through the co-determination model, i.e., their participation in the supervisory board.

According to Gelter (2009), these are two 'local optima' based on complementary levels of realization of two variables: concentration of ownership and legal protection of long-lasting labor contracts. When ownership is concentrated, so that shareholders exercise direct influence on the board of directors and corporate management, mandatory labor laws are required as complementary devices with which to protect specific investments in human capital from the threat of expropriation. When ownership is widely dispersed and does not exert any major direct influence, the unions' influence tends to decline, and the mediating hierarchy model of the board

of directors emerges as a more flexible solution able to provide a fair balance among all the relevant stakeholders' investment and interests.

If these two local optima are equilibria around which players interacting in the domains of institutional systems of CG tend to gravitate, some institutional, political, or technological change may eventually push systems out of the equilibrium path into situations that are not stable, and even less mutually beneficial. In the past decades, the indirect influence of shareholders over corporate management has been hugely increased by the wide diffusion of so-called 'incentive contracts' for managers' compensation, such as stock-option plans, that are intended to align managers' behavior with shareholders' interests by making the managers' compensation largely dependent on shareholder value as assessed by financial markets. This drove directors and managers to consider themselves as main shareholders and thus to conduct the company, not as trustees acting on behalf of some further group of stakeholders, but as self-interested agents acting in their own self-interest and maximizing the share value as far as it reflected their own self-interest. Under these incentives schemes, managers and directors no longer operate as impartial mediating hierarchs, and their wide discretion and informative advantage with respect to all stakeholders give them the opportunity for holding all them up. Many authors maintain that wide discretion plus the perverse self-interested incentives of managers legitimized under the "maximization of short-term share value" doctrine were among the main causes of the 2007–2008 global financial crisis (Cassidy, 2009; Posner, 2009; Aoki, 2010; Stiglitz, 2010).

At the same time, as a consequence of the 2010–2011 sovereign debts crisis in the Euro zone, growing political pressure has been exerted for labor law protection against arbitrary dismissals to be reduced in order to give more flexibility to the labor market. In the absence of any major restructuring of ownership concentration in continental Europe, this pressure may push these systems of CG very far from their local optima. Yet, the persistence of the co-determination model in Germany and the relative success of German companies even in the context of the global crisis may suggest that this is also a successful model of CG.

This chapter submits that insofar as the CSR movement is relevant to the shaping of CG models worldwide, it can be interpreted as an equilibrating force that concurs in rolling CG systems back to their optimal equilibrium position, or in changing them by moving towards new equilibria where a new fair balance of stakeholders' protection is reached.

Both sides in the CG debate acknowledge the importance of social norms in shaping CG institutions (Macey, 2008; Stout, 2006, 2011a). Thus, CSR may be seen as an emerging social norm shaping CG even within different legal frameworks. Social norms satisfy the definition of game-theoretical equilibria, and hence the emergence of CSR as a social norm of CG can be seen as essentially an equilibrium selection process. According to the social contract theory illustrated in this chapter, this process is initiated by the shared acceptance of a normative model of fair treatment among stakeholders. It then receives support from the preferences and beliefs affected by the social contract justification of CSR. These preferences and beliefs make it self-sustaining as the result of the iterated best responses of each stakeholder to the compliant choices of others.

This chapter provides a full-fledged social contract foundation for CSR as a model of multi-fiduciary CG whereby the protection of the controlling stakeholder's (i.e., shareholders) specific investments is complemented by symmetrical responsibilities for the protection of non-controlling stakeholders' specific investments, and their cognitive human assets' value as well. Taken into account is the challenge that "there is no legitimate theoretical or moral objection to those who assert that goals of the modern corporation should serve the broad interest of all stakeholders ... provided that these goals are clearly disclosed to investors before they part with their money" (Macey, 2008, p 3). That is, the enlarged goal of the corporation should be construed in terms of a fair agreement. The social contract of the firm precisely shows that the extension of fiduciary duties to all the stakeholders is exactly what they would accept voluntarily by a hypothetical fair agreement.

3. CSR AS A MULTI-FIDUCIARY MODEL OF CG

Various lines of research in new institutional economics, unorthodox law and economics, the stakeholder approach to management studies, and business ethics provide an understating of CSR that relates it to CG (Aoki, 1984, 2010; Freeman, 1984; Sacconi 1991, 2000; Donaldson and Preston, 1995; Clarkson, 1999; Blair and Stout, 1999, 2006; Evan and Freeman, 1993; Freeman and Velamury, 2006; Sacconi, 2006a, 2006b, 2007, 2010a, 2010b, 2011; Freeman, Harrison, Wicks, Parmar, and De Colle, 2010; Stout, 2011b; Donaldson, 2012). According to these views, CSR is not only a form of corporate strategic management but also a model for governing transactions among the firm's stakeholders. Here governance is no longer the set of rules simply allocating property rights and defining the owners' control over the company's management. Instead, it relates to the new-institutional economics view whereby firms, as well as contracts and other institutions, are governance structures that establish diverse rights and related responsibilities in order to reduce transaction costs (Coase, 1937; Williamson, 1975, 1986; Grossman and Hart, 1986) and the negative externalities related to economic transactions so as to approximate social welfare.

This view is 'constitutive' because it sees CSR as a constitutive trait inherent to how the corporation functions and to its goal. That is, this view sees CSR as the governance model on the basis of which a company pursues as its objective-function, namely, the joint interest and mutual advantage of all its relevant corporate stakeholders. Insofar as CSR is defined as a governance model entailing a multi-stakeholder definition of the corporate goal, it concerns less the sphere of corporate means than the domain of corporate ends (the corporation's goals) and constitutional rules, i.e., it is constitutive.

Sacconi (2006a, 2006b, 2007, 2010a) defined CSR as a model of extended corporate governance whereby those who run firms, such as entrepreneurs, directors, managers, have responsibilities that range from fulfillment of their fiduciary duties towards the owners to fulfillment of analogous fiduciary duties towards all the firm's stakeholders. Two terms must be defined for the foregoing proposition to be clearly understood. The first term is fiduciary duties. The assumption here is that a subject has a legitimate interest but is unable to make the relevant decisions, in the sense that he does not know what goals to pursue, what alternative to

choose, or how to deploy his resources in order to satisfy his interest. The trustor therefore delegates decisions to a trustee empowered to choose actions and goals. The trustee may thus use the trustor's resources and select the appropriate course of action. For a fiduciary relationship to arise, the trustor must possess a claim (right) towards the trustee. In other words, the trustee directs actions and uses the resources made over to him so that results are obtained that satisfy the trustor's interests. These claims (i.e., the trustor's rights) impose fiduciary duties on the agent who is invested with authority (the trustee) that he is obliged to fulfill. The fiduciary relationship applies in a wide variety of instances such as tutor/minor and teacher/pupil relationships. In the corporate domain, the relationship is between the board of a trust and its beneficiaries or between the board of directors of a joint-stock company and its shareholders, and then more generally between management and owners. The term *fiduciary duty* means the duty or responsibility to exercise authority for the good of those who have granted that authority and are therefore subject to it (Flannigan, 1989).

The second term is *stakeholders*. This term denotes individuals or groups with a major stake in the running of the firm and who are able to materially influence it (Freeman and McVea, 2001). However, from an economist's point of view, most relevant to defining stakeholders is the following distinction between two categories: stakeholders in the strict sense and stakeholders in the board sense.

Stakeholders in the strict sense are those who have an interest at stake because they have made specific investments in the firm, such as in the form of human capital, financial capital, social capital or trust, physical or environmental capital, or for the development of dedicated technologies. Such investments may substantially increase the total value generated by the firm and are made specifically in relation to that firm so that their value is idiosyncratically related to the completion of the transactions carried out by or in relation to that firm. These stakeholders are reciprocally dependent on the firm because they influence its value but at the same time depend largely upon it for satisfaction of their well-being prospects (lock-in effect). By contrast, *stakeholders in the broad sense* are those individuals or groups whose interest is involved because they undergo the 'external effects,' positive or negative, of the transactions

performed by the firm, even if they do not directly participate in the transaction, so that they do not contribute to or directly receive value from the firm.

One can thus appreciate the scope of CSR defined as an extended form of governance: it extends the concept of fiduciary duty from a mono-stakeholder setting where the sole stakeholder relevant to identification of fiduciary duties is the owner of the firm to a multi-stakeholder one in which the firm owes fiduciary duties to all its stakeholders including the owners.

4. CSR SOCIAL NORMS AND SELF-SUSTAINING INSTITUTIONS OF CG

Social norms are nowadays deemed no less important for CG than legal norms. In fact, these two types of norms are complementary (Stout, 2011a). Since the adoption of certain contracts or statutes at the corporate level is to some extent voluntary, social norms may be seen as drivers of the voluntary adoption of one or another legal model (e.g., shareholder vs. stakeholder oriented). Moreover, even if a legal system makes some legal constraints and principles in CG mandatory, it largely depends on social norms whether the legal constraints will be actually followed and whether adherence will spread at societal level. Certain legal institutions of CG, such as fiduciary duties, may or may not be established in a given context according to how social norms of trust are shaped at societal level. For example, if good social capital and trustworthiness in a given society were very low, assigning the fiduciary duties of autonomous trustees an important role in CG could be pointless (Macey, 2008)

Social norms are even more important for the economic rather than legal analysis of institutions because modern economists understand them as 'conventions' (Lewis, 1969; Schotter, 1981; Sudgen, 1986). *Conventions* are coordination game equilibria that may endogenously emerge from repeated strategic decisions among players participating in a given domain of interaction. They are stable and self-enforceable once a system of mutually consistent expectations has formed that sustains the common belief that all participants will maintain behavior consistent with the norm. Because of their self-enforceability and incentive

compatibility, conventions are the kind of institutions that economists like more, i.e., 'spontaneous orders' (Hayek, 1973; Sugden, 1986).

Hence, the gist of this section is that, once complementarity with the law has been recognized, and assuming that no mandatory laws are obstructing the emergence of a CSR model of CG, the endogenous beliefs, motivations, and preferences of economic agents such as companies and their stakeholders become the essential forces driving the implementation of the CSR model of multi-stakeholder governance. In game theoretical terms, the normative model is implementable in equilibrium. This is also the basis for the widely accepted view that CSR implementation is mainly a matter of voluntary self-regulation of self-enforceable principles and norms. Thus, its implementation may rest primarily on soft laws, social standards, code of ethics, voluntary adoption of contracts, provisos, and statutes, all of which are self-sustaining norms constraining 'from within' the discretion of corporate directors and managers (Wieland, 2003; Sacconi, 2006a).

The best way to integrate social norms into the emergence and stability of CG models is to resort to Aoki's (2001, 2010) account of institutions. Institutions "are not rules exogenously given by the polity, culture or a meta-game" but "rules created through the strategic interaction of agents, held in the minds of agents and thus self-sustaining" (Aoki, 2001, p. 11). An institution is "a self-sustaining system of shared beliefs about a salient way in which the game is repeatedly played" (Aoki, 2001, p. 11). The content of shared beliefs is "a summary representation (compressed information) of an equilibrium in a repeated game" (Aoki, 2001, p. 11). Thus, the salient feature of the equilibrium played has a symbolic representation inside the agents' minds and coordinates beliefs that in their turn induce behaviors and their replication over time.

Cognitive components (i.e., beliefs deriving from compressed mental representations of salient aspects of ongoing equilibrium play) and behavioral components (i.e., the iterated play of a given set of equilibrium strategies) are interlocked in a recursive scheme (Aoki, 2010; also see the inner circle of Exhibit 1). The starting point is cognitive, and it consists in pattern recognition whereby given situations of interaction are framed as games of a certain form wherein players

are expected to reason in a given quasi-symmetrical way. At step two, this framing of the situation induces players to entertain quasi-converging beliefs about a certain mode of playing the game. Thus, at step three, on passing from beliefs to the players' actual behavior, each player adopts a tentative strategy based on the belief that others will also adopt strategies consistent with the aforementioned mode of behavior. Hence, in step four, strategies clash and some of them prove to be more successful and based on a better prediction. By trial and error, therefore, strategies converge towards an equilibrium of the game. This may be construed as an evolutionary result because the mode of playing attracts more and more players through iterated adaptation to the other players' aggregate behaviors in the long run. At each repetition, however, this evolving equilibrium is summarily represented in its salient features by a compressed mental model resident in the players mind so the fifth step concluding the circle is again cognitive.

(Insert Exhibit 1 about here)

This circle can be recursively iterated so that the ongoing equilibrium mode of playing is repeatedly confirmed by beliefs that translate into equilibrium behaviors, which are represented summarily by mental models, and so on. At some point, this belief system reaches a nearly complete state of 'common knowledge' (Lewis, 1969; Binmore and Brandenburger, 1990) about how players interact. The resulting equilibrium is an institution: a regularity of behavior played in a domain of interaction and stably represented by the shared mental model resident in all the participants' minds. It is essentially equivalent to the notion of social norm as a 'convention.' However, a limitation is apparent in this understanding of institutions, and it concerns the normative meaning of an institution. Institutions in the above game-theoretical definition only ex post tell each player what the best action is. Once the players share the knowledge that they have reached an equilibrium state, then playing their best replies is actually a prescription of prudence that confirms the already-established equilibrium. Thus, institutions tell players only how to maintain the existing, already settled, pattern of behavior. They say nothing ex ante about how agents should behave before the mental representation of an equilibrium has settled

and a self-replicating equilibrium behavior has crystallized. Institutions only describe regularity of behavior and are devoid of genuine normative meaning and force.

However, institutions including CG (Donaldson, 2012) contain norms, such as constitutional principles, laws, statutes, ethical codes, standard rules, and shared social values, which are expressed by explicit utterances in the players' language concerning values, rights, and obligations. These statements have a primarily prescriptive meaning, and if individuals attribute them moral meaning, such prescriptions are also universalizable (i.e., extensible to all similar states of affairs) and overriding with respect to alternative prescriptions expressed in the same context (Hare, 1981). Norms thus defined literally have normative meaning independently of the fact that they induce replication of an already-settled collective equilibrium behavior. Thus, a second component of a proper definition of an institution should be the mental representation of the normative meaning of norms.

This makes a great difference. The normative meaning of norms does not depend on knowledge about the ongoing behavior of other players. Instead, norms are able to justify and give first-place reasons for shared acceptance of a mode of behavior addressing all the participants in a given interaction domain before it has been established as an equilibrium point. A norm gives intentional reasons to act independently on the evolutionary benefits of adaptation in the long run because when an individual or a group of agents in a given action domain initiate an institutional change, it cannot stem from the pressure of evolutionary forces, which unfold their attraction only in the long run. Instead, a norm enters the players' shared mental model (Denzau and North, 1994) of how the game should be played, shapes the players' reciprocal disposition to act and their default beliefs about common behaviors, and hence becomes the basis for their first coordination on a specific equilibrium. In other words, it works as the first move in a process of equilibrium selection that activates the recursive process outlined by Aoki (2010). According to a line of theorizing in behavioral game theory, because a norm has been (cognitively) commonly accepted it may affect both dispositions to act (preferences) and expectations (default beliefs about how other players behave), so that the norm becomes a

game equilibrium (Grimalda and Sacconi, 2005; Sacconi, 2007, 2011; Sacconi and Faillo, 2010; Sacconi, Faillo, and Ottone, 2011).

This equilibrium selection function of norms is deployed in two contexts: (1) within a well-defined game, where an old equilibrium path (old institution) has been abandoned for whatever reason and a new equilibrium path (new institution) has to be reached; and (2) when the underlying action domain changes because environmental or technological changes have occurred, or some further action opportunity is simply discovered by players, so that achieving a new equilibrium is necessary.

In these contexts, “the point is that some symbolic system of predictive/*normative* beliefs [emphasis added] precedes the evolution of a new equilibrium and then becomes accepted by all the agents in the relevant domain through their experiences” (Aoki, 2001, p. 19). The key point is, therefore, to explain how a norm (basis for a system of normative beliefs) becomes acceptable by agents before the relevant equilibrium behavior is settled through rational best response, evolution, or other behavioral mechanisms such as reciprocity and conformism. What is required is a collective mode of reasoning (cognition) able to explain how a normative mental model arises before any evolutionary pressure has operated in that direction, and on the basis of which a norm may become commonly accepted in a not yet an equilibrium state. Therefore, what is needed is a cognitive mechanism of justification for norms that can operate in a similar way in many different contexts, so as to be able to produce a social norm that adapts to diverse situations.

The best justificatory account for the *ex ante* shared acceptance of norms is the social contract model. Contractarian norms result from a voluntary agreement in a hypothetical choice situation that logically comes before any exogenous institution is superimposed on a given action domain, or before any institution has yet emerged. Thus, a norm arises only because of the voluntary agreement and adhesion of agents, even before it is established as an evolutionary equilibrium. To define the agreement, any social contract model sets aside threats, fraud, and manipulation – resources that would render the parties substantially unequal in terms of bargaining power – and considers all the agents as equal in respect to their rational

autonomy, so that many of their arbitrary differences are placed under a veil of ignorance.

Although a long tradition of contractarian models could be cited, the main reference here is to the Rawlsian model (Rawls, 1971).

By introducing the social contract as the cognitive mechanism by which a norm may be accepted and become a shared mental model, Aoki's recursive model can be reformulated. The inner circle of Exhibit 16.1 is retained. What is new (as shown in the upper part of Exhibit 1) is that the pattern derives from a shared social norm that categorizes the game as the domain of application of some more general principle. From this categorization it follows that some shared idea of the players' disposition to act (preferences) and common beliefs can be applied in the case under examination. In turn, the social norm derives from social contract reasoning (see Exhibit 16.1) employed by players in order to agree on basic principles and norms when equilibrium institutions are not already established.

5. SOCIAL CONTRACT AS AN EQUILIBRIUM SELECTION DEVICE

5.1 The Rawlsian Maximin Principle Vindicated

This subsection applies Binmore's (2005) game theoretical vindication of the Rawlsian social contract to the corporate stakeholders' interactions (Sacconi, 2010b). Assume that two stakeholders, a poor but skilled worker (Eve) and a rich proprietor of means of production and capital (Adam) meet in a 'state of nature' structured as a non-cooperative game. Assume that they repeatedly play the same game resulting in a wide set of feasible outcomes. The 'state of nature' precedes the institution of any legal artifice such as the 'corporation' under which they could form a regulated team. In Exhibit 2 the convex and compact payoff space X_{EA} corresponds to the outcome set of the state of nature repeated game. Let these outcomes be all equilibria of the repeated game (i.e., when one player chooses his component of one of these strategy combinations the other has no incentive to deviate from it by changing his strategy component).

(Insert Exhibit 2 about here)

Then assume that before agents engage in the relevant interaction (e.g., a largely incomplete contract), they want to agree ex ante on the selection of one of these possible equilibrium points/outcomes. This may be seen as agreeing on a social norm singling out to what they should be entitled by playing their roles under a “corporation”. This distributive norm is a skeletal constitution for the corporation that the agents would be prepared to enter. Since the constitution must be fair, impartiality and impersonality of the agreement are required. Taken together, these assumptions are the ‘veil of ignorance’ hypothesis. In other words, each agent makes his decision “as if” he were ignorant about his true identity, so that in order to reach a deliberation he takes in turn the positions of each possible participant in the game.

In this context, *impersonality* means that acceptance of the solution must not depend on personal and social positions. Thus, players should select a solution that cannot be affected by the symmetrical replacement of social roles and personal positions with respect to individual players. Technically, Exhibit 16.2 depicts this replacement by the symmetric translation of the initial payoff space X_{EA} with respect to the Cartesian axes representing the utility of player 1 and player 2, respectively. Thus, under the initial payoff space X_{EA} , player 1 will have all the possible payoffs of Eve and player 2 all the possible payoffs of Adam. But under the translated payoff space X_{AE} , roles are reserved and player 1 will then get Adam’s possible payoffs and player 2 will get Eve’s possible payoffs. Moreover, Exhibit 16.2 illustrates that each player, when taking the other’s perspective, exercises perfect empathetic identification. That is, when player 1, who under X_{EA} was Eve thinks to be Adam under X_{AE} , this player is able to reproduce exactly the same payoffs that player 2 experienced when the player was Adam.

Impartiality means that the players must agree on an outcome under the hypothesis that the reciprocal replacement of positions works in such a way that each stakeholder has an equal probability of finding himself in the position of each of the possible two roles. Equal-probability explains how the solution may not change under the symmetrical translation of the payoff space with respect to the players’ utility axes. Take an outcome x_{EA} that by replacing personal positions may realize in two non-coinciding ways (x_{EA} itself and x_{AE}). To make this outcome acceptable requires taking the expected value of an equal probability distribution over the two

realization ways: $\frac{1}{2}X_{EA} + \frac{1}{2}X_{AE}$. This would identify a point in the space that is invariant under the players' positions replacement (i.e., an egalitarian solution residing on the bisector).

However, this construction is not meant to be an excessive idealization. Agents retain awareness that the solution must be an equilibrium of the original game. That is, the solution must be a collective behavior that the parties know is self-enforceable and incentive-compatible once they think that they all are playing it. This is a requirement of realism of the agreed solution: agents cannot afford to agree ex ante on a solution if it is not incentive-compatible ex post (beyond 'the veil of ignorance'). The reason is simple. Admit that the impartial solution proves ex post not to be an equilibrium of the original game (does not belong to the original payoff space of the 'state of nature' game). Hence, the player who ex post would be most favored by returning to a solution belonging to the initial equilibrium set would simply deviate to an equilibrium strategy.

Consequently, the stability condition requires that the ex ante solution (agreed behind the 'veil of ignorance') must correspond to an outcome that under the players' place-permutation would nevertheless belong to the ex post equilibrium set. In other words, the selected outcome must be an equilibrium (say) either if player 1 takes the position of Adam (and player 2 respectively the position of Eve) or in the opposite case when their identification is reversed (player 2 occupies Adam's position, whereas player B takes Eve's position), and all the more so when an equally probable combination of the two identifications is taken.

What has been just set is a new feasibility condition. Owing to the state of nature game's assumptions, only equilibria of the original payoff space X_{EA} are feasible. Any further outcome – potentially subject to agreement – would be wishful thinking because no ex post equilibrium would exist that could implement it (see point U in Exhibit 2). Adding the conditions of impersonality and impartiality further restricts feasible outcomes to the symmetric intersection $X_{EA} \cap X_{AE}$ of the two payoff spaces generated by symmetrical translation of the original space, which is a proper subset of the initial outcome (equilibrium) set X_{EA} , as shown in Exhibit .2. This is a symmetrical payoff space wherein any bargaining solution necessarily falls on the bisector, which is the geometrical locus of egalitarian solutions (where parties share the bargaining

surplus equally). Note that this result takes for granted an egalitarian status quo preceding the agreement, but this assumption too is a consequence of the veil of ignorance.

In particular, players resort to the Nash bargaining solution (NBS), which is the most widely employed solution for bargaining games (Nash, 1950). It prescribes picking the point of the efficient (north-east) frontier of the payoff space (representing the outcomes set of possible agreements) where the product $\prod(u_i - d_i)$ of the utilities u_i of players ($i = 1, 2$), net of utility d_i associated with their status quo, is maximal. Assuming that the players bargain according to the typical rationality assumptions of game theory (Harsanyi, 1977), and given that the feasible outcome set is the symmetric intersection sub-space $X_{EA} \cap X_{AE}$, the NBS is by assumption egalitarian and selects the point S of Exhibit 2.

The striking result of this construction is that the minimal requirement of social justice (impersonality and impartiality) becomes compatible with realism and ex post stability in an interaction where players are free to choose according to their preferences. In spite of Hayek (1973), freedom of choice and incentive compatibility does not require relinquishing the moral demands of social justice. On the contrary, it entails that the solution must be egalitarian and must coincide with the Rawlsian maximin distribution, even within an originally asymmetrical set of possible outcomes. Thus, given a real-life set of possible outcomes reflecting possible inequality between the participants, the solution falls on the equilibrium that most favors the worst-off player, which in most cases is the egalitarian distribution.

5.2 The CSR social norm in a Trust Game

To give more concreteness to the foregoing exemplification of the stakeholder social contract, consider now a strategic interaction between a non-controlling stakeholder A (i.e., an employee with a specific investment at stake) and a controlling stakeholder B (the entrepreneur or the manager) taking the form of a Trust Game (TG) (see Exhibit 3). By entering the relationship, the trustor (player A) accepts (trusts) the authority of the trustee (player B). On the contrary, by not entering, he refuses to take a subordinate position in the relationship with B. Moreover by entering A invests idiosyncratically in the relationship. The trustee is an authority who can abuse

some discretionary power. Once the trustor has entered, the trustee may choose between abuse and no-abuse. *No-abuse* would maximize the two players' joint payoff and as well the Nash bargaining product in the outcome space, but abusing for a self-interested trustee is strictly dominant. Thus, in the one-shot TG, a self-interested trustee will always abuse, and hence the unique equilibrium solution of the game is no-entrance, abuse.

(Insert Exhibit 3 about here)

However, the TG game is played repeatedly. On considering repeated strategies and their average outcomes, many possible equilibria exist. These include the original (no-entrance, abuse), the perfectly fair (entrance, no-abuse), plus all the possible pairings of entrance with mixed strategies combining abuse and no-abuse up to a limit probability of $\frac{2}{3}$, and $\frac{1}{3}$, respectively. Indeed, the entire dashed region of the payoff space in Exhibit 4 is filled with possible equilibrium points of the repeated TG.

(Insert Exhibit.4 about here)

Given so many equilibria, many possible conventions would emerge from reciprocal coordination. In particular, the trustee has a “conformity problem” with a social norm of fair treatment consisting in the NBS (by which B equally shares the surplus). If the firm is run to the fair reciprocal advantage of both stakeholders, only the equilibrium coinciding with NBS can emerge. By contrast, a model of CG consistent with a purely shareholder-value maximization approach would justify the equilibrium corresponding to the Stackelberg solution.

Application of the Binmore-Rawls theory of equilibrium selection based on the ex ante social contract is starkly simple in this case (Sacconi, 2010b).

(Insert Exhibit 5 about here)

Exhibit 16.5 illustrates the symmetric translation of the repeated TG payoff space with respect to the player utility axes U_A and U_B , which consists of its rotation around the north-west boundary of the initial space X_{AB} . The symmetrical intersection subset $X_{AB} \cap X_{BA}$ reduces to the rotation axis itself, i.e., no more than a line segment (along the bisector) consisting of all the egalitarian distribution. By simply adding basic strong Pareto Optimality (i.e., agreeing on solutions that permit mutual improvements for all, if available) directly leads to choosing the

equilibrium point consistent with the NBS of the original game (2, 2), which is also its egalitarian (and maximin) solution. Nevertheless, once the egalitarian solution was selected, it would be incentive-compatible and stable.

This is an abstract representation of the CSR social norm endogenously emerging from the stakeholder vs. entrepreneur/manager interactions aided by the social contract reasoning. Under such a CSR norm, the trustee behaves as if he owed the trustor (stakeholder) fiduciary duties of fair treatment.

6. CORRESPONDENCE TO THE MULTI-STAKEHOLDER MODEL OF CG

This section employs the social contract theory in a different way. The previous section used social contract theory as an equilibrium selection device able to identify (theoretically predicting) which social norm tends to emerge as the basis for an institution. Here the social contract is used normatively to specify and justify the CSR extended model of CG. This section answers the main normative objections raised against the multi-stakeholder approach to CG. First, this approach is incapable of providing a bottom line against which managers' conduct can be assessed because the objective function representing the stakeholders' different goals must be multidimensional. Second, no simple exercise of maximization can represent a decision consistently aimed at achieving such incoherent goals (Jensen, 2001). Third, since multiple fiduciary duties are too indefinite, they cannot give priority and reserve justified privilege to any one stakeholder's legitimate claim among others, which would be constitutive of fiduciary duties (Marcoux, 2003).

The Mediating Hierarchy's Mode of Reasoning

In the mediating hierarchy view of CG, the board of directors is an arbiter of the cooperative interaction among the various stakeholders participating in team production. But how should directors mediate among different stakeholders? The suggestion is that they should devise the principle for impartial mediation by working out the social contract that all stakeholders would accept as a fair term of agreement for the implementation of a corporate joint cooperative strategy and the consequent allocation of rights, duties, and payoffs (Sacconi, 2006a, 2006b).

The board of directors may construe the stakeholders' social contract by the following procedure of impartial reasoning inspired by the Rawlsian veil of ignorance. This is a decision procedure by which the decision maker accounts for any personal perspective as if he were unable to identify it with his own personal perspective on the problem. This requires establishing the preconditions for a fair agreement. Hence, force, fraud, and manipulation must be set aside, and the only features of each stakeholder accounted for are his capability to contribute to team production under different joint plans, and the utilities that he can derive from each of them. Since any reasonable agreement must grant some advantage to some stakeholder, a fair reference point for advantage must be set. Thus, the agreement status quo must keep each stakeholder immune from hold up. That is, before discussing the agreement, each stakeholder is granted at least full reimbursement of his specific investment's costs.

In order to calculate the legitimate shares that stakeholders can claim, the impartial director will put himself in the position of each stakeholder in turn (impersonality) and will assign equal probability to each position (impartiality). Thus, by an effort of sympathy, he will accept or reject any available agreement according to each stakeholder's preference. Hence, the terms of agreement deemed acceptable are those that each stakeholder is willing to accept from his own personal point of view. Solutions acceptable to some stakeholder but not to others are then discarded. Thus, the process ends with the non-empty intersection of the allocations acceptable from whichever point of view. An agreement acceptable from whichever point of view must necessarily exist because team production is mutually advantageous with respect to an alternative organization of production where members would split into separate units. If an agreement were impossible, stakeholders would simply organize themselves into separate production units.

Note that the impartial director is applying exactly the same model of the social contract pointed out in the previous section. Thus, assume for simplicity the following: (1) only two stakeholders, (2) their possible agreements define a convex set of possible outcomes, and (3) the director applies the 'veil of ignorance' using his utility function as a tool to simulate in turn possible payoffs of both stakeholders at each possible agreement. Impartiality and

impersonality conditions therefore impose invariance of the impartial director's payoff under both perspectives that he may take. For any acceptable agreement, this entails that the impartial director's payoff is the expectation of an equal probability mixture of two stakeholders' payoffs. The solution must be sought in the symmetrical intersection of the two outcome sets that the impartial director reconstructs when taking the two stakeholders' perspectives in turn. Thus, the director must choose the agreement that maximizes the Nash bargaining product within this symmetric set.

Summing up, there is a behavioral and cognitive model of the mediating director. Such a fair mediation also corresponds to a unique and calculable objective function: maximizing the NBS within the symmetrical intersection subset of outcomes. Though abstract, this is by no means more distant from reality than the traditional profit maximization rule. Moreover, it is realistic insofar as the impartial director focuses only on agreements implementable by stakeholders who ex post act according to their individual incentives.

Two-step Social Contract Derivation of the Multiple Fiduciary Structure

The social contract will be now employed to tell a hypothetical story on how the multi-stakeholder corporation may have justifiably emerged, and its multiple, fiduciary governance may have justifiably settled.

At the beginning, all stakeholders face a state of nature plagued by incomplete contracts and opportunistic behaviour. To put an end to this mutually destructive interaction, they agree to form a multi-stakeholder productive association wherein all stakeholders have the same rights and duties. This avoids the situation where, by exclusive control, some may expropriate the fruits of other stakeholders' investments. In the productive association, therefore, all the stakeholders are confident that if any one of them makes a specific investment, nobody can hold up him with the threat of exclusion from the relevant transaction. This minimizes the contract costs that would derive from incomplete contracts.

Assuming that the multi-stakeholder association is a possible form of team production, each stakeholder will rationally negotiate his adherence to the association's plan of action, which

requires adhesion by all of them. The association's joint plan is then selected by the first social contract whereby stakeholders decide to coalesce.

This agreement stipulates the following: (1) rejection of (or redress for) joint plans generating negative externalities for broad-sense stakeholders who in fact join the association in order to ensure that they will not victimised; (2) production of the maximum surplus possible (i.e., the maximal difference between the value of goods and services for consumers, who also belong to the association, and the costs incurred by all other stakeholders to produce them); and (3) fair distribution of the surplus according to a rationally acceptable agreement reached among all the stakeholders in a bargaining process free from force or fraud and based on an equitable status quo insuring each stakeholder against hold up.

Stakeholders conduct the bargaining process under a veil of ignorance about their possible advantaged or disadvantaged positions in the productive association. The solution is calculated according to maximization of the NBS within the symmetrical payoff space deriving from the association's possible outcomes, when all feasible personal payoffs are equally affordable to all stakeholders given the possibility of reciprocal replacement of their relative positions and roles.

However, once the first social contract has been accomplished, stakeholders immediately realize that the equally inclusive association is plagued by governance costs. Collective choice costs, coordination costs, and also free-riding costs in peer-group-managed teams may greatly reduce its actual output. Thus, they agree to devise an optimal authority structure in order to minimize governance costs.

By a further step in the process, they settle a second social contract on the association's governance structure. This agreement stipulates that authority is delegated to the single stakeholder who is most efficient in governance. This problem has different solutions: either the typical public company with dispersed shareholders, or family-controlled companies, or partnerships or consumer cooperatives may be the most efficient governance solution according to contingencies (Hansmann, 1996).

The stakeholders' class invested with authority is remunerated with the residual and is authorized to appoint those who run the firm operationally (managing directors). But an understanding among the association's members is that the authority of the corporate governance structure will be legitimated only in so far as it is instrumental to the first social contract. In other words, the prospective non-controlling members of the association will accept authority if and only if the association's new ownership and control structure proves to be the best way to implement the first social contract of the firm, which pre-exists the authority relation and gives reasons for accepting it (Raz, 1985; McMahon, 1989). No constitution of the governance structure may be accepted if minimizing governance costs is not a means to improve the fair remuneration of the association's members. Of course, the remuneration of those appointed to the association's governing roles will impinge on the surplus recovered from reducing governance costs. But no governance structure could be accepted by the second social contract if it were not beneficial in an impartial way to all the stakeholders. Hence, a principle of accountability to non-controlling stakeholders asking that they participate in some internal committee having supervisory powers must be added, so that they may verify that corporate management does not substantially deviate from the principles settled by the first social contract.

Accordingly, there is a two-step agreement and the directors' fiduciary duties ensue from each step. They owe special fiduciary duties to residual claimants via a narrow fiduciary proviso replicating the typical duty of due care and non-conflict of interest. But this narrow proviso is obligating only under the constraint of respecting a broader fiduciary proviso owed to non-controlling stakeholders, which is more fundamental and overriding. In other words, once the three provisos of the first social contract have been met, if two or more courses of action indifferent in terms of broader proviso compliance are still feasible, the directors are obliged to choose the course of action more favorable to the residual claimant (owner or shareholders). A clear priority order of stakeholders' claims is thus established, and all stakeholders are privileged in some proper respect. Broad-sense stakeholders are assigned priority, but only in the weak sense of restricting the company's range of action to those joint plans that do not

engender strong externalities detrimental to them. Second in priority are strict-sense stakeholders, who are granted a wide range of privileges in the discretion area of directors who must protect their specific investments and then arbitrate cooperation according to the symmetric NBS. Last, in the subset of possible corporate decisions indifferent to the NBS, residual claimants are assigned privilege consisting in the decision of pursuing (constrained) shareholder value maximization. Indeed, since the NBS is a uniquely determined solution, substantial discretion in choosing shareholder value maximization strategies that do not also entail improvement of the other stakeholders' positions is quite unrealistic.

SUMMARY AND CONCLUSIONS

Social norms affect CG and have an important role in equilibrium selection because they help define which of many equilibrium behaviors is initially accepted. The social contract is the basic mode of reasoning by which agents initially work out an accepted social norm that then contributes to the affirmation of an equilibrium institution. It applies under conditions in which an endogenous and free agreement among reasonably equally rational agents is admitted. The social contract device entails some form of 'veil of ignorance' reasoning, i.e., some form of impartiality and impersonality with sympathy mechanism is a natural frame of mind available for this social norms acceptance endeavor.

In the domain of CG institutions, CSR is the social norm selected by the social contract, which can then be understood as a social norm affecting the emergence of a CG model. In games that non-controlling stakeholders play with entrepreneurs or owners of physical assets, the social contract identifies a social norm for the fair (egalitarian) distribution of the corporate surplus among all stakeholders. This is an equilibrium of the game that may then crystallize into an institution for governing these relationships. In particular, the corresponding institution is a CG regime that seems to abide by a social norm of stakeholders' fair treatment. Since the same social contract model also works as a justification for the normative model of extended fiduciary duties, these duties are also owed by directors to all the stakeholders. What is morally justified

tends also to emerge as an equilibrium institution (unless an endogenous agreement among free and reasonably equally rational agents is obstructed), and vice versa.

Summing up, the CSR model of CG is supported by the argument that it is an emerging social norm that may crystallize into CG economic institutions when an original position choice over CG institutions is allowed. That is, the CSR model would be an impartial spontaneous order in the domain of CG. No other CG model, especially the agency model giving absolute priority to shareholders, is supported by similar analysis of equilibrium selection in games. Under the agency model, the player interpretable as the entrepreneur or owner would be allowed to try to converge on equilibria such that he would appropriate the entire surplus (for example reaching the bargaining solution in X_{AE} that grants Adam's advantage). The social contract deletes these equilibria from what can be ex ante picked up by a fair equilibrium selection process. Other explanations can be given for the relative success of the agency model as an institution of CG, but not the social contract used to explain the initial acceptance of a social norm that then develops into a CG institution. Ex ante acceptability under fair conditions of agreement cannot be satisfied by the agency model.

Thus, the challenge put forward by Macey (2008) has been accepted and defeated. The CSR model of CG is justified as an acceptable agreement among all the company's stakeholders that can be reached before adopting any particular corporate form. Can the same be said for the promissory model giving absolute priority to shareholder value maximization? Insofar as the argument put forward in this chapter is sound, the answer is 'no'.

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Exhibit.1 Modified Aoki Recursive Model

(The inner circle “quasi symmetric reasoning –convergent beliefs-tentative strategies- evolving state of play-salient features of repeated game behavior” is the Aoki’s recursive model of an equilibrium institution. It is here completed with the above part pointing out that social acceptance of norms based of the social contract reasoning affects initial common beliefs on behaviors and dispositions and hence is the starting point for the emergence process leading to an equilibrium institution.)

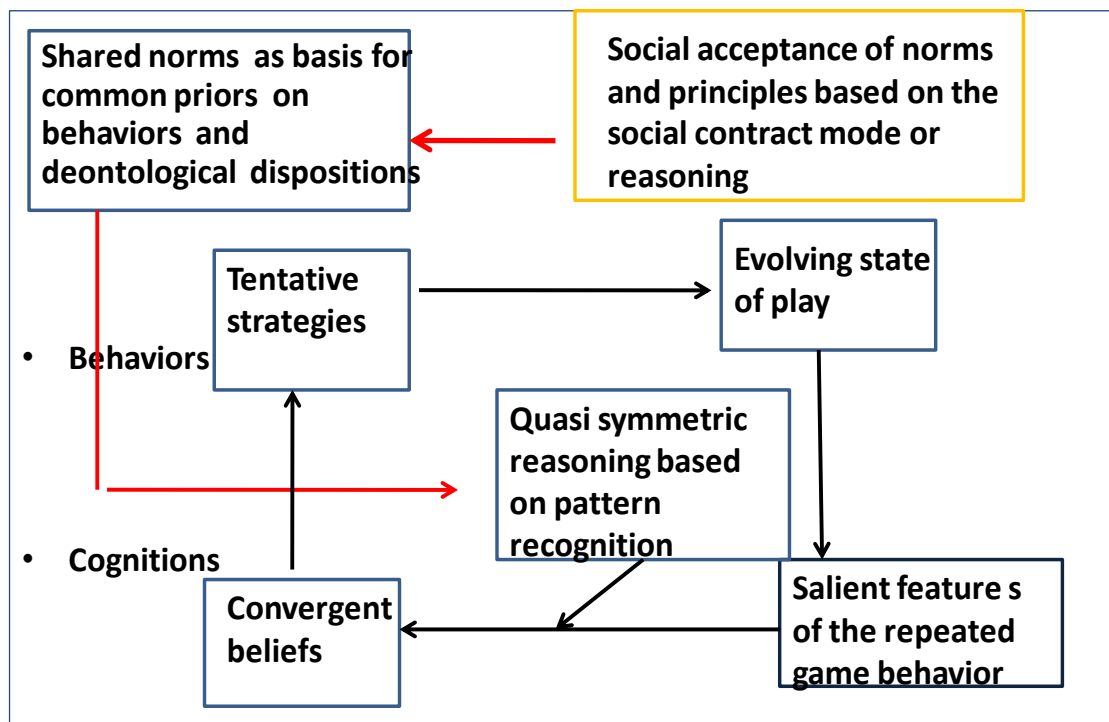
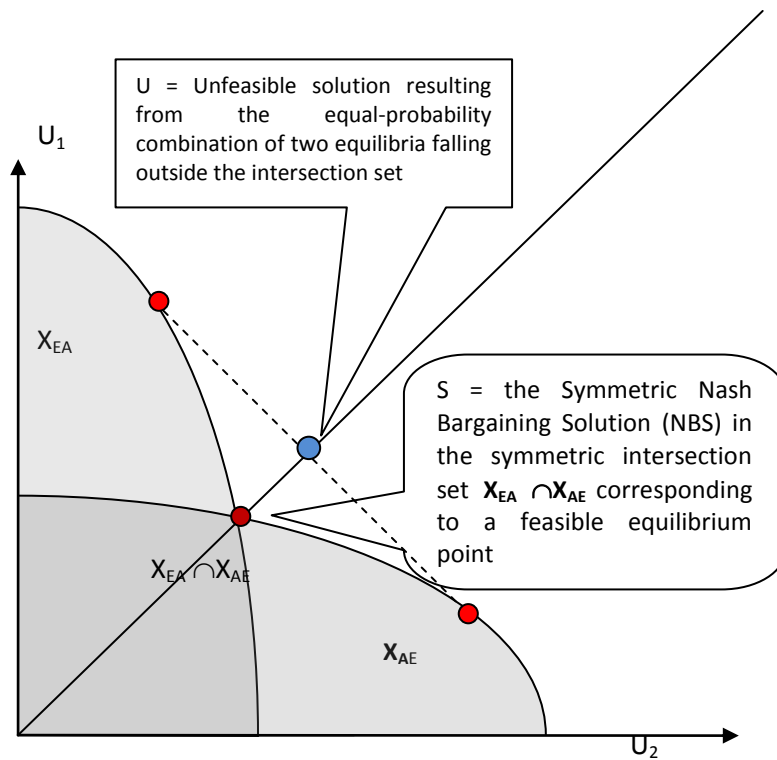


Exhibit.2 The Binmore-Rawls Egalitarian Social Contract

(The egalitarian solution S equal to the Nash Bargaining Solution within the symmetric intersection set $X_{EA} \cap X_{AE}$ is also the Rawlsian maximin with respect to the initial outcome space X_{EA} , and it derives by taking jointly the requirements of impartiality and impersonality and the stability condition that the solution must be incentive compatible)



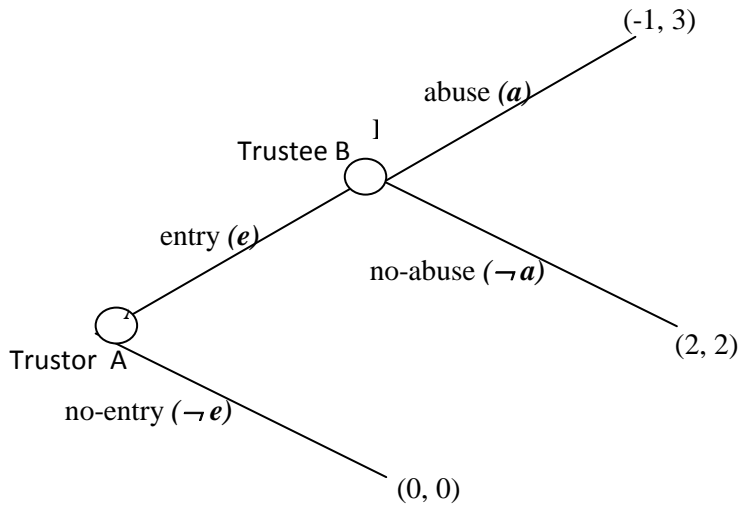


Exhibit . 3 - the stakeholder – entrepreneur/manager/owner Trust Game

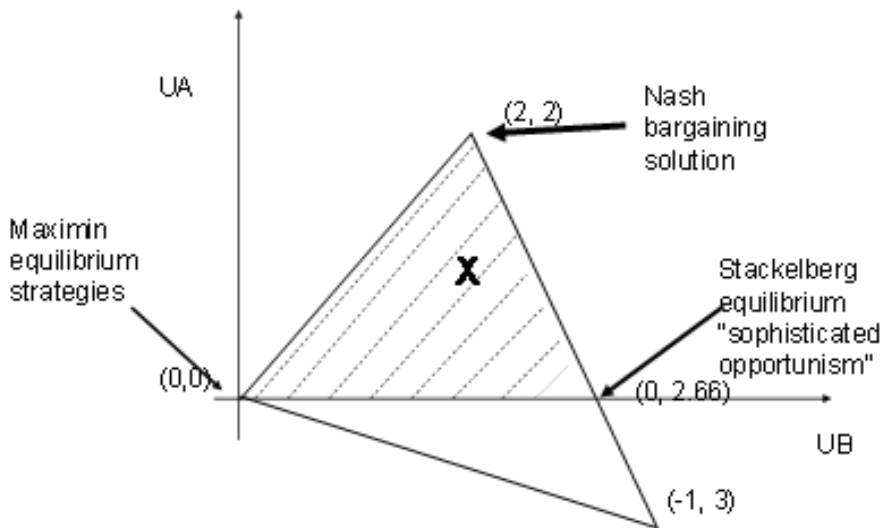


Exhibit. 4- Equilibrium set of a repeated TG

Exhibit 5. The Binmore- Rawls social contract applied to the TG

