Ethical Economy. Studies in Economic Ethics and Philosophy

Ingo Pies
Peter Koslowski *Editors*

Corporate Citizenship and New Governance

The Political Role of Corporations

Ethical Economy. Studies in Economic Ethics and Philosophy

Series Editor

Peter Koslowski, *VU University Amsterdam, Amsterdam*

Editorial Board

John Boatright, *Loyola University Chicago, Chicago, Illinois, USA*
George Brenkert, *Georgetown University, Washington D.C., USA*
Alexander Brink, *University of Bayreuth, Bayreuth, Germany*
James M. Buchanan, *George Mason University, Fairfax, Virginia, USA*
Allan K.K. Chan, *Hong Kong Baptist University, Hong Kong*
Christopher Cowton, *University of Huddersfield Business School, Huddersfield, United Kingdom*
Richard T. DeGeorge, *University of Kansas, Lawrence, Kansas, USA*
Thomas Donaldson, *Wharton School, University of Pennsylvania, Philadelphia, Pennsylvania, USA*
Jon Elster, *Columbia University, New York, New York, USA*
Amitai Etzioni, *George Washington University, Washington D.C., USA*
Michaela Haase, *Free University Berlin, Berlin, Germany*
Carlos Hoevel, *Catholic University of Argentina, Buenos Aires, Argentina*
Ingo Pies, *University of Halle-Wittenberg, Halle, Germany*
Yuichi Shionoya, *Hitotsubashi University, Kunitachi, Tokyo, Japan*
Philippe Van Parijs, *University of Louvain, Louvain-la-Neuve, Belgium*
Deon Rossouw, *University of Pretoria, Pretoria, South Africa*
Josef Wieland, *HTWG - University of Applied Sciences, Konstanz, Germany*

For further volumes:
http://www.springer.com/series/2881

Ingo Pies · Peter Koslowski
Editors

Corporate Citizenship and New Governance

The Political Role of Corporations

Editors
Ingo Pies
Martin-Luther-University
Chair of Economic Ethics
School of Law, Business
and Economics
Große Steinstraße 73
06108 Halle (Saale) Sachsen-Anhalt
Germany
ingo.pies@wiwi.uni-halle.de

Prof. Dr. Peter Koslowski
VU University Amsterdam
Department Philosophy
De Boelelaan 1105
1081 HV Amsterdam
The Netherlands
P.Koslowski@ph.vu.nl

ISSN 2211-2707 e-ISSN 2211-2723
ISBN 978-94-007-1660-5 e-ISBN 978-94-007-1661-2
DOI 10.1007/978-94-007-1661-2
Springer Dordrecht Heidelberg London New York

Library of Congress Control Number: 2011933233

© Springer Science+Business Media B.V. 2011
No part of this work may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, microfilming, recording or otherwise, without written permission from the Publisher, with the exception of any material supplied specifically for the purpose of being entered and executed on a computer system, for exclusive use by the purchaser of the work.

Printed on acid-free paper

Springer is part of Springer Science+Business Media (www.springer.com)

Preface

The contributions to this book document an international conference "Corporate Citizenship and New Governance – The Political Role of Corporative Actors in Societal Rule-Setting Processes" that took place in Wittenberg, Germany from November 26–28, 2009. The interdisciplinary meeting of experts was organized as the 12th Annual Conference of the Working Group for Business Ethics and Business Culture of the German Philosophical Association by the Working Group in cooperation with the Chair of Economic Ethics at the Martin-Luther-University Halle-Wittenberg, Germany.

The contributions documented here address two challenges that are of major importance both for the theory and practice of business behavior.

The first challenge highlights the societal role and, in particular, the self-understanding of business firms within a market economy. In an increasingly dynamic business environment, especially multi-national companies are more and more expected to take on a higher degree of social responsibility for moral issues such as fighting corruption, protecting the environment, curbing climate change, establishing labor standards, coping with child labor and poverty or providing amenities for weak local communities. In business practice, such claims eventually translate into companies contributing to the improvement of the (global, national or local) social order. This is exactly what *Corporate Citizenship* is all about: the role of companies as political actors in societal rule-setting processes.

The second challenge brings attention to the various kinds of political commitments that corporate actors can make in order to contribute to local, national or even international governance processes. Companies address this challenge by working together with state actors and civil society organizations in order to create a "level playing field" for market competition. In such new forms of governance, business firms participate not only in processes of rule-setting but also in discourses of rule-finding deliberation. And this is what *New Governance* is all about: the participatory role of businesses in multisectoral alliances that aim at improving the rules of the game.

The editors would like to thank the Dieter Schwarz Foundation for financial support of this project. Furthermore, our special thanks go to the team at the Chair

of Economic Ethics at Halle for the kind support during the conference and, particularly, to Stefan Hielscher for editorial assistance. The written contributions documented here were subjected to a double-blind peer review.

Halle (Saale) Sachsen-Anhalt, Germany Ingo Pies
Amsterdam, The Netherlands Peter Koslowski

Contents

1 **Introduction: Corporate Citizenship and New Governance – The Political Role of Corporations** 1
Ingo Pies

2 **An Overview of Current Practice and Policy Relating to Business Activities and Human Rights: Some of the Implications for Corporate 'Rule-Making'** 7
John Morrison

3 **Politicization of Companies? Empirical Evidence on Corporate Citizenship Activities in Europe** 19
André Habisch

4 **Corporate Citizenship and Private Regulatory Regimes: Understanding New Governance Roles and Functions** 39
Kernaghan Webb

5 **Corporate Citizenship as Organizational Integrity** 59
Jacob Dahl Rendtorff

6 **The Social Case as a Business Case: Making Sense of Social Entrepreneurship from an Ordonomic Perspective** 91
Markus Beckmann

7 **Morality as a Factor of Production: Moral Commitments as Strategic Risk Management** 117
Stefan Hielscher

8 **The Implications of the New Governance for Corporate Governance** 133
John R. Boatright

9 **D&O Deductibles as a New Standard of Responsible Governance** 147
Till Talaulicar

10 Competitive Markets, Corporate Firms, and New Governance—An Ordonomic Conceptualization 171
Ingo Pies, Markus Beckmann, and Stefan Hielscher

Index 189

Contributors

Markus Beckmann Centre for Sustainability Management, Leuphana University Lueneburg, Scharnhorststrasse 1, 21335 Lueneburg, Germany, markus.beckmann@leuphana.de

John R. Boatright School of Business Administration, Loyola University Chicago, Chicago, IL, USA, jboatri@luc.edu

André Habisch Ingolstadt School of Management, Catholic University, Eichstaett-Ingolstadt, Germany, andre.habisch@ku-eichstaett.de

Stefan Hielscher School of Law, Business and Economics, Martin-Luther-University Halle-Wittenberg, 06108 Halle (Saale), Sachsen-Anhalt, Germany, stefan.hielscher@wiwi.uni-halle.de

John Morrison Institute for Human Rights and Business, London, UK, john.morrison@institutehrb.org

Ingo Pies School of Law, Business and Economics, Martin-Luther-University Halle-Wittenberg, 06108 Halle (Saale), Sachsen-Anhalt, Germany, ingo.pies@wiwi.uni-halle.de

Jacob Dahl Rendtorff Department of Communication, Business and Information Technologies, University of Roskilde, Roskilde, Denmark, jacrendt@ruc.dk

Till Talaulicar University of Erfurt, Erfurt, Germany, till.talaulicar@uni.erfurt.de

Kernaghan Webb Department of Law and Business, Ted Rogers School of Management, Ryerson University, Toronto, ON, Canada, kernaghan.webb@ryerson.ca

Chapter 1
Introduction: Corporate Citizenship and New Governance – The Political Role of Corporations

Ingo Pies

(1) During the past decades the traditional clear-cut division of labor between market and state, between business and politics increasingly reaches its limits (Margolis and Walsh 2003). Traditionally, the task of the state government is to act as a rule-giver: to design and to enforce functional rules for the market economy. Within these rules, the traditional role of the company is to act as a rule-taker: to play the business game of market competition as profitably as possible. In the course of globalization, however, nation states increasingly face difficulties in providing global markets with a functional and reliable institutional framework for competition. Specifically, business firms and other market actors witness today many instances in which nation-state governance leaves the economy even with serious gaps in the (global) framework for market competition. This novel development bears two challenges for modern business firms. In public discourse as well as in the academic debate, these challenges are often connected with the concepts of "Corporate Citizenship" and "New Governance":

The first challenge highlights the societal role and, in particular, the self-understanding of business firms within a market economy. Traditionally, companies are seen as economic actors that optimize their business strategies subject to a given (and perfect) set of rules for market competition. In an increasingly dynamic business environment, however, business firms see themselves confronted with societal expectations that go well beyond such a mere economic role as passive rule-takers in society. In particular, multi-national companies are more and more expected to take on a higher degree of social responsibility for moral issues such as fighting corruption, protecting the environment, curbing climate change, establishing labor standards, coping with child labor and poverty or providing amenities for weak local communities. In business practice, such claims eventually translate into companies contributing to the improvement of the (global, national or local) social order. This

I. Pies (✉)
School of Law, Business and Economics, Martin-Luther-University Halle-Wittenberg,
06108 Halle (Saale), Sachsen-Anhalt, Germany
e-mail: ingo.pies@wiwi.uni-halle.de

I. Pies, P. Koslowski (eds.), *Corporate Citizenship and New Governance*,
Ethical Economy. Studies in Economic Ethics and Philosophy 40,
DOI 10.1007/978-94-007-1661-2_1, © Springer Science+Business Media B.V. 2011

is exactly what *Corporate Citizenship* is all about: the role of companies as political actors in societal rule-setting processes.

The second challenge brings attention to the various kinds of political commitments that corporate actors can make in order to contribute to local, national or even international governance processes. Companies address this challenge by working together with state actors and civil society organizations in order to create a "level playing field" for market competition. In such new forms of governance, business firms participate not only in processes of rule-setting but also in discourses of rule-finding deliberation. And this is what *New Governance* is all about: the participatory role of businesses in multisectoral alliances that aim at improving the rules of the game.

(2) These profound challenges in business practice have prompted a lively scholarly debate on the political role of companies. Most interestingly, the debate on private firms as political actors has not only remained a specialized discussion in the field of business ethics. In fact, this novel role of business in society is now also more broadly discussed in the realm of traditional management theory. Indeed, leading international academic journals have not only published numerous articles but have also initiated many special issues on the topic. Without any doubt, the debate on the political role of private actors is beginning to gain momentum in the field of management sciences and business ethics.

The growing interdisciplinary debate was launched by Matten and Crane (2005) as well as by Crane and Matten (2005), who evaluate the potential of companies to actually be "corporate citizens" from a political science viewpoint, and who develop specific criteria for such a participation of companies (cf. also Moon et al. 2005 and, more recently, Crane and Matten 2008). Drawing on the Habermasian concept of deliberate democracy, other scholars take a philosophical perspective and discuss legitimacy issues that, in their view, arise when business firms participate in governance activities, especially in the international context (Scherer et al. 2006, Palazzo and Scherer 2006, Scherer and Palazzo 2007).

The debate is, however, not only fueled by philosophical perspectives and viewpoints stemming from political theory. In fact, also rational-choice theorists contribute to the understanding of the new political role of business firms as "corporate citizens". Most recently, Pies et al. (2009) as well as Pies et al. (2010) put forward a so-called "ordonomic" approach to corporate citizenship. Unlike the "separation thesis of economic theory" (Scherer et al. 2006, p. 508), the ordonomic rational-choice approach allows conceptualizing the political role of companies in strict analogy to their economic role as agents of social value creation. According to Pies et al. (2009, p. 386), companies who act as corporate citizens (can) take on "ordo-responsibility" in that they participate in processes of political rule-setting and public rule-finding, thus not abandoning the win-win logic of value creation but, instead, strengthening this role by contributing to improving the (deficient) political rules of the game of the economy.

Given that this debate is fairly young, it does not come as a surprise that theorizing on the "new" role of companies as political actors is highly controversial. Some scholars raise conceptual issues and ask what new insights can be gained

by introducing the new concept of “corporate citizenship”, which is, at least at first sight, similar to the more broader and more established approach of “corporate social responsibility” (cf. e.g. Néron and Norman 2008, Néron 2010). Other critics go even so far to argue that the notion of corporate citizenship “remains a misguided metaphor at best, and is hence better dispensed with altogether” (van Oosterhout 2008, p. 35). In a nutshell, the debate on corporate citizenship and new governance is so far still in need of “conceptual clarification.”

(3) The contributions of this compendium shed new light on the debate on corporate citizenship and new governance. In fact, this book can be considered an interdisciplinary attempt to clarify some conceptual issues that still surface the ongoing debate on the political role of business firms. It thus brings together highly diverse perspectives that contribute to our understanding of the political role of private actors: a business practice perspective on the relevance of human rights issues for multinational companies (John Morrison), an empirical point of view on corporate citizenship activities of German and European companies (André Habisch), a legal perspective on private regulatory regimes (Kernhaggan Webb), a business ethics perspective on the inner-organizational preconditions for corporate citizenship (Jacob Dahl Rentdorff), a social innovation standpoint on “rule” entrepreneurship (Markus Beckmann), a risk management perspective on (political) CSR activities (Stefan Hielscher), a philosophical perspective on new governance (John Boatright), a management perspective on the German Corporate Governance Codex (Till Talaulicar), and an ordonomic perspective on economic ethics, business ethics, and process ethics as an ethics of corporate citizenship and new governance (Ingo Pies, Markus Beckmann and Stefan Hielscher).

More specifically, all these different perspectives significantly advance our understanding of corporate citizenship and new governance:

(a) From a viewpoint of business practice, John Morrison highlights that companies increasingly face human rights issues in their day-to-day-business activities, especially in the international context. According to Morrison, business-related human rights issues do not only pertain to problems along the international value-chain of production, e.g. when Indian suppliers of multinational corporations do not live up to internationally accepted labor standards. In fact, companies today are confronted with even more complicated political issues of human rights “administration” when they decide on whether (or when) to abandon altogether their activities in countries where human rights are not respected anymore, as it happened in Burma in 2009. According to Morrison, there is still a huge deficit in (management) theory which leaves companies without orientation of how to deal with such political issues in their daily activities.

(b) From an empirical point of view, André Habisch analyzes the corporate citizenship activities of companies in Germany and in Europe. On a yearly basis, Habisch and his colleagues conduct in cooperation with the German periodical “Manager-Magazin” a survey in order to screen the German and European landscape of business initiatives in corporate citizenship (CC) and corporate social responsibility (CSR). Eventually, this study results in the so called “Good Company Ranking”. After many years of thorough research, Habisch concludes that many CC

and CSR initiatives still lack a strong connection with their core business activities. Interestingly, André Habisch thus reaches a conclusion very similar to John Morrison's as he, too, identifies a theory deficit as the principal cause of the problem that business strategy very often lacks rigor, coherence and orientation.

(c) From a legal perspective, Kernaghan Webb examines the role of (multinational) corporations in private regulatory regimes in which business firms collaborate with state actors and civil society organizations in order to fill the gaps of the institutional framework for (global) market competition. Webb contends that private regulatory regimes play even a prominent role in the current global economic order. For Webb, many currently observable initiatives underline this proposition: the growing importance of private initiatives to establish international standards such as ISO 9001 (consumer satisfaction and quality management), ISO 14001 (environmental management systems), the Forest Stewardship Council (FSC) to certificate a sustainably resource management, the initiative "Responsible Care" for considering aspects of health, security and environmental protection in the chemical industry as well as the SA 8000 for world-wide labor and social standards. Webb argues that such private regulatory regimes follow a fundamentally different logic compared to more classic forms of national and supranational rule-setting. As a consequence, companies engaging in such new governance processes face new challenges with regard to the aspects of consensus and legitimacy.

(d) From a republican business ethics perspective, Jacob Dahl Rendtorff discusses the inner-organizational preconditions for corporate citizenship. According to his view, companies face the challenge to build up an organizational integrity – an independent organizational "character" – that allows business firms to be appreciated by their stakeholders as moral actors involved in business processes of value creation. In analogy to the concept of individual citizenship, Rendtorff contends that organizational integrity is the result of good and moral leadership which requires judgment on behalf of the management which plays a decisive role when it comes to solving moral dilemmas in value-driven business relationships.

(e) From an ordonomic perspective, Markus Beckmann accentuates the concept of social entrepreneurship in comparison to the concept of corporate citizenship. Beckmann argues that the concept of social entrepreneurship offers a semantic innovation (at the level of ideas) whose potential for social innovation can be fully reaped only if it is used as a heuristics for social structural change (on the level of institutions). In contrast to corporate citizens, social entrepreneurs recognize relevant social problems, interpret them as an entrepreneurial challenge, and succeed in turning a social case into a business case. According to Beckmann, corporate citizens typically follow a different path: corporate citizens identify entrepreneurial problems (threats to value creation brought about by deficient rule arrangements), interpret them as a societal challenge (corporate contribution to political rule-setting), and succeed in transforming a business case into a social case.

(f) Also from an ordonomic viewpoint, Stefan Hielscher develops an argument how companies can employ morality as a factor of production. Hielscher argues that the corporate process of value creation bears relationship-based risks that stem from precarious situations of antagonistic cooperation between the company and its

stakeholders. A successful management of such dilemma situations requires functional moral commitments on behalf of the company. According to his ordonomic view, business activities in corporate citizenship or corporate social responsibility can therefore be conceptualized as a valuable strategy of corporate risk management if moral commitments not only contribute to reducing undesirable core business risks but also to increasing the desirable risks in the process of corporate innovation.

(g) From a philosophical perspective, John Boatright analyzes the implications of the new governance for corporate governance. In his view, there are indeed implications of certain "new governance" aspects for the internal constitution of the firm, but Boatright argues that these consequences need not to be conceptualized as normative problems, but can be traced back to changing patterns of industrial value creation instead. According to Boatright's explicitly positive account, the process of industrial value creation has fundamentally changed in the last decades, and the main features of these changes are shifts from hierarchical, vertically-integrated firms dependent primarily on financial capital to loose networks that heavily rely on human capital. As a consequence, not only shareholders bear residual risks now but also employees, which means that companies increasingly have to "administer" also the rights of their employees. Additionally, implicit contracts become increasingly important which means that political negotiations that address corresponding problems grow also more important. According to Boatright's viewpoint, this development turns the causality on its head: Not globalization explains new governance, but the change in industrial value creation explains globalization and, associated with it, also "new" forms of governance.

(h) From a management perspective, Till Talaulicar discusses the "German Corporate Governance Codex" (GCGC) as a current new governance initiative. This Corporate Governance Codex is a voluntary standard of the German industry and represents an attempt to create a common basis for reforming the rules for management-owner relations which have recently been subject to severe public criticism. Besides various proposals to enhance the transparency of managerial decision rights, the GCGC also embraces higher standards for good and responsible management and supervision. One of these standards refers to a suitable deductible that shall trigger responsible management decisions if companies have introduced a directors' and officers' (D&O) liability insurance. Talaulicar's empirical analysis shows that companies more probably agree to a deductible regime (a) the bigger is the size of the company, (b) the bigger is the size of the management board, (c) the smaller is the supervisory board, and (d) the smaller are the risks associated with liability.

(i) From an ordonomic perspective, Ingo Pies, Markus Beckmann and Stefan Hielscher develop a rational-choice based alternative how to conceptualize corporate citizenship und new governance. In order to account for both developments, they present three different approaches to ethical theory: The ordonomic approach to an economic ethics of competitive markets argues that the social responsibility of business does not lie in maximizing profits but in addressing societal needs through the mutually advantageous creation of value. The ordonomic approach to the business ethics of corporate actors claims that corporate firms can use moral

commitments as a factor of production. The ordonomic approach to the process ethics of new governance holds that companies can act not only as economic actors but also participate as political and moral actors by taking ordo-responsibility in processes of new governance.

References

Crane, Andrew, and Matten, Dirk. 2005. Corporate Citizenship: Missing the Point or Missing the Boat? A Reply to van Ousterhout. *Acadamy of Management Review* 30(4): 681–684.

Crane, Andrew, and Matten, Dirk. 2008. Incorporating the corporation in citizenship: A response to Norman & Néron. *Business Ethics Quarterly* 18: 27–33.

Margolis, J. D., and Walsh, J. P. 2003. Misery loves companies: Rethinking social initiatives by business. *Administrative Science Quarterly* (48): 268–305.

Matten, Dirk, and Crane, Andrew. 2005. Corporate citizenship: Toward an extended theoretical conceptualization. *Academy of Management Review* 30: 166–179.

Moon, Jeremy, Andrew Crane, and Dirk Matten. 2005. Can corporations be citizens? Corporate citizenship as a metaphor for business participation in society. *Business Ethics Quarterly* 15: 429–454.

Néron, Pierre-Yves, and Wayne Norman. 2008. Citizenship, Inc. Do we really want businesses to be good corporate citizens? *Business Ethics Quarterly* 18(1): 1–26.

Néron, Pierre-Yves. 2010. Business and the polis: What does it mean to see corporations as political actors? *Journal of Business Ethics* 94(3): 333–352.

Palazzo, Guido, and Andreas Georg Scherer. 2006. Corporate legitimacy as deliberation: A communicative framework. *Journal of Business Ethics* 66: 71–88.

Pies, Ingo, Markus Beckmann, and Stefan Hielscher. 2010. Social value creation, management competencies, and global corporate citizenship – An ordonomic approach to business ethics in the age of globalization. *Journal of Business Ethics* 94(2): 265–278.

Pies, Ingo, Stefan Hielscher, and Markus Beckmann. 2009. Moral commitments and the societal role of business: An ordonomic approach to corporate citizenship. *Business Ethics Quarterly* 19(3): 375–401.

Scherer, Andreas Georg, and Guido Palazzo. 2007. Toward a political conception of corporate responsibility: Business and society seen from a Habermasian perspective. *Academy of Management Review* 32(4): 1096–1120.

Scherer, Andreas Georg, Guido Palazzo, and Dorothée Baumann. 2006. Global rules and private actors: Toward a new role of the transnational corporation in global governance. *Business Ethics Quarterly* 16(4): 505–532.

van Oosterhout, Hans. 2008. Transcending the confines of economic and political organization? The misguided metaphor of corporate citizenship. *Business Ethics Quarterly* 18(1): 35–42.

Chapter 2
An Overview of Current Practice and Policy Relating to Business Activities and Human Rights: Some of the Implications for Corporate 'Rule-Making'

John Morrison

Abstract Business and human rights has grown as a significant area of international policy and practice over the past 20 years and can be characterized by a diverse range of challenges for businesses, states and civil society alike. Ten of these key challenges are briefly described here and then an overview of the rule-making response is given. This can be categorized into five phases, in which the role of the state has gradually reemerged from the more laissez-faire and reactive business responses of the early 1990s to current attempts to create a global policy framework involving states and businesses alike.

Keywords Business strategy · Corporate citizenship · Human rights · Strategic management

Introduction

This chapter is developed from the presentation made in December 2009 to the Forum for Business Ethics and Business Culture meeting in Wittenberg. It reflects the reality that the 'business and human rights' policy and practice arena has grown significantly over the past 20 years and must now represent a key facet of the political role of corporate actors play in societal rule-setting processes. The article starts by setting out the range of policy and practice dilemmas that characterize the business and human rights agenda and then describes five stages of rule-making that have evolved over the past two decades. It therefore represents the reflections of a practitioner from which others might test theoretical models of rule-setting.

The global context is one where there are clearly some major deficits in the international institutional order. Rapid economic globalization, regional conflicts, poverty and the effects of climate change and quick uptake of new technologies have

J. Morrison (✉)
Institute for Human Rights and Business, London, UK
e-mail: john.morrison@institutehrb.org

I. Pies, P. Koslowski (eds.), *Corporate Citizenship and New Governance*,
Ethical Economy. Studies in Economic Ethics and Philosophy 40,
DOI 10.1007/978-94-007-1661-2_2, © Springer Science+Business Media B.V. 2011

all challenged the normal mechanisms of rule-making and enforcement to keep up. The scale and complexity of these changes have highlighted the limits in the capacity of nation states to find the necessary solutions on their own. The existence of these 'governance gaps' has been a rhetorical and conceptual premise for a number of key actors in the business and human rights field: such as 'norm forming' policy work of Professor John Ruggie, the United Nations Special Representative on Business and Human Rights, as well as a number of multi-stakeholder and business-led initiatives referenced in this chapter.

Two premises sit behind this analysis. First, human rights are taken as all those internationally (globally) recognized human rights that have emerged from international organizations, in particular the United Nations. This includes the Universal Declaration of Human Rights, the two Human Rights Covenants and various thematic UN human rights and ILO Conventions. It is also noted that human rights exist at the global regional and national levels and that although normally congruent, there are a number of significant distinctions between these regimes. For the purposes of this chapter, it is the global framework that is the object of the focus, primarily because this is the platform for the emerging norm on the corporate responsibility to respect all rights.[1]

Second, it is noted that whilst the linkage of business activity to that of human rights is not a new phenomenon, in fact is centuries old, it is one that has come into particular focus over recent years. During the 1990s, the focus was mainly on two significant but relatively isolated parts of the business and human rights puzzle. The first being the globalization of supply chains and an awareness of the exploitation that existed 'out of sight and out of mind' two or three steps down the value chain from the consumers. This included allegations of child labour and sweat shops in the production of sports clothing and footballs – such as those produced by Adidas or Puma. The other area of interest was the role of oil companies in countries such as Nigeria, Indonesia, Colombia or Myanmar. In the early 1990s, Ken Saro Wiwa became one of the first international 'business and human rights' activists until he was executed by the military government in Port Harcourt on the 10th of November 1995.

Now nearly 20 years later, we are in a more strategic part of the agenda. Business and human rights – is not a specific problem or series of problems – but has manifest itself as a spectrum of dilemmas many of which are interconnected.

The Institute for Human Rights and Business[2] has observed a wide range of current policy and practice dilemmas in the field of business and human rights. The ten that follow are amongst those seen as most pressing at the start of 2010.

---

[1] *Protect, Respect and Remedy: A Framework for Business and Human Rights.* Report of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises, John Ruggie – United Nations, 2008, A/HRC/8/5.

[2] The Institute for Human Rights and Business, established in April 2009, is an emerging global centre for policy and practice in this field, www.institutehrb.org.

The Range of Contemporary Business and Human Rights Policy and Practice Dilemmas

This is not an exhaustive list. Rather it is an attempt to illustrate the range of such dilemmas.

(i) *The supply chain challenge*. The private auditing of labour rights in supply chains is important but is not, on its own, a sustainable solution to the systemic challenges facing the societies where international businesses are increasingly exposed. There is a need for better labour inspections by states, less audit fatigue caused by multiple compliance codes and also ways of reaching much deeper in supply chains by developing greater capacity amongst small and medium-sized companies. A number of multi-stakeholder approaches have recognised this reality and have worked to increase local and national capacity within global supply chains (for example the 'Jo-in' pilot between a number of retail supply chain initiatives[3] and the Global Social Compliance Programme initiated between leading supermarkets and their suppliers[4]) and national contexts (such as International Labour Organisation/International Finance Corporation 'Better Work' programmes[5]).

(ii) *The resource curse challenge*. Too many countries in South America, Africa and Asia are still cursed, and not blessed, by their precious resources such as oil, gold, diamonds and other precious metals and minerals. The correlation with corruption, conflict and the abuse of human rights is still significantly high. Efforts such as the 'Voluntary Principles on Security and Human Rights',[6] the 'Extractive Industries Transparency Initiative'[7] and the 'Montreux Document on Private Military and Security Companies'[8] are important but they are, by their own admission, only small parts of the picture. It is pertinent to ask whether the mistakes of oil and gas production in Nigeria, Columbia, Indonesia or Myanmar have been truly been learned now that there is considerable business investment in countries such as Libya, Venezuela and Angola? The 'extreme case' remains the Democratic

[3] The Jo-In pilot was conducted in Turkey between 2005 and 2008 and involved the Clean Clothes Campaign – Netherlands (CCC), Ethical Trading Initiative – UK (ETI), Fair Labor Association – USA (FLA), Fair Wear Foundation – Netherlands (FWF), Social Accountability International – USA (SAI) and Worker Rights Consortium – USA (WRC); www.jo-in.org.

[4] The Global Social Compliance Programme was launched in October 2007 and aims to be "business-driven programme for companies whose vision is to harmonise existing efforts. The aim is to deliver a shared, consistent and global approach for the continuous improvement of working and environmental conditions across all categories and sectors", www.gscpnet.com.

[5] These country-focused programmes bring together national governments, international organizations, suppliers and buyers; initiated in Cambodia, there are now programmes in Jordan, Lesotho and Vietnam; www.betterwork.org.

[6] www.voluntaryprinciples.org.

[7] www.eitransparency.org.

[8] http://www.icrc.org/web/eng/siteeng0.nsf/htmlall/montreux-document-170908/$FILE/ICRC_002_0996.pdf.

Republic of Congo, but governance challenges exist in a wide spectrum of countries associated with the extractive industries (such as those listed by the OECD's Development Assistance Committee). How do we more fully engage good practice with the Russian, Indian and Chinese extractive companies in a way that is respectful to their interests and not seen just as western protectionism?

(iii) *The engagement challenge*. The international community does not seem to be much closer towards agreeing the criteria needed for decisions around divestment: what represents legitimate positive engagement and what represents complicity in human rights abuses? Short of investment criteria being agreed within the United Nations, as is the case for specific aspects of trade relations with countries such as Iran, Somalia or the Democratic Republic of Congo, a wider of spectrum of human rights criteria often come into play in bilateral criteria for divestment or positive engagement. The USA has had a significant influence here, through unilateral initiatives such as the Sullivan Principles[9] (South Africa), MacBride Principles[10] (Northern Ireland) or the Sudan Divestment Task Force,[11] which influenced business behaviour more globally given the strength of US economy. The United Nations Principles for Responsible Investment[12] is one interesting attempt to create a leveler playing field within international investment, but it is still driven many by OECD-based financial institutions and not the key emerging economies. The real test will be to develop a human rights related framework for investment that is as relevant to Russian, Indian and Chinese companies as it to those based in Europe or North America.

(iv) *The extra-territorial accountability challenge*. The current mechanisms to hold businesses accountable beyond national jurisdictions are at present relatively weak.[13] The OECD Guidelines on Multinational Enterprises[14] are currently being reviewed, but the way that National Contact Points work varies greatly between states and business does not always listen to the opinions expressed. Some states, such as the USA and the Aliens Tort Claims Act (ATCA) already have civil law extra-territorial mechanisms but these are inappropriate to replicate in many other jurisdictions. What then is the range of extra-territorial mechanisms that should be embraced by states to keep business accountable for its actions in areas of poor or weak governance?

---

[9] www.thesullivanfoundation.org.

[10] www.1.umn.edu/humanrts/links/macbride.html.

[11] www.sudandivestment.org.

[12] www.unpri.org.

[13] The mandate of the United Nations Special Representative is compiling an overview of extra-territorial functions that can be explored by states. The initial work was outlined by Professor John Ruggie in his presentation to the European Union Corporate Social Responsibility hosted by the Swedish Presidency of the Union (Stockholm, 10–11 November 2009); www.se2009.eu/en/meetings_news/2009/11/10/protect_respect_remedy_-_a_conference_on_corporate_social_responsibility_csr. The accompanying Declaration cited the governmental interest in identifying appropriate extra-territorial mechanisms.

[14] www.oecd.org/department/0,3355,en_2649_34889_1_1_1_1_1,00.html.

(v) *The impact challenge.* Increasingly civil society is calling for greater disclosure of the entirety of a business' impacts on human rights. One example is taxation. If a company is supportive of human rights, but at the same time has policies for minimizing (or sometimes evading) the payment of tax to national governments, then this might be detrimental to the states' ability to fulfill human rights, in particular rights such as health, education, housing and work.[15] What then are the human rights implications of tax policy? More generally, the impact of corporate human rights policies will need to be measured and recognized for wider business take-up of such policies and also for civil society and governmental acknowledgement of their value.

(vi) *The legal conflict challenge*. European business' operating in other countries around the world sometimes find themselves in a direct contradiction between national law (or practice) and international law and expectations. There are many examples, such as privacy law in China in relation to information technology,[16] labour rights in the USA[17] or women's rights in parts of the Middle East.[18] Of course, companies from elsewhere in the world operating in Europe might find also that our local laws fall a little short of international norms on issues such as freedom of expression or the rights of migrant workers. What then should a business do, it has to follow national laws but how does it navigate international norms and when will we have a leveler playing field for all businesses regardless of where they are operating?

(vii) *The advocacy challenge*. Related to point six, is the expectation on companies to 'speak out' or 'advocate' on human rights issues. This is a very hard one. Business leaders do make confidential interventions with host governments, sometimes this relates to the human rights of workers or other stakeholders. However, it is often inappropriate for a business to discuss publicly that it does do this. Is there ever a concept of 'silent complicity' and if so how is this monitored?[19] This

---

[15] www.business-humanrights.org/Documents/Taxavoidance.

[16] For example, the Chinese Government agreeing to postpone the introduction of 'Green Dam – Youth Escort' programmes on all computers in China following an outcry from international IT firms and local activities (New York Times: 30 June 2009), the formation of the Global Network Initiative (www.globalnetworkinitiative.org) or Google's threat of divestment (Financial Times: 14 January 2010).

[17] Note, for example, the challenges of applying ILO Convention 98 on Collective Bargaining in workplaces in the USA.

[18] For example, UNICEF (2007) cites that the women earn only 28% of the average male wage in the Middle East and North Africa, the lowest ratio of any global region, *State of the World's Children*, UNICEF: New York. The extreme example is Saudi Arabia, where many jobs are prohibited to women.

[19] For example, much has been written about what Shell managers did or did not say to the military government in Nigeria in 1995 to prevent the execution of the civil society leader, Ken Saro Wiwa. There is still no consensus in the public domain for this or most other high profile cases as to what is an appropriate 'advocacy' role for business. See for example Lynn Paine and Mihnea C. Moldoveanu, 'Royal Dutch Shell in Nigeria Case Study', *Harvard Business Review*, 22 February 1999.

makes Google's public statements on human rights in China in January 2010[20] and its threat of divestment all that more significant. At time of writing it is too early to tell the consequences of this on wider business advocacy.

(viii) *The corruption challenge*. Some significant progress has been made in some areas of corporate governance and anti-corruption legislation and practice; although it remains a big problem in many countries. How can human rights help here? How do we integrate human rights into business ethics and to look at integrity measures and not just compliance?[21] It is interesting to note that some multinational companies have used business ethics, rather than 'corporate social responsibility', as their main paradigm for integrating human rights into business management.[22]

(ix) *The code fatigue challenge*. We have yet to develop a common way of measuring all of our human rights impacts. There is a lot of activity here across many supply chain codes, the Global Reporting Initiative and ISO 26000 but not yet convergence around a common series of benchmarks that cover the full range of human rights. The Business Leaders Initiative on Human Rights[23] was one attempt to do this.

(x) *The methodology challenge*. Finally, we also have the problem of competing methodologies. There is much talk now about Human Rights Impact Assessments but we have yet to develop quality control around what methods of assessment are truly aligned with human rights and which are not.[24] It is anticipated that Professor John Ruggie's work in 2010 and 2011 will develop a number of 'process principles' for guiding the development of business and human rights methodologies over the years ahead but there will remain the challenges of effective application and quality control.

Evidence of a Rule-Making Response to Business and Human Rights Policy and Practice Dilemmas

Given the dilemmas outlined above, it is interesting to reflect on how business has responded over the past 20 years and what are likely to be some of future developments in corporate related rule-making.

---

[20] *Financial Times*: 14 January 2010.

[21] John Sherman (2009) 'Embedding rights compatible grievance processes for external stakeholders within business culture', *Report No. 36: August 2009, Corporate Social Responsibility Initiative*, Harvard Kennedy School, Harvard University.

[22] Institute for Human Rights and Business, *Review of Business Experience in Applying Human Rights Due Diligence* (2010), forthcoming.

[23] www.blihr.org.

[24] BLIHR et al., Report of the Seminar on the Integration of Human Rights into Business Practice, 1–2 April 2009, hosted by the United Nations, Geneva. http://www.InstituteHRB.org/pdf/Geneva_Seminar_on_the_Integration_of_Human_Rights.pdf.

First Phase: Ad Hoc Responses by Individual Companies (1990–1996)

During the first half of the 1990s, most governments had a generally laissez-faire approach to business and human rights. Generally, the 1990s was a good decade for human rights – with the Vienna Conference in 1993 – bridging Cold-War definitions of human rights and getting back to the vision of the 1948 Universal Declaration. There were a number of new human rights conventions agreed in this period and the big human rights issue for states was when to over-rule the sovereignty of nations – i.e. when was it justified for the international community to intervene, be it in Somalia, Bosnia, Rwanda or Kosovo.

During this period human rights focus was very much on the state, and less on non-state actors such as business. Business responses were seen very much therefore as voluntary and not an issue of international law. This is reflected, for example, in the position taken by the European Union under Jacques Delors – a definition of 'Corporate Social Responsibility' (or CSR) that is by definition 'voluntary'.[25] Business was then protected from even the threat of regulation in this space. It was up to Nike, Reebok or Adidas, or Shell, BP or Total to find their own way of reacting to human rights challenges in communication (or not) with their customers, investors, employees and communities and others. It is in this decade that term 'stakeholder' came into being.

This first phase of business and human rights can be seen as one with little rule-making except at the level of individual business entities. It was at this time that the first corporate human rights policies came into being,[26] but these were largely reactive to circumstance.

Second Phase: Establishment of Multi-stakeholder Initiatives (1999–2003)

The 1990s ended with Kofi Annan's speech in Davos in January 1999 calling for 'a global compact' between business and the agencies of the United Nations. This was just a speech, but it was the 'anti-globalization' riots in Seattle that summer that brought the United Nations Global Compact into existence by the end of 1999.

This second phase, then, witnessed the creation of a number of so-called 'multi-stakeholder initiatives' (MSIs) – in which various constellations of states,

---

[25] This focus on 'voluntarism' is still reflected in the work of 'CSR Europe', for example, although a more rules-based approach to business and human rights has been introduced by the Swedish Presidency of the EU in November 2009, which a call for 'a smart mix of regulatory and voluntary approaches' (report from the Swedish Presidency forthcoming).

[26] Two of the first corporate human rights policies were Novo Nordisk (based in Denmark) and The Body Shop International (based in the UK).

businesses, NGOs and trade unions worked together on specific aspects of business and human rights. Perhaps the most enduring have been the Voluntary Principles on Security and Human Rights, the Extractive Industry Transparency Initiative, the Kimberley Process, the Fair Labour Association, the Ethical Trading Initiative and Social Accountability International. Such initiatives are still being created, such as the Global Networking Initiative in 2008 between Google, Yahoo, Microsoft and a number of human rights organizations and academics, but it was the turn of the last decade that saw the greatest activity.

All of these initiatives have had a rule-making function, beyond individual companies, and across specific business sectors. Although they are all ‘voluntary’ in terms of membership, they have created norms of expected behaviour for their sectors, and are increasingly the benchmarks for investors as well as other businesses that are not directly members. However, they do encompass a number of challenges both of governance and scale. Not all these initiatives are fully transparent about their impacts or their accountability to wider society. They represent a significant drain of resources for members, particularly the human rights NGOs – whose members and funders might not necessarily see the benefits of such pragmatic engagement and compromise. Perhaps the most fundamental challenge of all has been their lack of global representation. With the exceptions of the UN Global Compact and the ISO 26,000 process – which have truly global membership but are much weaker in their expectations on participants, most of the other MSIs are still dominated by states, businesses and NGOs from the global North (i.e. OECD members).

Third Phase: Early Rule-Making Discussions (2003–2005)

2003 saw an attempt by a group of experts, nominated by Governments under the then United Nations Rights Commission, to create a set of ‘norms’ on business and human rights – the ‘so-called’ UN Norms. Like throwing a frog into very hot water, the response from the global business community (and most states) was immediate and almost universally negative, exception that from human rights NGOs. The major criticism was that it seemed to place on business the same legal responsibilities that rested with Governments. A notable exception was the position taken by the business members of the Business Leaders Initiative on Human Rights (BLIHR), which agree to remain agnostic on the political process but positively inclined to testing the ‘content’ of the UN Norms. In 2006, these companies reported that much of the substantive content of the UN Norms was in fact useful, even if the proposed mechanisms of application and accountability were poorly thought through.[27]

[27] BLIHR, *Towards a Common Framework: BLIHR3 Report*. Business Leaders Initiative on Human Rights, March 2006.

Whilst the UN Norms were very divisive, they did have two lasting effects:

- They placed into the international debate on business and human rights, that the respective legal and non-legal responsibilities of states and businesses had to be clarified;
- They began to bring states back into the discussion and they have increasingly followed and, in some areas, led the agenda ever since.

Whilst the UN Norms were unsuccessful, therefore, there achievement was to create enough of a reaction to focus business, government and NGO minds on what came after.

Fourth Phase: The UN Business and Human Rights Framework (2008–2011) and Its Implications

In 2005, Kofi Annan appointed a United Nations Special Representative on Business and Human Rights, Professor John Ruggie.[28] Whilst the immediate response of states, business and NGOs was one of suspicion, he has played a very astute and fundamental rule-setting game that has set the foundations of the international business and human rights policy agenda for decades to come. Although John Ruggie has not found the answers to many of policy and practice dilemmas outlined in the first part of this chapter, he has asked the right questions and created a common policy framework upon which all actors now agree.

In his 2008 report to the United Nations Human Rights Council, Professor Ruggie sets out a human rights and business framework that sits on three pillars:

- The State Duty to Protect Human Rights in relation to the activities of business;
- The Business responsibility to Respect Human Rights;
- The need for effective remedies and access to justice for the victims of corporate-related human rights abuse.

Some of the fundamental implications of the content of this framework are:

- The framework addresses all human rights – any time, any place, anywhere – so he is talking about any size of business, any business sector and in any geography. This directly link to the Universality and Indivisibility of Human Rights, proclaimed by States at the 1993 Vienna Conference, is fundamental and challenges all those aspects of CSR that are ‘culturally relative’ in their normative content.

[28] Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises.

- The first pillar places a duty on states to align their trade, investment, foreign affairs, corporate law, taxation and other policies with their own human rights commitments. This includes relatively complex areas such as bilateral investment and trade treaties, export credit guarantees, corporate reporting and international development assistance. It recognizes that 'mainstream' governmental policies have often acted in complete isolation from international human rights law and sometimes such policies have contributed directly to the abuse of rights.
- The second pillar focuses on the corporate responsibility to respect human rights. Professor Ruggie goes to great pains to stress he is not just talking about voluntarism here – nor is it a responsibility that only applies in relation to the state and its role. If businesses got to Mars before any state authority did, then the corporate responsibility to respect human rights would still apply directly to companies. This is important given the not insignificant number of states in the world that are unwilling or unable to fulfill their human rights duties.
- The third pillar brings into the fold the issue of legal and non-legal mechanism to hold business accountable. This includes best practice in internal grievance mechanisms – whistle-blower protections and so on. But it also includes this very vexed question as to when a business should be held criminally (or civilly) response for their actions by their own government, or the government of another country in which they are operating or some 'third government' affected by their actions. It brings into focus a question which has arisen over the decades from the Nuremburg trials to South Africa to Rwanda to Bosnia and now the International Criminal Court – when can businesses or business leaders be legally complicit in the human rights abuses of others?

This United Nations Framework is seen by the International Chamber of Commerce, the International Organization of Employers and many major companies directly as an essential part of the 'leveler playing field' moving forward. It creates greater business certainty moving forward and also allows for better management of non-financial and reputational risks. This is increasingly driven by the role of business in the key emerging markets, and in particular the 'BRIC' countries of Brazil, Russia, India and China. Where there are differences, it is to how or whether states should regulate not just their own activities but also those of businesses operating in their territory and possibly beyond.

Fifth Phase: Future Developments (2010–2020)

Some of the big business and human rights rule-making challenges for the years ahead are:

- Much greater take up by companies in emerging economies. Efforts like the Global Business Initiative on Human Rights[29] is part of this process, and is the

[29] www.global-business-initiative.org.

increasingly leadership of companies in countries such as India, South Africa and Colombia.

- Greater clarity on the precise thresholds between what is expected from business under its responsibility to respect. Are there something akin to 'safe harbours' for business if all the human rights due diligence has been adequately undertaken? If the primary duty to protect should always reside with states what does that mean if it fails to do so? This poses a wider challenge of governance challenges and expectations states can have each other to intervene or hold each other to account. What is the threshold for corporate complicity in any abuses under its own responsibility to respect human rights?
- Clarifying the responsibilities of state-owned companies – in particular those in Joint-Venture partnerships;
- What should be the expectation on small and medium-sized enterprises around the world and in the supply chains of all the majors;
- Is there a need for extra-territorial mechanisms? Following the Trafigura case in Cote d-Ivoire there is renewed interest in ways of holding European companies to account for their actions elsewhere (i.e. the Dutch Government is currently attempting to use the OECD Anti-Bribery Convention to do this in the case of Trafigura);
- When should businesses make tough business decisions based, in part, on human rights issues? This is what makes the current Google in China discussion very interesting.
- Businesses, states and NGOs working more closely to see what really works on the ground – what are the kind of partnerships that really have sustainable impact in the lives of vulnerable people in specific localities (note, for example the impact studies that Coca-Cola are doing with Oxfam in Zambia and El Salvador; or that undertaken by Unilever with Oxfam in Indonesia).

Chapter 3
Politicization of Companies? Empirical Evidence on Corporate Citizenship Activities in Europe

André Habisch

Abstract This chapter critically discusses the thesis of 'politization of companies' developed by some academic scholars. The Good Company Ranking' of Manager Magazin screened the social engagement of EuroStoxx and DAX listed companies biannualy from 2005 onwards. The architecture of the Ranking in general and the criteria for Corporate Citizenship Engagement in particular are explained. Drawing on best practice cases and tendencies of Corporate Citizenship Engagement derived from the ranking the business logic of CC is described. In spite of a academic conceptualization the chapter pledges for more careful analysis of real world projects and proposes first analytical tools in that respect.

Keywords Corporate citizenship · Corporate social responsibility · New governance · CSR ranking · Business case · Value creation

Preface: Some Remarks on Recent Developments in International Corporate Citizenship Research

The international discussion on Corporate Citizenship and Corporate Social Responsibility has not been invented by academic scholars; rather companies themselves – large as well as small and medium ones – decided to take actions which today are summarized under these theoretical headings. Relevant activities include the ethical management of international procurement, Human Resource policies addressing special needs, Diversity Management, environmental management, social engagement in the local community or educational sector, corporate volunteering, investment in cultural infrastructure, environmental policies etc.[1]

First conceptual documents reflecting the increasing interest of companies in social issues were brought forward by or in close contact with NGOs, political institutions or Chambers of Commerce. Since the 1990s specialized organizations like the Prince of Wales Business Leader's Forum [now IBLF], the World Business

[1] See the selection of contributions in Habisch et al. (2007).

A. Habisch (✉)
Ingolstadt School of Management, Catholic University, Eichstaett-Ingolstadt, Germany
e-mail: andre.habisch@ku-eichstaett.de

I. Pies, P. Koslowski (eds.), *Corporate Citizenship and New Governance*,
Ethical Economy. Studies in Economic Ethics and Philosophy 40,
DOI 10.1007/978-94-007-1661-2_3, © Springer Science+Business Media B.V. 2011

Council for Sustainable Development and later the UN Global Compact are playing an important role as promoters of the concept. In Europe, national institutions and regional networks like Business in the community [UK], the Copenhagen Centre [Dk], RespAct [A] and others became relevant (for an overview see Habisch et al. 2005). A recent milestone has been the constitution of a national advisory board for CSR in 2008 and the subsequent publication of the CSR strategy of the German Government in October 2010.

Even if the Corporate Citizenship concept originated in practical concerns and the necessity for companies to react to problems of globalization, more recently academia seems to have taken over. In the last 5 years or so a wave of publications popped up integrating the topic into overarching intellectual architectures. It seems that academia and business practice have developed disconnected from each other, without being constantly reconciled, like two ‘parallel universes’ (Waddock 2004). Several features characterize the trend in extant Corporate Citizenship literature:

- It is based on a broad interdisciplinary literature with a certain focus on political science and (political) philosophy (e.g. Scherer et al. 2006).
- It is somewhere less interested in issues of intra-organizational dynamics or implementation problems of Citizenship strategies.
- Even if cooperative relations with NGOs, Governments and external stakeholders play an important role in the academic discussion, empirical evidence on the reality of stakeholder dialogues in Europe (Maignan and Ralston 2002) is scarce, few cross-national studies (Boesso and Kumar 2009) have been conducted.
- It is dominantly focusing on a ‘global’ level – employing concepts like ‘Global governance’, ‘Global citizenship’ etc. Correspondingly it is pointing dominantly to Citizen-ship programs of large multinational companies.
- It refers to traditional political and social philosophical concepts, but rather makes them unfamiliar for example by calling for a ‘politicization’ of companies.

Thus, recent academic Citizenship literature provides information on what companies apparently should do rather than what they are actually doing (O’Riordan and Fairbrass 2008: 749). It is definitely the major challenge of academic research on Corporate Citizenship and Corporate Responsibility to come up with conceptual tools to better understand the potential dynamics and multiple social roles of companies. A trans- and interdisciplinary approach integrating philosophy, economics, political science, social ethics etc. seems to be especially helpful, here (Homann et al. 2007). However, the limits of the concepts described are also obvious:

(a) In Germany – as in many national economies of the world – more than 90% of companies are of small and medium size, providing more than 70% of employees. These companies are mostly run by the owner – entrepreneur. Their social activities follow a merely pragmatic approach aiming first and foremost towards value creation. Existing literature on Corporate Citizenship should take cognizance of this bulk of activities (see e.g. Spence et al. 2004, Mandl and Dorr 2007, Morsing and Perrini 2009).

(b) As mentioned above, empirical analysis concerning real existing programs and activities of companies seems to play a minor role in Corporate Citizenship research at the moment. Backhaus-Maul et al. (2008: 27) report a lack of empirical studies in Germany. Research should not lose touch with business practice but rather carefully elaborate concepts based on a rigorous empirical analysis. This might be done by large quantitative studies that screen the range of existing activities (thematic focus, modes of interaction, results within companies as well as in the social environment) as well as qualitative in-depth-studies that carefully elaborate the internal logic and motivations of Corporate Citizenship engagement.
(c) The role of 'cultural capital' for the scope and impact of Citizenship should be taken into consideration more explicitly. This includes institutional aspects like legal frame-works for companies as well as religious or ethical motivations of actors (see Bertelsmann Stiftung 2007, Visser and Tolhurst 2010).
(d) Finally a certain 'normative bias' is observable within the literature. In many articles a mere 'instrumental' approach of companies towards their engagement is perceived as inferior compared to an explicitly normative perspective that dominates in the political realm. The call for a 'politicization' of business seems to be guided by the desire to strengthen the later. However, scientific rigor might get lost if a too outspoken normative agenda is dominating research.

Empirical Evidence on Corporate Citizenship Activities: Qualitative Criteria of the 'Good Company Ranking'

The Structure of the 'Good Company Ranking'

The Center for Corporate Citizenship at Ingolstadt (http://www.corporatecitizen.de) has been established in 1999 and has since then focused on empirical research concerning Citizenship and CSR. The Center has been engaged in a series of ranking activities in cooperation with the business press for nearly a decade. In 2001 the emergence of the 'Initiative Freiheit und Verantwortung' ('Freedom and Responsibility') of the large German business associations has been stimulated in cooperation with the business magazine 'WirtschaftsWoche'. Under the patronage of the President of the Federal Republic of Germany prices are granted for the best Corporate Citizenship project in three categories: Small, medium and large companies. The initiative 'Freedom and Responsibility' has contributed considerably to the constitution of a wider audience for the concept of Corporate Citizenship in the German public. The Center for Corporate Citizenship scientifically accompanied the initiative until 2005 and evaluated more than 200 applications from companies of all size during that time.

In 2005 the 'Good Company Ranking' was called into existence by a Hamburg based communication agency together with another leading German business magazine 'ManagerMagazin'. CSR concepts of large European companies are

assessed and ranked every second year. Results are regularly published in the ManagerMagazin and even discussed during international events like a workshop during the 2007 World Economic Forum at the World Economic Forum at Davos. The ‘Good Company Ranking’ is covering the 30 DAX listed German companies and all companies listed in the STOXX index; some major privately owned companies were added according to certain criteria (see Kirchhoff Consult AG 2009).

Similar ranking activities, especially in the US are mainly based on peer-group assessment (see Gazdar 2006 for a more detailed analysis). In contrast to that rather subjective procedure the ‘Good Company Ranking’ is criteria based and tries to evaluate companies’ performance against objective criteria. Four main areas of evaluation have been fixed for the ranking:

1. Engagement for Society (‘Corporate Citizenship’)
2. Engagement for employees and their families
3. Responsible use of the natural environment and resources
4. Sustainable financial performance and transparency

While engagement for employees and financial performance is analyzed by practitioners and non academic analyst groups, the category ‘environmental responsibility’ is cared for by the Chair of environmental management at the University of Dresden (Prof. Dr. E. Günther). The Center for Corporate Citizenship is procuring the area ‘Society/Corporate Citizenship’.

In the context of the Good Company Ranking as a whole, some genuine aspects of ranking Society/Corporate Citizenship activities are obvious. Compared with established dimensions of sustainability management (like financial aspects, employee-orientated policies and environmental performance) criteria for Citizenship have only recently evolved. Likewise, dedicated management systems are not yet in place in many companies. Therefore it is more difficult to identify quantitative indicators. Qualitative assessment – ideally generalizable among different persons – is playing a more important role, here. For many external observers, reliance on qualitative assessment is of course problematic and should be gradually substituted by quantitative performance indicators.

Business Impact Related Indicators of Corporate Citizenship Practice

Within the ‘Good Company Ranking’ the criteria concerning Society are divided into three broad categories: Business case, Social case, Transparency and credibility.

(a) The *business case* aspect assumes that in the context of a market economy Corporate Citizenship engagement is expected to contribute to value creation and a strengthened competitive position of the corporation. Hence, a market

Society/Corporate citizenship	Quality of strategic approach Broad implementation Innovativeness of programs Social embeddedness Stewardship Communication/transparency	25%	Center for Corporate Citizenship (CCC), Ingolstadt
Employees	Strategy and principles Instruments Results and impact Communication	25%	Kaevan Gazdar, Munich, research fellow at CCC
Environment	Integration into overall strategy Operational environmental care Ecological innovation Dialogue with stakeholders Environmental communication	25%	University of Dresden Business School
Financial performance	Capital-asset-ratio EBIT/return in investment Total shareholder return Growth and volatility cash flow Communication and transparency	25%	Kirchhoff Consult AG, Hamburg

Fig. 3.1 Own illustration, areas of evaluation for the Good Company Ranking

economy is accepted as a social order, in which social goals are attained via the implementation of rules of competition (Koslowski 1998, Pies 2000).

Based on a similar attitude towards the market economy Porter and Kramer (2002, 2006) have laid theoretical foundations for a concept of ‘Strategic Philanthropy’. The authors criticize a widespread practice of Corporate philanthropy which is exclusively orientated towards personal preferences of Chief Executive Officers, their wives (‘CEO wife’s syndrome’) or other leading figures in the company. According to Porter and Kramer spending stakeholders’ money for the personal preferences of top management cannot be legitimized. Rather social engagement of companies should contribute to value creation and/or problem solving in the social environment – for example by providing better education or confronting environmental problems at a production site. In their view it is precisely the ‘business case’ of Corporate Citizenship which legitimizes corporate social commitment.

The alignment of programs with the economic goals of the company treats Corporate Citizen-ship as an investment strategy, which is also congruent with shareholder’s interest rightly understood. Moreover, integration of Citizenship programs into the architecture of internal value creation is a crucial prerequisite of a sustainable social impact. Only well designed projects which fit into the overall

vision and which obviously make sense for the company will 'survive' a change of responsible management.

Continuity of programs is a very important condition of Citizenship to achieve a sustainable impact inside and outside the company. Fast-changing activities will neither frame the Corporate Identity nor will it be identified with the firm's appearance. Moreover, only projects with a 'strategic fit' will be able to achieve a certain impact outside of the company. As in many other disciplines, also in Corporate Citizenship learning curves are exponentially sloped: the longer a certain type of engagement is kept up by the company, the higher is the potential impact as failures are minimized and professional behavior is acquired.

The Good Company Ranking's first two criteria of Good Corporate Citizenship ('orientation towards the *business case*') follow those theoretical considerations. The first criterion identifies a strategic concept underpinning reported projects and its foundation in the overall business strategy of the company. The second asks whether existing programs or Corporate Citizenship activities are broadly implemented in the company, creating as many interfaces with the operational processes of value creation as possible. It is assumed that successful engagement has to be firmly anchored within top management (Lunau and Wettstein 2004). If the Citizenship concept is integrated into the overall business strategy of the company (crit. 1) and the implementation into the organizational architecture of the company is professionally executed (crit. 2), the value of the activity for the company is supposed to be higher. Similar indicators of sustainability rating, employed for the SAM rating of the Dow Jones Sustainability Index (DJSI) or by the Global Reporting Initiative for the International GRI reporting standards, are supporting these criteria.

Social Impact Related Indicators – The Social Case of Corporate Citizenship Practice

Even more recent than the evolution of business case related indicators of Corporate Citizenship activities is the assessment of social impact factors ('Social Case'). Only very sparse quantitative evaluation exists concerning these issues. That deficit is not only a consequence of lacking measurement instruments but also due to a lack of fundamental theory. Basic questions concerning the potential role of business in society have to be answered if this gap is to be closed. Conceptual statements concerning the potential role of companies in the social fabric of a modern society are necessary.

As indicated above, the widespread summation of CSR academics for a more political role of companies is heading in the wrong direction, here. A politicization that blurs the conceptual line between business and politics is fraught with several conceptual problems. Instead of overstretching the category of politics it is necessary to better understand the role of civil society for the solution of social problems in general and the emergence of rules in particular.

Consequently the Good Company Ranking is based on a conceptual decision to attribute Corporate Citizenship activities to the realm of civil society. It is understood as a problem orientated activity, which may detect innovative approaches to confront social problems. Civil society does not strive to substitute government programs of social policy rather it may be seen as the ‘laboratory’ to develop those policies. Activities within civil society always remain voluntary – for better or worse. Therefore, Corporate Citizenship engagement is fundamentally different from any political activity in both its rule setting as well as its allocation function. With their social engagement companies are acting not as a substitute but rather as a complement of state administrations. They trigger ‘collective learning processes’ which help innovative solutions to emerge and knowledge to be created. This knowledge may sometimes be used for the optimization of government programs or the creation of new laws within the political process; however it always remain generically different from politics. In a similar vein, Backhaus-Maul et al. (2008: 20) perceive the companies’ aim to overcome dilemma situations as a possible driver for voluntary corporate commitment. Therefore, problem orientated innovation is chosen as one of three criteria (crit. 3) for the social impact part of the Ranking (crit. 3–5).

The second social case criterion of the ‘Good Company Ranking’ is referring to capacity building in the social environment (crit. 4). This notion is also following the lines of Corporate Citizenship as a part of Civil Society and is built on Social capital literature. Political scientists like R. Putnam (1993, 2000) and 2009 Nobel Prize winner E. Ostrom (1990, 2005) have emphasized the role of civil networks of cooperation and mutual trust for the successful political and economic development of a region. Structures of effective self-regulations and active networks of civil society are a vibrant social factor. Within the evaluative process of the Good Company Ranking, special interest is paid to:

- The connectedness of corporate activities with external partners (NGOs, educational sector, government agencies etc.),
- the implementation of issue-orientated networks and
- The emergence of social capital.

Even successful civil society projects which target a certain social problem will rarely achieve more than a regional and short term social impact. As they are restricted to a limited scope in time and place, they may only trigger larger transformational processes in society if they serve as point of reference for imitation. Issue-orientated networks provide the context in which corresponding processes of collective learning may be organized in that respect. Those net-works are of growing importance given the deep transition the balance between the ‘traditional’ social institutions – government, business, civil society – currently undergoes (Habisch and Jonker 2005). Therefore companies as Corporate Citizens should join forces with NGOs, government agencies etc. in order to pool resources and ensure a sustainable effect of common operations. Investing in specialized social capital is a very tangible aspect of professional social engagement.

Another aspect of Corporate Citizenship relevant for the Good Company Ranking is Steward-ship and public communication (crit. 5). Citizens are not only acting in their own immediate social realm. Rather they are also participating in the general discussion of society. They can put problems on the public agenda and they may do so especially with reference to 'forgotten groups or issues'. That kind of 'stewardship' is stimulating public discussion and – in the age of the information society – may serve as a concrete contribution to overcoming the marginalization of certain groups. Alternatively the Corporate Citizen may make use of his superior access to information and share it with society in order to raise awareness about certain aspects of the common good. This may result in the creation of innovative educational processes and/or organizing discussions in cooperation with other civic groups or organizations.

Within the framework of the Good Company Ranking a last point of excellent Corporate Citizenship is transparent reporting (crit. 6). This includes the evaluation of reports by external observers, various forms of external communication and a well accessible internet communication. Transparency may be perceived as an investment in the most fundamental asset of Corporate Citizenship activity, which is credibility. In a way, every Corporate Citizenship program primarily aims at the creation of credibility. Sustainable engagement for well de-signed and strategically implemented projects is of crucial importance in that respect.

Corporate Citizenship Performance of European Companies: Evidence from the Good Company Ranking

In this section of the chapter the criteria of the Good Company Ranking are exemplified with best practice of European companies. We do not state, however, that the companies mentioned here are exemplary in every aspect of their performance. Rather we make use of some aspects of their Citizenship performance in order to illustrate the logic of the criteria which are divided into three broad categories – Business case, Social case, Transparency and credibility – and subdivided into further aspects (see Fig. 3.2):

Business Case – First Criterion: Strategic Management of the Activities

Corporate Example: Ericsson

One of the most active corporate citizenship branches is telecommunication and IT. There are several reasons for that finding. First, telecommunication and IT companies are employing young technically orientated people that are driving the citizenship agenda with a lot of dedication. Second, IT is a young business sector

Fig. 3.2 Ranking criteria, area Society of Good Company Ranking

Business case

- Strategic management of the activities
- Professional implementation within the company

Social case

- Problem definition and innovation factor
- Capacity building in the societal environment
- Stewardship and public communications

Transparency and credibility

- Transparency and credibility

with a large growth potential especially in developing countries which drives the business case. Innovative communication tools lend themselves easily to projects of education, fight against poverty, disaster relief etc. Therefore it is not too difficult to link the corporate citizenship agenda with the core business of these companies. Another aspect should be mentioned: telecommunication and IT companies head-quarter in societies which score highest on a general trust index like the Scandinavian countries, California or the UK (see e.g. Delhey and Newton 2005: 315ff). Citizenship and CSR helps them to sharpen their profile in a social context of a society that highly esteems civic engagement. Pars pro toto the Swedish telecommunication provider Ericsson will be mentioned here.

In Ericsson's Corporate Responsibility and Sustainability Report 2008 we read (Ericsson 2009: Preface):

> Our vision is to be the prime driver in an all-communicating world. This means a world in which any person can use voice, text, images and video to share ideas and information whenever and wherever wanted. As the leading supplier of communication networks and services, Ericsson plays a vital role in making such a world a reality.

It is further explained (Ericsson 2009: 1) that:

> Sustainability requires vision. Ericsson's vision reflects our ambition to use technology to change lives for the better. We want to use our voice to show leadership, and we want to listen to others – to hear their side of the story. We believe our commitment to sustainability creates enduring value.

Here, Corporate Citizenship elements are already integrated into Ericsson's business vision. To illustrate that mutual linkage further a previous CSR statement from 2007 stated:

> To understand better Ericsson's philosophy toward corporate responsibility, you should think of these commitments not as costs but rather as investments. We carry out our corporate social responsibilities diligently because we believe that they do not lower profits; quite conversely, they are essential to sustainable value creation [. . .] In this case, the products

> that we create for less-developed regions are also suitable for rural areas of more developed countries, enabling us to expand our market in both developing and developed markets. This makes the initiative a real business opportunity, not philanthropy or charity.

Thus, Corporate Citizenship at Ericsson does not remain in the status of a mere add-on but rather directly influences the way Ericsson perceives the relationship with their larger social context. Business and citizenship engagement serve as two roads to that ambitious goal.

In the eyes of many observers these statements might not distinguish themselves from the usual PR phraseology of many corporate websites; however, if you check for the project port-folio of Ericsson's Corporate Citizenship engagement, credibility is strengthened by the mutual fit of vision statements and sustainable engagement. Even if the CSR report of Ericsson is currently (2010) somewhere outdated, the corporate website reports from the Ericsson affiliate company Testra to support initiatives training elderly people to use online technology, the Turkish affiliate Turkcell to use its IP to strengthen disaster relief, and numerous Ericsson projects for the development of 'Bottom of the Pyramid' markets. Ericsson supports the Global Business Leader's Initiative for Human Rights and cooperates closely with the Columbia Universities' Earth Institute to participate in the Millennium Villages Project, an initiative to support the Millennium Development Goals (MDGs).

As a résumé, Ericsson shows a close connection between core business and its Citizenship activities, based on a clear strategy of investing into the societal framework.

Corporate Example: Banco Santander

Spanish bank Banco Santander provides another example for a strategic focus of activities. A large internet portal 'Universia' connects about 10 million students and researchers at Spanish and Portuguese speaking universities world-wide. University cards facilitate scientific ex-change. Another internet portal 'cervantesvirtual.com' pools Spanish and Latin American culture – more than 28,000 books have been digitalized and offered for download since 1999. Even though Banco Santander does not explicitly reflect this aspect in their CR reporting, a clear business case orientation is obvious: an interesting clientele is addressed as university students will constitute the wealthy class of society and represent interesting clients for the bank. We know about lock-in effects of young clients especially in banking and telecommunication, who use to stick to their original service provider for many years: therefore reaching out towards future elites in their core business area, the Spanish speaking countries can be seen as an interesting business strategy for Santander. Accordingly Banco Santander manages its activities in a strategic way, and considers longer commitments as value-creating (Banco Santander 2009: 50):

> The Bank adapts the objectives and goals of local projects to each country's social and economic circumstances. In most cases, the programmes are medium-and long-term, which determines the limits of one-off sponsorships.

Corporate Example: Intesa San Paolo/Banco Unicredito

Italian economy has a high percentage of small and medium enterprises: 95% of Italian firms employ less than 9 members of staff, their workforce nearly constitutes half of a country's employed population.[2] In order to include stakeholder expectations into business operations and stay in close contact with relevant societal groups, several Italian banks installed Regional Committees' aiming at the creation of local networks. Committees include intellectual elites and have the potential to contribute to the production of local public goods, e.g. by elaborating a touristic concept for a region or a Public-Private Partnership for traffic infrastructure. Another commitment of Unicredito provides an example for smart business case orientation: The Foundation for Italian Quality' assembles local entrepreneurs, artists and civil society leaders. The purpose of the foundation is to come up with practical solutions to confront competition from low-salary countries in Asia which threatens many Italian companies, an apparent challenge of Globalization. Moreover, the Foundations aims at opposing the rhetoric of decline which is widespread among Italian SMEs struggling to maintain their international competitiveness threatened by Chinese imitators who often do not respect intellectual property rights.

In order to include stakeholder expectations into business operations, Intesa San Paolo places a strong focus on including various relevant stakeholders (Intesa San Paolo 2009: 8):

> The 'value' to be protected refers to all categories of stakeholders. [...] It is our belief that, in a complex and changing society, our customers and all those who form the social fabric within which the Bank operates can play a key role in achieving the goals we have set for ourselves by listening to the opinions of the people who work alongside us.

The satisfaction of regional needs is clearly seen as a strategic advantage (Intesa San Paolo 2009: 9):

> The Corporate Social Responsibility Report is the culmination of a process consisting of hundreds of projects and initiatives that bear witness to Intesa San Paolo's ability to provide ser-vices capable of supporting local economies and satisfying the needs of profoundly disparate situations, and it does so without neglecting those who have always had the greatest difficulty in securing access to credit: immigrants, young people, the unemployed and the elderly. It is clear that the satisfaction of the needs of local communities has once more become a strategic qualifying factor for all banks.

Furthermore, Intesa San Paolo is committed to the creation of Social Report Focus groups and Multi-Stakeholder Forums (Intesa San Paolo 2009: 36). Relevant topics are discussed with stakeholders, e.g. employees, customers, SMEs, universities and trade union representatives. By inclusion of various stakeholders and top management, the bank is able to anticipate relevant challenges affecting the bank's business activities. On an international scale, Intesa San Paolo's subsidiary CIB

[2] ISTAT (2001) 8° Censimento Generale dell'Industria e dei Servizi 2001. Rome: Istituto Nazionale di Statistica.

Bank set up a stakeholder engagement initiative in close contact with community organizations in Eastern Europe.

Overall, Intesa San Paolo emphasizes close ties between the company and relevant actors affecting or affected by its business operations, and handles this process of balancing stake-holder expectations with a clear strategy.

Business Case – Second Criterion: Professional Implementation Within the Company

Corporate Example: Danone

A very good example for a professional implementation of Corporate Citizenship into the internal management system is the DANONE Way. The program of the French alimentary group was launched in 2001 to enable business units to define concrete social objectives and link business strategy and sustainability more effectively, with the participation of stakeholders in the local context. Today the program is extended to more than 90% of all business units, all of which define clear objectives to link business strategy and sustainability more effectively. Moreover, throughout the consolidation of data, DANONE Way enables the group to identify areas for improvement by defining new targets to meet expectations of stakeholders, such as the respect of Fundamental Social Principles for suppliers or Diversity as a powerful level for success. Stakeholder participation facilitates clear and faster perception of environment and precise analysis of optimization potential.

Danone considers its management system an important part of corporate culture, and mentions the need for constant dynamic adoption to real market situations (Danone 2009: 34):

> The decision to change the method comes from the belief that Danone Way Fundamentals, ingrained into the DNA of the Group reflects the culture and dynamic strategy of Danone, which does not remain immobile. [...] Danone thus anticipates a trend of rising standards of corporate social responsibility. External communities, stakeholders and even employees expect the company to pay more attention to these issues and demonstrate greater involvement in the search for possible solutions to societal problems.

Corporate Example: Anglo American

The British-Canadian extraction trust Anglo American has implemented the management sys-tem SEAT (Socio-Economic Assessment Toolbox).[3] Launched in 2003 and enhanced in 2007, SEAT is in place at 60 Anglo American sites in 16 countries from Australia to Zimbabwe. Its key steps include:

[3] Freely accessible at http://www.angloamerican.co.uk/aa/development/society/engagement/seat/seat_toolbox2.pdf (Accessed 05 November 2009).

- profile operations and host communities,
- identify and engage key stakeholders,
- assess the impacts of operations and the community's key socio-economic development needs,
- develop a management plan to mitigate any negative aspects of the company's business presence and to make the most of its business operations,
- work with stakeholders and communities to help addressing development challenges they would face even without commercial presence,
- produce a report with stakeholders to form the basis for ongoing engagement with and support for the community.

Several hundred managers participated in SEAT workshops in Australia, Brazil, Peru and South Africa and have been trained on the most recently updated methodology. Moreover, Anglo American installed 'Social Forums' connecting more than 200 managers and civil society leaders around the respective business units. Main field of discussion is how to apply core competencies in order to create employment opportunities. In case of closure of a business unit, Anglo American commits to create substitutive employment.

Social Case – First Criterion: Problem Definition and Innovation Factor

Corporate Example: Bayer

German pharmaceutical company Bayer provides a good example for problem orientation and the innovation factor of Citizenship activities. Tackled issues are highly relevant in the respective countries of operation and lie within the company's core capacities: Hunger, poverty, diseases (Malaria, AIDS), or LIBRA initiative against antibiotics resistance. Moreover, Bayer offers qualification initiatives in Rhineland (Germany) for unemployed youth ('Second chance'): Evaluation proved that about 80% of involved young people did find jobs after running through the program. The aspect which differentiates 'Second chance' from many public sector programmes is Mentoring: each participant is guided by a mentor throughout the qualification process. In Brazil, Bayer tries to motivate pupils to attend school in the morning by arranging training with soccer stars in the afternoon. A joint project with WHO and National Geographic Germany against Malaria represents innovativeness: international scientists were challenged to come up with innovative ideas to protect drinking water (2005).

Bayer strives for combining its Citizenship engagement with core business (Bayer 2009: 6):

> In order to ensure that Bayer's expertise can be used to the greatest possible effect, we are looking to align our core business even more systematically than before to sustainable development criteria.

Social Case – Second Criterion: Capacity Building in the Social Environment

Corporate Example: BASF

In 1996 the German chemical giant BASF developed the Eco-Efficiency Analysis. The goal of that analytical tool has been to assess the sustainability of BASF's products and processes. Since then, over 350 analyses have been carried out: internally for BASF business units but also for external partners and customers. The analysis is a comparative method; the advantages and disadvantages of alternative productions are assessed according to a predefined customer benefit. The analysis uses a Life Cycle Assessment approach with the whole life cycle of a product – from cradle to grave – being considered. All economic factors as well as the environmental impact are taken into account. BASF has conducted Eco-Efficiency Analyses for important products in 90% of the business units carrying out a total of approximately 40 analyses per year; moreover, even a label has been developed to mark ecoefficient products.

Recently, Eco-Efficiency Analysis has been further developed towards SEEBALANCE (Society, Ecology, and Economy) which also incorporates relevant social criteria such as lost time accidents, training levels, spending on research and development, equal opportunities as well as wages and salaries. With SEEBALANCE, companies can calculate costs and environmental impact alongside the social effects of products and production processes.

Why do Eco-Efficiency and SEE-Balance as internal analytical tools have any relevance for Corporate Citizenship? BASF does not restrict itself to employing them in its own research and development activities; rather the company also regularly builds up educational capacities to introduce business partners in developing countries into this methodology. For example, textile companies in Northern African countries are educated to employ the tool in order to qualify for the environmental standards of the European Union's textile markets. In June 2005, the Espaço

Fig. 3.3 SEEBALANCE, retrieved from http://www.basf.com/group/corporate/de/sustainability/eco-efficiency-analysis/seebalance, November 10, 2009

Eco Foundation was inaugurated aiming at environmental education, eco-efficiency and reforestation activities in Brazil. Situated on an area of about 300 thousand m^2 and considered by UNESCO as ‘The Biosphere Reserve of the Green Belt of the State of São Paulo’ the Foundation is located behind BASF’s Coating Complex in São Bernardo do Campo’s city. BASF also participates in global networks, e.g. UN Global Compact and UN Habitat, as well as on a national scale, e.g. Econsense in Germany. Another network, ‘Wissensfabrik’ (‘Knowledge factory’) in Germany consists of 50 companies and was founded in 2005. Involved companies support education institutions by Mentoring programmes or education partnerships, aiming at pooling of knowledge and ideas in order to have an impact on education and knowledge at the governance level.

Corporate Example: Deutsche Telekom

Another example for Capacity building is the German telecommunication provider Deutsche Telekom. Participation in various networks is widespread, e.g. UN Global Compact, Econ-sense (Germany), telephone counseling, Community Roundtable Programme on antennas.

Deutsche Telekom focuses on the area of education. The initiative ‘Schulen ans Netz’ (‘Schools go online’) was started in cooperation with the Federal Ministry of Education and Research in 1996. The programme has shown constant development – from initial provision of internet access for schools to methodological skills training for teachers. For more than a decade the initiative has offered an important contribution to the integration of information and communication technology in schools. This is consistent with a strong focus on core capacities (Deutsche Telekom 2009: 27):

> We focus our social commitment on areas where we can make a significant contribution to the sustainable, viable future development of society through our core business, knowledge and economic power. We are committed to enabling as many people as possible to access and actively participate in modern ICT.

Deutsche Telekom’s Flagship project 2009 ‘Yes, I can!’ (‘Ich kann was’) focuses on individual skill development of children from disadvantaged economic and social backgrounds. Financial support is provided for projects chosen by an external jury.

Social Case – Third Criterion: Stewardship and Public Communications

Corporate Example: Shell Foundation

Indoor air pollution (IAP) is affecting no less than 3 billion people in developing countries (see http://www.who.int/indoorair/en/index.html). In India alone, almost half a million people a year die prematurely due to breathing smoke from cooking and heating with biomass fuels such as dung, wood, crop residues and coal. Despite

such a worrying death toll, there is little awareness of IAP throughout the sub-Continent. And in the developed World compared with media relevant catastrophes like the Tsunami, IAP is a non-issue.

In that situation Shell Foundation joined forces with around 100 of the world's key players in indoor air pollution (IAP) at the end of March 2008 to discuss new ways forward in the fight against killer smoke. The conference, held over 3 days in Bangalore/India, tackled awareness raising, improving technologies and the development of commercial markets as key priorities. Energy and health leaders not only reported on breakthrough achievements but also committed to challenging, future goals to reach the next stage of reducing indoor air pollution.

The Foundation helped engaged NGOs to organize a media briefing in New Delhi the day before the conference opened, communicating on TV, radio, and newspaper journalists that IAP was the fourth greatest health risk in the world's poorest countries. With more than 130 million households in India still using solid fuel for cooking, deaths caused by indoor smoke will continue to rise until more families turn to improved and more efficient cooking stoves, the media was told. The conference explained how important it is to maintain effective net-works with others involved in raising the visibility of indoor air pollution as a significant health risk (Shell Foundation 2009).

In Bangalore, the conference contributed to capacity building in multiple ways. Shell Foundation's Breathing Space team shared the charity's own strategy and solutions and learned from partners around the world how the global problem of IAP could be tackled. Shell Foundations activity may serve as an example of Stewardship as well as capacity building and investment in social capital as the activity clearly aim at strengthening issue-related networks worldwide.

Corporate Example: Volkswagen

German car producer Volkswagen has been engaged for more than a decade to implement the project 'Autostadt' (car city) which was set up in cooperation with the city of Wolfsburg. Autostadt created thousands of jobs and is still unfolding broad cultural and societal impact in the region. Innovative pedagogical methods are developed and adapted in numerous schools and youth facilities. But Volkswagen's initiative goes one step further: a transdisciplinary 'Curriculum Mobilität' (curriculum mobility) is elaborated in collaboration with the Ministry of Education in Lower Saxony. This represents the conceptual foundation of this Ranking criterion: learning experiences (here: new pedagogical concepts) are made available for a broader audience, with potential to be adapted elsewhere also in other parts of the county.

Final Criterion: Transparency and Credibility

Corporate Example: Shell

The British-Dutch Energy trust Shell, for the fourth successive year, has invited an External Review Committee to assess the content and the process of producing its

Sustainability Re-port. The assessment is presented in Shell's 2008 Sustainability Report (Shell 2009: 38f). Members express their views as individuals, not on behalf of their organizations. The 2008 committee included the Founder and Chair Business for Social Responsibility, business ethics academic from various countries, CSR managers from other companies. They are recovered their costs and an Honorarium is paid according to the time consumed.

Moreover, a rubric 'What the others say' runs through the whole CSR report: external observers or representatives of important stakeholder groups are granted the possibility to express their views or to report how they experience the policies and the behavior of the company. The inclusion of external persons – who have to worry about their own reputation as independent specialists – into the CSR reporting has a high impact on the creation of credibility. This courageous step may even be more effective than an expensive certificate of large Audit firms, which in general only attest the technical correctness of the information provided. The fact that Shell implemented an external review committee for the fourth time choosing different people each year is indicating that a culture of transparency has grown which enhances credibility.

Conclusion: Corporate Citizenship as a Part of Civil Society

In their classical contribution on business ethics Homann and Blome-Drees (1992) propose an ordo-ethical approach. They frame society-orientation (with high moral appeal of business activities) and profit-orientation (with a high return on investment) of corporate strategies as two axes creating a 4-area-matrix (see Fig. 3.4 below). The north-eastern area is marked by positive compatibility, in which

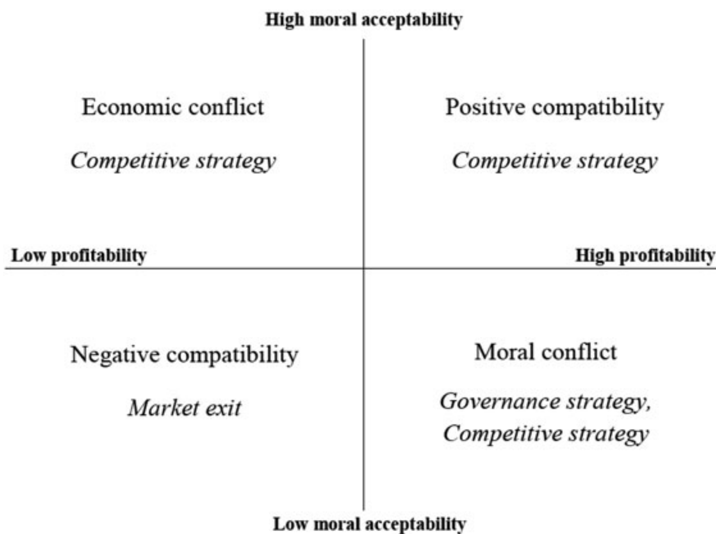

Fig. 3.4 Own illustration, based on Homann and Blome-Drees (1992)

a win-win-scenario between companies and society is realized. The south-east is a moral conflict area, in which straightforward economic interests of the company burden its public perception. In the north-western area of economic conflict a favorable public appearance is linked to a bad economic performance. In the south-west both impacts are negative – leading to an extinction of the company in the context of a market economy.

The authors propose two alternative strategies for the conflict areas: the *Competitive strategy* for both – economic and moral – conflicts and the *Governance strategy* for the moral conflict only. The former includes communication tools, which allow for the transformation of the company's ethical resources into economic advantages (by attracting highly motivated staff, satisfying clients, impress a general public etc.). The later includes overcoming dilemma situations of a branch by aiming at a transformation of the institutional and regulatory framework (f.e. by political initiatives, branch-wide codes of conduct, voluntary self-commitments etc.). It is the later, which has dominantly stimulated the public discussion and has very strongly influenced the German discussion on business ethics during the 1990s.

However, if we analyze the existing Corporate Citizenship programs of large companies under these criteria, the main emphasis has to be shifted. Relatively few activities are explicitly governance orientated and aim at changing the institutional framework of their social environment. Most of the examples refereed above are situated in the north-eastern 'win-win' area. Therefore, what Homann and Blome-Drees call the Governance strategy ('ordnungspolitische Strategie') is obviously rather exceptional in present Corporate practice, at least in those parts which are documented within the Good Company Ranking. The Competitive strategy – somewhere neglected by academic scholars because of low intellectual appeal – is much more important in day-to-day practice of Corporate Citizenship.

This analysis is confirmed by another observation: As companies quite seldom run Governance strategies, they quasi never overtly claim a political role within their constituency. Rather they carefully legitimize their activities in an ethical code avoiding even to account to the general public for their economic motivations. Companies generally avoid becoming identified with a certain political position – also because they fear being criticized by groups of stakeholders that oppose their position. Scholars who call for a politicization of companies – making the concept of politics unfamiliar in relation to the general use of the word – should reflect on the fact that this claim is somewhere contradicting the dominant self-concept of companies.

Instead of focusing on political governance an economic analysis might understand Corporate Citizenship activities as a contribution to the allocation of public goods or club goods. Social theory in the tradition of 2009 Nobel Prize winner E. Ostrom (1990) analyses the stability of cooperative but potentially dilemmatic arrangements like common pool resources even in the absence of an external enforcement agency. Citizenship projects lend themselves as interesting examples

in that respect. The creation of (additional) business value through corporate social engagement seems to be an important motivation, here.

Summing up, the dominant types of Corporate Citizenship activities we identified within the Good Company Ranking do not support an interpretation of Corporate Citizenship as a part of any ‘political’ role of the company. A dualism of market and state – so dominant in social and economic science – forces Corporate Citizenship in a Procrustean bed and does not grasp the peculiarities of corporate civic engagement. Academic research should not follow that road. Rather a careful study of corporate practices may serve as a point of departure for a renewed theory of business in the context of civil society; this includes a focus on

- The Role of regional identity including local ‘social capital’ (E. Ostrom) for the provision of public goods and the establishment of social order.
- The Role of Corporate Citizenship and social Entrepreneurship as Innovators who create knowledge for imitators as well as public actors.
- The importance of collective learning processes for the emergence of rules.
- The Role of Reciprocity (Bruni and Zamagni 2007) as a mode of inter-personal and inter-organisational exchange.

Careful analysis on Corporate Citizenship practice is needed. Beyond any fashionable phraseology academic research should aim at a more detailed understanding of what is actually transforming the relationship between socially engaged companies and their social context.

Acknowledgement I am grateful to Dipl.-Kfm. Christoph Schwarz for substantial input and redaction. I am of course responsible for all remaining failures.

References

Backhaus-Maul, H., C. Biedermann, S. Nährlich, and J. Polterauer. 2008. Corporate citizenship in Deutschland. Die überraschende Konjunktur einer verspäteten Debatte. In *Corporate citizenship in Deutschland*, eds. H. Backhaus-Maul, C. Biedermann, S. Nährlich, and J. Polterauer, 13–44. Wiesbaden: Verlag für Sozialwissenschaften.

Banco Santander. 2009. *Sustainability report 2008*. Madrid: Banco Santander, S.A.

Bayer. 2009. *Sustainability at a glance 2009*. Leverkusen: Bayer AG.

Bertelsmann Stiftung. 2007. *The CSR Navigator. Public policies in Africa, the Americas, Asia and Europe*. Gütersloh: Verlag Bertelsmann Stiftung.

Boesso, G., and K. Kumar. 2009. Stakeholder prioritization and reporting: Evidence from Italy and the US. *Accounting Forum* 33: 162–175.

Bruni, L., and St. Zamagni. 2007. *Civil economy. Efficiency, equity, public happiness*. Frankfurt: Peter Lang.

Danone. 2009. *Sustainability report 2008*. Paris: Danone.

Delhey, J., and K. Newton. 2005. Predicting cross-national levels of social trust: Global pattern or Nordic exceptionalism? *European Sociological Review* 21: 311–327.

Deutsche Telekom. 2009. *Corporate responsibility report*. Bonn: Deutsche Telekom AG.

Ericsson. 2009. *Corporate responsibility and sustainability report 2008 – Vision, voice and value*. Stockholm: Ericsson.

Gazdar, K. 2006. Das Good-Company-Ranking im internationalen Vergleich. In *Erfolgsfaktor Verantwortung*, eds. K. Gazdar, A. Habisch, K.R. Kirchhof, and S. Vaseghi, 51–58. Berlin u.A.: Springer.

Habisch, A., and J. Jonker. 2005. Introduction. In *Corporate social responsibility across Europe*, eds. A. Habisch, J. Jonker, M. Wegner, and R. Schmidpeter, 1–12. Berlin u.A.: Springer.

Habisch, A., J. Jonker, M. Wegner, and R. Schmidpeter, eds. 2005 *Corporate social responsibility across Europe*. Berlin, Heidelberg and New York: Springer.

Habisch, A., M. Neureiter, and R. Schmidpeter. eds. 2007. *Handbuch corporate citizenship*. Heidelberg, Berlin: Springer.

Homann, K., and F. Blome-Drees. 1992. *Wirtschafts- und Unternehmensethik*. Stuttgart: UTB.

Homann, K., P. Koslowski, and Chr. Lütge. 2007. *Globalization and business ethics*. Aldershot: Ashgate Publishing Limited.

Intesa San Paolo. 2009. *Social report 2008*. Torino: Intesa San Paolo.

Kirchhoff Consult AG. 2009. The Good Company Ranking. Evaluation of the Corporate Social Responsibility of Europe's 90 biggest firms. Report, Edition 2009. Hamburg: Kirchhoff Consult AG.

Koslowski, P. 1998. *The social market economy. Theory and ethics of the economic order*. Berlin: Springer.

Lunau, Y., and F. Wettstein. 2004. *Die soziale Verantwortung der Wirtschaft: was Bürger von Unternehmen erwarten*. Bern u.A.: Haupt.

Maignan, I., and D.A. Ralston. 2002. Corporate social responsibility in Europe and the U.S.: Insights from businesses' self-presentations. *Journal of International Business Studies* 33(3): 497–514.

Mandl, I., and A. Dorr. 2007. CSR and competitiveness – European SMEs' good practice. Consolidated European Report. Austrian Institute for SME Research, Vienna.

Morsing, M., and F. Perrini. 2009. CSR in SMEs: Do SMEs matter for the CSR agenda? *Business Ethics* 18(1): 1–6.

O'Riordan, L., and J. Fairbrass. 2008. Corporate social responsibility: CSR: Models and-theories in stakeholder dialogue. *Journal of Business Ethics* 83: 745–758.

Ostrom, E. 1990. *Governing the commons: The evolution of institutions for collective action*. Cambridge, UK: Cambridge University Press.

Ostrom, E. 2005. *Understanding institutional diversity*. Princeton, NJ: Princeton University Press.

Pies, I. 2000. *Ordnungspolitik in der Demokratie. Ein ökonomischer Ansatz diskursiver Politikberatung*. Tübingen: J.C.B. Mohr (Paul Siebeck).

Porter, M.E., and M.R. Kramer. 2002. The competitive advantage of corporate philanthropy. *Harvard Business Review* 80(12): 56–69.

Porter, M.E., and M.R. Kramer. 2006. Strategy & society: The link between competitive advantage and corporate social responsibility. *Harvard Business Review* 84(12): 78–92.

Putnam, R.D. 1993. *Making democracy work: Civic traditions in modern Italy*. Princeton, NJ: Princeton University Press.

Putnam, R.D. 2000. *Bowling alone: The collapse and revival of American community*. New York: Simon & Schuster.

Scherer, A.G., G. Palazzo, and D. Baumann. 2006. Global rules and private actors: Toward a new role of the transnational corporation in global governance. *Business Ethics Quarterly* 16(4): 505–532.

Shell. 2009. *Sustainability report 2008*. The Hague: Shell.

Spence, L.J., A. Habisch, and R. Schmidpeter. eds. 2004. *Responsibility and social capital: The world of small and medium-sized enterprises*. New York: Palgrave Macmillan.

Visser, W., and N. Tolhurst. 2010. *A global guide to CSR. A country-by-country analysis of corporate sustainability and responsibility*. Sheffield: Greenleaf.

Waddock, S. 2004. Parallel universe: Companies, academies, and the progress of corporate citizenship. *Business and Society Review* 109(1): 5–42.

Chapter 4
Corporate Citizenship and Private Regulatory Regimes: Understanding New Governance Roles and Functions

Kernaghan Webb

Abstract Private regulatory regimes have emerged as an increasingly important component of global social ordering, with potentially significant implications for corporate decision-making and the conventional theory of the firm and corporate governance, institutionalization of the values of corporate citizenship, and understandings of the technologies of business ethics. Private regulatory regimes do not operate in the same manner as public international law regimes. This chapter describes three notable features of private rule-making (competition among private rule makers, particular importance of consent as basis for private regulation, and importance of "legitimacy" conferring capabilities on the players). The purpose of this chapter is to explore the connections between private regulatory regimes and concepts such as new governance, corporate citizenship and corporate governance. Does private rule-making related to corporate citizenship pose new challenges or raise novel questions concerning conventional theories or understandings of the firm and corporate governance, global regulation of corporations, and theories of how social and environmental behaviours of corporations are institutionalized? The main conclusions of the chapter are that yes, private rule making in the global corporate citizenship context stimulates new thinking concerning how and why firms participate in global private rule making pertaining to corporate citizenship, how such activities can be aligned or understood in light of the conventional theories of the firm which downplays relational implicit contracts with stakeholders and sees the firm as a nexus of formal contracts, and the conventional focus of institutional theory on firms as seekers (not bestowers) of legitimacy. In short, the phenomenon of private regulatory regimes in support of global corporate citizenship stimulates new thinking on a number fronts that in turn suggest new directions in research concerning corporate theory and practice.

Revised version of chapter presented at "*Corporate Citizenship and the New Governance – The Political Role of Corporate Actors in Societal Rule-Setting Processes*," 12th Annual Conference of "Forum fur Wirtschaftsethik und Wirtschaftskultur der Deutschen Gesellschaft fur Philosphie (DGPhil)," Wittenberg, Germany, November 26–28, 2009.

K. Webb (✉)
Department of Law and Business, Ted Rogers School of Management, Ryerson University, Toronto, ON, Canada
e-mail: kernaghan.webb@ryerson.ca

I. Pies, P. Koslowski (eds.), *Corporate Citizenship and New Governance*,
Ethical Economy. Studies in Economic Ethics and Philosophy 40,
DOI 10.1007/978-94-007-1661-2_4, © Springer Science+Business Media B.V. 2011

Keywords Private regulation · Governance · Corporate citizenship · Globalization · Legitimacy

Introduction

As Scherer et al. (2006: 506) have noted, the activities associated with global rule making and implementation are "no longer a task managed by the state alone." They describe a "new governance" model, where the process of decision making in the social and political order is now performed with the active involvement of state and non-state actors (Scherer et al. 2006: 506). In this context, private regulatory regimes have emerged as an increasingly important component of global social ordering, with potentially significant implications for corporate decision-making and the conventional theory of the firm and corporate governance (Boatright 2009), institutionalization of the values of corporate citizenship (Misani 2009), and understandings of the technologies of business ethics (Pies et al. 2008).

Private regulatory regimes do not operate in the same manner as public international law regimes. This chapter describes three notable features of private rule-making:

1. the potential for direct competition among private rule regimes (no ready analogue to this in public international law);
2. the particular importance of consent by firms to agree to be subject to the rules in private regulatory regimes (whereas in public international law, the state or inter-state bodies have the unique ability to legally require compliance by firms, regardless of the desires or objections of firms who are subject to the rules); and
3. the ability of firms to confer legitimacy on the private regulatory regimes through their involvement in rule development or rule application (Black 2009).

These three distinct features of private regulatory regimes put corporations in a different position vis-à-vis their involvement in private regulatory regimes when compared with the role firms play in public regimes.

The purpose of this chapter is to explore the connections between private regulatory regimes and concepts such as new governance, corporate citizenship and corporate governance. Does private rule-making related to corporate citizenship pose new challenges or raise novel questions concerning conventional theories or understandings of the firm and corporate governance, global regulation of corporations, and theories of how social and environmental behaviours of corporations are institutionalized? The main conclusions of the chapter are that yes, private rule making in the global corporate citizenship context stimulates new thinking concerning how and why firms participate in global private rule making pertaining to corporate citizenship, how such activities can be aligned or understood in light of the conventional theories of the firm which downplays relational implicit contracts with stakeholders and sees the firm as a nexus of formal contracts, and the

conventional focus of institutional theory on firms as seekers (not bestowers) of legitimacy.

A definition of private regulatory regimes is proposed, the rise of private regulatory regimes is described, distinctive characteristics of private regulatory regimes are explored as are the roles these regimes play and how they relate to public regulatory regimes and law. In addition, a typology of private regimes is proposed, possible future developments are explored, and future directions in research are discussed. As noted above and explored in this chapter, the phenomenon of private regulatory regimes in support of global corporate citizenship stimulates new thinking on a number fronts that in turn suggest new directions in research concerning corporate theory and practice.

Private Regulatory Regimes Defined

When speaking of private regulatory regimes, commentators have used different terms to describe similar concepts. Cashore (2002) speaks of "non-state market-driven (NSMD) governance," which he distinguishes from self-regulation in the sense that actors other than corporations may play an active role in the governance regime (and hence it is not self-regulation). The *market-driven* element underlines the importance of profit as a driver for the proponents and users of the regimes and foreshadows the possibility of competition among private regulatory regimes, different dynamics when compared with those animating conventional public regulatory systems. Webb (2004: 11) uses the term "voluntary codes" to describe the private regulatory regime phenomenon, where *non-legislatively required* commitments – in the form of codes, standards, certification schemes, and the like – are used to address a particular problem and change behaviour. The particular contribution of value in this discussion is the idea that "voluntary" is essentially defined as "not legislatively required." This definition does not deny the possibility that a firm might feel "compelled" to become involved in or to commit to the terms of a private regulatory regime, even though not required by government or intergovernmental legal instruments to become so involved. Black (2009: 5) states that "a regulatory regime is the set of interrelated units which are engaged in joint problem-solving to address a particular goal; its boundaries are defined by the definition of the problem being addressed; and it has some continuity over time," drawing on the work of Hood et al. (2001) as a foundation. The functions-based definition of Black usefully focuses attention on the objective of the regime and the administrative units involved, but does not concern itself with instrument modalities (e.g., distinctions between command and control regulation on the one hand, or consent-based certification standards on the other, as techniques for achieving a particular goal).

The main objective of private regulatory regimes, as with public regimes, is a *change of behaviour toward a particular objective*. That is, at the centre of private regulatory regimes are rules or standards that attempt to *delineate acceptable from unacceptable behaviour in the pursuit of a particular objective such as improved*

environmental protection, worker protection, community protection, or consumer protection. Private regulatory regimes are not simply forums for learning and for sharing of information (for example, the United Nations Global Compact has been described as a forum for learning, but not a regulatory regime, as noted by Braun and Pies (2009: 253)). The rules or standards in private regulatory regimes are not intended to be simple re-statements of existing behaviour; rather, participants are expected to meet the rules designed to drive them to higher levels of performance or protection or to constrain unacceptable behaviour.

A basic pragmatic question faced by any corporation considering involvement in a private regulatory regime (either as a participant in the development and implementation of the regime, or in the agreement of the corporation to commit to its terms) is whether the rules at the centre of the regimes are ones that the corporation is capable of meeting and whether expenditure of corporate resources is important to the ongoing effective operation of the corporation (e.g., compliance with the rules will increase efficiency, attract customers, or make the activities of the corporation seem more acceptable and thereby decrease the likelihood of problems arising). This calculus is quite unlike that associated with corporate involvement in a public regulatory regime, where in the final analysis compliance with the rules is not optional: with public regimes, compliance is compulsory, backed up by the authority of the state to levy penalties including imprisonment. Summarizing the work of others, Misani (2009: 4) suggests that there are at least three theories about the kind of pressures that push firms to converge through use of private regulatory regimes and other conformity-inducing activities on social activities: first, firms may wish to associate themselves with private regulatory regimes as a form of herd behaviour, stimulated by the uncertainties and ambiguities that surround social issues (thus, information externalities are a main driver of the diffusion of practices); second, convergence around the terms of a private regulatory firm is seen as the result of legitimacy-seeking efforts by firms, which try to conform to what other stakeholders define as appropriate behaviour (institutional isomorphism); third, as a way of decreasing the likelihood that bad behaviour of others will harm the reputation of "good players," firms may agree to strategic cooperation around the terms of a private regulatory regime.

Misani (2009: 10) states that institutional theory sees CSR as the consequence of a political process whereby NGOs, states and other stakeholders put pressure on firms to adopt given social practices and apply legal, social and economic penalties to non-adopters. But firms actually have leverage to influence the terms of the rules of private regulatory regimes in a manner quite different to the rule-making dynamic associated with firm participation in public regulatory regimes. In effect, a private regulator (including a private regulator in which NGOs and other non-industry entities play major roles) may strive for corporate approval and commitment in order to attract users and thereby succeed in a competitive marketplace, and this "rent-seeking impulse" could affect the substance and nature of the terms of a private regulatory regime in a way unfamiliar to the operation of most public regulatory regimes (see for example, description of the way in which the rules of the Forest Stewardship Council were altered to reflect industry concerns, as discussed

in Cashore 2002). To put it another way, with public regulatory regimes, the fact that a particular firm did "not like" a particular proposed public regulation is not at first instance likely to prevent those rules from being adopted and applied by government agencies to that firm. The fact that the success (as measured in use by firms) of private regulatory regimes depends on the approval of the terms of the regime by firms is a distinctive element to private regulatory regimes that relates to issues of consent and legitimacy (two points that are discussed further below).

The use of the word "regimes" refers to the fact that there is *some centralized administrative capacity to develop the rules and to monitor usage by corporations.* This function may be carried out by widely different types of entities, from industry associations (e.g., by associations of chemical producers) or non-governmental organizations or specialized sub-units of such entities (e.g., Forest Stewardship Council, an offshoot of the WorldWildlife Fund), to multi-stakeholder entities (e.g., ISO or the Global Reporting Initiative). Associated with this entity carrying out these administrative tasks is a specific governance structure and related procedures for rule making and implementation. This capacity may or may not entail some capability to investigate incidents of alleged non-compliance, to do conformity assessments and "certify" that operations are in compliance with the regime's rules, or to attempt to resolve disputes. However, rule enforcement against non-compliant entities (penalties) is a particularly difficult activity for a private regulatory regime to undertake. Oliver (1991) and Teerlak (2007) are two scholars who have explored this sort of strategic firm behaviour associated with implementation of private regulatory regimes, where the regulators on the one hand need to attract adherents while at the same time they to discipline those who do not comply, with firms always maintaining the ability to "walk away" rather than face penalties.

In terms of the issue of administrative capacity, a basic pragmatic question faced by any corporation considering involvement in a private regulatory regime (either as a participant in the development and implementation of the regime, or in the agreement of the corporation to commit to its terms) is whether the entity charged with the responsibility of developing and implementing the rules is the sort of entity that the corporation is capable of working with as issues arise that could affect the operation of the corporation (e.g., does the entity have the competence and the willingness to work in a sympathetic and/or even-handed manner with entities such as the corporation, should issues arise). Again, this calculus is quite unlike that associated with a public regime where the regulator, backed up by the courts, has the ability to compel performance on pain of penalty regardless of the views of the corporation (as long as the behaviour of the regulator or court meets formal, pre-determined standards of fairness, such as notice and comment of any impending decision affecting the corporation). Hence a more formal and adversarial stance between corporation and regulator is possible and even likely with respect to the development and implementation of public regulations when compared with the stance of regulators and firms in private regulatory contexts.

Non-state entities (civil society non- governmental organizations and private sector firms and industry associations) often play a pre-eminent role in the development

and implementation of private regulatory regimes. This does not mean that states or inter-governmental bodies cannot or do not play any role at all in private regulatory regimes. But this role is secondary. In private sector regimes, non-state actors "have their hands on the steering wheel," so to speak. It is not uncommon for the terms of private regulatory regimes to draw directly on substantive norms devised by public sector bodies, as is the case with the draft ISO 26000 social responsibility standard, which draws on various UN and ILO instruments (International Organization for Standardization 2009). In addition, governments may support the development and implementation of private regulatory regimes (with financial contributions, which has been the case with the Forest Stewardship Council, as discussed in Rhone et al. 2004), and private regulatory regimes may play roles in the formal public law system (as discussed in greater detail below). The potential for private regulatory regimes to be integrated into public regulatory regimes (e.g., for a legislature, public regulatory agency or a court to draw on the terms of standard certification processes in support of public regulatory objectives) is a subject discussed later in the chapter.

The foundation of private regulatory regimes is their *consent base*. As has been alluded to above, unlike the situation with respect to conventional public regulatory regimes, corporations have a choice as to whether they commit to apply the rules in a private regulatory regime. In contrast, public regulatory regimes typically rely heavily on coercion and the state's monopoly on the exercise of coercion as a basis of compliance (other features of public regulation are the fact that public regulations are the product of a deliberative, representative and democratic rule-making process, at least in Western countries). This is not to deny that firms can feel pressured or coerced to participate in the development of a private regulatory regime, or to adhere to the terms of a private certification standard. Scholars such as Teerlak (2007) speak of certified management standards as a form of "coercive" isomorphism. However, the point being made here is that it is important to distinguish between "market pressure" (which may feel very coercive to the managers of a particular firm) to become certified to a private standard and "legal compulsion" to comply with a law (where jail is a possibility).

In the final analysis, a firm cannot be compelled by market forces alone to become certified to a private standard. The firm's managers have discretion to meet these pressures through other means (e.g., there may be a competing standard, or they may decide to meet a standard of their own making). The centrality of the consent base for private regulatory regimes has significant effects on the dynamics of rule creation and rule implementation within private regulatory regimes, in the sense that, in the absence of coercion or a democratic base, private regulatory regimes *must compete to attract users* and be perceived as legitimate. In a sense they "trade" in legitimacy (i.e., they confer legitimacy on corporate actors that use their standards while at the same time they gain legitimacy through the support of corporate and other actors). Thus, firms not only seek to have their activities viewed as legitimate through their involvement in and adherence to private standards – a form of mimetic isomorphism, as discussed in Deephouse (1996). They also confer legitimacy on private regulators, a point discussed by Black (2009). We will return

to the discussion of legitimacy below. For present purposes what is important to note is that:

- it would be understandable for firms to carefully and strategically consider *which* private regulatory regimes they choose to participate in or commit to because in so doing they confer legitimacy on that regime; and
- private regulatory regimes are to some extent dependent on these conferrals of legitimacy.

An obvious question to ask at the outset of any exploration of private regulatory corporate citizenship regimes is why such regimes have developed at all. Why not leave societal rule making and implementation to governments (at the domestic level) or to inter-governmental agencies (at the global or multi-jurisdictional level)? After all, isn't firm participation in private rule-making risk a non-compensated externality, with the strong possibility that some firms will simply "free ride" on the activities of leading firms who invest energies in the development of the private regimes, in keeping with Olson's (1965) observations concerning the logic of collective action? The simple answer is that effective, universally agreed upon, authoritative rule-making and rule implementation at the global level by inter-governmental bodies (e.g., the United Nations) has proven to be particularly difficult, and in the absence of such public rules being in place, firms, NGOs, and others have articulated rules to reduce operational ambiguity and transaction costs, gain legitimacy in the eyes of parties impacted by corporate-decision-making and action. Governance at the global level faces challenges not found at the domestic level – particularly the issue of state sovereignty (exclusive legislative authority within their jurisdiction to develop laws applying to activities within the state's territorial jurisdiction, and hence resistance by states to having other states impose rules upon them), and the related ability of any country to refuse to ratify and implement international treaties (as witnessed by the U.S. refusal to sign the Montreal Protocol, or the refusal of tropical countries to sign on to forestry conventions that would constrain their ability to deplete their rainforests as they see fit). As Pies, Hielscher, and Beckmann state, "cross-border challenges illustrate that nation-state governance is well equipped only for a particular subset of governance challenges." (Pies et al. 2008: 11).

In the absence of effective, authoritative inter-governmental rules, there is a space for other actors (i.e., non-state actors) to take on rule roles that might otherwise be performed by state or inter-governmental bodies. As evidenced by the statistics concerning the growth of several private regimes described below, and the discussion of the emerging institutional infrastructure for corporate responsibility by Waddock (2008), it is apparent that many corporations, industry associations and non-governmental organizations are willing to invest in the development and implementation of private regulatory regimes. They do so for pragmatic reasons such as to reduce operational uncertainty/ambiguity (Misani 2009), or to enhance the perceived legitimacy of their actions (e.g., as an investment in their credibility), or for other reasons as discussed below.

Increasing Prominence of Private Regulatory Regimes Pertaining to Corporate Citizenship

Evidence suggests that private regulatory regimes are assuming a position of increasing prominence in the "global corporate citizenship" landscape. For example:

- more than 1,106,000 operations have been certified to either ISO 9001 customer satisfaction/quality management or ISO 14001 environmental management systems standards as of December, 2007, up from 1,025,140 certificates in December, 2006 (International Organization for Standardization 2007).
- more than 109 million hectares of forests around the world have been certified to sustainable forest standards of the Forest Stewardship Council as of October, 2008, up from 88 million hectares in March, 2007 (Forest Stewardship Council 2008).
- chemical companies representing 90% of the world's production are members of Responsible Care, a voluntary program addressing health, safety and environmental aspects of chemical production that is in operation in more than 53 countries. The initiative was started in Canada in 1985, and is currently active in 53 countries around the world, up from 45 countries in 2000 (Responsible Care 2008, Moffet et al. 2004).
- more than 980,000 employees around the world work in facilities that have been certified to the SA 8000 standard pertaining to human rights protections of workers as of September, 2008, up from 700,000 in December 2007 (Social Accountability Accreditation Services 2009).

On particular environmental and social issues, it is increasingly common for there to be competing private regulatory regimes (for example, this is the case with respect to sustainable forestry standards, as described in Cashore 2002; and Rhone et al. 2004). This competition frequently revolves around the issue of "legitimacy" – as in "which private regulatory regime is the most 'legitimate' entity to develop and implement standards on a particular topic?" In this chapter, the thinking of scholars such as Black (2009: 1), Suchman (1995: 574) and Scott (2001: 59) concerning legitimacy is adopted – namely, that legitimacy revolves around social credibility and acceptability, a generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed system of norms, values, beliefs and definitions. The centrality of concepts of competition and legitimacy to the ongoing viability of private regulatory systems and the fact that corporations both confer and receive legitimacy from private regulatory regimes are complicating factors of private regulatory regimes when compared with their public counterparts.

Private Regulatory Regimes and Corporate Citizenship

Involvement of corporations in global private regulatory regimes aligns well with the "corporate citizenship" conception of Moon et al. (2005: 440) in which businesses partner with governments and non-governmental organizations, "contributing to

societal governance outside the firm" (Moon et al. 2005: 440). Related to the concept of corporate citizenship, Matten and Moon (2008) speak of implicit and explicit corporate social responsibility (CSR), with explicit CSR referring to corporate policies that lead companies to assume responsibility for some interests of society, normally involving voluntary, self interest driven policies, programs and strategies of corporations to address issues perceived by the company and/or its stakeholders as part of their social responsibility (Matten and Moon 2008). Following Matten and Moon, it is submitted that corporate participation in the development of and commitment to the terms of private rule regimes is a form of explicit CSR.

Pies et al. (2008: 15) suggest that "morality is a production factor" for corporations – that firms need to invest in their credibility to enhance value creation and maintain the confidence of their partners. To enhance credibility and confidence with partners, firms become rule entrepreneurs, participating in the development and use of self binding commitment technologies and corporate binding services (Pies et al. 2008: 11). Private regulatory regimes can be described as one form of commitment technology. In effect, corporations participate in the development of and commit to compliance with the terms of private regulatory regimes that address social, environmental and economic impacts of their activities, thereby making an investment in their credibility through the adoption of externally approved standards and processes, with the objective of altering the reward systems within their operations (e.g., third party audits reinforce positive behaviours and reveal and deter non-compliant activities) and of demonstrating their bona fides to external stakeholders.

Private Regulatory Regimes and Corporate Governance

Boatright (2009: 16) states that "the changed competitive environment of present-day corporations has led them to adopt strategies and structures that challenge the traditional foundations of corporate governance and produce a need to search for new foundations." Globalization, as Boatright notes, is driven in part by the search for cheaper, more secure resources, and for larger markets (Boatright, 2009: 17). The question then becomes, if "all the world is a market" (apologies to Shakespeare for the adjustment of his original phrasing), what are the rules that corporations need to follow in a globalized economy in their search for cheaper more secure resources and larger markets? We have already identified the inadequacies of public international rule systems. From a firm standpoint, adherence to private corporate citizenship regulatory regimes can be a strategy to minimize transaction costs and reduce ambiguity (e.g., the likelihood of disruptions in the form of consumer boycotts, community disapproval, or licensing/approval delays), and to increase legitimacy in the eyes of external stakeholders, as discussed in Misani (2009). Adherence by a corporation to the terms of private rule regimes provides information about that corporation's decision-making processes to partners that can thereby act to alleviate some operational uncertainty and increase efficiencies, signaling increased transactional security to potential partners in the marketplace and providing a framework by which institutions and the marketplace can better monitor corporate transactions (Christmann 2000, King 2007).

By adhering to the terms of private regulatory regimes concerning corporate citizenship, firms are in a position to strengthen relations with a range of stakeholders who are shaping corporate decision making and are being shaped by corporate decision making. While viewing new governance as a consequence of changes in the strategies and forms of the organization of firms to meet a changed competitive environment, Boatright (2009) states that these changes have called into question the key assumptions of conventional corporate governance (i.e., that only shareholders bear residual risk, that only shareholders are affected by corporate decisions, and that only explicit contracts matter in corporate governance). For this reason, Boatright (2009) speaks with apparent approval of the notion of the "extended enterprise," of the importance of residual equity holders other than shareholders (such as suppliers), of relations embodied in implicit contracts, and the need for wide-based collaboration with non-shareholder residual equity constituencies. Boatright (2009) concludes that the new governance has some implications that require rethinking of the traditional account of corporate governance, with its fixation on the firm as a nexus of formal contracts.

Thomsen (2006: 40) speaks of "implicit contracts with stakeholders" as the third of three ways that firms can express corporate social responsibility values through their approach to corporate governance (the other two ways being ownership and board structure). Thomsen notes that if stakeholder concerns were explicit and verifiable they could easily be included in a formal contract, but because of transaction costs this is not always possible (Thomsen 2006: 47). Thomsen expands on this point as follows:

> Precisely because stakeholder claims are not easily articulated or verifiable, even implicit contracts may be difficult to enforce. For example, managers may pay lip service to business ethics, stakeholder concerns and environmental issues, but it may be difficult to establish whether they give these objectives sufficient weight in actual decisions. Likewise, in the absence of reliable measures and criteria, it will always be possible for outsiders to claim that managers have not done "enough" to meet these concerns. As a result, implicit contracts are often implemented by way of proxies or "signals" that are believed to be correlated with the underlying goals just like performance measures contribute to the solution of shareholder-manager problems. (Thomsen 2006: 47)

The position taken here is that private regulatory regimes – particularly those that take the form of certification programs – could potentially be characterized as representing an important evolution in implicit contracts and the sort of "proxies" referred to by Thomsen, because of the precision of the "stakeholder-generated" obligations contained in them, as well as their formality and enforceability. Leading examples of such private regulatory regimes such as the Forest Stewardship Council's sustainable forestry certification regime (Cashore 2002, Rhone et al. 2004) are the product of formal multi-stakeholder standards development processes, include specific performance metrics, third party assurance, and take the form of binding contracts (e.g., between the companies submitting to certification and the certifying entities), with legal consequences prescribed in the terms of the contract (e.g., loss of certification and publication of this information if evidence shows non-compliance, as set out in the terms of the contract). Private regulatory regimes are a way of codifying

the expectations of stakeholders (in keeping with Carroll's (1979: 500) definition of CSR as "the economic, legal, ethical and discretionary expectations of society," and making those codifications enforceable.

Private Regulatory Regime Typologies

In the context of a discussion of corporate citizenship and the new governance, it is important to provide typologies of private regulatory regimes, in order to better understand the different implications they can have on participation in and use by corporations. Two classifications are proposed here: a functions-based approach and a "nature of the proponent" approach.

Functions-Based Typology

From a functions standpoint, private regimes can be classified into four types: those that articulate substantive social and environmental norms (Type One), those that articulate procedures for achieving social and environmental objectives, through process-oriented management standards (Type Two), those that articulate reporting metrics (Type Three), and those that are a hybrid of the above (Type Four). These are briefly discussed below.

Type One – *Private regimes that articulate substantive norms of behaviour*. The rules articulated through this sort of regime delineate acceptable from unacceptable performance outcomes concerning particular environmental or social issues (e.g., human rights, worker health and safety or rights, community development), or some combination thereof. In effect, these standards often have explicit moral or ethical content. Examples of such regimes include the Sullivan Principles, the Caux Principles, and the draft ISO 26000 social responsibility standard. A key issue with such regimes revolves around the authority (including the moral authority) and credibility of these private regulatory to set substantive norms of behaviour (given that it is normally international treaties and conventions or domestic laws that set out ethical/moral-centred societal outcomes to be met by the private sector). The legitimacy and credibility of the rules of such regimes may be enhanced by explicit reference to international instruments of the United Nations or the Organization for Economic Co-Operation and Development, and through involvement of UN, OECD, and other inter-governmental organizations;

Type Two – *Procedure-oriented private regimes that set out approaches for corporate management to follow in meeting a particular objective defined by the corporation (type two).* This type of private regime provides standards for corporate decision making to meet a particular goal, without stipulating what performance outcomes are expected. It is for the corporation to set the performance outcome (perhaps after consulting with other stakeholders through a process set out in the "management system standard" that is at the heart of this type of regulatory regime. Examples of such management systems standards include ISO 9001 (quality

management); ISO 14001 (environmental management); OHSAS 18001 (occupational health and safety management). Because these regimes do not attempt to articulate substantive performance outcomes on environmental and social issues, the moral or democratic authority of the rules to address a particular social or environmental issue is less of an issue to corporations or other stakeholders. Instead, a key issue is the practical utility of the standards (i.e., do they "work" in terms of achieving an objective, what is the cost of complying with the standard and what is the benefit?), and the expertise and capability of the private regulatory regime proponents and administrators to set those standards. It is not uncommon for the option of third party conformity assessment to be available for this type of standard (as is the case with ISO 9001, ISO 14001 and OHSAS 18001, although in all three cases, self declaration is also possible). Management system standards sometimes are used as adjuncts or supplements to public regulatory regimes that set out substantive norms to be met by the private sector, since they can essentially provide systematic approaches for the implementation of statutory objectives (Webb 1999);

Type Three – *Private regimes that establish approaches to reporting.* Private reporting regimes provide standard metrics on environmental, social or other issues, facilitating cross-firm and cross-sector comparisons. Type Three regimes do not purport to stipulate what outcome should be achieved (as with Type 1 regimes above) or how it should be achieved (as with Type 2 regimes above). The best example of a private reporting regime is the Global Reporting Initiative (2009). Firms have turned to assurance standards such as AA10001 and ISAE 3000 to assist in establishing the credibility of non-financial reporting to both internal (e.g., boards of directors, employees) and external audiences (investors, partners). It is not uncommon for reporting and assurance standards to be used together. Because private reporting and assurance regimes do not attempt to articulate substantive performance outcomes on environmental and social issues, these sorts of standards do not appear to raise the sort of moral or democratic/representative issues that private regulatory regimes setting substantive norms do. In that sense, they are more like type 2 (procedural) than type 1 (substantive norm) regimes. Nevertheless, considerable effort is expended by the private regulators producing this sort of standard to put in place development processes that are seen to be multi-stakeholder in nature (for example, GRI has an elaborate multi-stakeholder-based guidelines development process and governance structure) (Global Reporting Initiative 2009). These efforts seem to be directed at persuading users of the standard of the alignment of the private regulatory regime with substantive public regulatory regimes, and to ensure that the guidelines or standards are perceived as of practical utility (since the "users" of the standard have been directly involved in the standard's development);

Type Four – *Hybrid private regulatory regimes.* These regimes combine two or more of the above types. Thus, for example, they simultaneously set out substantive, performance-outcome based standards (type one), they address how firms are to meet those outcomes (type two), and they may involve reporting and assurance (type three). The Forest Stewardship Council (FSC) sustainable forestry standard regime, the SA 8000 labour standard regime, and the Responsible Care environmental protection regimes are examples of such regimes (Webb 2004). Because these regimes

attempt to articulate substantive performance outcomes on environmental and social issues, at the same time as they purport to describe how to achieve those outcomes, and address reporting, the key issues associated with such regimes would appear to be their authority and credibility among multiple stakeholder groups to set and ensure compliance with the substantive standards, and their practical utility.

The value of the functions-based typology is that it can assist in understanding why there are different incentives for firm participation in and adherence to private regulatory regimes, depending on the function performed by the regime. Arguably, a Type Two private regulatory regime that focuses on providing structure and criteria to firms concerning how they meet environmental and social objectives *set by the firm itself* is considerably less intimidating than a private regulatory regime stipulating the environmental or social performance that firms are to meet (Type One). Hence, there is potentially considerable confinement of "private sector environmental and social performance discretion" at stake, should a sector or a firm feel pressured to comply with the terms of a particular Type One private regulatory regime with terms favourable or unfavourable to that firm or sector. Thus, a firm or group of firms (e.g., an industry association) might invest considerably greater resources attempting to influence the terms of a Type One private regulatory regime that is perceived as a potential threat to their operational freedom than they might to a Type Two or Type Three private regulatory regime, which does not so constrain private sector behaviour.

"Nature of Proponent"-Based Typology

A major consideration for corporations in their decision to participate in the development of a private regulatory regime or to commit to compliance with the terms of that regime revolves around the identity and nature of the proponent that is playing the lead role in developing or implementing the regime. From a nature of proponent-based typology standpoint, private regimes can be classified into the four categories:

- *Private regimes spearheaded by industry*. Examples of this type of regime include the Sullivan Principles, the Caux Principles and Responsible Care. Industry-led regimes may have credibility and legitimacy among their private sector peers, and are well positioned to develop practical standards; however their credibility and legitimacy with other stakeholders may be more problematic and hard to come by. Therefore, corporations contemplating becoming involved with such regimes may need to consider whether association with such regimes will be seen as credible by stakeholders other than industry peers. If non-peer (external stakeholder) credibility is not an important motivating factor for a firm's involvement in a private regime, or if there are other strong reasons for participating or using an industry-led regime (e.g., it is a requirement for membership in an industry association, as is the case with the Responsible Care program for members of the Canadian Chemical Producers Association, as noted in Moffet et al. 2004: 180), then issues of lack of credibility among non-peers may be discounted in the eyes of that firm;

- *Private regimes spearheaded by non-governmental organizations (NGOs).* A good example of this type of regime is the Forest Stewardship Council (Cashore 2002, Rhone et al. 2004). NGO-led regimes may have immediate credibility with their NGO peers, but credibility beyond the NGO sector may need to be carefully nurtured. In the case of FSC, the creation of a governance structure and rule making procedure in which industry interests are given recognized status has arguably been undertaken in order to enhance private sector credibility (Rhone et al. 2004: 251–252);
- *Private regimes spearheaded by multi-stakeholder entities.* The Global Reporting Initiative and the International Organization for Standardization (ISO) are two examples of private regimes that are positioned as multi-stakeholder entities (Global Reporting Initiative 2009, International Organization for Standardization 2009). A focus of attention with such regimes may be on just how multi-stakeholder these entities really are, in terms of their governance structure and procedures for participation (for example, does one particular interest receive undue attention?).

As noted, firms or groups of firms may choose to participate in the development of particular proponent-based private regulatory regimes, or to comply to particular proponent-based regimes, depending upon their calculus of which private regime will have the greatest positive impact on that firm or group of firms.

Private Regulatory Regimes and Legitimacy

As noted earlier, private regulatory regimes are frequently involved in intense competitive struggles to enhance their legitimacy in the views of others, and one important reason why corporations participate in or subject themselves to private regulatory regimes, is to enhance their own legitimacy. Suchman (1995: 574) synthesized the diverse literature on legitimacy to define the phenomenon as “a general perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions”. Legitimacy provides organizations with credibility and increases their chance of persistence or survival within their environments. Suchman notes that legitimacy is both independently held by organizations and simultaneously construed by other actors.

Although it is true that legitimacy is an important element in the effective operation of public regulatory regimes (Black 2009: 1–2), legitimacy assumes particular prominence and importance in private regulatory regimes because as noted above, unlike their public counterparts, private regulatory regimes are in the final analysis, consent-based in the sense that individual firms have choice as to whether they wish to participate in or commit to compliance with the terms of private regulatory regimes (i.e., as noted above, it is not at first instance against the law to not comply with the terms of private regulatory regimes). As Black (2009: 1–2) notes,

regulators attempt to create and manage their own legitimacy, with legitimacy being "an endowment" not an attribute. Thus, legitimacy is an actively sought after and central characteristic of private regulatory regimes. That this is the case is but one example of how different private regulatory regimes are from conventional public regulatory regimes, and why caution must be exercised in applying public regulatory regime concepts of participation to private regulatory regimes. The notion that firms through their participation in the development of private regulatory regimes and/or their agreement to comply with the terms of private regulatory regimes confer legitimacy on those regimes means that a complex and perhaps problematic, two-way legitimacy dynamic is at play, with the private regulatory regimes in a position to confer needed legitimacy on firms while firms (and others) confer legitimacy through their participation in the regimes.

The Connection Between Private and Public Regulatory Regimes

While as noted, private regulatory regimes are voluntary – in the sense that there is no legislative requirement that firms must meet their terms – this does not mean that there are not significant legal implications associated with their development and use. All parties concerned – be they businesses, or governmental agencies, or non-governmental organizations – need to be alert to the potential legal implications associated with use of private regulatory regimes (Webb and Morrison 2004: 97–99). In some ways, private regulatory regimes may align well and be supportive of public regulatory regimes. For example, in Canada, environmental legislation stipulates that in imposing a sentence, a court is to take into account "whether any remedial or preventive action has been taken or proposed by or on behalf of the offender, including having in place an environmental management system that meets a recognized Canadian or international standard." The same legislation also expressly authorizes the court to make orders "directing the offender to implement an environmental management system that meets a recognized Canadian or international standard." (Webb and Morrison 2004: 136–137). In fact, as part of sentencing, Canadian courts have required convicted companies to become ISO 14001 certified (Webb and Morrison 2004: 136). In this sense, a private regulatory regime has through a judicial decision become part of a public regulatory regime. The significance of this, from the standpoint of corporate citizenship, and corporate involvement in private regulatory regimes, is that firms may find themselves participating in the development of a private regime that ultimately has public regulatory implications perhaps without being aware of this possibility, or they may find themselves committing to the terms of a private regulatory regime that may have an impact on public regulatory liability without being fully aware of this possibility.

On the other hand, firms may participate in the development of private regulatory regimes, and/or commit to compliance with the terms of private regulatory regimes in the belief that putting in place a public regulatory regime to address that topic would not be appropriate, or with the hope that the development and implementation of the private regime might forestall development of a public regulatory regime.

This was the case with the initial development of the Responsible Care program in Canada (developed by the Canadian Chemical Producers Association), as noted by Moffet et al. (2004: 179).

Private regulatory regimes may be used as a way of elaborating on issues that have so far not been codified in law and may be difficult to codify into law. For example, John Ruggie, the United Nations Special Representative of the Secretary General on human rights and transnational corporations and other business enterprises, has noted that "[i]n addition to compliance with national laws, the baseline responsibility of companies is to respect human rights. Failure to meet this responsibility can subject companies to the courts of public opinion. . . and occasionally to charges in actual courts. Whereas governments define the scope of legal compliance, *the broader scope of the responsibility to respect is defined by social expectations* – as part of what is sometimes called a company's social licence to operate. . . . ." (Ruggie 2008: 16) (emphasis added). The draft ISO 26000 social responsibility standard can be seen as an example of a private regulatory regime that attempts to articulate the broader societal expectations, beyond the legal requirements (International Organization for Standardization 2009: clause 3.3.2).

Increasingly, the potential for hybrid public/private regulatory regimes has been recognized. John Ruggie, has stated that ". . . . hybrid arrangements such as the Kimberley Process Certification Scheme. . . . . the Voluntary Principles on Security and Human Rights, and the Extractive Industry Transparency Initiative represent important innovations by embodying. . . . a concept of shared responsibility: involving importing and exporting states, companies and civil society actors, as well as integrating voluntary with mandatory measures. Although each has flaws that need fixing, this genre of initiative deserves greater attention, support, and emulation in other domains." (Ruggie 2008). Thus, although we have here been focusing our attention here on private regulatory regimes, in contrast to public regulatory regimes, there seems to be some potential for public-private hybrids.

Future Developments

While it would be fair to characterize the current new governance situation with respect to global private regulatory regimes and the inter-connections of these private regimes to public regulatory regimes as chaotic, complicated, and overlapping, the position taken here is that there is an emerging global corporate citizenship regulatory architecture that shows some promise of being more straightforward. The ISO 26000 standard and the work of John Ruggie are two examples of ways in which some of the complexity currently evident in private regulatory regimes may be reduced and a more orderly and straightforward global governance regime might emerge. The ISO 26000 standards development process has brought together developed and developing countries, inter-governmental, industry, labour, consumer, and other stakeholders into an innovative international standards development process capable of leading to a standard that reduces current confusion and answers heretofore vexing questions concerning the international normative framework for global

corporate citizenship (Webb, forthcoming). The work of John Ruggie also shows promise that it will bring together the business, NGO and government communities to agree on a common vision for a global human rights standard applying to transnational corporations.

As noted in this chapter, the current range of private regulatory regimes pertaining to corporate citizenship can be classified into substantive/normative, procedural, reporting/assurance, and hybrid types. This typology can act as an organizing framework for corporations and scholars alike, allowing them to identify what private regulatory regimes are of particular relevance or importance. The "nature of proponent" typology can also assist in prioritization and resource allocation exercises.

Future Research

An area particularly well suited for future research pertains to the legitimacy enhancing activities and impacts of firms and other stakeholders on private regulatory regimes, and visa versa (Webb and Helms, forthcoming), building on the work of scholars such as Black (2009) and Cashore (2002). The role of private regulatory regimes as enforceable forms of implicit contracts between firms and other stakeholders is another area ripe for further research. The use of the functional and proponent-based typologies of private regulatory regimes articulated in this chapter as a way of generating new insights concerning the differential institutional pressures on firms to participate in and comply with private regulatory regimes is another research angle worthy of further attention. Finally, further research into the inter-connections between private and public regulatory regimes in support of corporate citizenship is an area likely to be of considerable interest to scholars and practitioners alike.

Conclusions

This chapter has explored the inter-connections between corporate citizenship and private regulatory regimes, in an effort to develop a better understanding of the new governance roles and functions of private regulatory regimes. Evidence suggests that private regulatory regimes are an increasingly importance feature of the global new governance landscape. Private regulatory regimes align well with the Moon et al.'s (2008) concept of corporate citizenship in the sense that they typically involve businesses partnering with others to contribute to societal governance, and can be seen as a form of "explicit CSR" in the language of Matten and Moon 2008. Private regulatory regimes also could be characterized as "commitment technologies" that are invested in by corporations as morality production factors, in the language of Pies et al. (2008). Following Boatright (2009), private regulatory regimes are not incompatible with current conceptions of corporate governance, and building on Thomsen (2006), they might be characterized

as an evolution from the imprecise implicit contracts on ethical issues that he describes.

The chapter has proposed a definition of private regulatory regimes which in addition to noting the obvious fact that non-state actors play the lead role as proponents, highlights the central importance of rules delineating acceptable from unacceptable content as a distinguishing factor when compared with "learning fora" or other global citizenship initiatives, and consent as a distinguishing feature when compared with conventional public regulatory regimes. Linked to the central element of consent, the chapter builds on the work of "legitimacy scholars" such as Black (2009), Cashore (2002), Suchman (1998) and Scott (2001), to emphasize how the non-coercive, non-monopolistic nature of private regulatory regimes makes them unusually sensitive to and concerned with attributes of legitimacy so that they can "compete" for usage in the marketplace. As has been discussed, "legtimacy enhancing" is a two way street, since firms might wish to use private regulatory regimes as a way of legitimizing their approaches at the same time as the participation of firms in private regulatory regimes (in the development stage or by commiting to comply with the terms) is a conferral of legitimacy by corporations on those private regulatory regimes. Adding to the complexity, the chapter notes that private regulatory regimes can have significant linkages to public regulatory regimes – linkages that may not be immediately apparent to a corporate actor that is considering participating in the development of a private regulatory regime or commiting to comply with the terms of same. The chapter highlights a wide variety of factors that might play a role in a decision by a corporation to participate or not in a private regulatory regime. The chapter also suggests some recognition of the need to develop public-private new governance solutions on corporate citizen issues, in the interests of heightened effectiveness and efficiency, and proposes several possible paths of research building on the ideas explored in this chapter.

References

Black, J. 2009. Legitimacy and the competition for regulatory share. LSE Legal Studies Working Paper No. 14/2009.

Boatright, J. 2009. The Implications of the New Governance for Corporate Governance. Paper to be presented at "Corporate Citizenship and the New Governance – The Political Role of Corporate Actors in Societal Rule-Setting Processes," 12th Annual Conference of "Forum fur Wirtschaftsethik und Wirtschafts- kultur der Deutschen Gesellschaft fur Philosphie (DGPhil)," Wittenberg, Germany, November 26–28, 2009.

Braun, J., and I. Pies. 2009. United Nations global compact. In *Handbook of transnational economic governance regimes*, eds. C. Tietje and A. Brouder, 253–265. Boston, Leiden: Martinus Nijhoff Publishers

Carroll, A. 1979. A three-dimensional conceptual model of corporate performance. *Academy of Management Review* 4(4): 497–505.

Cashore, B. 2002. Legitimacy and the privatization of environmental governance: How non–state market–driven (NSMD) governance systems gain rule–making authority. *Governance* 15: 503–529.

Christmann, P. 2000. Effects of "best practices" of environmental management on cost advantage: the role of complementary assets. *Academy of Management Journal* 43(4): 663–680.

Deephouse, D.L. 1996. Does isomorphism legitimate? *Academy of Management Journal* 39(4): 1024–1039.
Forest Stewardship Council. 2008. Facts and figures. http://www.fsc.org/facts-figures.html. Accessed 21 Jan 2009.
Global Reporting Initiative. 2009. About Global Reporting Initiative. www.globalreporting.org/. Accessed 10 Aug 2009.
Hood, Rothstein, and Baldwin. 2001. *Government of risk.* Oxford: Oxford University Press.
International Organization for Standardization (ISO). 2007. The ISO survey – 2007. http://www.iso.org/iso/survey2007.pdf. Accessed 21 Jan 2009.
International Organization for Standardization (ISO). 2009. ISO/DIS 26000 Guidance on Social Responsibility (draft). http://isotc.iso.org/livelink/livelink/fetch/2000/2122/830949/3934883/3935837/ISO_DIS_26000_Guidance_on_Social_Responsibility.pdf?nodeid=8385026&vernum=0. Accessed 10 Aug 2009.
King, Andrew. 2007. Cooperation between corporations and environmental groups: A transaction cost perspective. *Academy of Management Review* 32(3): 889–900.
Matten, D., and J. Moon. 2008. “Implicit” and “Explicit” CSR: A conceptual framework for a comparative understanding of corporate social responsibility. *Academy of Management Review* 33(2): 404–424.
Misani, N. 2009. The convergence of corporate social responsibility practices. Academy practices 2009. SSRN. http://ssrn.com/abstract=1338708. Accessed 15 Nov 2009.
Moffet, J., F. Bregha, and M.J. Middelkoop. 2004. Responsible care: A case study of a voluntary environmental initiative. In *Voluntary codes: Private governance, the public interest, and innovation*, ed. K. Webb, 177–208. Ottawa, ON: Carleton Research Unit for Innovation, Science and Environment, Carleton University.
Oliver C. 1991. Strategic responses to institutional processes. *Academy of Management Review* 16(1): 145–179.
Pies, I., S. Hielscher, and M. Beckmann. 2008. Moral commitments and the societal role of business: An ordonomic approach to corporate citizenship. *Business Ethics Quarterly* 19(3): 375–401.
Responsible Care. 2008. What we do. http://www.responsiblecare.org/page.asp?n=whatwedoandl=1
Rhone, G., D. Clarke, and K. Webb. 2004. Two voluntary approaches to sustainable forestry practices. In *Voluntary codes: Private governance, the public interest, and innovation* ed. K. Webb. Ottawa, ON: Carleton Research Unit for Innovation, Science and Environment, Carleton University.
Ruggie, J. 2008. Protect, respect and remedy: A framework for business and human rights. A/HRC/8/5 7 April 2008 www2.ohchr.org/english/bodies/hrcouncil/docs/.../A-HRC-8-5.doc. Accessed 10 Aug 2009.
Scott, W.R. 2001. *Institutions and organizations*, 2nd edition. London: Sage.
Scherer, Andreas George, Guido Palazzo, and Dorothée Baumann. 2006. Global rules and private actors: Toward a new role of the transnational corporation in global governance. *Business Ethics Quarterly* 16: 505–532.
Social Accountability Accreditation Services. 2009. Certified facilities list. http://www.saasaccreditation.org/certfacilitieslist.htm. Accessed 1 Apr 2009.
Suchman, M. 1995. Managing Legitimacy: Strategic and Institutional Approaches. *Academy of Management Review* 20(3): 571–561.
Suchman, M. 1998. Working without a Net: The sociology of legal ethics in corporate litigation. *Fordham Law Review* 67: 837–874.
Teerlak, A. 2007. Order without law? The role of certified management standards in shaping socially desired firm behaviors. *Academy of Management Review* 32(3): 968–985.
Thomsen, S. 2006. Corporate governance and corporate social responsibility. In *Corporate social responsibility – Reconciling aspiration with application*, eds. A. Kakabadse and M. Morsing, 40–50. London: Palgrave McMillan.
Waddock S. 2008. Building a new institutional infrastructure for corporate responsibility. *Academy of Management Perspectives* 22(3): 87–108.

Webb, K. 1999. Voluntary initiatives and the law. In *Voluntary initiatives: The new politics of corporate greening*, ed. R. Gibson, 32–50. Peterborough: Broadview Press

Webb, K. ed. 2004. *Voluntary codes: Private governance, the public interest and innovation*. Ottawa, Carleton Research Unit for Innovation, Science and Environment, Carleton University.

Webb, K. 2011. ISO 26000: the Emergence of a Global Norm of Social Responsibility Custom, Paper presented at European University Institute Florence Workshop on Transnational Governance Interactions: Theoretical Approaches, Empirical Contexts and Practitioners' Perspectives (May, 2011).

Webb, K., and W. Helms. (forthcoming). Perceived voluntary code legitimacy: Towards a theoretical framework and research agenda. Draft paper presented at AOM Conference, Chicago, August 2009.

Webb, K., and A. Morrison. 2004. Voluntary Codes and the Law: Examining the 'Tangled Web'. In *Voluntary Codes: Private Governance, the Public Interest and Innovation*, ed. K. Webb, 97–146. Ottawa: Carleton University Research Unit for Innovation, Science and Environment.

Chapter 5
Corporate Citizenship as Organizational Integrity

Jacob Dahl Rendtorff

Abstract The chapter presents the notion of organizational integrity as an expression of the ideal moral and political unity of a corporation. We begin with a discussion of the relation between individual and organizational integrity. After this the chapter elaborates the problems of building and maintaining integrity in corporations: the concept of organizational integrity. Moreover, we analyze the dimensions of integrity and values-driven management in relation to dilemmas of leadership. Finally the chapter deals with integrity and managerial judgment in order to provide the basis for dealing with organizational dilemmas in daily practice of leadership. Managerial judgment is based on a required capacity to understand the complex relation between personal and organizational integrity and include all relevant stakeholders in decision-making processes in a fair and just manner. Accordingly, corporate citizenship is an important outcome of integrity management.

Keywords Integrity · Corporate citizenship · Leadership · Values-driven management · Organizational unity · Business ethics

Introduction

In this chapter I will discuss the notion of organizational integrity as an expression of the ideal moral and political unity of a corporation. Organizational integrity can be conceptualized as foundation for good corporate citizenship in the sense that organizational integrity is the result of good values-driven management. Organizational integrity may also be understood as the theoretical conceptualization of the moral and legal responsibility understood in a broad legal sense as expressing the capacity of prudence, reflection and accountability. The concept of integrity expresses an ancient republican virtue of citizenship and it can be promoted to indicate the commitment of individuals or corporations to be virtuous and faithful to their obligations towards social and political community. The concept of integrity is also an essential

J.D. Rendtorff (✉)
Department of Communication, Business and Information Technologies, University of Roskilde, Roskilde, Denmark
e-mail: jacrendt@ruc.dk

I. Pies, P. Koslowski (eds.), *Corporate Citizenship and New Governance*,
Ethical Economy. Studies in Economic Ethics and Philosophy 40,
DOI 10.1007/978-94-007-1661-2_5, © Springer Science+Business Media B.V. 2011

concept in business ethics in this sense that it expresses the virtue of civic commitment of the corporation and its members. Hence, there is a close link between corporate citizenship, agency and corporate organizational integrity. Furthermore, a determination of corporate integrity is the content of an approach to organization theory from the perspective of organization ethics.

Indeed, there are many possible uses and faces of the concept of integrity. It is usually defined as "wholeness, completeness and freedom from moral corruption".[1] The concept is understood as a moral virtue that is broader than practical rationality or autonomy of decision-making, but also narrower than the concept of moral judgment and practical wisdom. Integrity is also linked to honesty and uprightness in character in the sense that it implies commitment and conscientious adherence to one's moral principles. Integrity is therefore important for republican business ethics and corporate citizenship because it expresses the willingness, capacity and readiness to be committed to act as a good citizen and responsible moral agent in society. In this sense, integrity becomes an important virtue of corporate citizenship and indicates the commitment of corporations to be involved in social community. Moreover, integrity is linked to concepts of identity and moral character because the concept expresses the capacity to be moral in ones choices, actions and concerns in a way that benefits others.

When dealing with corporate citizenship on the basis of business ethics we need integrity as the virtue that accompanies values-driven management in business. At the level of the decision-making structure and of company policies integrity expresses the good character of the organization as a moral agent and political actor in society. Accordingly, integrity can be said to constitute the application of moral virtue in the practice of business life. Integrity expresses the capacity to integrate ethical worldviews and values into the organization as a whole. The theoretical concept of corporate integrity is the foundation of integrity in business ethics in practice. With regard to the different concepts of business ethics we can define integrity as loyalty to the fundamental set of corporate virtues that constitute the specific corporation.

From the point of view of republican business ethics we can adopt Lynn Sharp Paine's definition of integrity as the "quality of moral self-governance"[2] emphasizing that integrity is linked to concepts of "moral conscientiousness, moral accountability, moral commitment and moral coherence".[3] Moreover, it is essential

---

[1] Robert Audi and Patrick E. Murphy, "The Many Faces of Integrity," *Business Ethics Quarterly* 16, 1 (2006): 3–21.

[2] Ibid. p. 6. Lynn Sharp Paine, *Cases in Leadership, Ethics and Organizational Integrity. A Strategic Perspective* (Chicago: Irwin, 1997), 335.

[3] Robert Audi and Patrick E. Murphy, "The Many Faces of Integrity," *Business Ethics Quarterly* 16, 1 (2006): 6. Audi and Murphy discuss that integrity is defined rather differently in the literature on business ethics. There is a tension between definitions emphasizing honesty (for example John Della Costa in his book *The Ethical Imperative*) and other definitions that consider moral completeness as the central component. Virtue ethics definitions are also different. Some are very substantial taking loyalty, congeniality, cooperation and trustworthiness as components of integrity (p. 6) while other definitions are less substantial and consider integrity to an attitude of moral consistency and coherence with regard to one's commitments to the good life. Audi and Murphy ask

to Paine's account of integrity that values-driven management based on integrity combines ethics and law in the sense that integrity as wholeness means that the manager combines compliance with legal regulations with ethical behavior.[4] With this approach we can situate the concept of integrity within the classical tradition of republican political philosophy. An outcome of this could be to define ethical action and ethical integrity to the commitment to common social and political values in society.

Accordingly integrity must be conceived as a virtue, which is necessary to implement justice in society and organizations. I agree with Audi and Murphy when they emphasize that the epistemology of integrity relating to oneness, completeness, purity and wholeness refers to the realization of moral principles in organizations. An important core of the principle of integrity can therefore be defined with the concept of integration.[5] However, I go beyond the point of view of Audi and Murphy, when I define integrity as central for republican business ethics moving from individual to organizational integrity. I would argue that integrity is a general principle of commitment to integration of "political morality", moral principles and moral standards in organizations. Integrity is the capacity to integrate the values and ethical ideas of the organization in a common framework for individual members and also for the organization and its stakeholders. Integrity refers to good judgment and strong moral character. We can say that integrity is a virtue of linking the corporation to the moral requirements of society understanding that action in organizations is an issue of political morality. There is a close connection between integrity and commitment to justice and fairness.[6] In order to clarify the concept of organizational

---

the delicate question whether there is a precise definition of integrity left. I would like to argue that integrity should be conceived as a moral and political virtue of doing what is ethically and morally right. When I define integrity as central to republican business ethics and therefore constitutive of corporate citizenship, I am more optimistic with regard to the possible applications of the concept that it is the case with the position of Audi and Murphy who after all seem to be very pessimistic concerning the possibilities of giving integrity a concrete significance. Audi and Murphy have not understood the importance of integrity in corporate citizenship. Therefore, I think the approach that is proposed by Lynn Sharp Paine is more useful for this purpose. Moreover, I use integrity as the concept indicating the commitment to business ethics of organizations in their concrete business activities.

[4] Lynn Sharp Paine, "Managing for Organizational Integrity," *Harvard Business Review* 72, 2 (1994): 106–117.

[5] Robert Audi and Patrick E. Murphy, "The Many Faces of Integrity," *Business Ethics Quarterly* 16, 1 (2006): 10.

[6] Stephen L. Carter, *Integrity* (New York: Basic Books, Harper Collins Publishers, 1996). This book can help to justify our argument that integrity is very important in a republican theory of business ethics and commitment of organizations to corporate citizenship. Carter discusses integrity as a pre-political virtue that is a virtue of good moral behavior as the foundation of citizenship with a wide range of applications in media ethics, politics, family life, e.g. marriage, sport etc. He considers integrity as a virtue and life stile applied to good people with honorable moral characters. This means that there also can be integrity in civil disobedience. This was shown by Martin Luther King who argued that civil disobedience and acceptance of punishment for civil disobedience was an adherence to the highest law, manifesting civil disobedience as a great act of morality and belief in justice.

integrity we will therefore have to confront a number of problems concerning the definition of integrity, the relation between individual and organizational integrity, the concept of organizational integrity, integrity and philosophy of leadership and finally ethical judgment and organizational integrity.

Accordingly, this chapter focuses on the following issues: (1) The concept of integrity: from individual to organizational integrity. (2) Building and maintaining integrity in corporations: the concept of organizational integrity. (3) Integrity and values-driven management: dilemmas of leadership. (4) Integrity and managerial judgment: Coping with organizational dilemmas in daily practice of leadership.

Case 1. Profit and Principles: A Transformation of Shell Towards Integrity?

The case of the Royal Dutch Shell Corporation may be read as a case about how a corporation comes to awareness about organizational integrity. This case has been selected as a classic case of a multinational corporation wanting to transform its image towards ethical integrity. In this sense it is a case of a corporation trying to do an ethical effort. Accordingly, for many the case represents the challenges that a multinational corporations are confronted with.

Indeed, the corporation faces the importance of ethical issues and about how a corporation understands that it is necessary to have a policy on ethical problems and issues and to show an awareness of the requirements of corporate citizenship.[7] Royal Dutch Shell is among the wealthiest corporations in the world. The corporation is mainly an oil company producing and delivering petrol and gas oil to the customers. The Shell Corporation is also one of the largest firms in the world. It focuses on oil but it also has interests in coal mining, forestry, chemicals and renewable energy.

The policy of the company used to be based on mainstream international management techniques with no particular emphasis on ethics. During the 1990s the company changed and developed a policy on corporate social responsibility. This change represents a "wake-up" call that helped to transform the Shell Corporation into a corporation with focus on sustainability management and business ethics. Two fundamental events contributed to this transformation of the Shell Corporation. The first event was the Brent Spar incident in the early 1990s. In this case Shell wanted to dump the Brent Spar oil storage and loading buoy in the North Sea. The oil storage buoy had earlier been taken out of service. In 1995 Greenpeace boarded the platform and created a media storm about the environmental damages of the dumping of the

[7] Material for this case is selected from James E. Post, Anne T. Lawrence and James Weber, *Business and Society*, *Corporate Strategy*, *Public Policy, Ethics* (New York: McGraw-Hill, Irwin, 2002). See also John R. Boatright, *Ethics and the Conduct of Business* (Prentice Hall: Pearson International Education, 2003), 441.

platform. The other event that also happened in the mid-1990s happened in around the Shell productions in the North Sea and in Nigeria, where the corporation did not have any policy on respect for human rights and sustainability. Before these events Shell did not develop any specific policy on corporate social responsibility and as a business organization it preferred to be neutral with regard to local politics in the states where it operated. After the incidences in Nigeria this policy issued a major crisis of legitimacy in the world for the Shell Corporation.

In fact, the events of Brent Spar and Shell Oil in Nigeria lead to a major transformation of the corporation trying to integrate business ethics into the core strategy of the corporation. This was at least going on at the discursive and rhetoric level. However, also at the level of organizational development, the corporation tried to introduce new organizational structures that could help the organization to develop from a matrix organization to a horizontally oriented organization.[8] One of the diagnoses of the reason why the corporation could not respond properly to the crisis of Brent Spar and listen to stakeholders in the Nigeria case was said to be due to the technical and bureaucratic structure of the corporation. It was argued that it may be possible to make the corporation open to stakeholders by changing the organizational structure so that there were better communication lines and conceptions of management. The idea was that the corporation by a new organizational structure would be able to realize stakeholder dialogue and introduction of ethical principles into the organization. The public criticisms of Shell contributed to this development. By the mid 1990s the corporation began a major revision of its policies and strategies. It was argued that the Shell Corporation had to be more open to new expectations of society. The crisis of the corporation manifested the inability to conform to those expectations.

In order to establish this change of the corporation management undertook a general change of its major business principles dating back to 1976.[9] These general principles were now changed in a way that they were built on conceptions of sustainability, human rights, protection of the environment and stakeholder dialogue. The corporation published a very controversial report about these issues in 1998 called *Profit and principles. Does there have to be a choice*? In this context the Shell Corporation redefined itself from being a purely shareholder focused corporation to a corporation, which based its

---

[8] James E. Post, Anne T. Lawrence and James Weber, *Business and Society, Corporate Strategy, Public Policy, Ethics* (New York: McGraw-Hill, Irwin, 2002), 595.

[9] Ibid. p. 598.

strategies and policies on the concept of corporate citizenship. John Elkington and his consultancy Group Sustainability was indeed important for contributing to the development of this strategy.[10]

The Shell Chairman Mark Moody Stuart was very active in the formulation of new ethical principles for the corporation. Mark Moody Stuart expresses his view on the strategy of the Shell Corporation in the speech "The Values of Sustainable Business in the Next Century".[11] He argued for the values of new economic fundamentals that take into account the interests of forthcoming generations. He said that we should not forget fundamental economic laws, when we define the concept of sustainability. Profitability is necessary for business, but profitability is not sufficient for good business and human happiness.[12]

The Concept of Integrity: From Individual to Organizational Integrity

I consider the concept of integrity as being the virtue that contributes to the integration of individual and organization according to the idea of the good life with and for the other in just institutions. In this sense integrity builds the bridge between theoretical virtues and principles of business ethics and the practical moral and political life in organizations. This may be why integrity is a very popular concept of business ethics, indicating coherence, purity or completeness of a totality. The notion of integrity is often associated with true identity, honesty, respect and trust. In this sense integrity has in many contexts been defined as a personal virtue or moral value, which is most commonly associated with individuals. The value of integrity may be defined as a basic value, which should be the outcome of values-driven management. In this way integrity can be said to be of intrinsic value.

In the following I will elaborate a little bit on the contents of integrity as a personal virtue or value. However, I do not want to stop with personal integrity, but in the analysis of individual integrity, I will try to show how individual integrity is the basis for organizational integrity in the sense that the civic responsibility of individuals helps to improve corporate citizenship. Mark S. Halfdon discusses the concept

[10] Ibid. p. 600.

[11] Mark Moody Stuart, "The Values of Sustainable Business in the Next Century," 12 July 1999. Mark Moody-Stuart, former Chairman and the Committee of Managing Directors (CDM) of the Royal Shell Group of Companies and Chairman of the "Shell" Transport and Trading Company, plc. at St. Paul's Cathedral, London. See www.shell.com.

[12] Ibid.

of integrity.[13] He defines integrity as "wholeness, completeness, unimpaired or an unmarred state". With regard to individual human beings integrity expresses the wholeness of human life.[14] In existentialist philosophy there is a close link between personal commitment and the authenticity of individual existence. It is maintained that integrity involves a commitment for a certain cause or objective. A person of integrity is a person who is committed to his personal life project. With Jean-Paul Sartre we may emphasize that a person of bad faith is a person without integrity.[15] In this sense integrity involves an engagement or a commitment for an ideal, principle or cause.

But then the problem is if integrity depends solely on commitment or if it is possible to distinguish between good and bad commitment. John Rawls criticizes integrity for being an empty notion that allow for almost any content. In this perspective it may be possible to be a Nazi with integrity. It is argued that this person would be able to live with integrity with unethical principles as long as you are consistent in your actions.[16] According to this view there cannot be anything that is intrinsically valuable integrity. The notion of integrity can only have an instrumental value. Even though integrity sometimes seems to be without substantial content I do think that this criticism fully grasps the moral content of integrity. As linked to personal identity and self-respect, integrity cannot be isolated from ideas of the good and of human dignity.[17]

---

[13] Mark S. Halfdon, *Integrity. A Philosophical Inquiry* (Philadelphia, PA: Temple University Press, 1989).

[14] Ibid. p. 11.

[15] Jean-Paul Sartre, *L'Etre et le Néant* (Paris: Gallimard, 1943). Mark S. Halfdon, *Integrity. A Philosophical Inquiry* (Philadelphia, PA: Temple University Press, 1989), 18. We can say that there is a close relation between integrity and authenticity in existentialist philosophy. In fact, there are many deep issues and also some paradoxes at stake in the concept of integrity from the point of view of existentialist philosophy. If integrity is related to sincerity we can ask the question how you can be sincere with integrity when the basic condition of existence is to be in bad faith that is according to Sartre "not to be the one that you are and to be the one that you are not" because existentialism is the philosophy of the human condition as negativity that is that human reality is to negate being in order to create meaning. From this existentialist point of view of negation and non-being, integrity would include a fundamental ability to have reflective self-awareness and existential wisdom of the individual. It would be sincerity in the existentialist sense where sincerity and authenticity are closely linked with integrity as the ability to be committed and engaged in life as a person with an authentic life project who is faithful to one's personal ideals and concepts of a good life with commitment, engagement and sincerity. Accordingly, from the existentialist point of view, personal integrity is closely linked to personal identity where ontological commitment and understanding of existence in a deep personal sense including a reflexive understanding of cynicism, irony and sincerity is an important dimension of integrity.

[16] Mark S. Halfdon, *Integrity. A Philosophical Inquiry* (Philadelphia, PA: Temple University Press, 1989), 136.

[17] Robert C. Solomon states this very clearly when he emphasizes that the virtues of the Nazi do not have anything to do with integrity. The concept of integrity is closely linked to morality and values. There can be no integrity without real moral values. Robert C. Solomon, *A Better Way to Think About Business. How Personal Integrity Leads to Corporate Success* (Oxford: Oxford University Press, 1999), 43. As defined as wholeness integrity should be defined as implying the wholeness of

Along with Bernard Williams we might say that utilitarian or consequentialist thinking is incompatible with integrity because consequentialism does not imply any basic commitments but a willingness to give up every moral ideal as long as it leads to the best consequences.[18] Bernard Williams holds that our moral actions come from projects to which we are fundamentally committed in a way that we do them because they contribute to constitute our fundamental identity and integrity. In this perspective integrity defines our basic dispositions and motives for actions.[19] Thus, the importance of integrity is founded in its expressions of our deepest motives and values.

Moreover, there seems to be some implicit moral requirements in the concept of integrity excluding that any commitment could be a commitment of integrity. Integrity constitutes the wholeness of personal identity which has a narrative content as the unity of personal character which is defined by the virtues, practices and dispositions of the individual that are realized as personal identity in a life-long moral commitment.[20] Accordingly, it seems like there are internal constraints on the possible commitments from the perspective of integrity. Possible commitments of individuals are limited to consistent moral ideals.[21]

On this foundation integrity as a personal commitment to moral ideals may be defined as a virtue that orients individuals towards practical goodness and excellence. Good and virtuous people are people who possess integrity and in the life-long period of their existence they develop integrity as a part of their character and commitment to life. In the perspective of such a Kantian moral philosophy, integrity is closely linked to autonomy and dignity. Integrity functions as a norm

---

virtue, wholeness of the human person. Integrity is not selfishness because it is about the individual in relation to the larger picture and it integrates the individual in the sense of being an integral part of something larger than the person, that is for example community, corporation, society, humanity and cosmos (p. 38). In this sense integrity involves openness, flexibility, affection, cooperation and caring and it stands in sharp contrast to other figures of personal morality who are without integrity: the hypocrite, the opportunist and the chameleon (p. 41). In integrity one remains morally autonomous by being true to one-self and to community. With this approach Solomon emphasizes that the most important aspect of integrity may be the ability top follow basic virtues of honesty, fairness and trustworthiness as means between extremes (p. 69). Accordingly, for Solomon, we have to formulate a catalogue of good business virtues as expression of integrity. These virtues should not come from the top like the ten commandment of Moses, but they should rather be based on human deliberation, choices and decisions aiming at the good life (p. xvi).

[18] Bernard Williams, ed. "Ethical Consistency," *Problems of the Self* (Cambridge: Cambridge University Press, 1973), 166–186.

[19] Bernard Williams, in *Utilitarianism: For and Against*, eds. J.C. Smart and Bernard Williams (Cambridge: Cambridge University Press, 1973), 98f. See also Bernard Williams, *Utilitarianism and Moral Luck* (Cambridge: Cambridge University Press, 1985).

[20] Susan E. Babbitt, *Artless Integrity, Moral Imagination, Agency, and Stories* (New York and London: Rowman and Littlefield Publishers Inc., 2001).

[21] Mark S. Halfdon, *Integrity. A Philosophical Inquiry* (Philadelphia, PA: Temple University Press, 1989), 37.

for autonomous actions of individuals.[22] It puts constraints on duties and defines individual's concerns for wholeness and unity of life. Integrity refers to a commitment for basic goods and to self-control linked to personal commitment.[23] Moreover, integrity is close connected to the idea of the individual as a moral agent with self-respect and a good will striving towards ad moral ideal. We might say that integrity represents a set of values and principles to which one is fundamentally committed. Free human beings form the moral identity in good judgment according to a reasonable life-plan of good disposition. In the Kantian perspective integrity is a fundamental virtue of good moral character that includes moral principles.[24]

A challenge to this concept of integrity is the relation between commitment and adversary. How do persons of integrity behave in situations of moral conflict? It is indeed a problem how we should understand the ethics of adversary.[25] A person of real integrity will not give in when this person is confronted with other challenges and demands to behave in another manner. Instead a person of integrity will stick to the moral ideals that define this person's identity. There is a close link between integrity, consistency and commitment to moral ideals. A person of integrity maintains the commitment in situations of conflict and temptation.

But these ideas lead us to the problem of the connection between moral integrity and compromise. The problem is whether compromise in action can be accepted as an integral part of the virtue and value of integrity. It could be argued that compromise cannot be accepted as a part of integrity because integrity requires uncompromising behavior with regard to basic moral principles or ideals. Uncompromising behavior would in this perspective be a fundamental part of the character of the good person. So the problem is to which extent compromise can be justified as a part of the value of integrity. Indeed this is difficult to admit if we like Bernard Williams define the value of integrity as closely connected with personal responsibility.[26] There seems to be very little space for compromise according to our definition of integrity as moral purity and consistency. It might be difficult to see how one can keep integrity and still confront other people with other moral values.

However, I think it may be possible to engage in compromise and still keep your moral integrity. In this context we may introduce the notion of reassessment. This concept implies that it is possible to revise the one's idea of integrity in a way that a moral compromise would not lead to the loss of integrity.[27] But opposed to this

---

[22] Immanuel Kant, *Grundlegung zur Metaphysik der Sitten* (1785) (Hamburg: Felix Meiner, 1999). Immanuel Kant, *Kritik der praktischen Vernunft* (1784) (Hamburg: Felix Meiner Verlag, 1985). Immanuel Kant, *Metaphysik der Sitten* (1797) (Darmstadt: Werke, Band IV, 1983).

[23] Hayden Ramsey, *Beyond Virtue. Integrity and Morality* (New York: MacMillan Press, 1997).

[24] Ibid. p. 54.

[25] See Arthur Isak Appelbaum, *Ethics for Adversaries. The Morality of Roles in Public and Professional Life* (Princeton, NJ: Princeton University Press, 1999).

[26] Mark S. Halfdon, *Integrity. A Philosophical Inquiry* (Philadelphia, PA: Temple University Press, 1989), 83.

[27] Ibid. p. 100.

view we may say that integrity remains an ideal that cannot be realized in every situation. In some situations compromise is necessary in order to keep integrity. This might imply a reassessment of some principles, but it does not lead to giving up every kind of ideal and principles constituting personal visions of integrity. Given this, we can still admit that moral conflict may be desirable for persons of integrity in a way that the value of integrity involves an attitude where individuals are ready to confront moral issues as a part of their effort to keep their personal integrity.

We may argue that ethical responsibility relates to different contexts and therefore the self in some cases has to enter into compromise in order to maintain the relation with these different contexts. Of course there is a tension between integrity and compromise, but in some cases to preserve the core of the self may include compromise in certain contexts.[28] We can argue that the idea of reasonableness and of prudence and judgment are the concepts that allow us to combine compromise and maintenance of integrity.[29] Instead of total reassessment we may say that integrity is the capacity to maintain oneself in confrontation with others. This is the capacity to maintain and develop important values in the life with others in community. It might be the real sense of good integrity that you can engage in dialogue with others and reach morally view that are morally acceptable for everybody.

A further argument against integrity and in particular the attempt to go from individual to organizational integrity is that it is impossible to combine individual and organizational integrity. This argument may recognize the importance of individual moral integrity, but it thinks that it is impossible to move from individual to collective moral integrity. Such an argument that is critical towards applying integrity at the organizational level can be found in the work of Milton Friedman who can be said to have defended the position that companies as economic-legal entities do not represent anything else than the sum of individual actions.[30] From this point of view, an organization can have legal responsibilities as an artificial, judicial person, but this has nothing to do with individual integrity. The organization remains according to this criticism a legal fiction and there it is not meaningful to talk about integrity at the organizational level. Individuals can have integrity, but not organizations. Accordingly, in Friedman's perspective, the concept of organizational integrity is meaningless, because organizations are not collective units, only combinations of individuals. Only human individuals with consciousness and intentions and with a free will can be attributed moral integrity and accountability, not organizational systems and structures. So it is true that an individual has integrity, but it is impossible to say that an organization as a collective structure can have

[28] Jerry D. Goodstein, "Moral Compromise and Personal Integrity: Exploring the Ethical Issues of Deciding Together in Organizations," *Business Ethics Quarterly* 10, 4 (2000): 805–819, 809.

[29] Ibid. p. 815.

[30] Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits." *New York Times Magazine* 1970. Reprinted in Scott B. Rae and Kenman L. Wong, *Beyond Integrity. A Judeo-Christian Approach to Business Ethics* (Grand Rapids, MI: Zondervan Publishing House, 1996), 241–246.

moral integrity. This view is combined with a refutation of the idea that an organization should have aims and fundamental responsibilities than being an agent that serves the interests of owners or shareholders. This is a *single objective conception* of the firm where the manager does not have any other responsibility than being an agent for the interests of the owners and the shareholders.[31]

Friedman admits that the personal responsibility of the CEO may be oriented towards society, but this does not coincide with his responsibility as an employee in the company. If the firm is not committed to this objective it is no longer only an economic actor but it also functions as a political agent, which in the same way as the state takes taxes and reallocates resources between shareholders, customers, consumers and the weakest in society. But here we go beyond the professional integrity of the manager that commits him or her to serve the interests of shareholders and owners. So the argument against the move from individual to organizational integrity is build on the combination of the individualist conception of the firm as nothing more than an economic and legal contract between individual agents and the view of integrity as understood as the professional integrity of the manager to stay committed to the interests of the owners and shareholders. In order to argue for collective accountability as the basis of organizational integrity, we would have to show that a corporation at the institutional and collective level can be attributed integrity and responsibility. Here, we have to go against the point of view of Milton Friedman. But according to the point of view of integrity of the finance professor Michael Jensen there does not have to be an opposition between individual and organizational integrity and it also seems that individual integrity applied at the organizational level is a condition for good financial performance. However, Jensen is so much focussed on performance that he does not really have the power to conceptualize the ethical basis of integrity, because he considers organizational integrity mainly from the strategic point of view.[32]

[31] The Harvard Professor Michael Jensen has recently started to work on the concept of integrity as central to leadership (Harvard Business School Research Paper No 07-03 - see se website: ssrn.com/sol3/papers). In fact, Jensen does not seem to agree with the point of view that we cannot move from individual to organizational integrity since he says that he provides a model of integrity that provides powerful access to increased performance for "individuals groups, organizations and societies". Jensen and his colleague Steve Zaffron argue that there is confusion between morality, ethics and legality in the concept of integrity and that they want to clarify this but they do not seem an opposition between the single objective view of the firm in relation to the idea of collective integrity of the firm. They define integrity as a state of "being whole, complete, unbroken, unimpaired, sound, perfect condition". What is argued by these supporters of the financial view of the firm is that integrity is a necessary condition of workability in order to increase performance. So in this view integrity becomes an important element in increasing organizational performance and in contrast to the nominalist and individualist position proposed by Friedman. Accordingly, there does not have to be a contrast between the financial view of the firm and idea of going from individual to organizational integrity. However, the debate may be whether this financial view can be combined with an ethical view of organizational integrity.

[32] Michael Jensen, "Integrity: Where Leadership Begins. A New Model of Integrity," *Harvard Business School*, *NOM Research Paper*, No. 07-03.

Contrary to the point of view of Jensen, we find in the legal theory of the famous philosopher of law Ronald Dworkin an attempt to consider integrity at the organizational level simultaneously as a legal and as an ethical principle. So with Ronald Dworkin we can develop the move from individual integrity towards organizational integrity. In law Dworkin defines integrity as simultaneously a legislative and adjudicative principle. The idea is that judges understand all laws and legal principles as created by one judge who searches to apply those laws and principles consistently in moral framework.[33] Those principles are in law a matter of interpretation and the judge ought to interpret the law as expression of historical and cultural consistency with the rules and principles of the legal order. A law as integrity is a political ideal for the application of the norms of the order in order to create a "true community".[34]

In being concerned with jurisprudential integrity, Dworkin helps to bridge the gap between individual and collective action in defining the concept of integrity. He is right in explaining integrity as systemic wholeness and coherence in the judicial system. But Dworkin does not define integrity only as systemic coherence but includes a moral dimension and striving for moral excellence in his definition of law of integrity. Integrity is the definition of the effort to achieve moral excellence in the judicial system as a whole. This effort implies individual integrity, but it also goes beyond the moral behavior of persons towards the legal system as an independent unity with specific judicial requirements of integrity.[35] This vision of integrity helps us to understand the concept of integrity as an expression of practical reason, virtues and dispositions of collectivities. In this context we can refer to the professional integrity of specific organizational groups, for example integrity of the nursing profession or of the professional integrity of lawyers and indeed of organizations as a unity with a specific identity and narrative history.

Case 2. Individual Integrity and Organizational Integrity: The Case of Nick Leeson and Barings Bank

The importance of individual integrity for organizational integrity is manifested quite explicitly by the case of Nick Leeson and Barings Bank. This case is selected although it is rarely used as a classic case in business ethics. The case may however be said to be a case about *ethical crisis* in the sense that Nick Leeson was confronted with his ethical duty to tell his wrongful actions to the bank in order to make collective action possible.

In 1992 Nick Leeson is placed in Barings Bank department in Singapore. Barings Bank was founded in 1762 and it is well-estimated international bank.

[33] See Ronald Dworkin, *Law's Empire* (Cambridge, MA: Harvard University Press, 1986).

[34] M.D.A. Freeman, ed. *Lloyd's Introduction to Jurisprudence*, Seventh Edition (London: Sweet and Maxwell, A Thomson Company, 2001), 1401.

[35] Ronald Dworkin, *Law's Empire* (Cambridge, MA: Harvard University Press, 1986).

Leeson was promoted very quickly and soon he became supervisor and general manager in Barings Bank in Singapore that among others was operating on the Singapore Monetary Exchange. However, soon Leeson shows lack of integrity and managerial judgment.

His position as general manager gives him the possibility of hiding losses in trading at special accounts and in 1992 he establishes a special account in order to hide a trading loss of 20 million dollars. Moreover, he does not stop with this incident and due to bad transactions the losses of the account has reached 512 million dollars 2 years later in 1994. However, the bad character of Leeson is not the only reason for this development. Due to failure of organizational control it is very easy for him to hide the errors of investment management. And there had already in 1993 been internal warnings about his position in the bank stating that it was problematic that Leeson was both controller and investment trader and negotiator.

The result of this lack of control is a loss of the Bank at more than 1.3 billion dollars and most of this is due to the dispositions of Leeson. Leeson escapes when the managers of the bank discovers what he has done but he is soon arrested in Germany and brought back to Singapore in 1995 and Leeson is punished by 6 and a half years prison. Moreover, Barings bank is not able to cover the losses and the bank goes bankrupt and more than 1200 employees are without jobs. Investors in the bank loose their money and Barings bank with all its debts is bought by the Dutch bank ING.

The lesson of this case is an account of the importance of both individual and organizational integrity. Individual integrity is dependant on personal judgment and ability to make good choices, but it is also dependant on organizational structures. Leeson said to BBC that he "did not consider himself as a criminal" and in his autobiography "The Rough Trader" he argues that there was an ethos in Barings of profits that was an obstacle to his ability to be aware of the problems with his choices. From this perspective it is important to emphasize the need of good organizational structures to promote a background culture for ethics in organizations.[36]

[36] Material for this case is inspired by Judith H. Rawnsley, *Total Risk: Nick Leeson and the Fall of Barings Bank* (Mass Market Paperback) (London: HarperCollins Publishers, 1996), Reprint edition. See also Nick Lesson, *Rogue Trader: How I Brought Down Barings Bank and Shook the Financial World* (London: Little Brown and Company, 1996). Analysis of the discursive elements in this case is based on Anders Bordum and Jacob Holm Hansen, *Strategisk ledelseskommunikation. Erhvervslivets ledelse med visioner, missioner og værdier* (København: Jurist og Økonomforbundets forlag, 2005).

Integrity in Corporations: The Concept of Organizational Integrity

In fact, with the work of the Harvard Business Lawyer and Business Ethicist Lynn Sharp Paine, we can find an attempt to combine the strategic and the ethical concept of integrity at the level of organizational integrity that accomplishes the move from individual to organizational integrity. In organization theory and business ethics, Lynn Sharp Paine has done a pioneering work with her effort to make the move from individual to organizations and define the concept of organizational integrity.[37] We might say that the starting point is the requirements of a modern business environment marked by increasing competition, higher demands on employee knowledge and qualifications as well as a value-pluralistic society where employees and management not necessarily have common values prior to their participation in the organization. Lynn Sharp Paine defines organizational integrity in a broad sense as "honesty, self-governance, fair dealing, responsibility, moral soundness, adherence to principle and consistency of purpose".[38]

This concept of "organizational integrity" comes also from the Latin origin of the word, which is "integritas", wholeness or purity. In this sense integrity implies a sense of responsibility, commitment and self-governance. Integrity is closely linked to the identity of the organization. Defined in such a way the quality of integrity comes in degree in accordance with the status and stability of the organization.[39]

Paine is concerned with how to build and maintain integrity in organizations. She is not only interested in the concept of personal integrity, but she wants to apply integrity at the organizational level as a particular basis for analysis. The problem is how organizations can be improved in order to develop organizational integrity. This includes the particular strategies and knowledge that is required for managers in order to develop organizational integrity. There is a close link between organizational integrity and personal integrity. Paine emphasizes that high integrity organizations cannot exist without individual commitment to integrity, but it must also be recognized that individual integrity cannot persist without a more global commitment to integrity at the level of organizational policies and purposes.

In many cases individuals lose their personal moral commitments when the organization cannot support the development of personal integrity through institutionalized procedures of values-driven management and organizational policies. It is important to be aware of the fact that organizational integrity goes beyond personal integrity in the sense that it involves purposes and ideals of the organization as an independent unit with its own responsibility and commitment. In this sense, organizational integrity may be determined as the goal of management and leadership of the organization. Organizational integrity can therefore be defined as the suggested

[37] Lynn Sharp Paine, *Cases in Leadership, Ethics and Organizational Integrity. A Strategic Perspective* (Chicago: Irwin, 1997).

[38] Ibid. p. vii.

[39] Ibid. p. 98.

outcome of successful policies of values-driven management, e.g. on human rights, environmental protection or product safety.

On this basis, we might develop a strategy in order to build and maintain organizational integrity. The work for values-driven management can be considered as an effort to establish such norms. This involves the development of strategies to foster organizational integrity in specific organizations. Indeed, responsible decision–making at all levels of the organization is the ultimate dimension of organizational integrity contributing to organizational effectiveness. In this perspective, along with Paine we can emphasize some important requirements for organizational decision-making leading to improvement of organizational integrity. Ethical principles should be interpreted in the light of social and technological change for this specific organization. Ethical principles are applied according to the specific dimensions of the reality of the specific organization. In this context work for organizational integrity must take into account different stakeholders and cultural dimensions of the organization.

Accordingly, organizational integrity means that policies and strategies in organizations are based on ethical principles and values that are promoted as the foundation of organizational excellence. In this way the company is considered as an agent, which shows its character and identity in its actions and capacity of self-governance. In such a perspective of organizational integrity we may define ethics as an “invisible infrastructure of norms”.[40] But these norms may also be formulated explicitly in the policies of values-driven management of the company. Ethics and values imply the effort to engage in right relationships with the stakeholders and constituencies of the firm in order to create an environment of trust and responsibility. Indeed, in the modern knowledge-based economy, these requirements for organizational integrity are becoming increasingly important in order to ensure cooperation for good performance in the organization.[41]

This strategic perspective on integrity does not agree with those who argue that there is a necessary opposition between economic efficiency and organizational excellence.[42] Rather, organizational integrity is a basic requirement for building

[40] Ibid. p. 2.

[41] Lynn Sharp Paine, *Cases in Leadership, Ethics and Organizational Integrity. A Strategic Perspective* (Chicago: Irwin, 1997), 3.

[42] Robert C. Solomon emphasizes that the idea of integrity implies a whole new way to think about business that seeks to overcome the dominant trivial metaphors of how we do business: “The question ‘who really benefits’ is a misunderstanding. To transcend the opposition of self-interest (profitability) and ethics is what the focus on the virtues is all about. Whether or not virtue is ‘its own reward’, the virtues on which one prides oneself in personal life are essentially the same as those essential to good business – honesty, dependability, courage, loyalty and, in short, integrity. To be virtuous, in other words, is to act in one’s own *best* interests” Robert C. Solomon, *A Better Way to Think About Business. How Personal Integrity Leads to Corporate Success* (Oxford: Oxford University Press, 1999), 34. In fact, an integrity strategy suggests to go beyond the many metaphors that Solomon thinks contribute to a “dehumanization of business” including “Making money, business is war, business is brutal violence, business is a battlefield, business is based on survival of the fittest, a corporation is an efficient money machine, business is a game of decisions, a corporation is

and maintaining effective organizations.[43] Empirical analysis of values-driven management has shown that well-defined values-systems and ethical principles are important in order to develop competitive companies.[44] A coherent set of values throughout the organization helps to strengthen and improve the image, market share and social position of the company. Social responsibility efforts in order to improve the social reputation and image of the company are important dimensions of Lynn Sharp Paine's integrity strategy. High integrity companies are recognized by their ability to take part of social efforts of community. Global social responsibility initiatives contribute to improvement of the long-term integrity of the company.

We might emphasize that organizational integrity is the result of a long process of developing values in organizations.[45] Moreover, organizational integrity has an independent status, when we compare it to individual integrity. It may be possible to have an organization where all individuals consider themselves as individuals of high integrity while the organization as a whole is acting unethically. But the contrary can also be possible. Due to organizational policies and strategy a high integrity organization may consist of a number of low integrity individuals who due to these structures act with integrity in the organization. With a somewhat free citation of Immanuel Kant we might say: – even a "population of devils can live in a community based on the rule of law".[46] But this is only the case in very rare circumstances. Based on our analysis of personal integrity a close connection between integrity of individuals and of organizational structures seems to be the best way to achieve organizational integrity. The need for construction of integrity at the organizational level is due to the fact that it is not possible to presuppose a common ethical culture among the stakeholders of the company.

Moreover, an integrity strategy is aware of human fallibility and vulnerability and therefore it is considered necessary to build organizational structures that can ensure good ethical principles and values in the company. Even though Paine is aware of the necessity to consider economic performance as a part of a successful integrity strategy of a company, she also suggests that an overemphasis of financial results may be damaging to organizational integrity as well as to the motivation and

---

a machine, business is characterised by competitive cowboy capitalism and finally the idea that the abstract greed as such is good". I agree with Solomon that we need to go beyond such metaphors and that it is very important to acknowledge that integrity is closely linked to professionalism as the result of the virtue of integrity. We may say that the strategy for organizational integrity goes beyond the dehumanizing metaphors of business.

[43] Lynn Sharp Paine, *Cases in Leadership, Ethics and Organizational Integrity. A Strategic Perspective* (Chicago: Irwin, 1997), 3. We can as indication of the importance of integrity in business refer to the motto of Harvard Business school: "Make Business a Profession".

[44] Joshua Joseph, "Integrating Ethics and Compliance Programs. Next Steps for Successful Implementation and Change," *ERC Fellows Program* (Washington, DC: Ethics Resource Center, 2001).

[45] Muel Kapten and Johan Wempe, *The Balanced Company. A Theory of Corporate Integrity* (London: Oxford University Press, 2002), 152.

[46] See Immanuel Kant, ed., *Metaphysik der Sitten* (1797), (Metaphysics of Morals) *Werke* (Darmstadt: Band IV, 1983).

commitment of employees.[47] Financial success and profit maximization is not likely to give the best outcome of integrity and long-term stability of a company.

Organizational integrity relies on the ability to establish, maintain and communicate ethical standards throughout the company. Along with Paine we may cite Chester Barnard's classical study *Functions of the Executive* (1938).[48] In this book personal values and commitments of the executive managers are referred to as fundamental for organizational development. As we have seen top management has leading roles in enforcing and developing the values system of the firm.

A very important dimension of an integrity strategy for organizational improvement is the distinction between "compliance" and "ethics" oriented strategies. While compliance strategies focus on compliance with the law, integrity based strategies focus on values, ethics and organizational excellence. Lynn Sharp Paine emphasizes that integrity based corporations do not only search to prevent wrongdoing, but they have the broader aim at ensuring ethical and responsible behavior.[49] Legal compliance and law enforcement are not viewed as the ultimate goals of management, but rather as some necessary means in order to attain the higher goal of corporate integrity.

Even though integrity based companies may adopt standards of compliance in their values and ethics program they also differ in their ethos, objective and behavioral assumptions lying behind their conception of a strategy for ethics management.[50] Indeed, compliance is an important goal, but an integrity strategy is not satisfied with compliance with law. Some issues may be legal, but still not very ethical and moral. Moreover, not being aware of ethical sensibility in the public and the specificity of ethical problems in a gray zone between ethics and law can cause huge problems for an organization. The law might be limited with regard to give individual guidance for good and responsible behavior. Indeed, legal approaches may presuppose knowledge of the law and well-developed legal systems and regulations.[51] But many specific corporate issues are marked by a striking absence of legal regulation. In addition, organizational excellence goes far beyond mere compliance with legal rules.

Accordingly, an integrity-based strategy, driven by values is much broader than the legal approach. In the integrity-driven approach, words like commitment, empowerment and accountability are central. Moreover, this strategy seeks to motivate the creativity and initiative of the employees.[52] Integrity-based strategies are

[47] Lynn Sharp Paine, *Cases in Leadership, Ethics and Organizational Integrity*. *A Strategic Perspective* (Chicago: Irwin, 1997).

[48] Chester Bernard, *Functions of the Executive* (Cambridge, MA: Harvard University Press, 1938).

[49] Lynn Sharp Paine, "Managing for Organizational Integrity," *Harvard Business Review* 72, 2 (1994): 106–117.

[50] Lynn Sharp Paine, *Cases in Leadership, Ethics and Organizational Integrity. A Strategic Perspective* (Chicago: Irwin, 1997), 94.

[51] Ibid. p. 96.

[52] Ibid. p. 96.

more flexible and consider employees more responsible. But even though compliance strategies may be quite stiff and based on top-down management and rather bureaucratic police structures, there may not be an intrinsic opposition between integrity and compliance. Rather these two strategies can complement each other in a global strategy for organizational integrity.

In this context companies following an integrity-oriented strategy in their approach to values-driven management may develop very different concrete outcomes of their strategies following their specific corporate history, identity and symbolic structures. These different histories and identities are reflected in different formulations of corporate values and codes of conduct.

However, it is also possible to identify some general aspects going across the different corporate strategies. A general characteristic of a high integrity company based on values-driven management is the great commitment of the members to the organization. There is a high degree of coherence between principles and values and the daily practice of the organization. The organization works for little opposition between practice and principles. In an integrity-based organization, members take ownership of their conduct and their relations to the organization. Moreover, members tend to be fair, accountable and truthful about their actions in the organization. They are aware of their responsibility in the organization and they have a strong sense of the identity of the organization. They are very committed to the purposes and ideals of the organization. Indeed, an organization is capable of acting with collective identity, but a determinant characteristic of this identity is that the organization is committed to respectful and fair relations to its stakeholders.[53]

Case 3. KPMG International: Accounting Practices with Integrity

We can mention the Swiss based KPMG International as a European based international accounting firm that searches to appear as a good corporate citizen.[54] This case has been selected as an illustration of a company that searches to do an *ethical effort*. It is a case of a company that deals with the problem of organizational integrity at the collective level.

KPMG is a network of firm that has more than 103.000 employees worldwide. The corporation provides audit, tax and advisory services to many different organizations with different political, legal and economic challenges. Today KPMG focuses on global and multinational companies and the firm delivers accounting services and financial services to many different international companies. KPMG refers to "Performance of integrity" as

[53] Ibid. p. 98.

[54] Material for this case is among others selected from the KPMG Global Code of Conduct.

the most important virtue of the accounting profession. Integrity is linked to professionalism, transparency and quality. Those values are reflected in the KPMG Global Code of Conduct, which is based on the values of the organization that are supposed to create a shared sense of identity. The values of KPMG imply "leading by example, working together, respect for the individual, seeking facts and providing insights, being open and honest in communication, being committed to communities, and as fundamental being organization acting with high integrity".[55] The firm emphasizes that integrity as core value integrity underlies all the principles of the global code of conduct. To act with integrity means treating everyone with respect and dignity, respecting privacy and creating a non-discriminatory work-environment. Moreover, it implies commitment to the professional responsibility with the organization as well as loyalty to the procedures and methodologies of the organization. Furthermore, it includes respecting the law and ethics of business, including confidentiality and fair competition. Therefore KPMG links integrity to the performance of being a responsible corporate citizen.

At its website KPMG promotes the company as an accounting firm with social responsibility, committed to the communities in which it operates. For KPMG corporate social responsibility is linked to reputation and implies concern for different stakeholders like the people in the organization to who the firm feels responsible. Moreover, corporate social responsibility implies transparency and integrity with regard to the clients and customers of the firm. The organization also mentions responsibility towards local communities as important for its work. Finally, the virtue of efficiency and the best use of resources are considered an important part of corporate social responsibility. Individual responsibility based on integrity of employees in KPMG include willingness to "stay informed, stand firm, take ownership, surface the issues and to consult with others". In this sense integrity is considered at the same time as a collective and individual process integrating individual and collective concerns in a unity based on teamwork and feeling of commitment to the professional community of the organization.

Finally, in its Global Code of Conduct KPMG includes an ethics checklist: "When making a decision or following a directive, ask yourself: Does my action comply with the spirit and letter of KPMG policy and applicable law?

[55] KPMG Global Code of Conduct It is also inspired by McIntosh, Malcolm, Deborah Leipziger, Keith Jones, and Gill Coleman, *Corporate Citizenship, Successful Strategies for Responsible Companies,* Financial Times (London: Pitman Publishing, 1998), 244–245. See also Muel Kapten and Johan Wempe, *The Balanced Company. A Theory of Corporate Integrity* (London: Oxford University Press, 2002). In this book they develop the concept of integrity on the basis on analysis

Is my behaviour consistent with KPMG's core values and ethical or professional standards? Does my decision reflect the right thing to do? Is my decision being driven by responsible professional judgment? Would I feel confident that I could explain my decision if it were made public? Be attentive: stay informed the ethical and legal standards that apply to your job activities. Know whom to ask if you are unsure of the right thing to do. Speak up if you have a concern. Get help if you need it".[56]

Possibilities and Dilemmas of Leadership Strategies for Organizational Integrity

On the basis of our clarification of the notions of individual and organizational integrity we will now try to address how it may be possible to improve the establishment of organizational integrity.[57] The problem is how integrity can be a direct part of strategies for leadership and organizational excellence at different levels of the organization. In opposition to the view of management not as a practical art for achieving excellence, but as a science of strategic planning and corporate finance Joe Badaracco Jr. and Richard Ellsworth have addressed this problem.[58] They examine how different management strategies face dilemmas of leadership in their efforts to achieve organizational integrity.

This analysis focuses on the basic assumptions and presuppositions of three common strategies of management, which are (1) political leadership (2) directive leadership and (3) values-driven leadership. These different strategies are then considered in relation to the most important dilemmas that managers are confronted with in order to understand the possibilities and dilemmas of management's quest for integrity and excellence in organizations. The different philosophies of leadership may be understood as some fundamental prejudices that managers have when they approach different problems in their organizations. In these different prejudices the quest for integrity plays an important role in helping managers to overcome problems and strife towards organizational excellence.[59]

---

of this concept as presented by the KPMG, KPMG International. Audit, Tax, Advisory. KPMG International 2005.

[56] Ibid.

[57] Muel Kapten and Johan Wempe, *The Balanced Company. A Theory of Corporate Integrity* (London: Oxford University Press, 2002).

[58] Joe Badaracco, Jr. and Richard R. Ellsworth, *Leadership and the Quest for Integrity* (Cambridge, MA: Harvard Business School Press, 1989), 4.

[59] Ibid. p. 9.

I think that the different strategies of leadership can be considered as some of the most common strategies for improving values-driven management of an organization. In this context we may distinguish between the management strategy of values-driven management and other strategies of management based on process, formality and substance. In some cases organizations work with values-driven management without accepting that it may be necessary to reflect the strategy of values in the leadership style of the organization. So organizations may try to improve organizational integrity and excellence by using a political or directive style of leadership, which would be somewhat different from a strategy that is directly based on personal integrity and values.

The strategy of political leadership is based on the view that good managers are good politicians. They have the acquired political sensitivity and cleverness to translate a political vision into reality. The political perspective on organizations focuses on the capacity of management to gain power over forces of self-interest.[60] Political management view leadership as an ability to get power and unite different forces of the organization. The basic assumption of political management is that they are certain forces that split the organization and make it more bureaucratic and resistant to change.[61] From the perspective of political management self-interest and lack of common perspective contributes to disorganization of the corporation. Scarce resources and increasing complexity contribute to disorganization of the corporation. Thus, bureaucracies and resistance to change is the natural reaction of people of self-interest who seek security. Therefore people are reluctant to new strategies and they hide themselves behind formal and informal routines.

It is the job of good business leaders to make the organization overcome these oppositions in the company. The political leader is searching for a strong consensus about the goals and values of the organization. This strategy is based on a broad policy in order to make consensus among the members of the organization. Political leadership seeks to view their objectives form pragmatic viewpoints of how to find the best way of achieve agreement among members of the organization in order to develop the organization. Political leaders are both interested in substance and processes and they work on realizing their goals and visions through a long series of negotiations and compromises.[62] In this perspective organizational integrity is the result of this process of conflict mediation in order to achieve unity.[63]

While political leaders may see an advantage of placing themselves in the background and in some cases only behave as process managers, directive leadership emphasizes the importance of direct personal involvement. Directive leadership seeks to guide the company by outstanding visible managers that contribute with

[60] Ibid. p. 14.

[61] Ibid. p. 15.

[62] Ibid. p. 36.

[63] The metaphor of the fox and the ability to act behind the scenes are important aspects of political leadership in this sense. Contrary to a deliberative conception of political leadership this view considers management as a rather "Machiavellian exercise". See for example the classic work of Anthony Jay, *Management and Machiavelli* (Englewood Cliffs, NJ: Prentice Hall Press, 1996).

a direct, clear and forceful intervention in conflicts. It is argued that the leader must take strong responsibility for key decisions.[64] Good leaders are present at all levels of the organization and they contribute to coherence by giving their employees a strong a forceful motivation. This philosophy of leadership is based on the assumption that employees are driven by strong personal forces of motivation that help to encourage them in their daily work. It is argued that people are willing to work harder if they can see the visible presence of the leader in a strong commitment to the basic values of the organization. The philosophy of directive leadership thinks that it is the creation of bureaucratic structures without presence of leadership setting a strong example that causes deterioration of organizations.[65] This management strategy argues that political leadership is dangerous for trust and common vision of the company.

Directive leaders focus on putting their personal vision into the company and commit it to a basic mission or purpose. They are critical towards political consensus strategies. Companies are considered to be fundamentally different from democracies. Outstanding managers are not afraid of conflict and they do not work to get consensus at any means.[66] Rather consensus is the result of the acceptance of directive decisions of management. Leaders focus on few basic objectives that they communicate clearly to members of the organization. Lack of such communication may be the cause of complexity and lack of clarity and focus in modern organizations. But it may also be determined by the fact that managers of the organization have not managed to show their outstanding leadership abilities. Instead leaders should communicate openly and frankly put forward their views and make their decisions clear to the members of the organization. Employees should be in direct contact with leadership and it is the task of management to focus on the education of strong and good leaders of high integrity that secure unity and commitment in organizations.[67]

While both political and directive leadership often are used to install and work with values-driven management in organizations it is only values-driven leadership that directly addresses values of the organization. Values-driven leadership is fundamentally oriented towards basic values in the organization. This kind of leadership wants ethical values of fairness, integrity or justice to be the focus of the organization. Moreover, we can argue that good performance of the company is dependent on its commitment to common values. Leadership might involve both political and directive measures but surely in order to achieve organizational integrity, managers should rather work with development of values and norms at all levels of

[64] Joe Badaracco, Jr. and Richard R. Ellsworth, *Leadership and the Quest for Integrity* (Cambridge, MA: Harvard Business School Press, 1989), 40.

[65] Ibid. p. 42.

[66] Ibid. p. 45.

[67] The concept of directive leadership may indeed be compared to the concept of "Charismatic Leadership" in Max Weber's sociology of leadership. We can find many similarities between the two concepts.

the organization.[68] Badaracco and Ellsworth have the opinion that the strategy of values-driven leadership cannot be considered to be a simple alternative to the other two strategies, but it rather transcends these strategies.[69] I think that this is correct, but would like to add that values-driven leadership seems to be an overlapping strategy that includes elements from the two other strategies. Neither political abilities nor directive capacities are sufficient because values-driven management demands commitment of leaders to basic values both in his or her personal behavior as in organizational policies.

We can therefore argue that integrity is an important part of good management as a strategy for good corporate citizenship. Values-driven leadership is based on a commitment to the common good of the corporation rather than to personal interests or gain. It is the task of the leader to make the values visible and present in the company. This view is based on a conception of human nature that implies a vision of employees as being committed to their job in a manner that differs from pure economic interest or interest in power or prestige.[70] In fact this view of human nature is rather ambitious due to the fact that work is not considered as purely an economic necessity but as a part of human creativity and accomplishment.[71] In this perspective the aim of the company is not only economic performance, but respect for basic values and the mission statement of the organization indicates that the company has an important mission to fulfill in society. Moreover, the company is considered as the realization of a vision of shared values, which fundamentally have an ethical dimension of justice and integrity.[72]

The strategy of leadership based on values-driven management is therefore focusing on the embodiments of values in work in order to intensify commitment and creativity among employees.[73] Values have an ability to support financial compensation with psychological award so that employees are producing better and feeling happier when they do something, which they feel have an importance for society. Values are also supposed to improve the level of communication as well as the decision-making process in the organization because they create greater commitment and trust among members of the organization. Accordingly, values-driven leadership does not exclusively formulate strategy on the basis of economic values. Instead, economic and other original values of the firm are considered in the perspective of what is viewed as the meaningful purpose of the company.[74]

---

[68] Joe Badaracco, Jr. and Richard R. Ellsworth, *Leadership and the Quest for Integrity* (Cambridge, MA: Harvard Business School Press, 1989), 65.

[69] Ibid. p. 66.

[70] Ibid. p. 71.

[71] Ibid. p. 73.

[72] Dawn-Marie Driscoll and W. Michael Hoffman, *Ethics Matters. How to Implement Values-Driven Management* (Waltham, MA: Center for Business Ethics, Bentley College, 2000).

[73] Joe Badaracco, Jr. and Richard R. Ellsworth, *Leadership and the Quest for Integrity* (Cambridge, MA: Harvard Business School Press, 1989), 74.

[74] Ibid. p. 74.

This purpose defined in values is related to a number of particular goals of the company embodied in vision, purposes and values statements. These values are then used as the basis for management of formal structures and systems in the company. It is considered as a fundamental concern for values-driven management to secure the commitment to the company's values in daily work of the company. This strategy of values-driven management considers the function of top management to secure and develop the commitment to values among members of the organization. Thus, the leaders profile or policy is less important as long as it is secured that leadership contributes to institutionalization of basic values in daily practice of the organization in order to secure loyalty and commitment of members of the organization.[75]

Badaracco and Ellsworth address a number of dilemmas of management for integrity on the basis of their description of the strategies of leadership. Such an approach to values-driven management is very important.[76] It illustrates that integrity management is not without difficult problems and dilemmas. We have to discuss the general dilemmas that managers face in order to find out how to respond to these dilemmas on the basis of a strategy for integrity in organizations.[77] The first dilemma includes the tension between general and flexible, open-ended approaches to problems and precise, clean approaches. The second problem is the tension between top-down and bottom-up influences on decision-making. The third question is the conflict and process in the problem-solving process. The forth dilemma is the opposition between confrontation and compromise and how to formulate strategies with regard to this tension.[78] The fifth dilemma is the tension between tangibles and intangibles in the decision making process.

Then, the different strategies of leadership are related to these dilemmas of management. Each of these philosophies of management can be said to be concerned with organizational integrity in the way that leadership is understood as wholeness and coherence. Integrity is related to both personal beliefs and but also to organizational values. Badaracco and Ellsworth therefore argue that leadership with integrity includes that the manager has strong personal ethics, a positive belief in others and a compelling vision of the goals and purposes for the company.[79] Good managers are searching to establish high ethics and community feeling around fundamental values in the company. But even though integrity may be realized with basic values based on the different strategies of leadership, the quest for integrity is facing the fundamental dilemmas of management in daily practice.

With regard to the problem of the relation between flexibility versus clarity and precision it is sometimes argued that it may be an advantage not to be very

---

[75] Ibid. p. 90.

[76] See also another book by Joe Badaracco, *Defining Moments. When Managers Must Choose Between Right and Right* (Cambridge, MA: Harvard Business School Press, 1997). This book includes an elaborate discussion of the Integrity conflicts in management.

[77] Joe Badaracco, Jr. and Richard R. Ellsworth, *Leadership and the Quest for Integrity* (Cambridge, MA: Harvard Business School Press, 1989), 7.

[78] Ibid. p. 8.

[79] Ibid. p. 102.

clear about commitment to basic values in order to be more flexible with the policies of the organization. Sometimes, political leadership would go for this option. However, it seems that clarity about values can make it easier to predict outcomes.[80] Both directive and values-driven management would be more open for this way to proceed. According to this view, a strategy for values-driven management is most efficient when managers are clear about their conception of critical values, goals and ethics for the company.

The problem of the relation between top-down versus bottom up influences on basic decisions constitutes a further dilemma. Political leadership would favor a bottom-up approach to decision-making while directive leadership would base management on top-down determination. In this context values-driven management favors bottom-up decision-making.[81] The reason is that this is the better way to be sure of participation in the decision-making by employees. However, it does not imply total decentralization of the company. A strategy for integrity may leave possibility of management to intervene in order to maintain and develop organizational values even if bottom-up decision-making generally is preferred.[82]

With regard to relations between substance and process political leadership would favor process while directive leadership would focus on both process and substance. Values-driven management strategies might also be aware of both aspects. Here management must be involved in substance of values and it is also interested process. However, from the point of view of values-driven management the ideal is not to be involved in every process of the organization. It is realized that management cannot know every aspect of the organization.[83] But then values are important because they help managers' overview of substance and process without being present in every aspect of decision making.

With regard to the tension between confrontation and compromise, political leaders are working towards compromise, while directive leaders are more likely to confront conflicts directly. Values-driven management strategies tend to reject the reasoning of political leadership. This approach thinks that it is better to have a constructive confrontation about substantial values than leaving everything to a search for compromise, which tend to focus on the process of negotiation.[84] In opposition to political leadership stressing the need for political consensus, values-driven management is attracted by the idea that leaders "confront and embody" conflict in their work for good values and integrity of the company. Leaders working for values-driven management are marked by the prejudice of confronting problems in fairness and honesty.

The final dilemma concerns the relation between "intangibles" and "tangibles" opportunities and goals of the company including the opposition between long-term

[80] Ibid. p. 119.

[81] Ibid. p. 129.

[82] Ibid. p. 140.

[83] Ibid. p. 153.

[84] Ibid. p. 168.

versus short term factors of management, the concern for economic performance versus the need for ethical standards or the tension between social responsibility and financial concerns. While directive leadership tend to see this as conflicts of interests within the company and political leadership proposes to view each situation in a pragmatic perspective, strategies for values-driven management focus on the values of the company. The prejudice, even in hard economic times is that ethics must prevail.[85] This kind of management can be said to narrow the gap between "tangibles" and "intangibles" with special regard to find new solutions to confront the economic necessity in organizations.

The different philosophies of leadership confronted with dilemmas in organizational decision-making show some of the problems of implementing the integrity strategy in organizations.[86] But, according to Badaracco and Ellsworth it also indicates that there are not only scientific solutions or professional management attitude of charisma or style to good organizational decision-making. Rather decision-making is an art based on personal virtue and integrity, combined with the ability to perform good managerial judgment. Therefore, we will now give some clarification of the concept of managerial judgment at work in values-driven management.

Integrity and Managerial Judgment

The concept of managerial judgment necessary for organizational integrity can be considered as a manner to mediate between different constituents and stakeholders of the firm in order to overcome the above mentioned different tensions of the dilemmas of leadership. Organizational integrity in judgment is aiming at the ideals of openness, honesty, wholeness and thoughtfulness.[87] It is based on commitment, trust, promise and engagement among actors and the final goals of integrity are justice and fairness in organizations. As the basis for judgment integrity expresses the virtues of self-control and self-respect of persons in organizations.[88] Integrity is the foundation of the unity of the personality, but individual integrity is a part of the relation between individual and organizations. In this perspective judgment should not only focus on rules and compliance, but also rather go beyond compliance towards values as the foundation of organizational morality. Programs of values-driven management become instruments for judgment in order to promote a culture of responsibility and trust in the organization. In this way a room for

[85] Ibid. p. 183.

[86] See for example Marvin T. Brown, *Rethinking Organizational Ethics and Leadership* (Cambridge: Cambridge University Press, 2005) that touches on many of the same themes that the we have presented in this analysis of strategies for leadership of organizational integrity.

[87] Stephen L. Carter, *Integrity* (New York: Basic Books, Harper Collins Publishers, 1996). See also the discussion of judgment in chapter 3.9.

[88] Lynn Sharp Paine, "Integrity." In *The Blackwell Encyclopedic Dictionary of Business Ethics,* eds. R. Edward Freeman and Patricia H. Werhane (Blackwell Publishers, 1997).

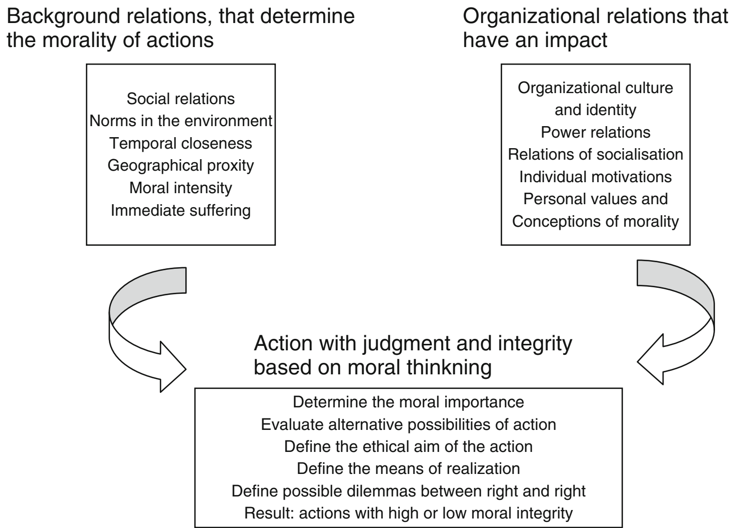

Fig. 5.1 Integrity, judgment and moral thinking

personal responsibility and judgment of employees is promoted.[89] It is important to be aware of the distinction between compliance and integrity strategies for organizational judgment. Integrity strategies aim at forming ethical cultures in organizations (Fig. 5.1).

In order to be aware of the different dimensions of integrity, purpose, principle and people, we can use Paine's approach to develop a model of practical reasoning and managerial judgment, which follows our concept of basic theories of business ethics.[90] This model of managerial judgment works on the basis of a combination of reflective judgment with teleological, deontological and utilitarian considerations as framework for decision-making dealing with ethical dilemmas of confrontation between different ethical concerns of utility versus duty, virtue versus need etc. Paine argues that the purpose of the organization refers to the teleological goal of the organization.[91] At this level primary aims and ideals are analyzed. Principle might refer to the deontological dimension of the organization. Principle interrogation might block teleological considerations if they are in contrast with fundamental rules of universability. This is the Kantian dimension of morality. Finally, we may also mention a utilitarian dimension of moral decision-making, which has to do with people, that is the preferences and commitments of specific individuals. This

[89] Lynn Sharp Paine, "Managing for Organizational Integrity," in *Harvard Business Review* (Boston: Harvard, 1994), 72(2), 106–117.

[90] Ibid. I.3.

[91] Lynn Sharp Paine, *Cases in Leadership, Ethics and Organizational Integrity. A Strategic Perspective* (Chicago: Irwin, 1997), 229.

dimension concerns human well-being and we may add that it aims at the "good life with and for the other in just institutions".

In an important article "Moral thinking in management: An essential capability" Paine makes a link between judgment, management and moral thinking. Moral thinking is closely linked to the concept of judgment and we can understand moral thinking as a realization of corporate citizenship in the sense that ethics initiatives are important for good business. They challenge conventional wisdom that there is no relation between ethics and business and that they are incompatible. Ethics is something that companies should care about because it is right not because it is effective.[92] Business leaders who care about ethics are on the right track. Ethics should be taken seriously. It is not only a question about strategy. Business leaders should use the concept of "moral thinking". Moral thinking is an essential capability for managers. Paine refers to R. M. Hare who in *Moral Thinking. Its levels, Method and Point* (1982) has developed the concept of moral thinking. Paine proposes this concept as the framework for her view of moral thinking.[93] However, Paine changes the viewpoint of Hare in important respects. Hare talks about the level of intuitive and of reflective moral thinking. Paine proposes to call the level of intuitive moral thinking for the level of principled moral thinking. Principled thinking refers to immediate ruling out of specific moral actions according to given moral principles. At another level we have the level of reflective moral thinking. At that level we refer to prescriptive universalism. Hare defines this as a kind of utilitarian pragmatism.

However, Paine thinks that this level can be determined as a level of a reflective attitude which can be said to refer to the kind of utilitarianism which is included in stakeholder analysis and what she calls people oriented moral thinking. This level may be determined as the level of principled consequentialism. At this reflective level of moral thinking moral principles are evaluated at a reflective level according to the possible impact on the good of society. Moral thinking refers to the capacity of dealing with moral problems in management and it may be viewed as the capacity of reflection that we find in the ability of reflective judgment. It is this capacity of moral evaluation of company action which is essential for management. Thus, Paine argues that there is a close relation between moral thinking and trust: "Most effective managers realize that the corporation's success depends on securing the trust and ongoing cooperation of participants in these relationships, whether they are shareholders, customers, employees, creditors, suppliers, or the public. That trust and cooperation, in turn, depend on observing certain ethical principles and serving important interests of each constituency on an on-going basis".[94] In this perspective moral thinking is an essential element in creating a good company. And we can say that Paine's concept of moral thinking illustrates what is needed in order

[92] Lynn Sharp Paine, "Moral Thinking in Management: An Essential Capability," *Business Ethics Quarterly* 6, 4 (1996): 477.

[93] R.M. Hare, *Moral Thinking: Its Levels, Method and Point* (Oxford: Oxford University Press, 1982).

[94] Lynn Sharp Paine, "Moral Thinking in Management: An Essential Capability," *Business Ethics Quarterly* 6, 4 (1996): 489–490.

to conceptualize the moral judgment and ethical engagement of a company with integrity.

This ideal of commitment in organizational integrity is the foundation of concrete efforts to build organizational integrity.[95] Even though it seems very idealistic, it is often presupposed as the foundation of interaction in organizations. As we have seen programs of values-driven management are very different from legal compliance programs. In opposition to a compliance program, a program based on organizational integrity and excellence may – taking into account our earlier remarks about requirements for ethics programs and considering this as the basis for a concept of corporate citizenship – be summarized in the following points: (1) There should be focus of the role of management. (2) A mission and vision statement should be formulated. (3) There should be emphasis on organizational values in a value statement in relation to the vision or mission statement. (4) An ethics code should be formulated. (5) An ethics officer should be appointed. (6) Such an officer should report to higher authorities, for example an ethics task force or to an ethics committee in the organization. (7) The organization should have strategy for external and internal ethics communication. (8) The organization should give employees courses in ethics training. (9) There should be offered possibilities of ethics in crisis situations and there should be some possibilities of discussion and communication of ethical problems at the workplace. (10) Ethical behavior should be rewarded or sanctioned. (11) It should be possible to have systems for evaluating and cataloging ethical data in the firm. (12) These should be submitted to periodical evaluation of ethics committees or management. This should include a reporting system involving ethics officers, ethics committees and management. (13) This includes development of special strategies for implementation of organizational values program according to the specific context of the firm implying specific legal, values or virtue oriented codes following the specific identity and history of the firm.[96]

Although these institutional requirements are important for organizational integrity as corporate citizenship based on values-driven management we should not forget the significance of competency to formulate and understand ethical problems. This is indeed required in situations of distrust and lack of integrity. There is a close connection between the moral manager and the moral organization. This is what we mean when we say that managerial judgments imply development of the capacity of managers to do "moral thinking".[97] In focusing on ethics, managerial judgment avoids the problems of compliance. Ethics is not separated from rules, but

[95] Muel Kapten and Johan Wempe, *The Balanced Company. A Theory of Corporate Integrity* (London: Oxford University Press, 2002), 137. The authors propose a "corporate autonomy" mode to deal with the moral and political commitment of organizations with integrity.

[96] A critical reply may be that all this talk about ethics programs and ethics management seems rather overwhelming and takes away focus on daily business practice. I want to emphasize that although all the mentioned initiatives are very important it is of course the task of moral thinking to apply values and ethics structures correctly to the reality of particular organizations.

[97] Lynn Sharp Paine, "Law, Ethics and Managerial Judgment," *The Journal of Legal Studies Education* 12, 2 (summer/fall 1994): 153–169.

ethical judgment is broader than legal judgment. Ethical judgment linked to moral thinking is an essential capacity of good managers working for corporate integrity.

This integrity strategy involves commitment to substantial responsibilities and ideals. Lynn Sharp Paine gives the foundation for her strategy in three P's: *Purpose, Principle and People*.[98]

Purpose refers to the mission and value of the organization. Integrity-based strategies see purpose as a very important part of developing a good and coherent organization. The framework of values and mission statements is considered central to further achievement of organizational integrity.

Principle refers to the obligations and ideals, which are central to the ethical behavior of the organization. In this context it is important to develop organizational structures and systems that are strong enough to build and maintain the ideals of the organization.

People refer to the required respect for different stakeholders and constituencies of the organization. High integrity strategies involve fair treatment of these different stakeholders in specific situations.

At the level of organizational structures integrity is at stake at many different levels as management, career development, performance evaluation and rewards, employee education and treatment, planning and goal development, budget and resource allocation, information and communication, audits and controls.[99]

Moreover, Paine mentions that organizational integrity may be important in many different contexts of business, e.g. gift-giving, gender and race relations, environmental concerns, employment practices, employee health and safety, worker and consumer privacy, intellectual property rights, competitive fairness, whistle-blowing etc. In all these areas high integrity organizations try to behave with excellence, honesty and fairness in order to achieve organizational unity. This is done in the development of different programs of values-driven management in order to improve organizational structure.

However, it is not sufficient to establish structures of integrity in an organization without continuous revision of these structures. Indeed, organizational integrity must be viewed as a continuing, ongoing process. Organizational integrity must be considered as a part of daily management practices. This should also be present in public relations.[100] Therefore integrity is never accomplished but it is always a concern in organizational decision-making. In fact, the strength of the integrity of the organization is tested in times of organizational crises. In such cases, managers must make critical decisions including ideals of purpose, principle and people. In many cases, ethical decisions are not easy and different facts, norms and decision criteria might conflict. The problem might be lack of awareness of ethical issues in specific economic decisions based on bottom-line considerations. Cost-benefit analysis may have certain "ethical blind spots", a kind of moral blindness, which

[98] Lynn Sharp Paine, *Cases in Leadership, Ethics and Organizational Integrity. A Strategic Perspective* (Chicago: Irwin, 1997).

[99] Ibid. p. 101.

[100] Stephen L. Carter, *Integrity* (New York: Basic Books, Harper Collins Publishers, 1996). In this book there is a long discussion of media practice and integrity.

make actors unaware of ethical problems. Rational economic decision making is often neglecting the specific ethical issues in the case that have to be decided.

Because of this danger of moral blindness, Lynn Sharp Paine gives the advice that managers should focus directly and explicitly on ethical issues in the decision-making process. In this way these problems will not be excluded or overlooked from the decision-making process.[101] In this context it is important not to neglect specific stakeholders or other concerns in the process. If a specific stakeholder group is not recognized in the decision making process it may have unforeseen consequences.

These different claims and ethical needs of stakeholders must be accounted for, when evaluating specific cases of ethical judgment in order to achieve organizational integrity as the basis for corporate citizenship in complex organizations. Integrity is an instrument to create a balanced company that can communicative with society and stakeholders.[102] The three dimensions might be defined as the evaluation of the aims and objectives, the rights and obligations, as well as the stakeholders that are affected by the decision-making of the organization. Indeed, it is very difficult to find the right determination of organizational integrity when evaluating these different dimensions of managerial judgment. But, there is a close connection between ethical judgment and organizational strategy in order to find the right balance between compliance to rules and efforts to integrate values in organizational culture. Managerial judgment is based on a required capacity to understand the complex relation between personal and organizational integrity and include all relevant stakeholders in decision-making processes in a fair and just manner. Accordingly, corporate citizenship is an important outcome of integrity management.

Integrity as an Important Concept in Codes of Ethics

Murphy's collection of ethics statements is very representative for major US companies and therefore I have selected this book as references for different important concepts of values in codes of ethics. The concept of integrity is very important in codes of ethics and of values-driven management. This concept can indeed be conceptualized as paramount for good business ethics in organizations. Corporations give for example the following definitions of integrity in their codes of conduct:

AES, a US power company: "Integrity. AES has attempted to act with integrity, or 'wholeness'. The Company seeks to honor its commitments. The goal has been that the things AES people says and do in all parts of the Company should fit together with truth and consistency".[103]

---

[101] Lynn Sharp Paine, *Cases in Leadership, Ethics and Organizational Integrity*. *A Strategic Perspective* (Chicago: Irwin, 1997), 226.

[102] Muel Kapten and Johan Wempe, *The Balanced Company. A Theory of Corporate Integrity* (London: Oxford University Press, 2002).

[103] Patrick E. Murphy, *Eighty Exemplary Ethics Statements* (Notre Dame, IN: University of Notre Dame Press, 1998), 15.

Binney & Smith, a US children's product company: "Integrity – Conduct yourself with the highest standards of ethics, personally and corporately.– Conduct honest, open, and forthright dealings inside and outside the company".– "Conduct fair and equitable treatment of employees, customers, suppliers and the community. – Conduct yourself and your organization in a fiscally moderate way."[104]

Boeing, an aerospace company: "Integrity statement – Integrity is a fundamental part of Boeing history and of the way we do business. Our commitment to integrity means that all of our actions and relationships are based on these uncompromising values: – Treat each other with respect – Deal fairly in all our relationships – Honor our commitments and obligations – Communicate honestly – Take responsibility for our actions – Deliver safe and reliable products of highest quality – Provide equal opportunity to all – Comply with all laws and regulations".[105]

Coachmen Industries, a recreational vehicle company: "'Integrity is our Commitment'. The conduct of our Company's affairs must be pursued in a manner that commands respect for its honesty and integrity".[106]

Commins Engine Company, Inc, an automotive supplier: "Integrity is the foundation of Cummins' relationships with customers, suppliers, shareholders, competitors, partners, our communities, and each other. It provides us the opportunity to meet the needs of our customers better than our competitors. All members of Commins – directors, officers and employees, distributors, subsidiaries and affiliates – continually work to develop and protect this critical asset through their everyday activities."[107]

Ethyl Corporation, a chemicals corporation: "Unquestionable integrity. Personal and corporate integrity are the foundation of all our activities. Integrity is a cherished possession we want never to lose".[108]

First Bank System: "Integrity. We are honest, ethical and fair. We tell the truth and expects to hear the truth from others".[109]

Hannah Andersson, a children's products company: "Integrity. Being true about your values and honest about your commitment to them."[110]

Mary Kay, Inc: "Integrity and the Golden Rule must guide every business decision."[111]

---

[104] Ibid. p. 23.
[105] Ibid. p. 25.
[106] Ibid. p. 57.
[107] Ibid. p. 63.
[108] Ibid. p. 73.
[109] Ibid. p. 75.
[110] Ibid. p. 106.
[111] Ibid. p. 144.

Chapter 6
The Social Case as a Business Case: Making Sense of Social Entrepreneurship from an Ordonomic Perspective

Markus Beckmann

Abstract This chapter discusses how the theoretical perspective of ordonomics provides a framework for better understanding and advancing the practice of social entrepreneurship. From an ordonomic perspective, the concept of social entrepreneurship offers a semantic innovation (at the ideas level) whose potential for social innovation can be fully reaped only if it is used as a heuristics for social structural change (on the institutions level). Social entrepreneurs recognize relevant social problems, interpret them as an entrepreneurial challenge, and succeed in turning what was a social case into a business case in a broader sense. Using the real-life example of a successful eco-social entrepreneur, the chapter demonstrates that such win-win solutions can be reconstructed as the sophisticated management of social dilemmas. It sketches a strategy matrix for the practice of social entrepreneurship and distinguishes four paradigmatic strategies social entrepreneurs can employ to create win-win scenarios by changing the rules of the game to overcome undesirable social dilemmas. The chapter concludes by discussing social entrepreneurship in the context of new governance processes and highlights key similarities and differences to the concept of corporate citizenship.

Keywords Social entrepreneurship · Commitments · Corporate citizenship · Semantics · Social structure · Business ethics

Introduction

"Social entrepreneurship" is a dynamic phenomenon and the subject of increasing interest in the current academic debate.[1] However, it is not theory that has been driving the development of social entrepreneurship, but real-world practice

[1] In recent years, the debate about social entrepreneurial has in fact become a topic that is increasingly finding its way into prominent mainstream journals. See, for example, Seelos and Mair (2007), Christie and Benson (2006), Mair and Marti (2006), Certo and Miller (2008), Neck and Allen (2009) or Zahra et al. (2009).

M. Beckmann (✉)
Centre for Sustainability Management, Leuphana University Lueneburg, Scharnhorststrasse 1, 21335 Lueneburg, Germany
e-mail: markus.beckmann@leuphana.de

I. Pies, P. Koslowski (eds.), *Corporate Citizenship and New Governance*, Ethical Economy. Studies in Economic Ethics and Philosophy 40,
DOI 10.1007/978-94-007-1661-2_6, © Springer Science+Business Media B.V. 2011

(cf. Bornstein 2007). Take the example of Muhammad Yunus, one of the most well-known social entrepreneurs in the world. He founded his famous Grameen Bank in 1983. It still serves as a role model for numerous micro-finance institutions (cf. Yunus 2007). Three years earlier, in 1980, Bill Drayton founded Ashoka, the first and today biggest nonprofit organization with the aim of supporting the field of social entrepreneurship (cf. Drayton 2006). Other foundations followed suit, such as the Schwab Foundation for Social Entrepreneurship, founded in 1998, and the Skoll Foundation, created in 1999.[2] Throughout the 1980s and 1990s, these civil-society organizations worked to advance social entrepreneurship and to foster literally thousands of social entrepreneurs around the world as important change agents for societal innovation and progress. This work continues to the present day.

In short, social entrepreneurship is a practice-driven phenomenon. The purpose of this chapter is to discuss how *theory* can play a constructive role in better understanding and advancing the practice of social entrepreneurship. A starting point for this endeavor is the idea that theory can provide conceptual perspectives that will allow looking at social entrepreneurship from different angles. To this end, the paper draws on the theoretical perspective of ordonomics. Ordonomics is a rational-choice based research program for analyzing institutions and ideas, as well as the interdependencies between them. From an ordonomic viewpoint, the concept of social entrepreneurship offers a semantic innovation (at the ideas level) whose potential for social innovation can be fully reaped only if it is used as a heuristics for social structural change (on the institutions level). Social entrepreneurs recognize relevant social problems, interpret them as an entrepreneurial challenge, and succeed in turning what was a social case into a business case in a broader sense. The ordonomic perspective highlights that successful social entrepreneurs realize such win-win solutions by investing in an infrastructure of innovative rules and functional commitments that overcome undesirable social dilemmas and thus make new ways of value creation possible.

This ordonomic argument is developed in four steps. The first step (Section "The Ordonomic Approach: Linking the Analysis of Institutions and Ideas") introduces the ordonomic perspective and establishes a three-tiered conceptual framework that distinguishes between the basic game of social interaction, the meta-games of social rule-setting (institutions), and the meta-meta games of rule-finding discourse (ideas).

The second step (Section "Social Entrepreneurship as a Semantic Innovation") applies this framework to the concept of social entrepreneurship. It argues that social entrepreneurship is relevant to all three levels of the three-tiered ordonomic framework. However, although we already have a good understanding of the role of social entrepreneurship in the first level of social interaction as well as with regard to the relationship between social entrepreneurship and the third level of semantics and discourse, it is as yet much less clear how social entrepreneurship interacts with the second level of institutional rule-setting.

[2] See http://www.schwabfound.org/ and www.skollfoundation.org/ respectively.

Against this backdrop, the third step (Section "Win-Win Through Functional Commitments—The Case of Neumarkter Lammsbräu") offers an ordonomic approach to understanding the institutional contribution of social entrepreneurship. For social entrepreneurship to be sustainable, it must be economically viable in the long run and therefore needs to be based in entrepreneurial innovations that create genuine win-win solutions. Using the real-life example of a successful eco-social entrepreneur, the chapter demonstrates that such win-win solutions can, through an ordonomic lens, be reconstructed as the sophisticated management of social dilemmas. More specifically, this real-life example illustrates how functional commitments can change the rules of the game and thus can make possible the sustainable realization of a social entrepreneur's mission. Generalizing this logic, the chapter sketches a strategy matrix for the practice of social entrepreneurship and distinguishes four paradigmatic strategies social entrepreneurs can employ to create win-win scenarios by changing the rules of the game to overcome undesirable social dilemmas.

The fourth step (Section "Social Entrepreneurship, Corporate Citizenship, and Business Ethics") places the concept of social entrepreneurship developed here within the larger debate over business ethics, corporate citizenship, and new governance. From an ordonomic perspective, there are significant differences between social entrepreneurship on the one hand and the concept of corporate citizenship on the other. Yet, there are also striking similarities. In fact, even though each has a different point of departure, social entrepreneurship and corporate citizenship have a common point of convergence—namely, the win-win logic of mutually advantageous value creation. The paper concludes with an important lesson for business ethics theory: when critically discussing the (normative) semantics that shape societal discourse, business ethics needs to have a systematic understanding of the social structure that drives value creation in a market society. Given this social structure, win-win solutions are absolutely necessary for *any* enterprise to be sustainable. Business ethics theory is thus well advised to take into account the win-win concept more systematically.

The Ordonomic Approach: Linking the Analysis of Institutions and Ideas

Ordonomics builds on a still fairly young research program.[3] The basic concern of this research program is the systematic exploration of interdependencies between institutions and ideas or, more specifically, the analysis of interdependencies

[3] For an introduction to the "ordonomic" approach and a broad overview of applications of the ordonomic perspective to the domains of business and economic ethics see Pies (2009a, b). For a more general discussion of the ordonomic approach, see Pies et al. (2009a, b) as well as Beckmann (2010). The "ordonomic" approach builds upon the German tradition of an "economic theory of morality" (Homann and Pies 1994) that was originally restricted in a more narrow sense to discussing matters of business and economic ethics. This ordo-theoretical approach to economic

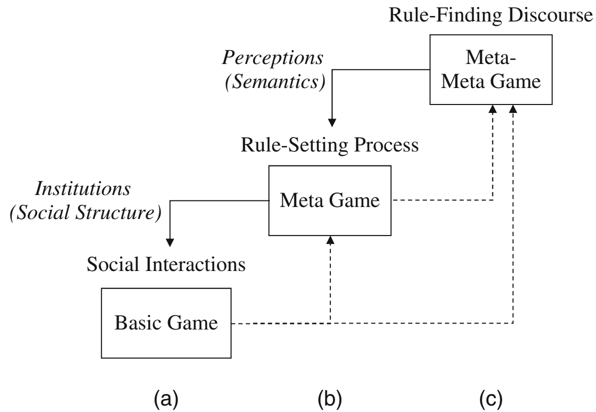

Fig. 6.1 The three-tiered conceptual framework of the ordonomic perspective

between "social structure" and "semantics." To this end, the ordonomic approach makes use of elementary game theory and a rational-choice based analysis of institutional arrangements. According to ordonomics, "social structure" (institutions) is defined as formal and informal institutional arrangements, including their incentive properties, whereas "semantics" (ideas) has to do with the terminology and underlying thought categories that shape public and organizational discourse. Semantics is important because it channels how people perceive, describe, and evaluate social phenomena and, in particular, social interactions, conflict, and cooperation.

An important framework of the ordonomic perspective is illustrated by Fig. 6.1, which shows three different levels of social games. Although Fig. 6.1 is a very simple diagram, it provides a basic illustration of the interdependencies between ideas (semantics) and institutions (social structure). Ordonomics is interested in the question of how certain mental models and perception patterns of interpreting social reality influence and even determine our thinking and communication, thus shaping the social rules that coordinate human and organizational interactions, and, ultimately, channeling our behavior and social outcomes. At the same time, ordonomic is interested in looking at this same question from the opposite direction, that is, how do social outcomes and institutional arrangements affect shared mental models and the prevailing patterns of perceiving social reality.

ethics argues that the incentive properties of social institutions play an important role in implementing moral concerns and was originated by Karl Homann. Cf. Homann (1990, 2002, 2003). Meanwhile, there are numerous publications available that specifically refer to this intellectual tradition. Cf. Habisch (2008), Hirsch and Meyer (2009), Lin-Hi (2009), Lütge (2005, 2007), Schönwälder-Kuntze (2008), Suchanek (2007), Suchanek and Lin-Hi (2007), Waldkirch (2001) as well as Waldkirch et al. (2009).

To conceptualize this interplay between ideas, institutions, and interactions, the ordonomic approach reconstructs society as an arena of interdependent social games and distinguishes between the following three levels of social interaction.

(1) The first level describes the *basic game* of social interactions, both in society at large as well as within organizations (Fig. 6.1a). This basic game concerns the day-to-day interactions that occur not only in the marketplace and in companies and other organizations, but also in politics, sports, science, and in all other societal domains. In each of these environments, the basic social game unfolds as individual actors pursue their respective goals, interact with each other, and respond to the incentives and opportunities.[4]

What is of particular interest for the ordonomic perspective is that these basic games can lead to highly divergent outcomes at the social level. Some interactions produce aggregated social results that are highly desirable from a normative point of view. Take the case of economic growth and prosperity, or high levels of innovation in oligopolistic competition (cf. Baumol 2002, 2010). Here, the basic game seems to be led by some sort of "invisible hand" that promotes societal objectives. However, other interactions appear to be more guided by what could be termed an "invisible fist" and result in severe societal problems. Unemployment, corruption, and climate change are just a few examples of aggregate social outcomes that are highly undesirable but, nevertheless, ensue through actions of individual players in the basic game.

From an ordonomic perspective, the highly divergent aggregate outcomes of the basic game illustrate an important point. Whether the social result of the interaction of many individual players is normatively desirable or undesirable is not primarily due to individual motivations; rather, given the complexity of social interdependencies, it is the social structure—the incentive properties of the rules of the game—that systematically channels the game's outcome. The outcome of the social game results from the sum of the individual moves of the game—with these being channeled by the relevant rules of the game that define its very logic.[5]

(2) Against this backdrop, a second level of social interaction is of systematic importance to the ordonomic analysis, namely, the *meta-game* of societal and organizational rule-setting (Fig. 6.1b). This meta-game concerns those processes by which the players establish the rules that shape the logic of the basic game. It serves to form and reform institutions and set incentives, thus having the potential to change and improve the social structure that channels the interactions in the basic game. Such meta-games are important because they allow the players to establish functional rules that enable cooperation in the basic game interactions. Also, if the basic game produces undesirable social outcomes, it is the meta-game

---

[4] Ordonomics thus draws on the broad tradition of social theories that explain macro-level phenomena with a micro-level rational-choice foundation. Cf., for example, Becker (1976, 1993), Coleman (1990, pp. 1–23).

[5] Cf. Popper (1945, 1966, Ch. 14, pp. 89–99).

that opens up the possibility for changing the situation into one that is mutually advantageous.[6]

(3) However, to change the rules of the meta-game, it is rarely enough that an individual player sees the desirability of doing so. In many cases, (re-)forming the institutional framework requires collective action and the collaboration of diverse players. Yet, the players will never agree on institutional reform and cooperation in the meta-game unless they first understand and agree that these new rules will be of benefit to them individually. An awareness of common interests is therefore an important condition for institutional reform.

Creating such awareness is what the third level of social interaction is about. This *meta-meta game* serves as a rule-finding discourse (Fig. 6.1c). Whereas the meta-game focuses on institutions or, in other words, social structure, the meta-meta game is focused on the importance of ideas, that is, semantics. Semantics is important in this regard because cooperation between players is largely dependent on how they perceive the situation, each other, and their relationship. For example, it makes a huge difference whether the players perceive their situation as a zero-sum game or as a precarious positive-sum game.[7] This is why discourse is an important social arena. By engaging in discourse, we discuss, reflect, and develop the mental models and ideas (semantics) that guide what we perceive as relevant problems and, consequently, that determine where we will look for solutions. Discourse is thus important in defining the relevant problems and even more crucial to developing a shared understanding of the common interest in addressing these problems.

Social Entrepreneurship as a Semantic Innovation

The three-tiered conceptual framework of the ordonomic approach provides a fresh perspective on social entrepreneurship: it reveals what we already know about social entrepreneurship, as well as the gaps in our knowledge regarding this phenomenon. To demonstrate the usefulness of this framework, the next sections relate the concept of social entrepreneurship to all three levels of the ordonomic framework. Note, however, that the three levels of the social game will be discussed in a different order than that set out in the general overview above (Fig. 6.2). The argument starts with the level of the basic game (1) but then goes on to the discourse level of the meta-meta game (2), leaving the intermediate level of the social meta-game (3) for last. This order is followed because it is at this last-discussed level of institutional innovation that the most work needs to be done to refine our understanding of social entrepreneurship.

[6] Following the distinction between the "choice within constrains" and the "choice amongst constraints", the ordonomic approach thus strongly builds on the perspective of constitutional economics as advanced by James M. Buchanan (1987, 1990).

[7] Cf. Schelling (1960, 1980).

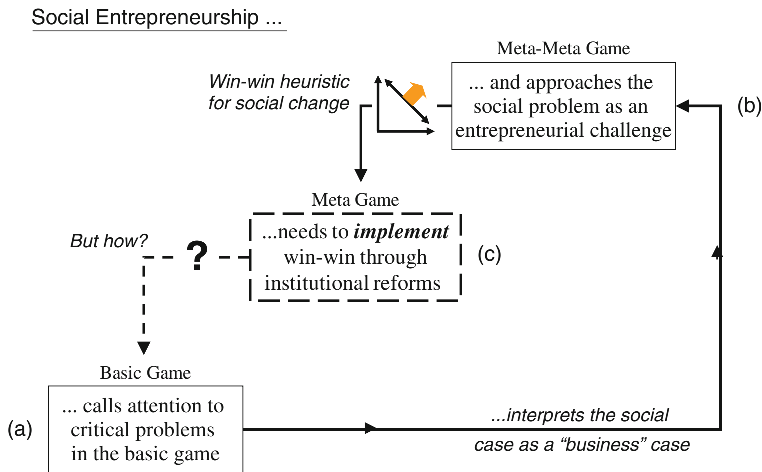

Fig. 6.2 Social entrepreneurship in the three-tiered ordonomic framework

(1) Social entrepreneurship and the level of the *basic game*: What is social entrepreneurship? Although there is still no universal agreement on how to define this concept (cf. Martin and Osberg 2007), the ordonomic perspective provides at least one important element of such a definition: social entrepreneurship is always a reaction to perceived deficiencies in society's *basic game*. Social entrepreneurs react to situations in which the conventional problem-solving mechanisms of market exchange or government action fail to satisfyingly address important moral, ecological, or social objectives (cf. Seelos and Mair 2005). From an ordonomic perspective, the activity of social entrepreneurs reveals that the societal outcomes of extant social games are undesirable in that they fall short of addressing essential human needs (Fig. 6.2a).

The work of three well-known social entrepreneurs provides an illustration. Through his activism, Muhammad Yunus brought attention to the fact that the conventional basic game in the economic and banking system in Bangladesh fails to eradicate poverty, causes credit rationing in rural areas, and prolongs the social exclusion of women.[8] Andreas Heinecke, founder of "Dialogue in the Dark," raised awareness of the fact that in the basic social game many people, such as the blind, are marginalized and that little interaction takes place between "them" and "us."[9] Finally, take the case of Aravind Eye Hospital & Aurolab,[10] a social enterprise founded in response to the problem that the basic social game in India fails to provide millions of people with urgently needed ophthalmic health care services.

[8] Cf. Yunus (2007). For the economics of micro-finance see Armendáriz and Morduch (2007).

[9] See http://www.dialogue-in-the-dark.com.

[10] For an informative analysis of this case of social entrepreneurship, see Mair and Marti (2006).

Social entrepreneurs direct attention to areas in which the basic social game needs improvement. Yet, social entrepreneurship is not only about increasing awareness of social problems; rather, it is essentially about creating, organizing, and managing a venture that *addresses* these problems and seeks to engineer sustainable *social change*. Social entrepreneurship thus differs from conventional forms of business entrepreneurship in the relatively higher priority given to achieving social and environmental goals versus merely optimizing financial performance. This does not mean, however, that social entrepreneurs are completely uninterested in financial performance. In fact, social entrepreneurship includes both not-for-profit and for-profit-enterprises. What is characteristic of all forms of social entrepreneurship, however, is that a social entrepreneur never defines its mission and never measures its success exclusively in terms of financial profit and return. Put simply, a social enterprise is a "more-than-profit": Muhammad Yunus's success criterion is not (only) the financial viability of his Grameen Bank, but also, maybe more importantly, the number of poor people who have improved their lives by way of his services; Andreas Heinecke measures his success not only in profits, but in terms of how the status of blind people has been improved; similarly, when assessing its success, Aravind measures its performance by how much eye care it has provided to those so urgently in need of it.

In all these cases, the initial rationale for social entrepreneurship was not the desire to maximize profits, but was motivated by a desire to improve the workings of the basic game in business, health, education, and other societal domains. Social entrepreneurship thus starts with a social case; a social case that arises from the basic game of societal interactions.

(2) Social entrepreneurship and the level of the *meta-meta game*: From an ordonomic perspective, social entrepreneurship is noteworthy not because it attempts to address social problems in the basic game, but because of *how* it does so. Ordonomics sees social entrepreneurship as an important semantic innovation. Social entrepreneurship takes a social problem as its starting point and then turns this social problem into an entrepreneurial challenge (Fig. 6.2b) and, moreover, often meets the challenge by creating a successful business that not only addresses the problem but is also financially viable or even makes a profit. Social entrepreneurship hence changes the discourse—the way we think and communicate—about social challenges. It is a win-win way of thinking about social challenges and, more importantly, of searching for solutions to them.

Perhaps this point is best made by looking at alternative semantic concepts that also address urgent problems in the social basic game. After all, social entrepreneurship is certainly not the only means for trying to make the world a better place; there are any number of other ways to go about this, including, to name a few, charity, philanthropy, aid, social transfers, and redistribution. What is of interest here is that these semantic concepts all build on a common mental model that, at least implicitly, promotes a certain kind of tradeoff thinking. Figure 6.3a is a graphic illustration of this type of thinking. Plotted on the horizontal scale are the interests of disadvantaged people; the interests of the more privileged are plotted on the ordinate scale.

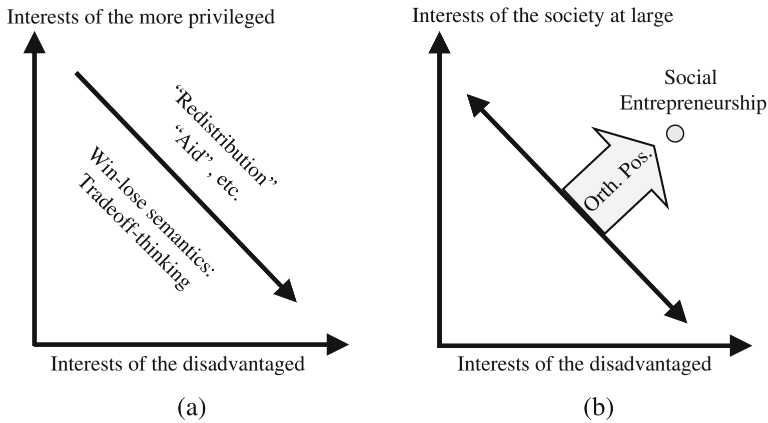

Fig. 6.3 Social entrepreneurship as a semantic innovation

The negatively inclined line in Fig. 6.3a illustrates the notion that there is a trade-off between these two interests. As denoted by the arrow pointing southeast, the concepts of charity, philanthropy, aid, social transfers, and redistribution strongly convey the idea that the only way to help the disadvantaged is for the privileged to give up something, whether it be through voluntary donations, taxation, or by some other method. Such thinking assumes a zero-sum game in which one side can benefit only at the expense of the other. In other words, this sort of thinking is a win-lose semantics. According to this mental model, richer people have an ethical responsibility to act against their self-interest by giving up a part of their wealth, however measured, whereas the people to be helped are purely beneficiaries, receiving unidirectional transfers, with no obligation—and no capacity!—to send anything back the other direction.

In contrast, social entrepreneurship involves a very different semantics. It interprets an urgent social need as an entrepreneurial challenge with the potential for innovative win-win solutions that benefit not only the disadvantaged few but society at large. Social entrepreneurship does not view the disadvantaged as passive recipients of help; rather, it assumes that even the worst off have something valuable to offer in return. Muhammad Yunus's Grameen Bank does not treat the people in poor rural areas as powerless recipients of charity, but takes them seriously as micro entrepreneurs who can and will pay reasonable interest rates on their loans. Similarly, Andreas Heinecke's Dialogue in the Dark provides blind people with an opportunity to demonstrate (and be paid for) their talents and skills. Finally, Aravind Eye Hospital treats poor people as normal patients and appreciates them as critical consumers of high-quality ophthalmic health care services. Social entrepreneurship is thus strongly anchored by the belief that entrepreneurial success is largely the result of creating and organizing positive-sum games. This means, very often, the inclusion of the formerly excluded in the process of social value creation. In short,

social entrepreneurship takes a view of social problems and business opportunities as not conflicting but as compatible and even complementary.

As Fig. 6.3b illustrates, the idea of social entrepreneurship transcends conventional tradeoff thinking. Graphically, it looks for a position orthogonal to the tradeoff line (Cf. Pies 2000, p. 34) and thus and provides a strong win-win heuristics geared toward mutually advantageous social reform. Such a win-win orientation is important because it focuses the social learning process on innovative solutions that are more likely to have a truly sustainable impact. Strategies for addressing daunting social needs that operate within the win-lose paradigm and that rest on unidirectional transfers depend on the willingness of donors to contribute resources. Thus, such strategies often only amount to short-term changes of individual moves in the basic social game. This is not a truly sustainable solution. By contrast, a win-win strategy that changes the rules of the game so as to blend together a social problem and a business opportunity in a new and mutually advantageous game can initiate lasting and sustainable social development. From an ordonomic viewpoint, the concept of social entrepreneurship thus takes seriously the fact that any venture for social or environmental betterment will only work in the long term if it is also sustainable economically and financially. For social entrepreneurship to be sustainable, the social case must be turned into a business case in a broader sense. This does not mean that all social enterprises ultimately need to be for-profit business ventures. It does mean, however, that social enterprises will fulfill their full potential as catalysts of social change best if they are based on a self-sustaining "business" model, be it a trust, a not-for-profit cooperative, a civil-society organization, a body corporate, or a society whose members pool resources for achieving a common social goal.[11]

(3) Social entrepreneurship and the level of institutional innovation in the *meta game*: The above discussion has looked at social entrepreneurship from an ordonomic perspective, thus showing the concept's utility in addressing important social problems. Another look at Fig. 6.2 provides a good summary of the discussion so far. At the level of the basic game (Fig. 6.2a), social entrepreneurship reacts to undesirable outcomes of the existing game and takes the social problem as its starting point. At the discourse level of the meta-meta game (Fig. 6.2b), the concept of social entrepreneurship provides a semantic innovation that interprets the social problem as an entrepreneurial challenge.

Ordonomics sees such semantic innovations as key to advancing social development. Semantics are influential in defining social problems and in searching for solutions to them. Thus, the innovative semantics of social entrepreneurship provide a powerful new heuristic for win-win reforms.

As Fig. 6.2 illustrates, however, semantic innovation alone is not enough to achieve sustainable change. Nor is it enough to simply postulate the desirability

---

[11] For an overview of the diverse models and organizational forms of social entrepreneurship see, for example, Nicholls (2006).

of win-win solutions. The real challenge for social entrepreneurs it not to just dream up win-win solutions, but to *implement* them.

This is easier said than done, of course. Win-win solutions are far from self-evident. Indeed, in most cases, devising a win-win solution is a creative act. Social entrepreneurship, therefore, involves far more than just implementing a plan; the plan itself must be invented, sometimes out of "thin air."

So how do social entrepreneurs create win-win solutions? From an ordonomic point of view, it is clear that the arena for creating win-win solutions is the meta-game of social rule-setting (Fig. 6.2c). A win-win semantics in the meta-meta game discourse can lead to a fully sustainable impact on the very basic game only if it translates into a constructive rule-setting meta-game for changing the rules of the game in a way that produces a mutually advantageous social structure. Institutional reform is a prerequisite to improving the outcome of the basic game, thus making a win-win solution possible.

In summary, then, the pivotal questions that need to be answered both for the practice and theory of social entrepreneurship are follows. How can social entrepreneurs contribute to institutional reforms that change the rules of the game? What are viable strategies that allow social entrepreneurs to act as institutional change agents? How can social entrepreneurs blend their social mission with financial sustainability through functional institutional arrangements?

Figure 6.2 thus serves to illustrate that while we have a clear idea of the semantic contribution of the social entrepreneurship concept, we are just beginning to understand the social structural contribution of successful social entrepreneurs. Deepening our understanding of this contribution is not only of theoretical interest, it could be of enormous practical value too. Thus, the next section develops an ordonomic approach to understanding the institutional contribution of social entrepreneurship, illustrating the theory with a real-life example of a successful eco-social entrepreneur.

Win-Win Through Functional Commitments—The Case of Neumarkter Lammsbräu

(1) Social entrepreneurship is about finding a win-win solution to a social problem. How is this done? Ordonomics begins to answer this question by defining what is meant by a "social dilemma." The technical term "social dilemma" refers to a situation in which rational actors fail to realize their common interests due to their conflicting individual interests. A social dilemma is, therefore, a situation of collective self-damage: the result of social interactions is undesirable from a group perspective although—or, more precisely, *because*—each player acts in a way that is individually rational. There are many well-known examples of collective self-damage, including the "tragedy of the commons" (Hardin 1968), collective action problems and the corresponding "free-riding" issues (Olson 1965), and principal-agent problems (Arrow 1985), as well as specific investments

(Williamson 1985) and the resulting problem of appropriable rents (Klein et al. 1978).

This definition of a social dilemma aids in understanding how social entrepreneurship works because it reveals that, looked at in this way, that is, as a social dilemma, almost any social problem, any negative outcome of societal interactions, or any conflict can be interpreted (or re-interpreted) as a situation with potential for a win-win solution. The logic behind this argument is simple yet compelling. In almost any conflict or other instance of negative social outcome, there are—notwithstanding the simultaneous existence of conflicting interests—almost always common interests as well. For example, as soon as conflict "hurts" by consuming resources and thus becoming costly—and what conflict is not, at least in some way, costly?—there is a common interest in avoiding or at least reducing these costs.[12] The fact that rational actors fail to achieve this Pareto-superior solution shows that their conflicting individual interests keep them trapped in a social dilemma. After all, the defining characteristic of a social dilemma is that it is incapable of a win-win solution due to an incentive structure that induces rational actors not to act in a mutually beneficial way even though it would be in their common interest to do so.

The ordonomic perspective on social entrepreneurship revolves around the idea that social entrepreneurs can create and realize win-win situations by overcoming such social dilemmas. However, success in this endeavor will not be achieved merely by a social entrepreneur simply changing his or her individual moves in the given game. Remember that the social dilemma is indeed a *social* and not an individual dilemma. After all, the collective self-damage inherent in a social dilemma is the result of the interaction of many players. To overcome a social dilemma, therefore, it is necessary to change the very game itself—and that means changing the rules of the game, its social structure.

How can social entrepreneurs change the rules of the game so as to overcome a social dilemma? According to ordonomics, the answer is straightforward: through functional commitments. However, depending on the social structure of the dilemma situation, different types of commitment are necessary. There are basically two types of social dilemmas—one-sided dilemma structures and many-sided dilemma structures.

The one-sided social dilemma is characterized by the possibility of *asymmetric* exploitation (cf. Kreps 1990). Player A can exploit Player B, but not vice versa. If Player B anticipates that he will be exploited if he cooperates, he is unlikely to cooperate—even though successful cooperation would be mutually advantageous. As a consequence, *both* players are left worse off. Due to the incentive structure of the game, they fail to realize a possible win-win solution. In this situation, an *individual self-binding moral commitment* can overcome the collective

[12] Cf. Schelling (1960, 1980, p. 4 et passim).

self-damage. In the one-sided dilemma, it is indeed sufficient that Player A—the player who has the asymmetric possibility to exploit the other player—undertakes a binding commitment that renders his exploitation of Player B unattractive to him. Such a binding commitment can change the social structure of the interaction and thus, ultimately, amounts to playing another game. If the binding commitment lends credibility to A's promise not to exploit Player B, Player B will be more willing to cooperate, and both sides can reap the win-win rewards of their cooperation.

The many-sided social dilemma is a *symmetric* situation in which cooperation fails because of the *reciprocal* opportunity for mutual exploitation (cf. Bowles 2004, pp. 23–55). All players can mutually exploit each other. This leads to a situation of collective self-damage because each player behaves exactly the way he fears the others will, that is, exclusively in their own self-interest. Given the social structure of the many-sided dilemma, no individual self-commitment can solve the problem. If just one player committed unconditional cooperation, the others would still have an incentive, perhaps even a stronger incentive, to exploit this cooperative behavior. The only way to avoid or stop this collective self-damage is through a credible collective self-commitment that changes the incentives for all players and induces them to simultaneously change their strategies. Only a multilateral commitment device can overcome the symmetric logic in many-sided dilemma structures and make a win-win outcome possible.

Depending on the type of social dilemma involved (one-sided or many-sided), therefore, social entrepreneurs can use different commitment devices to overcome social dilemmas and create win-win solutions. Just as there are two types of social dilemmas, there are two types of commitment devices, namely, *self*-binding commitments and commitment *services* that help other actors bind themselves. In the first case, a social entrepreneur voluntarily commits to a course of action (or non-action), either individually or collectively with others. In the second case, social entrepreneurs help others (e.g., customers, suppliers, etc.) to overcome one-sided or many-sided social dilemmas by offering them a functional device for individual or collective commitment.

To summarize, the ordonomic approach offers a theoretical perspective for conceptualizing social entrepreneurs as institutional change makers. It highlights that social entrepreneurs can create win-win solutions through the sophisticated management of functional commitments. Such commitments can change the social structure of the basic game and thus help overcome social dilemmas. This theoretical perspective, however, is only of value if it actually aids in understanding real-world instances of social entrepreneurship. The next section therefore applies the ordonomic approach to the real-life example of Neumarkter Lammsbräu. The analysis substantiates the argument developed here on theoretical grounds and shows how this successful eco-social enterprise has created a win-win venture through the sophisticated management of functional commitments.

(2) Neumarkter Lammsbräu is a German brewery with a more than 30-year history of brewing organic beer and being an agent of social change in its community.[13] The owner and manager, Dr. Franz Ehrnsperger, can be viewed as a classic eco-social entrepreneur. Inspired by a vision of creating an ecologically and socially sustainable enterprise, Ehrnsperger took over the family business from his parents and decided as early as 1980 to manufacture organic beer, to run his brewery according to ecological principles, and to take responsibility for local farmers. In so doing, Ehrnsperger reacted to what he perceived to be negative outcomes in the basic game of modern, highly industrialized agriculture, including increasing damage to the soil and groundwater ecosystems and the marginalization of small traditional farmers.

Ehrnsperger's vision had another side to it, however; one that involved the profit side of his business. Following his creed that "ecology is long-term economy,"[14] Ehrnsperger was convinced that running an organic brewery according to sustainability principles would create a win-win outcome for all stakeholders—providing consumers with high-quality products, employees with jobs, and regional farmers with a long-term demand for locally produced organic raw materials.

However, all this was easier dreamed than done. The traditional rural community in which Neumarkter Lammsbräu operates posed several barriers to the transformation of its conventional agricultural structure into organic sustainable farming: to make the dream a reality, a number of social structural innovations were necessary. Today, the institutional innovations created and implemented by Neumarkter Lammsbräu have made this eco-social enterprise an impressive success. Neumarkter Lammsbräu was not only the first brewery to ever convert its entire range to 100% organic, it is also the biggest organic brewery in Europe, possibly the world.

Neumarkter Lammsbräu's success story not only demonstrates how a social enterprise can create a win-win implementation of economically sustainable ecological and social objectives, it is also an excellent real-world example of how a social entrepreneur achieved this success by a sophisticated use of functional commitments to overcome social dilemmas. The Neumarkter Lammsbräu case, in fact, wonderfully illustrates a comprehensive strategy matrix that identifies four paradigmatic options of how social entrepreneurs can employ functional commitments to create win-win solutions. Figure 6.4 is a graphic representation of this ordonomic strategy matrix.[15]

The vertical dimension in Fig. 6.4 differentiates between the two types of dilemma structure—one-sided and many-sided. In the horizontal dimension, the matrix distinguishes between the two commitment technologies—self-binding commitments and commitment services for others. In the left column, the social entrepreneur binds himself or herself, either individually or collectively. In the right

[13] The following analysis of the case of Neumarkter Lammsbräu draws on the material as published on the brewery website at http://www.lammsbraeu.de as well as on the publication by Riess et al. (2008, pp. 105–114). For a similar analysis, see also the publication by von Winning (2009).

[14] http://www.lammsbraeu.de/index.php?id=7&L=1.

[15] For a previous discussion of a similar ordonomic strategy matrix see also Hielscher et al. (2009, pp. 57–61).

Fig. 6.4 The ordonomic strategy matrix

Dilemma Structure	*Commitment technology*: Self-binding commitments	*Commitment technology*: Commitment service for binding others
one-sided	(I) Individual self-commitment (Price and sales volume guarantees for farmers)	(II) *Service* for individual self-commitment (Monitoring for farmers)
many-sided	(IV) Collective self-commitment (Foundation of the "Association of Organic Food Producers")	(III) *Service* for collective self-commitment (Initiation of the "Growers Association for Organic Brewing Raw Materials")

column, the social entrepreneur helps other actors—in this case, the farmers—to make credible commitments. This two-dimensional structure makes it possible to identify four paradigmatic strategies a social entrepreneur can engage in to further his or her mission through functional commitments. In the following, the Neumarkter Lammsbräu case will be used as a real-life example of each of these strategies.

(a) Box I represents the case where a social entrepreneur binds himself or herself so as to induce others to enter a cooperative relationship. In the case of Neumarkter Lammsbräu, such an individual self-commitment was important in overcoming a one-sided social dilemma between the brewery and its farmers. Figure 6.5a illustrates this situation graphically.

At a time when ecological products had not entered the mainstream market, Neumarkter Lammsbräu asked local farmers in its community to go organic. For

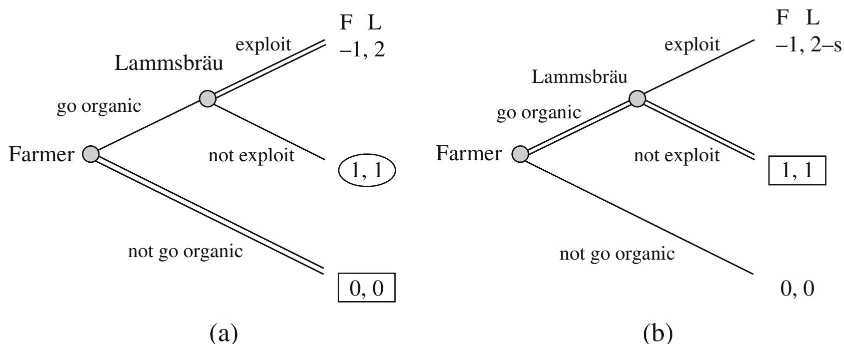

Fig. 6.5 The one-sided prisoners' dilemma

the farmers this was problematic for a number of reasons. To begin with, according to EU regulations, farms have to be run organically for at least 2 years before the products can be sold as organic. Furthermore, the local farmers did not have the knowledge or management processes necessary for producing organically and meeting product standards for organic foods. As a consequence, farmers who agreed to go organic would have to make a number of highly specific investments. Such specific investments, however, could easily have been exploitable by Lammsbräu. In fact, with Lammsbräu being the only purchaser of organic brewing material in the region, the farmers had reason to be afraid that their costly specific investments would be subject to hold-up by Lammsbräu: Referring to the pressure of competition Lammsbräu could ex post try to renegotiate and lower the prices it paid the farmers. For this reason, the farmers' initial skepticism regarding Lammsbräu's offer was actually highly rational. At first, therefore, the farmers decided not to go organic.

Given the incentive structure of this one-sided social dilemma, both Lammsbräu and the farmers failed to realize a possible win-win solution. Within the given parameters of this game, it was impossible for Franz Ehrnsperger to achieve his mission of ecological and social change. In this situation, Lammsbräu had an incentive to change the social structure of the interaction. Facing a one-sided social dilemma, Ehrnsperger needed to overcome the collective self-damage by imposing on himself a credible self-commitment (Fig. 6.5b) and this is exactly what he did. Today, Lammsbräu offers its farmers long-term contracts that guarantee for 5 years the amount and the price of organic brewing raw materials that the brewery will purchase. In addition, the price Lammsbräu pays is 10–15% higher than the market price the farmers would receive for conventional raw materials. Moreover, Lammsbräu helps its growers reduce the cost of their specific investments by supporting them in the process of going organic. To this end, Lammsbräu pays a professional agricultural engineer to assist the farmers not only with regard to the actual farming challenges, but also in the auditing process for the eco-certification of their products.

These self-commitment strategies of Neumarkter Lammsbräu changed the interactions between the brewery and the farmers. By making Lammsbräu's commitment to organic agriculture credible, they convinced the formerly skeptical farmers to invest in the organic agricultural structures. For the rural community in which Lammsbräu operates, the eco-social enterprise has triggered substantial social change. Today, more than 100 local farmers have gone organic and devote some 4,000 hectares purely to organic brewing material.

(b) Box II represents the case where a social entrepreneur offers a mechanism for individual self-commitment as a service to its interaction partners. In the case of Neumarkter Lammsbräu, the brewery offers such a service for individual self-commitment to its farmers. The one-sided social dilemma that this commitment device solves is in a way a mirror image of the social dilemma described in Box I, but in this case, it is not Lammsbräu that needs to be bound, but each individual farmer. This situation evolved as follows.

Lammsbräu's credible commitment to pay a premium price for organic brewing material made it lucrative for the farmers to sell their products to the brewery. Due to the nature of organic products, there are, however, information asymmetries between Lammsbräu and its suppliers. For Lammsbräu, it is very difficult, if not impossible, to know whether the raw material it receives really fulfills the high-quality standards it demands. To a certain extent, Lammsbräu needs to trust that the farmers are honoring the agreed-upon ecological principles in the farming process. Consequently, each farmer could exploit Lammsbräu by simply adding conventionally cultivated raw material to the organic material sold at the premium price.

This incentive structure threatened to destabilize the cooperative interaction between Lammsbräu and its farmers. In an extreme case, the ensuing (nonorganic) quality of the brewery's products could destroy its organic business model and both the brewery and the farmers would be worse off. As a result, each farmer has an incentive to make a credible commitment that his or her products really do comply with the standards for organic crops. Small farmers, however, often do not have the expertise or resources to have their production process monitored, audited, or even eco-certified.

Neumarkter Lammsbräu solved this one-sided social dilemma by offering its organic contract farmers a service that makes their individual commitment credible. The brewery organizes the monitoring process, sends a Lammsbräu employee to each farm, and evaluates the quality of the organic farming process. The monitoring costs are borne by Lammsbräu, and, no doubt, are substantial, but the monitoring process makes the farmer's commitment to organic agriculture credible. It creates a social structural incentive scheme that allows all participating stakeholders to invest in the value creation process for organic products.

(c) Box III depicts the case where a social entrepreneur offers a device for collective commitment as a service to its interaction partners. In the case of Neumarkter Lammsbräu, such a commitment service helped overcome a many-sided social dilemma on the side of the farmers. Figure 6.6a illustrates the incentive structure of this situation.

Because Lammsbräu credibly promised to pay a premium for organic brewing material, ecological agriculture became a possible new and lucrative market for the farmers. As a group, the organic farmers had a common interest in seeing that this market came into existence. At the same time, however, the farmers had conflicting individual interests. Each farmer feared that competition from the other farmers would drive down prices in the long run. Also, the farmers worried that their competitors might not honor the sometimes costly standards for organic agriculture to the degree desirable. In fact, each farmer had an incentive to undercut the costly organic standards as much as possible, thus creating pressure on others to do likewise. In total, interdependencies between the farmers created significant uncertainty that threatened to keep the farmers from going organic.

In this situation, the farmers had a shared interest in going organic as a group, monitoring each other, and negotiating prices with Lammsbräu collectively.

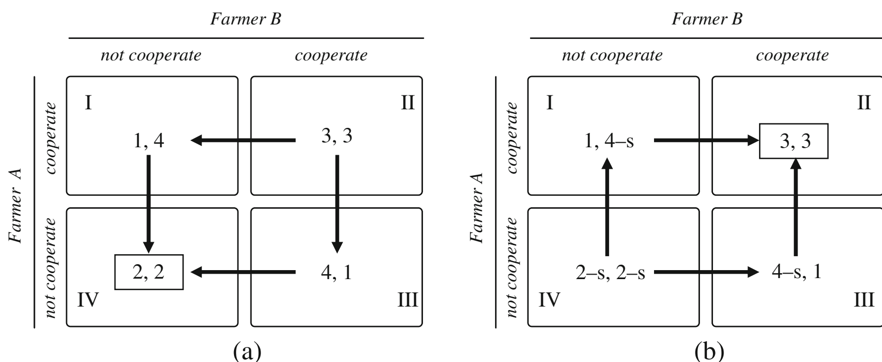

Fig. 6.6 The many-sided prisoners' dilemma

However, as pointed out by Mancur Olson (1965), organizing a collective interest is subject to free-rider problems and is rarely easy. Figure 6.6a illustrates that the conflicting individual interests kept the farmers locked in a many-sided social dilemma. For each farmer, it was rational not to cooperate—even though the group would be better off if everyone cooperated. What was needed, therefore, was a collective self-commitment that committed all farmers to an arrangement allowing them to realize their common interests.

In the case of Neumarkter Lammsbräu, the farmers did not have the resources to create such a collective self-commitment. However, Franz Ehrnsperger, also, had an interest in the farmers organizing themselves and thus adding stability to provision of organic material. Ehrnsperger thus offered the farmers a service for collective self-commitment. In 1988, Neumarkter Lammsbräu initiated the "Growers Association for Organic Brewing Raw Materials" (EZÖB) and required all then organic contract farmers to join this association. The EZÖB was an important institutional innovation that solved a number of problems that were keeping the eco-social enterprise from meeting its full potential. First, the EZÖB now negotiates the framework contract between Lammsbräu and the growers and thus decides on the sales volumes and sale prices for the organic brewing raw material. Thanks to this collective commitment, the farmers no longer need fear that their specific investments will be devalued by competition driving down prices. Second, the EZÖB obliges all members to honor strict standards of organic agriculture. It thus helps the farmers to uphold high-quality standards as a group. Third, Lammsbräu requires that any grower wishing to become an organic contract farmer for the brewery must join the EZÖB. Farmers who leave the EZÖB forfeit their contract with Lammsbräu. By helping set up the EZÖB and making membership in it compulsory for its suppliers, Lammsbräu solved the free-rider problem on the side of the farmers. It is now rational for each farmer to cooperate with the other farmers through the EZÖB. Providing this service for collective self-commitment thus proved to be an important catalyst for structural change toward sustainable agriculture in the region.

(d) Box IV represents cases where a social entrepreneur enters into a collective self-commitment with other actors. This case is of particular importance because in many instances an individual social entrepreneur does not have the means to address an important challenge alone. In fact, partnerships and alliances are crucial for promoting sustainable social change. Also, in many cases, a moral first-mover might not obtain any individual advantage by his or her action and, worst case, could be exploited because of the self-commitment. In these instances, collective self-commitments are needed to "bring on board" other partners and, in particular, other competitors.

Neumarkter Lammsbräu has made use of collective self-commitments to address challenges it, as well as other pioneering enterprises, has faced in the organic food sector. When, in 1980, Franz Ehrnsperger decided to work toward a sustainable business model that creates local jobs and furthers ecological objectives, organic products were still little known in the German food market. In the early years of his new business model, Lammsbräu capitalized on its local reputation. By the 1990s, however, Ehrnsperger wanted to increase the scope of his market. Unfortunately, though, the market for organic products at that time was still rather small and undeveloped. Thus, Neumarkter Lammsbräu had an incentive to invest in raising public awareness of organic products. Such marketing, however, is costly. What is more, it is also a public good, as it has the side effect of benefiting other companies engaged in producing organic products. In short, this is a classic example of the free-rider problem.

Neumarkter Lammsbräu decided to address this free-rider problem by cooperating with other businesses in its sector. In 1994, Lammsbräu founded the "Association of Organic Food Producers" (AÖL) in conjunction with the HIPP company and Ludwig Stocker Hofpfisterei. AÖL's goal is to develop joint strategies for pricing, product, communication, and distribution policies. Today, the AÖL has more than 60 members in Germany and Europe, with a total annual turnover of more than 1.3 billion Euros in 2008 for these members. Both on the national and European level, it promotes organic food and farming. At present, Neumarkter Lammsbräu is using its membership in the AÖL to develop a market for GMO-free, organic food products.[16]

(3) The Neumarkter Lammsbräu example demonstrates the logic of mutually advantageous commitments. It shows that the strategy matrix derived from the ordonomic perspective is a useful tool for making sense of what social entrepreneurs do in practice. It substantiates the claim that social entrepreneurs can use the sophisticated management of functional commitments to overcome social dilemmas and create win-win solutions to them. The *social* dimension of these strategies lies in their ability to realize important social or ecological objectives. In the case of Neumarkter Lammsbräu, institutional innovations have transformed not only the

---

[16] See also http://www.aoel.org.

brewery itself but also the entire supply chain and its local environment. As an eco-social business, Neumarkter Lammsbräu has proven to be a true innovator and an agent of social change.

The Neumarkter Lammsbräu case also illustrates the *entrepreneurial* side of social entrepreneurship. Social entrepreneurship is not about playing a given game better; it is about playing better games. In each of the situations discussed above, Neumarkter Lammsbräu did not simply try to optimize its individual moves within a given game, it worked to change the rules of the game (in effect, making a new, better game) and thus was able to achieve win-win outcomes for all stakeholders.

Social Entrepreneurship, Corporate Citizenship, and Business Ethics

In academic discussions of social entrepreneurship, a frequent topic is the question as to how, or even whether, the concept of social entrepreneurship can be distinguished from other concepts in the fields of business and society, business ethics, or management. From an ordonomic perspective, this is a particularly interesting question. The ordonomic approach to social entrepreneurship developed in this chapter maintains that social entrepreneurship is highly relevant to the innovative management of social dilemmas. Yet, as discussed by Pies et al. (2009a, b), there is also an ordonomic approach to corporate citizenship that is very similar. Therefore, the remainder of this chapter is a discussion of the relationship between social entrepreneurship and corporate citizenship.

According to ordonomics, social entrepreneurship and corporate citizenship are strikingly similar in a number of ways. First, both concepts can be understood as semantic innovations that rest on a strong *win-win* orientation. Social entrepreneurship and corporate citizenship both decry the win-lose mentality of zero-sum thinking and focus, instead, on strategies for creating positive-sum games.

Second, the ordonomic perspective highlights that both social entrepreneurs and corporate citizens can systematically create win-win solutions if they manage to overcome social dilemmas. Functional commitments are needed to overcome social dilemmas, which is why both social entrepreneurship and corporate citizenship focus on the innovative *management of functional commitments*. In fact, the four paradigmatic strategies displayed in Fig. 6.4 can be viewed as a strategy matrix for social entrepreneurship and corporate citizenship alike.

Third, the ordonomic perspective sees both social entrepreneurship and corporate citizenship as aspects of *new governance*. The concept of new governance focuses on the development of rule-making and rule-implementation processes that are "no longer . . . task[s] managed by the state alone" (Scherer et al. 2006, p. 505). In the new governance, businesses, civil-society organizations, and social enterprises are no longer merely rule-takers who simply seek to optimize their individual moves in the given game; rather, private actors contribute to setting and implementing rules and thus participate in the creation of new societal games. This process is

almost a definition of social entrepreneurship and corporate citizenship. Both social entrepreneurs and corporate citizens create and realize win-win outcomes through their contributions to the societal governance.

The similarities between social entrepreneurship and corporate citizenship are remarkable, but there is also one important difference between the two. Corporate citizenship involves the way a for-profit business pursues its corporate objective of profit maximization under the new governance. Given its fiduciary responsibility to shareholders, the starting point of any business venture is the pursuit of profits. In competitive markets, however, a company will realize profits only if it creates value for its stakeholders.[17] If a business firm cannot create value for its customers, suppliers, employees, and debtors, it will soon not have any customers, suppliers, employees, or debtors. In short, it is profit that motivates firms to create win-win outcomes for society. In a free-market economy, profits signal that a company has succeeded in creating such win-win outcomes. Yet, in a number of instances, win-win outcomes are not possible within the given, deficient rules of the games. In these cases, corporate citizens can react to societal problems and help improve the rules of the game in a way that allows them to create value. Put differently, it is the goal of making a profit that motivates corporate citizens to think about the needs of their stakeholders, to search for innovative strategies of self-binding and commitment services geared toward mutually advantageous reforms, and thus to play an active role in new governance processes. In short, corporate citizenship is business entrepreneurship in the age of new governance.

In contrast, social entrepreneurship begins from a fundamentally different starting point. The fundamental and initial driver for social entrepreneurship is not the realization of profits, but the solution of a social or ecological problem. By this logic, social entrepreneurs do not try to maximize their financial return, but seek to maximize their social impact. However, in order to maximize this social impact, social entrepreneurs need to create a sustainable "business model." If social entrepreneurship wishes to promote social change, it needs to create social value in a way that will proliferate on a broader scale. Indeed, many social entrepreneurs see the epitome of success as being that their "business model" is so attractive that other entrepreneurs copy it. A number of social entrepreneurs have even developed a franchising system. Take the example of Andreas Heinecke's "Dialogue in the Dark," which started in Frankfurt in 1988 and has been marketed worldwide as a franchise since 1996. Thanks to this scaling up, more than 6,000 blind people living in more than 160 cities across 19 countries have been empowered. As of 2009, more than 6 million people had experienced Dialogue in the Dark.[18]

Scaling up a social entrepreneurship venture increases its social impact, but it also means a need for more resources, such as money, knowledge, or volunteer time. As a consequence, only those social entrepreneurs whose business model generates

---

[17] Cf., for example, the classical argument put forward by Mises (1951, 2008). For a present-day position, see Jensen (2002, p. 239).

[18] See http://www.dialogue-in-the-dark.com/about/history-founder/ as of October 15th, 2009.

sufficient resources can scale up their projects—whether those resources are accumulated through earned income, public grants, donations, or private social venture capital. In a free society where people and organizations exchange freely, a social enterprise will attract these resources only if it, too, creates value for those with whom it cooperates. This is why social entrepreneurship needs to create win-win scenarios in order to maximize its impact. Only through the creation of value can social entrepreneurs really generate a sustainable social impact.[19]

Comparing social entrepreneurship and corporate citizenship thus results in an interesting and fundamental insight: corporate citizenship and social entrepreneurship have very different points of departure, namely, the maximization of profits for corporate citizenship and the maximization of social impact for social entrepreneurship. However, in pursuing these very different objectives, the two approach a point of convergence—namely, the win-win logic of mutually advantageous value creation. In the end, the often-stressed difference between "mere profit-seeking" and "social objectives" seems not to be such a vast chasm after all. From a societal point of view, business and social entrepreneurship have a common raison d'être: both solve social problems by creating value.

Business ethics theory could learn an important lesson from this conclusion. Business ethics is an academic discipline that critically reflects upon the (normative) semantics with which we perceive, explain, and evaluate our social world and, in particular, the business and the market society. Perhaps business ethics should ask whether our semantic notions do justice to the actual real-world structure of social problems. From an ordonomic perspective, it is no surprise that the semantics of corporate citizenship and the semantic innovation of social entrepreneurship both ultimately emphasize the importance of mutually advantageous value creation. In the social structure built out of competitive markets and freely cooperating individuals, the win-win creation of value is an absolute necessity for any enterprise to be sustainable. Against this background, the preoccupation of the business ethics fields with the dichotomy between profit and morality, stakeholder and shareholder value,

[19] Note again that this assertion does not mean that a successful social enterprise necessarily needs to earn a profit. Take, for example, the case of social entrepreneur Peter Eigen, who founded the not-for-profit civil-society organization Transparency International (TI). The starting point for Eigen was the social problem of corruption. He reacted to the fact that in the economic, political, and bureaucratic basic game, corruption is a highly undesirable outcome with devastating consequences for society. In the meta-meta game of discourse, Transparency International not only creates awareness of this problem, it also points out that there is potential for a win-win solution for governments, bureaucracies, and, above all, companies who take up the fight against corrupt practices. Most importantly, Transparency International works to change the rules of the game by playing a constructive role in rule-setting meta-games. TI's instrument, the "Integrity Pact," for example, a tool aimed at preventing corruption in public contracting, helps other actors play a better game. Ordonomically speaking, by way of the Integrity Pact, TI offers a service for collective self-commitment to players who otherwise have difficulties binding themselves. The point is that this commitment service creates value for those stakeholders—including the companies—whose cooperation is imperative for achieving TI's mission. Without this ability to create social value for the relevant stakeholders, TI's anti-corruption activities would not have had the success and social impact that they actually have.

and ecological and economic objectives appears misguided. Business ethics might be well advised to look at these concepts from more of an "and" perspective, instead of an "or" one. Profit and morality? It is conceivable.

References

Armendáriz, Beatriz, and Jonathan J. Morduch. 2007. *The economics of microfinance*. Cambridge, MA: MIT Press.

Arrow, Kenneth. 1985. The economics of agency. In *Principals and agents: The structure of business*, eds. John W. Pratt and Richard J. Zeckhauser, 37–51. Boston: Harvard University Press.

Baumol, William J. 2002. *The free-market innovation machine. Analyzing the growth miracle of capitalism*. Princeton and Oxford: Princeton University Press.

Baumol, William J. 2010. *The microtheory of innovative entrepreneurship.* Princeton and Oxford: Princeton University Press.

Becker, Gary S. 1976. *The economic approach to human behavior*. Chicago: University of Chicago Press.

Becker, Gary S. 1993. Nobel lecture: The economic way of looking at behavior. *Journal of Political Economy* 101: 385–409.

Beckmann, Markus. 2010. *Ordnungsverantwortung. Rational-Choice als ordonomisches Forschungsprogramm*. Berlin: Wissenschaftlicher Verlag Berlin.

Bornstein, David. 2007. *How to change the world: Social entrepreneurship and the power of new ideas*. 2nd ed. New York: Oxford University Press.

Bowles, Samuel. 2004. *Microeconomics. Behavior, institutions, and evolution*. New York, Oxford and Princeton: Princeton University Press.

Buchanan, James M. 1987. Constitutional economics. In *The new Palgrave dictionary of economics*, Vol. 1, ed. John Eatwell, 585–588. London: Macmillan.

Buchanan, James M. 1990. The domain of constitutional economics. *Constitutional Political Economy* 1(1): 1–18.

Certo, S. Trevis, and Toyah Miller. 2008. Social entrepreneurship: Key issues and concepts. *Business Horizons* 51(4): 267–271.

Christie, Michael J., and Benson Honig. 2006. Social entrepreneurship: New research findings. *Journal of World Business* 41(1): 1–5.

Coleman, James S. 1990. *Foundations of social theory*. Cambridge, MA: Belknap Press of Harvard University Press.

Drayton, William. 2006. Everyone a changemaker: Social entrepreneurship's ultimate goal. *Innovations* 1(1): 80–96.

Habisch, André. 2008. *Handbuch corporate citizenship: Corporate social responsibility für manager*. Berlin and Heidelberg.

Hardin, Garret. 1968. The tragedy of the commons. *Science* 162: 1243–1248.

Hielscher, Stefan, Ingo Pies, and Markus Beckmann. 2009. Wie können Corporate Citizens voneinander lernen? Anregungen für den Global Compact der Vereinten Nationen. *Zeitschrift für Wirtschafts- und Unternehmensethik* 10(3): 41–65.

Hirsch, Bernhard, and Matthias Meyer. 2009. Integrating soft factors into the assessment of cooperative relationships between firms: Accounting for reputation and ethical values. *Business Ethics: A European Review* 19(1): 81–94.

Homann, Karl. 1990. Wettbewerb und Moral. *Jahrbuch für Christliche Sozialwissenschaften* 31: 34–56.

Homann, Karl. 2002. *Vorteile und Anreize*, Tübingen: Mohr Siebeck.

Homann, Karl. 2003. *Anreize und Moral: Gesellschaftstheorie—Ethik—Anwendungen*. Münster: LIT Verlag.

Homann, Karl, and Ingo Pies. 1994. Wirtschaftsethik in der Moderne: Zur ökonomischen Theorie der Moral. *Ethik und Sozialwissenschaften (EUS)* 5(1): 3–12.
Jensen, Michael C. 2002. Value maximization, stakeholder theory, and the corporate objective function. *Business Ethics Quarterly* 12(2): 235–256.
Klein, Benjamin, Robert G. Crawford, and Armen A. Alchian. 1978. Vertical integration, appropriable rents, and the competitive contracting process. *Journal of Law and Economics* 21(2): 297–326.
Kreps, David M. 1990. Corporate culture and economic theory. In *Perspectives on positive political economy*, eds. James. E. Alt and Kenneth A. Shepsle, 90–143. Cambridge: Cambridge University Press.
Lin-Hi, Nick. 2009. *Eine Theorie der Unternehmensverantwortung. Die Verknüpfung von Gewinnerzielung und gesellschaftlichen Interessen*. Berlin: Schmidt.
Lütge, Christoph. 2005. Economic ethics, business ethics and the idea of mutual advantages. *Business Ethics: A European Review* 14(2): 108–118.
Lütge, Christoph. 2007. *Was hält die Gesellschaft zusammen?* Tübingen: Mohr Siebeck.
Mair, Johanna, and Ignasi Marti. 2006. Social entrepreneurship research: A source of explanation, prediction, and delight. *Journal of World Business* 41(1): 36–44.
Martin, Roger L., and Sally Osberg. 2007. Social entrepreneurship: The case for definition. *Stanford Social Innovation Review* Spring 2007: 28–39.
Mises, Ludwig v. [1951] 2008. *Profit and loss*. Auburn, Alabama: Ludwig von Mises Institute.
Neck, Heidi, and Elaine Allen. 2009. Business horizons. *Business Horizons* 52(1): 13–19.
Nicholls, Alex. ed. 2006. *Social entrepreneurship: New models of sustainable social change*. Oxford: Oxford University Press.
Olson, Mancur. 1965. *The logic of collective action*. Cambridge: Harvard University Press.
Pies, Ingo. 2000. *Ordnungspolitik in der Demokratie. Ein ökonomischer Ansatz diskursiver Politikberatung*. Tübingen: Mohr Siebeck.
Pies, Ingo. 2009a. *Normativität als Heuristik. Ordonomische Schriften zur Wirtschaftsethik*. Berlin: Wissenschaftlicher Verlag Berlin.
Pies, Ingo. 2009b. *Moral als Produktionsfaktor. Ordonomische Schriften zur Unternehmensethik*. Berlin: Wissenschaftlicher Verlag Berlin.
Pies, Ingo, Markus Beckmann, and Stefan Hielscher. 2009a. Sozialstruktur und Semantik—Ordonomik als Forschungsprogramm in der modernen (Welt-)Gesellschaft. In *Moral als Heuristik. Ordonomische Schriften zur Wirtschaftsethik*, ed. Ingo Pies, 282–312. Berlin: Wissenschaftlicher Verlag Berlin.
Pies, Ingo, Stefan Hielscher, and Markus Beckmann. 2009b. Moral commitments and the societal role of business: An ordonomic approach to corporate citizenship. *Business Ethics Quarterly* 19(3): 375–401.
Popper, Karl R. [1945] 1966. *The open society and its enemies*, Vol. 2. New York: Hegel and Marx, Princeton University Press.
Riess, Birgit, Carolin Welzel, and Arved Lüth. eds. 2008. *Mit Verantwortung handeln. Ein CSR-Handbuch für Unternehmer*. Wiesbaden: Gabler.
Schelling, Thomas C. 1960, 1980. *The strategy of conflict*. Cambridge, MA and London: Harvard University Press.
Scherer, Andreas G., Guido Palazzo, and Dorothée Baumann. 2006. Global rules and private actors: Toward a new role of the transnational corporation in global governance. *Business Ethics Quarterly* 16(4): 505–532.
Schönwälder-Kuntze, Tatjana. 2008. "Corporate citizenship" from a (systems)-theoretical point of view. In *Corporate citizenship, contractarianism and ethical theory. On philosophical foundations of business ethics*, eds. Jesus Conill, Christoph Lütge, and Tatjana Schönwälder-Kuntze, 49–65. Aldershot and London: Ashgate.
Seelos, Christian, and Johanna Mair. 2005. Social entrepreneurship: Creating new business models to serve the poor. *Business Horizons* 48(3): 241–246.

Seelos, Christian, and Johanna Mair. 2007. Profitable business models and market creation in the context of deep poverty: A strategic view. *Academy of Management Perspectives* 21(4): 49–63.

Suchanek, Andreas. 2007. *Ökonomische Ethik*. Tübingen: Mohr Siebeck.

Suchanek, Andreas, and Nick Lin-Hi. 2007. Corporate responsibility in der forschenden Arzneimittelindustrie. *Jahrbücher für Nationalökonomie und Statistik* 227(5+6): 547–562.

Waldkirch, Rüdiger W. 2001. Prolegomena for an economic theory of morals. *Business Ethics: A European Review* 10(1): 61–70.

Waldkirch, Rüdiger W., Matthias Meyer, and Karl Homann. 2009. Accounting for the benefits of social security and the role of business: four ideal types and their different heuristics. *Journal of Business Ethics* 89: 247–267.

Williamson, Oliver. 1985. *The economic institutions of capitalism*. New York: Free Press.

Winning, Alexandra von. 2009. *Anreizkompatibles CSR-Management: Die Perspektive einer ordonomischen Organisationstheorie*. Berlin: Wissenschaftlicher Verlag Berlin.

Yunus, Muhammad. 2007. *Creating a world without poverty: Social business and the future of capitalism*. New York: Public Affairs.

Zahra, Shaker A., Eric Gedajiovic, Donald O. Neubaum, and Joel M. Shulman. 2009. A typology of social entrepreneurs: Motives, search processes and ethical challenges. *Journal of Business Venturing* 24(5): 519–532.

Chapter 7
Morality as a Factor of Production: Moral Commitments as Strategic Risk Management

Stefan Hielscher

Abstract Through an analysis of Alfred Krupp's 19th-century social welfare program, this chapter employs an ordonomic perspective on how morality can be employed as a factor of production. The chapter's main argument is that corporate social responsibility (CSR) can be conceptualized as a corporate strategy of moral commitments. Such strategic commitments help to manage the relationship-based risks that arise out of social dilemma situations between the company and its stakeholders. In focusing primarily on relationship-based social risks that emerge from antagonistic cooperation, this chapter also provides an ordonomic contribution to corporate risk management.

Keywords Corporate risk management · Ordonomics · Corporate social responsibility · Corporate citizenship · Morality as a factor of production · Strategic commitments

Introduction

(1) Business scandals such as Contergan, Bhopal, Brent Spar, and Lehman Brothers are excellent examples of how societal criticism of business is intimately related to the process of value creation. Civil society actors (CSOs) such as Greenpeace, Amnesty International, Transparency International, and trade unions, as well as important corporate stakeholders, increasingly urge companies to assume responsibility in a widening field of social interests, even to the extent of demanding that firms abandon business-as-usual-strategies in order to meet this responsibility. Suppliers may push through the adoption of ethics codes in a fight against corruption, consumers may use boycotts to force the improvement of social and labor standards, investors may exert pressure on companies to implement new environmental or health standards, and employees may decelerate or even inhibit the implementation of technological or organizational innovations if they feel it runs against their interests. As a consequence, core business relationships between

S. Hielscher (✉)
School of Law, Business and Economics, Martin-Luther-University Halle-Wittenberg, 06108 Halle (Saale), Sachsen-Anhalt, Germany
e-mail: stefan.hielscher@wiwi.uni-halle.de

I. Pies, P. Koslowski (eds.), *Corporate Citizenship and New Governance*, Ethical Economy. Studies in Economic Ethics and Philosophy 40,
DOI 10.1007/978-94-007-1661-2_7, © Springer Science+Business Media B.V. 2011

companies and their important stakeholders are increasingly becoming precarious situations of voluntary cooperation and, consequently, primary sources of corporate risk.

(2) In the literature, relationship-based risks that arise out of the process of corporate value creation always play a certain role in justifying the corporate social responsibility (CSR). The management literature, however, is only recently starting to emphasize the strategic importance of CSR for value creation,[1] as is the more specialized field of corporate risk management. For instance, Kytle and Ruggie (2005, p. 1) state that with the advent of globalization, businesses now face a "significant shift in market power—not just to customers and traditional investors, but also, and more importantly, toward stakeholders: communities, employees, regulators, politicians, suppliers, NGO's and even the media. As a result of this shift in market power, 'social risk' is a rising area of concern for global corporations." In view of this global competitive environment, the authors take a practical hands-on management perspective and argue that, properly understood, global firms can (and should) employ CSR as a professional tool of corporate risk management.[2]

(3) This chapter takes an ordonomic view of relationship-based risks in corporate risk management. The chapter's main argument is that CSR can be conceptualized as a corporate strategy of moral commitments to manage the relationship-based risks that arise out of social dilemma situations between the company and its interaction partners.

Through an analysis of Alfred Krupp's 19th-century social welfare program, this chapter employs an ordonomic perspective on how morality can be employed as a factor of production.[3] The argument is developed in three steps. The first step (Section "The Krupp Welfare Program as Risk Management of Moral Commitments") interprets selected elements of Alfred Krupp's social welfare program as a differentiated management of strategic commitments to overcome social dilemma situations. By successfully experimenting with such commitments, Krupp established cooperative relationships with core business partners. The second step (Section "Commitments as Insurance-Like Protection Against Relationship-Based

---

[1] See, for example, Porter and Kramer (2002, 2006).

[2] Cf. Kytle and Ruggie (2005, p. 15). For the German academic discussion, cf., e.g., Fürst (2005).

[3] The ordo-theoretical approach to economic ethics argues that the incentive properties of social institutions play an important role in implementing moral concerns. This approach to economic ethics was originated by Karl Homann. Cf. Homann (1990, 2002, 2003). Meanwhile, there are numerous publications available that specifically refer to this intellectual tradition. Cf. Habisch et al. (2008), Hirsch and Meyer (2009), Lin-Hi (2009), Lütge (2005, 2007), Schönwälder-Kuntze (2008), Suchanek (2007), Suchanek and Lin-Hi (2007), Waldkirch (2001) as well as Waldkirch et al. (2009). The "ordonomic" approach builds upon the German tradition of an "economic theory of morality" (Homann and Pies 1994) that was originally restricted in a more narrow sense to discussing matters of business and economic ethics. Ordonomics advances this school of thought to a general social and organizational theory that takes a rational-choice perspective on the analysis of interdependencies between institutions and ideas or, more specifically, on the analysis of interdependencies between social structure and semantics. For the ordonomic approach cf. Pies (2009a, b) as well as Pies et al. (2009, 2010), Beckmann and Pies (2008), Pies and Hielscher (2008, 2011).

Risks") demonstrates that such corporate risk management is productive by illustrating how Krupp managed to (a) reduce unpreferable core business risks and (b) increase preferable risks in the process of innovation. The third step (Section "Insurance-Like Provisions as 'Moral' Commitments") argues that insurance-like commitments qualify as "moral" commitments if they further not only the company's self-interest, but also the interest of others. The chapter concludes with an outlook on CSR.

The Krupp Welfare Program as Risk Management of Moral Commitments

Alfred Krupp is deemed one of the most successful and also most controversial corporate patriarchs of 19th-century Germany.[4] Krupp is not only renowned as the mighty "canon king" but also as a pioneer of corporate social policy. This section argues that Krupp was a successful entrepreneur mainly because he was able to organize a strategic risk management of moral commitments—a social arrangement widely known as the Krupp social welfare program.

Instead of presenting at detailed account of the numerous provisions of the Krupp welfare program, the argument is developed by reconstructing the underlying logic of Krupp's social policy. To do so, this section is divided into two parts: Part (1) elaborates on the pivotal importance of dilemma situations in social cooperation and on the logic of strategic commitment as a device to overcome collective self-damage. Part (2) illustrates this logic with two elements of the Krupp welfare program that tackled two risks Krupp faced in the 19th century: fluctuation-induced risk and the risk of epidemic plagues.

(1) Value creation is a process of social cooperation. Companies engage in various cooperative relationships with customers and investors, but also with communities, employees, regulators, politicians, suppliers, CSOs, and even the media. Companies engage with these partners to reap the benefits for cooperation or, put differently, to create value.

Social cooperation, however, is antagonistic cooperation. Cooperation always involves common interests but also conflicting interests. Take the relationship between a company and its investors. Managers prefer to work for a successful market leader; investors want a high return on their deposits. Hence, both parties have a common interest in the business flourishing. There are, however, also conflicting interests between the two parties. Managers are risk averse and, hence, tend to engage in mainly low-risk projects with a certain payoff; investors, however, prefer managers to invest in high-risk projects that yield—although more uncertain—higher expected payoffs. Successful cooperation between managers and shareholders requires, therefore, a suitable institutional arrangement that minimizes

[4] For a general discussion of Krupp's social policy with a detailed bibliography of the relevant business history literature, cf. Hielscher (2010) as well as Hielscher and Beckmann (2009).

the frictional impact of conflicting interests on the one hand, but that emphasizes the common interests of cooperation on the other. In fact, the whole system of traditional corporate governance is an attempt to institutionally stabilize the precarious cooperation between management and shareholders—a principal-agent relationship that constantly runs the risk of not reaping the full benefits of cooperation.

From an ordonomic perspective, the simultaneous presence of common and conflicting interests can be understood as a social dilemma situation. The defining feature of a social dilemma is that it is a situation of collective self-damage: a situation in which a win-win solution cannot be realized due to an incentive structure that makes it difficult (if not impossible) for rational actors to behave in a mutually beneficial way even though it would be in their common interest to do so. Paradigmatically, the ordonomic approach distinguishes between two types of collective self-damage: one-sided dilemma structures and many-sided dilemma structures. Analogously, there are two ways of overcoming collective self-damage: individual commitments in one-sided dilemma situations and collective commitments in many-sided dilemma situations.[5]

Social dilemma situations are a major source of company-related entrepreneurial risk. However, engaging in professional risk management through strategic commitments can reduce the entrepreneurial risks of social cooperation. By analyzing two elements of his social welfare program, the next part demonstrates how Krupp successfully experimented with institutional provisions to solve those dilemma situations crucial to Krupp's process of value creation.

(2) When, in 1826, Alfred Krupp took over the small crucible steel company of Essen, the main asset he attained was knowledge of how to produce high-quality cast steel. Over the next 20 years, Krupp industriously sought to tap new markets, searching for new products that could take advantage of his ductile cast steel. In the beginning, the crucible steel company produced simple tanner tools, steel cutlery, and steel roll work pieces; later, production mainly shifted to complex products. Krupp manufactured the first seamless engine steel tire, ship and locomotive axles, and steel canons of all sorts.

In the early days, however, Krupp faced severe problems due to an uneven product quality. Two major risks were responsible for this problem—(a) a fluctuation-induced quality risk and (b) an epidemic-induced production risk. Both risks were directly attributed to one important stakeholder group—Krupp's employees—and were tackled by Krupp's social welfare program.

(a) Krupp offered extensive product guarantees in an effort to convince new customers to buy his innovative products and tap into new sales markets, and he thus needed to be able to keep his promises of high quality. This required highly qualified and trained personnel. In the early stages of industrialization, however, the

[5] The pivotal importance of social dilemmas for social theory explain Buttkereit and Pies (2008). For one-sided social dilemmas and the important role of individual commitments, cf. Kreps (1990). For many-sided social dilemmas and the important role of collective commitments, cf. Bowles (2004). For a dilemma-based plea for (ethical) voluntarism, cf. Freeman (2007).

industrial workforce typically consisted of migrant workers who jumped companies in the expectation of higher salaries at other plants. Highly mobile workers refrain from company-specific investments both in human capital (in-plant training for firm-specific skills) and in social capital (in this case, settling down near Krupp's factories with their families) and related investments. Employees were worried that Krupp would exploit their company-specific investments and thus preferred to remain flexibly deployable as migrant workers. Especially after the introduction of the Bessemer process, an innovation that made possible the mass production of cast steel, low-qualified migrant workers became a source of company-specific risk: a fluctuation-induced quality risk.

Krupp took steps to avoid this risk as early as 1844 by promising to pay higher wages than his competitors. In addition, however, Krupp provided his workers with institutional benefits, including a company-owned bakery (1858), an employees' retail store (1868), hostels for unmarried workers (1856), company dwellings for foremen, and workers' housing estates (1861 and 1863, respectively).

If increasing wages was sufficient to bind his employees, why did Krupp make the effort to increase not only their monetary income, but also paid them in kind? To answer this question, it helps to view the situation Krupp faced at the beginning of the 19th century as a one-sided social dilemma that had the potential to result in collective self-damage. Such a situation is characterized by the possibility of *asymmetric exploitation*. Employees had the option of making a specific investment in Krupp's company, but if they did so, Krupp had a strong incentive to exploit such investment. Anticipating Krupp's noncooperative ex-post conduct, his workers refrained from investing in specific human capital. The result was a collectively self-damaging equilibrium. Because simply promising to pay higher wages did not solve this dilemma, Krupp had a strong interest in making his promise of higher wages more credible so as induce his workers to bind themselves to the company, to settle down and make company-specific investments in human capital. This required not only higher nominal wages, which are relevant in only the short term at best, but also long-term provisions such as workers' housing estates or a retail store.

This is precisely the underlying logic of Krupp's method of addressing the fluctuation-induced quality risk: Krupp used an individual self-commitment to make his pay promise credible by rendering himself more vulnerable—i.e. more exploitable through fluctuation—in order to solve this hold-up situation and to be able to jointly create value through social cooperation.

(b) High-quality steel production requires a healthy and reliable workforce. In the early stages of industrialization, workers began to loosen their once-strong ties to extended family by moving from rural areas to places of more opportunity employment-wise and thus also lost much of the support they had previously been able to access in times of illness, unemployment, and when old. In the expanding and overpopulated urban area of Essen, this lack of community support resulted in a particularly weak local health infrastructure, which directly translated into an epidemic-induced production risk for Krupp's crucible steel company. Three disastrous cholera epidemics (1831, 1854, and 1874) that caused numerous deaths are

grim illustrations of the hygiene problems and the underdeveloped health infrastructure in Essen at the time. To address this risk, in 1836, Alfred Krupp introduced a voluntary health and dependents' pension fund for his approximately 60 workers. In 1853, by which time the number of employees had increased to around 1,000, the fund was converted into a compulsory health and death insurance scheme. A pension fund followed in 1855.

In principle, the public goods of "health protection" and "prevention of epidemics" could have been organized by the workers themselves, but trying to get workers to voluntarily contribute to a common fund is an excellent example of a many-sided social dilemma. Such a situation involves symmetrical interaction between actors whose cooperation fails because of the reciprocal opportunity for *mutual exploitation*. Each worker would find it advantageous to free ride on the contributions of others, with the consequence being that the aggregate contributions are insufficient to render the services needed (a mortality statistics, sanitary infrastructure, hospitals, etc.). By introducing health and death insurance and related services, Krupp organized a functional equivalent for collective action on behalf of his workers. What is most interesting is that Krupp did not bind himself, but instead offered a service for committing others. He introduced this *service* of self-commitment in two steps. At first, in 1836, the enforcement mechanism was informal as the small size of his staff allowed for a voluntary scheme of funding. However, by the 1860s, informal mechanisms no longer sufficed due to the much larger workforce. Therefore, a formal compulsory scheme became necessary to organize collective action. In fact, by linking the insurance to the employment contract, Krupp simultaneously avoided free riding by means of an ex-ante sanction *and* made cooperation among workers their best strategy.

This is precisely the underlying logic of Krupp's method of addressing the epidemic-induced production risk: Krupp rendered a service of collective self-commitment to solve a problem of collective action on the part of his workers, a problem that negatively affected his business. This strategy enabled Krupp to reap the full benefits of social cooperation.

(3) To summarize, Krupp was such a successful entrepreneur because he was able to manage risk by way of well-designed strategic commitments. Using both (individual) self-commitments and *services* for (collective) self-commitments,[6] Krupp successfully addressed important relationship-based risks of social cooperation that had the potential to threaten his main competitive edge: the quality of his innovative cast steel.

[6] Obviously, Krupp's social policy also had an impact on other stakeholders, such as politicians, regulators, the media, and other companies, and it also contains other forms of commitment. For a detailed analysis of the Krupp social welfare program, cf. Hielscher and Beckmann (2009) as well as Hielscher (2010), who develop a strategy matrix of four insurance-based commitments organized by Krupp. The matrix comprises four types of commitments: individual and collective self-commitments, as well as services for individual and collective self-commitments.

Commitments as Insurance-Like Protection Against Relationship-Based Risks

Strategic commitments enable social cooperation. The argument of this section is that social cooperation can work to a company's good in several ways. First, strategic commitments are productive if the corporation manages to reduce unpreferable core business risks. Second, strategic commitments can be even more productive if the corporation is willing to use the protection provided by strategic commitments to engage in innovation risks. This argument is developed by means of an economic model of insurance introduced by Sinn (1982) and Sinn (1985, 1986), that maps expected returns over risk. Arguing that strategic commitments have properties similar to those of market-based insurance schemes, the model provides two major insights. First, the model shows that by insuring against relationship-based risks, moral commitments provide higher security in the production process. As a result, corporations may conduct the same production scheme with lower risk. Second, the model implies that after establishing insurance-like commitments, continuing the same manufacturing schedule as previously is no longer optimal for rational managers. Under these circumstances, a risk-averse rational management will select projects that are not only higher in risk, but also have the possibility of higher expected returns to investment. Thus, this section argues that moral commitments are valuable for businesses precisely because they make it possible to take chances on innovation. Below, these two insights are illustrated by examples from the Krupp case.

(1) From an ordonomic perspective, the key argument is that strategic commitments play a functional role when it comes to risk management. In fact, properly understood, strategic commitments are very similar to conventional insurance: they enable the company to trade an insecure income distribution scheme for a more secure expected value of the distribution. This implies that strategic commitments enable a risk-averse company to protect itself against core business risks and provide higher security in the production process.

Figure 7.1 illustrates this logic using a (μ, σ)-diagram in which μ represents the expected profit—the expected value of return—and σ is the risk—the standard deviation of the income distribution—both from the perspective of the insurance holder. The diagram includes three convex indifference curves, IDC1, IDC2, and IDC3, which start horizontally at the ordinate and display the manager's risk preference: Starting at the ordinate, the manager will take a higher risk only if a higher expected return compensates the risk-based reduction of utility. The indifference curves hence map the subjective propensity of the manager to trade off return against risk, where the manager evaluates movements between indifference curves in the northeastern direction as an increase in utility and movements in the southeastern direction as a reduction in utility.

In the context of the Krupp case, Fig. 7.1 can be interpreted as follows. Point A indicates the situation when Krupp took over the crucible steel company from his father. Point A′ represents a (μ, σ)-combination, the point at which Krupp

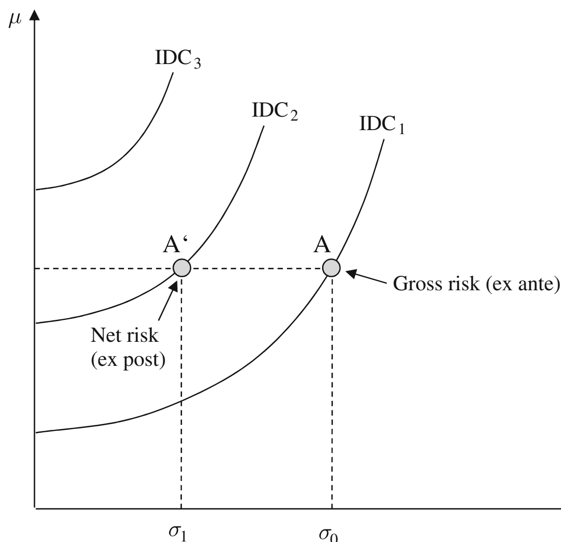

Fig. 7.1 Higher utility through strategic commitments[7]

introduced essential elements of his welfare program. As discussed in Section "The Krupp Welfare Program as Risk Management of Moral Commitments", the social welfare program successfully reduced unpreferable risks, such as, among others, the fluctuation-induced quality risk and the epidemic-induced production risk. Krupp's insurance-like moral commitments enabled the company to reduce the standard deviation from $\sigma 0$ to $\sigma 1$. Note that this model assumes Krupp's moral commitment to run cost-free so that both point A and point A′ are drawn on the same horizontal line.[8] Therefore, Krupp's commitment strategy enabled the company to reach a higher indifference curve (IDC2), which corresponds to a higher level of utility. In short, the welfare program sustainably reduced the core business risks and, therefore, acted as an insurance scheme. Moral commitments are valuable because they provide security in the production process.

(2) Moral commitments do not just provide security. Krupp was not merely faced with income risk; his was a two-faceted problem. In addition to investing in moral commitments, Krupp also had to make production plans.

The S-shaped graph in Fig. 7.2 illustrates a situation Krupp might have faced in the 1830s. On the one hand, Krupp could expect a relatively secure income stream if he confined himself to producing simple equipment or intermediate products, such as tanner tools, steel cutlery, or simple steel roll work pieces. On the other hand,

[7] The graphical representation refers to Sinn (1988, p. 13).

[8] This assumption may be very close to reality because Krupp promised a high gross wage and thus was able to substitute the monetary wage with payments in kind.

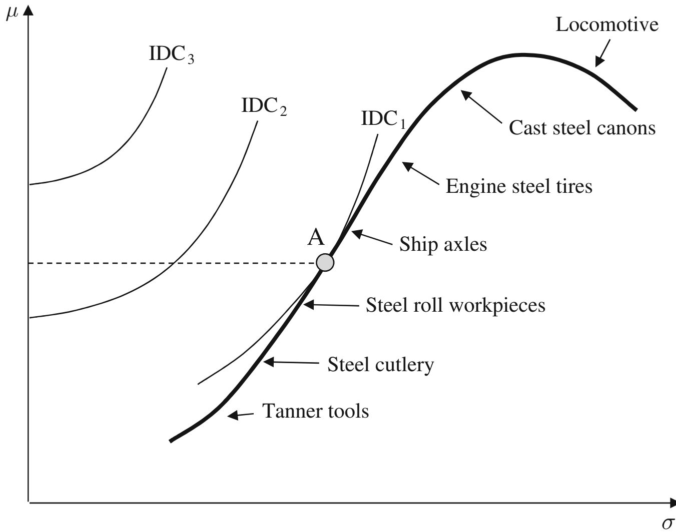

Fig. 7.2 The S-shaped production-possibility frontier[9]

Krupp could take the chance of producing more complex products. Products such as ship axles, engine steel tires, and cast steel canons would have a higher profit margin than the simpler products due to Krupp's competitive edge as an innovative first mover. Producing such products, however, entailed more risk: the production process is more difficult and the facilities and investment needed to produce such items are more product-specific. For example, to produce an engine steel tire, Krupp needed to know not only how to produce firm and elastic steel, but also how to adapt the steel for usage in a locomotive. Furthermore, in the case of poor quality, losses would be higher for these more specialized products than for the simple ones: if a defective tanner tool breaks, Krupp could lose the custom of a few tanners; if, however, an engine steel tire bursts, Krupp ran the risk of losing the business from an entire railroad company. The S-shaped production-possibility frontier in Fig. 7.2 sorts the products according to how difficult and complex it is to produce them and assumes that risk increases with complexity. Up to a certain point, it is fairly safe to assume that not only is the risk positively correlated with the complexity of the production process but also with the expected returns. But it is also safe to assume that there are certain products for which this relationship is in the opposite direction. For example, Krupp would need other than his core competencies to produce a steam locomotive. Such a radical departure from his core business would so dramatically increase the expected costs that they would by far exceed expected profits. The indifference curves display the *subjective willingness* to trade profit for risk, whereas the efficient production frontier represents the *objective possibility*

[9] The graphical representation refers to Sinn (1988, p. 16).

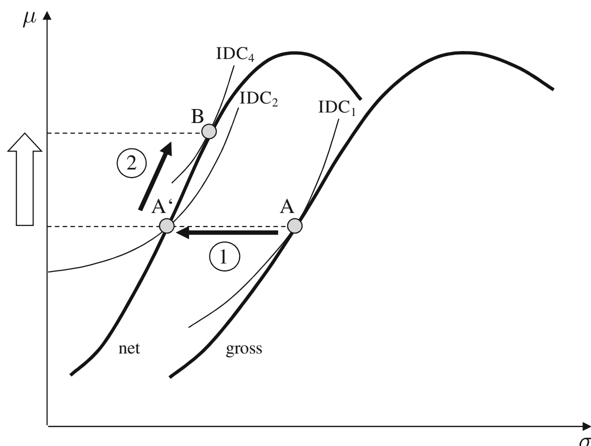

Fig. 7.3 Value creation through moral commitments[10]

of trading profit for risk. A risk-averse actor will chose a production scheme at tangent point A at which subjective willingness exactly equals the objective potential to trade off. Furthermore, the actor is located on the highest possible indifference curve that still touches the efficient production frontier in the part of positive inclination.

Interpreted as a system of insurance-like moral commitments engaged in to reduce unpreferable risks, the Krupp social welfare program not only shifts point A to the left, but also each point on the production possibility frontier—in this case, by half the interception of the abscissa. As a consequence, a net production possibility frontier results that represents all (μ, σ)-combinations possible after introduction of the welfare program (Fig. 7.3).

In the situation illustrated by Fig. 7.3, Krupp could continue to confine himself to the production of simple steel roll work pieces (represented by arrow 1). After introducing insurance-like moral commitments, point A′, however, doing so is no longer optimal because Krupp could increase expected profits by raising the net risk of production.[11] In terms of Fig. 7.3, point A′ is not tangent to indifference curve IDC_2 but intersects with it. Consequently, Krupp has an incentive to take higher risks and choose point B instead of point A′ (represented by arrow 2). In our case, Krupp does not need to confine himself to simple steel roll work pieces or steel cutlery, but can risk producing complex products, such as engine steel tires or cast steel canons, which yield higher expected profits. In short, moral commitments are valuable because they make it possible to take a chance on innovation. Krupp realizes indifference curve IDC_4.

[10] The graphical representation refers to Sinn (1988, p. 18).

[11] One effect was neglected here: Low residual absolute risk induces the actor's marginal risk aversion to decrease as well. As a consequence, also the inclination of the indifference curves decreases and Krupp can realize production plans which are located even further to the right.

Insurance-Like Provisions as "Moral" Commitments

The previous two sections argued that strategic commitments contribute to establishing and maintaining social cooperation and that social cooperation can be productive for a company if the commitments display insurance-like properties. But should strategic, insurance-like commitments also qualify as "moral" commitments?

This section argues that the answer to that question is yes. The argument is developed in two steps. In Step (1), it is shown that commitment devices aim at a win-win solution to morally relevant conflicts of social cooperation. In Step (2), it is shown why such a win-win orientation that aims at overcoming conflicts between private interests and public interest interests qualifies as being truly "moral."

(1) As discussed in Section "Commitments as Insurance-Like Protection Against Relationship-Based Risks", Krupp organized strategic commitments in order to solve situations of collective self-damage, meaning situations in which neither interaction partner reaps the benefits of social cooperation. With regard to fluctuation-induced production risk, Krupp bound himself to his promise not to exploit the company-specific investments of his workers by means of a short-term wage premium and additional long-term social benefits. With regard to the epidemic-induced production risk, however, Krupp did not bind himself, but instead provided his workers a service for a collective self-commitment—company-wide health insurance and a pension fund. Both provisions aim at a win-win solution: Krupp not only reduced the chances of at least two production-related risks,[12] he also significantly improved the lives of his employees. In other words, Krupp's social welfare program was a sustainable solution to social problems in that he envisaged both his *self-interest* as a competition-driven industrial entrepreneur *and* the legitimate interests of his partners, the workers. Or, as Eugen McCreary put it, "one of Germany's greatest industrialists began doing some-thing at a time when few did; that his were among the first steps toward industrial social responsibility .... [F]or its time it was a remarkable effort, revealing an intelligent understanding both of an employer's *self-interest* and the most pressing needs of a new but constantly expanding industrial labour force."[13]

(2) Some approaches to business ethics insinuate that only acts that go beyond the self-interest of corporate actors have a genuine moral quality.[14] Such a definition, however, would turn a blind eye on those acts that by furthering public interests (i.e., legitimate interests of others in society) also advance the self-interest of corporate actors.

The results of this "blindness" are illustrated in Fig. 7.4a. This view of morality runs the risk of putting those who try to conform to it in a conflict of interest situation—a situation that would imply that making a profit (which is acting in a

---

[12] Cf. McCreary (1968, p. 42): "Mobility of trained manpower meant a constantly recurring loss of time and effort, which would be translated directly into higher production costs."

[13] McCreary (1968, p. 25, emphasis original, and p. 49, emphasis added).

[14] Cf. Ulrich (2008, p. 105 et seq.).

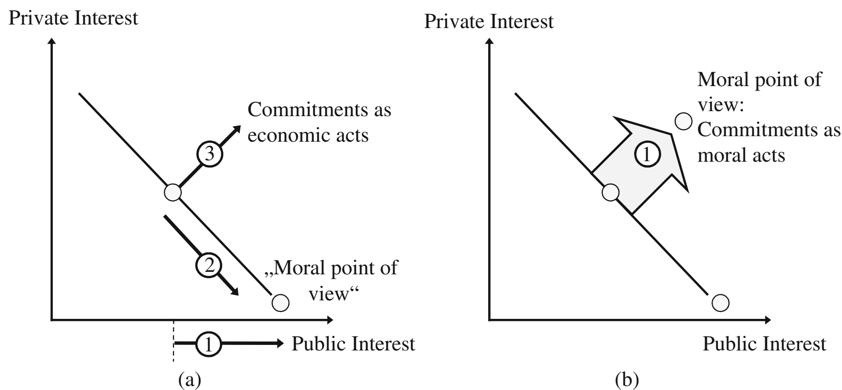

Fig. 7.4 (**a**, **b**) Ethical orientation: win-lose vs. win-win[15]

business's self-interest) means harming (or at least not benefiting) the larger society and vice versa. As a consequence, the moral impetus (arrow 1) can be realized only if companies at the same time curb their profit-seeking self-interest (arrow 2). Indeed, under this view, it is not obvious how strategic commitments that sustainably further the public interest and also advance the private interest could qualify as "moral": such commitment strategies are merely economic acts without a specific moral quality (arrow 3).

The main problem with this ethical proposition is that an act deemed as having a genuine moral quality would not be sustainable in the long run. As a consequence, corporate actors that follow this proposition in a competitive market economy either cease to act according to "genuine morality" or vanish from the market, neither of which seems desirable. The ordonomic approach proposes a different understanding of morality that is better tailored to the social structure of corporate commitment strategies: The ordonomic perspective suggests classifying as genuinely moral those acts that aim at an orthogonal position (arrow 1 in Fig. 7.4b). Such ethical orientation would qualify strategic commitments as moral commitments if the institutional

[15] In a sense, Fig. 7.4a also helps to illustrate the idea of "socio-economic rationality" as proposed by Peter Ulrich's "integrative" approach to economic ethics. Ulrich (2008, p. 106) argues that an "instrumentally rational treatment of the *scarcity* of resources and goods (efficiency) cannot be dissociated conceptually from the question of an ethically rational treatment of the social *conflicts* between those involved." In his figure 3.2, Peter Ulrich (2008, p. 107) insinuates that the *ethical aspect* of economic transactions refers to the potential conflict between the private interests of economic actors, while the *economic aspect* refers to all decisions of value creation. Such division of labour between ethics and economics, however, would assign a rather uncomfortable position to ethics: If ethics is by definition determined to elaborate (only) on the legitimational aspects of conflict of interests, all questions of how to explain and how further the creation of (social) value would consequently be left to the analytical tools of economics. More fundamentally, the question of how to implement moral ideals in modern societies would then not be a primary task of ethics, not to mention the explanation of how (Western-type) market societies have achieved moral progress within the last 200 years.

provisions have a win-win orientation and enable social cooperation by overcoming a seeming conflict between the profit-seeking of corporate actors and the legitimate interests of other actors in society. The Krupp case is a good illustration of the ordonomic approach. Krupp's social welfare program not only furthered the interests of his partners (the workers), but also advanced the interests of his company—the program, in short, used *moral commitments* as a risk management strategy. To put it even more precisely, Krupp employed morality as a factor of production.

3 The ordonomic approach holds that it is misguided to see only those acts as moral that neglect or even run against self-interest. The ordonomic approach instead takes the stance that the moral quality of corporate acts should primarily be judged by whether they further the legitimate interests of others. Under this understanding of "morality," even acts undertaken in the furtherance of self-interest can be called moral if they also further the public interest.[16]

The economic tradition is well acquainted with such view of morality. As early as 1921, Ludwig von Mises, for example, states:

> Morality consists in the regard for the necessary requirements of social existence that must be demanded of each individual member of society. . . . In requiring of the individual that he should take society into consideration in all his actions, that he should forgo an action that, while advantageous to him, would be detrimental to social life, society does not demand that he sacrifice himself to the interests of others. For the sacrifice that it imposes is only a provisional one: the renunciation of an immediate and relatively minor advantage in exchange for a much greater ultimate benefit. . . . The meaning of this regard for the general social interest has frequently been misunderstood. Its moral value was believed to consist in the fact of the sacrifice itself, in the renunciation of an immediate gratification. One refused to see that what is morally valuable is not the sacrifice, but the end served by the sacrifice, and one insisted on ascribing moral value to sacrifice, to renunciation, in and for itself alone. But sacrificing is moral only when it serves a moral end. There is a world of difference between a man who risks his life and property for a good cause and the man who sacrifices them without benefiting society in any way. *Everything that serves to preserve the social order is moral; everything that is detrimental to it is immoral.*

While such ethical orientation may seem rather unorthodox in the context of (business) ethics, the identification of the tension between self-interest and the "moral point view" as an as yet unsolved issue is also prominent in the philosophical tradition. Richard Rorty, for instance, argues:

> Plato thought that the philosopher's task was to answer questions like: "Why should I be moral?" . . . He thought this because he thought that the best way to deal with people like Thrasymachus and Gorgias was to demonstrate to them that they had an interest of which they were unaware, an interest in being rational, in acquiring self-knowledge. Plato thereby saddled us with a distinction between the true and the false self. The distinction was, by the time of Kant, transmuted in a distinction between categorical, rigid moral obligation and flexible, empirically determined self-interest. Contemporary philosophy is still lumbered with this opposition between self-interest and morality, an opposition which makes it hard to realize that my pride in being a part of the human rights culture is no more external to my self than my desire for financial or sexual success.[17]

[16] Mises (1927, 2002, pp. 14–15, emphasis added). Cf. also Mises (1922, 1981, p. 357).

[17] Rorty (1998, p. 176).

Conclusion

This chapter's main argument is that CSR can be conceptualized as a corporate strategy of moral commitments engaged in for the purpose of managing the relationship-based risks that arise out of social dilemma situations between the company and its interaction partners.

The Krupp case is a vivid example of how effective a risk management tool of moral commitments can be, especially in a fast-changing competitive environment. Such an environment makes cooperative value creation an especially risky undertaking and, therefore, requires professional management of the essential, but precarious, relationships necessary for value creation. Two major lessons can be learned from Krupp's employment of insurance-like moral commitments. First, such commitments can considerably reduce a firm's exposure to the unpreferable risk of losing important cooperative business relationships. Second, such commitments can make it possible for a company to take a chance on innovation, which is essential to long-term value creation.

The current process of globalization is similar in many respects to the Industrial Revolution of 200 years ago. Both then and now, competition increases the pressure to innovate. Both then and now, professional management is required to establish or stabilize precarious situations of cooperation pivotal to the process of value creation. Both then and now, as the Krupp case reveals, CSR, interpreted in ordonomic terms as a risk management of moral commitments that addresses social dilemma situations, is one way of successfully dealing with these issues.

References

Beckmann, Markus, and Ingo Pies. 2008. Ordo-responsibility—Conceptual reflections towards a semantic innovation. In *Corporate citizenship, contractarianism and ethical theory on philosophical foundations of business ethics*, eds. Jesus Conill, Christoph Lütge, and Tatjana Schönwälder-Kuntze, 87–115. Aldershot and London: Ashgate.

Bowles, Samuel. 2004. *Microeconomics. Behavior, institutions, and evolution*. New York, Oxford and Princeton: Princeton University Press.

Buttkereit, Sören, and Ingo Pies. 2008. Social dilemmas and the social contract. In *Corporate citizenship, contractarianism and ethical theory: philosophical considerations of business ethics*, eds. Jesus Conill, Christoph Lütge, and Tatjana Schönwälder, 135–147. Aldershot and London: Ashgate.

Freeman, R. Edward. 2007. Stakeholder management: Framework and philosophy. In *Corporate social responsibility. Volume 2: Managing and implementing corporate social responsibility*, ed. Andrew Crane, 267–299. Los Angeles and London: Sage Publications.

Fürst, Michael. 2005. *Risiko-Governance. Die Wahrnehmung und Steuerung moralökonomischer Risiken*. Marburg: Metropolis.

Habisch, André, René Schmidpeter, and Martin Neureiter. 2008. *Handbuch corporate citizenship: Corporate social responsibility für manager*. Berlin and Heidelberg: Springer.

Hielscher, Stefan. 2010. Wie man durch Moral ins "Geschäft" kommt: Ein ordonomischer Beitrag zum betrieblichen Risikomanagement. *ZVersWiss—Zeitschrift für die gesamte Versicherungswissenschaft* 99(2): 155–183.

Hielscher, Stefan, and Markus Beckmann. 2009. Social Entrepreneurship und Ordnungspolitik: Zur Rolle gesellschaftlicher Change Agents am Beispiel des Kruppschen Wohlfahrtsprogramms. In *ORDO—Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft Band 60*, 435–461.

Hirsch, Bernhard, and Matthias Meyer. 2009. Integrating soft factors into the assessment of cooperative relationships between firms: Accounting for reputation and ethical values. *Business Ethics: A European Review* 19(1): 81–94.

Homann, Karl. 1990. Wettbewerb und Moral. *Jahrbuch für Christliche Sozialwissenschaften* (31): 34–56.

Homann, Karl. 2002. *Vorteile und Anreize*. Tübingen: Mohr Siebeck.

Homann, Karl. 2003. *Anreize und Moral: Gesellschaftstheorie—Ethik—Anwendungen*. Münster: LIT.

Homann, Karl, and Ingo Pies. 1994. Wirtschaftsethik in der Moderne: Zur ökonomischen Theorie der Moral. *Ethik und Sozialwissenschaften. Streitforum für Erwägungskultur* 5(1): 3–12.

Kreps, David M. 1990. Corporate culture and economic theory. In *Perspectives on positive political economy*, eds. James E. Alt and Kenneth A. Shepsle, 90–143. Cambridge: Cambridge University Press.

Kytle, Beth, and John G. Ruggie. 2005. Corporate social responsibility as risk management: A model for multinationals, corporate social responsibility initiative, Kennedy School of Government Working Paper No. 10, March 2005, Cambridge, MA: John F. Kennedy School of Government, Harvard University, http://www.hks.harvard.edu/m-rcbg/CSRI/publications/workingpaper_10_kytle_ruggie.pdf.

Lin-Hi. 2009. *Eine Theorie der Unternehmensverantwortung. Die Verknüpfung von Gewinnerzielung und gesellschaftlichen Interessen*. Berlin: Erich Schmidt.

Lütge, Christoph. 2005. Economic ethics, business ethics and the idea of mutual advantages. *Business Ethics: A European Review* 14(2): 108–118.

Lütge, Christoph. 2007. *Was hält die Gesellschaft zusammen?* Tübingen: Mohr Siebeck.

McCreary, Eugene C. 1968. Social welfare and business: The Krupp welfare program, 1860–1914. *The Business History Review* 42(1): 24–49.

Mises, Ludwig von. 1922, 1981. *Socialism. An economic and sociological analysis*. Indianapolis: Liberty Classics.

Mises, Ludwig von. 1927, 2002. *Liberalism in the classical tradition*. New York: The Foundation for Economic Education.

Pies, Ingo. 2009a. *Moral als Heuristik. Ordonomische Schriften zur Wirtschaftsethik*. Berlin: Wissenschaftlicher Verlag Berlin.

Pies, Ingo. 2009b. *Moral als Produktionsfaktor. Ordonomische Schriften zur Unternehmensethik*. Berlin: Wissenschaftlicher Verlag Berlin.

Pies, Ingo, and Stefan Hielscher. 2008. Why the international market for pharmaceuticals fails and what to do about it: A comparison of two alternative approaches to global ethics. In *Corporate citizenship, contractarianism and ethical theory. On philosophical foundations of business ethics*, eds. Jesus Conill, Christoph Lütge, and Tatjana Schönwälder-Kuntze, 169–190. Aldershot and London: Ashgate.

Pies, Ingo, and Stefan Hielscher. 2011. The international provision of pharmaceuticals: A comparison of two alternative argumentative strategies for global ethics. *Journal of Global Ethics* 7(1): 71–87.

Pies, Ingo, Stefan Hielscher, and Markus Beckmann. 2009. Moral commitments and the societal role of business: An ordonomic approach to corporate citizenship. *Business Ethics Quarterly* 19(3): 375–401.

Pies, Ingo, Markus Beckmann, and Stefan Hielscher. 2010. Social value creation, management competencies, and global corporate citizenship—An ordonomic approach to business ethics in the age of globalization. *Journal of Business Ethics* 94(2): 265–278.

Porter, Michael E., and Mark R. Kramer. 2002. The competitive advantage of corporate philanthropy. *Harvard Business Review* December 2002: 5–16.

Porter, Michael E., and Mark R. Kramer. 2006. Strategy and society: The link between competitive advantage and corporate social responsibility. *Harvard Business Review* 84(12): 78–92.
Rorty, Richard. 1998. *Truth and progress*. Cambridge: Cambridge University Press.
Schönwälder-Kuntze, Tatjana. 2008. 'Corporate citizenship' from a (systems)-theoretical point of view. In *Corporate citizenship, contractarianism and ethical theory. On philosophical foundations of business ethics*, eds. Jesus Conill, Christoph Lütge, and Tatjana Schönwälder-Kuntze, 49–65. Aldershot and London: Ashgate.
Sinn, Hans-Werner. 1982. Kinked utility and the demand for human wealth and liability insurance. *European Economic Review: EER* 17: 149–162.
Sinn, Hans-Werner. 1985, 1986. Risiko als Produktionsfaktor. Risk as a factor of production. *Jahrbücher für Nationalökonomie und Statistik* 201(6): 557–571.
Sinn, Hans-Werner. 1988. Gedanken zur volkswirtschaftlichen Bedeutung des Versicherungswesens. *Zeitschrift für die gesamte Versicherungswissenschaft* 77: 1–27.
Suchanek, Andreas. 2007. *Ökonomische Ethik*. Tübingen: Mohr Siebeck.
Suchanek, Andreas, and Nick Lin-Hi. 2007. Corporate responsibility in der forschenden Arzneimittelindustrie. *Jahrbücher für Nationalökonomie und Statistik* 227(5+6): 547–562.
Ulrich, Peter. 2008. *Integrative economic ethics. Foundations of a civilized market economy*. Cambridge and New York: Cambridge University Press.
Waldkirch, Rüdiger W. 2001. Prolegomena for an economic theory of morals. *Business Ethics: A European Review* 10(1): 61–70.
Waldkirch, Rüdiger W., Matthias Meyer, and Karl Homann. 2009. Accounting for the benefits of social security and the role of business: Four ideal types and their different heuristics. *Journal of Business Ethics* 89: 247–267.

Chapter 8
The Implications of the New Governance for Corporate Governance

John R. Boatright

Abstract This chapter examines the implications of the new governance for corporate governance. The main conclusion of this examination is that both the new governance and corporate governance have resulted from broader changes in the competitive environment of business. The main features of these changes are shifts from hierarchical, vertically-integrated firms dependent primarily on financial capital to loose networks that rely heavily on human capital, and from strategies built less on market share and economies of scale to those based more on innovation and quality. These changes have not only driven globalization, which is central to the new governance, but also undermined some of the main assumptions of corporate governance that support shareholder primacy.

Keywords New governance · Corporate governance · Globalization · Modern industrial revolution · Shareholder primacy · Theory of the firm · Human capital · Networks · Residual risk · Implicit contracts

Introduction

In the development called "the new governance", corporations, especially multinational or transnational corporations, have become politically engaged and have assumed new functions that have traditionally belonged to governments alone. According to Scherer et al. (2006), the task of creating and implementing rules in a globalized world is "no longer a task managed by the state alone" (p. 506). Rather, multinational corporations, along with governments and other civil society groups, participate "in the formulation and implementation of rules in policy areas that were once the sole responsibility of the state" (ibid., p. 506). In addition to this rule-making function, corporations, it is claimed, serve another role traditionally reserved for government, namely as a provider or guarantor of the "triad" of civil, political, and social rights. Because the activities of making rules and administering rights involve close collaboration with many groups in society and also raise issues

J.R. Boatright (✉)
School of Business Administration, Loyola University Chicago, Chicago, IL, USA
e-mail: jboatri@luc.edu

I. Pies, P. Koslowski (eds.), *Corporate Citizenship and New Governance*,
Ethical Economy. Studies in Economic Ethics and Philosophy 40,
DOI 10.1007/978-94-007-1661-2_8, © Springer Science+Business Media B.V. 2011

of legitimacy, Scherer and Palazzo advocate a "communicative framework" for the new governance based on Habermas's idea of deliberative democracy (cf. Palazzo and Scherer 2006, Scherer and Palazzo 2007).

Closely related, if not identical, to this concept of new governance as formulated by Scherer, Palazzo, and Baumann is the thesis of Matten, Crane, and Moon that the corporate role in society can now be characterized as "corporate citizenship" (cf. Moon et al. 2005, Matten and Crane 2005, Matten et al. 2003, Moon 2002), and as the "republican concept" of corporate ethics presented by Steinmann and Löhr (1996). According to Moon et al. (2005), the activities of corporations "can be understood as being in some meaningful way *similar* to that of citizens or citizenship" (p. 432). This citizenship role is filled by corporations by, first, "administering [citizenship] rights *within* the normal operation of a firm", and, second, partnering with governments and non-governmental organizations in "contributing to societal governance *outside* the firm" (Moon et al. 2005, p. 440). For Steinmann and Löhr, a republican conception of the corporation or business ethics is necessary because business organizations have a responsibility not only to engage in economic production but also to help secure peace in society by facilitating processes of conflict resolution. Corporations thus have a "double responsibility" for "both economics *and* ethics" (Steinmann and Löhr 1996, p. 49). In accepting this responsibility, corporations assume a politicized role usually reserved for government. Consequently, they claim,

> [c]orporate ethics should be understood as a discoursive ethics procedure directed towards a consensus about good reasons for the peaceful resolution of ad-hoc conflicts with the (internal and external) stakeholders of the corporation. (ibid., p. 50)

One question that arises about the concept of new governance or, alternatively, corporate citizenship or republican ethics is its bearing on corporate governance. The *governance* referenced in the phrase "new governance" is not *corporate* governance but the process of decision making in the social and political order, which has traditionally been a function of government and is now performed with the active involvement of private parties, including corporations (cf. Cutler 2003, Hall and Biersteker 2002, Reinicke 1998, Pattberg 2005). *Corporate* governance, by contrast, is the set of legal rules which assigns the decision-making or control rights in business organizations and specifies the processes and procedures for exercising these rights. Assuming that present-day corporations, especially large firms that operate globally, have changed in the ways described by these scholars of the new governance, need the governance systems for corporations that prevail in the world today be altered in any way? In short, does the new governance have any implications for corporate governance?

This question is raised but not answered in one brief passage by Scherer et al. (2006):

> Does the new role of the corporation have consequences for the internal constitution of the corporation and corporate governance? Would it not be appropriate to argue that, given that corporations act politically, they also have to open up their internal structures and processes for public control, thereby enabling democratic legitimacy? (p. 520)

This suggestion of an affirmative answer is vague both about the "consequences" that follow from this new role aside from "opening up their internal structures" and enabling more democratic "public control" and about the reasons for these changes that make it "appropriate" to argue for them. Since systems of corporate governance are derived from some theory of the firm, the question of the implications of new governance for corporate governance extends to the need for some change in the theory of the firm, which is a question that is also raised, but not answered, by Scherer et al. (2006, p. 524). None of the other advocates of the new governance or corporate citizenship or republican ethics discusses the possible implications of this development for either corporate governance or the theory of the firm.

The aim of this chapter is to examine the question of what implications, if any, the new governance has for corporate governance and, by extension, the theory of the firm. Is the new governance compatible with traditional systems of corporate governance, which are based on the standard economic theory of the firm, or are some changes required? And if some changes are required, what are these changes and, more importantly, why are they required? The main conclusion of this examination is that, yes, the new governance has some implications for corporate governance and the theory of the firm. However, these implications are due primarily to broader changes in the competitive environment of present-day corporations of which the features cited in the new governance literature are only a relatively small part. One value of this chapter, then, aside from addressing the question of the implication for corporate governance, is to place the new governance in a larger context and identify some additional forces at work in its development.

Traditional Corporate Governance

Corporate governance has been understood traditionally as the rules that define the relationship between a firm and its capital providers or financiers. For example, Shleifer and Vishny (1997) write that corporate governance "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (p. 737). This view is based on a theory of the firm in which a corporation is a nexus of contracts in which every group participating in joint production provides some input in return for a claim on revenues. Since the equity capital providers' return is the residual revenues or profits, thereby making them residual risk bearers, they have a special contracting problem that is best addressed by the possession of control rights. Although other groups provide needed inputs, these contributions to production are generally not firm-specific and the return, in any event, can usually be secured by other contractual means. Other groups thus have little need of the kind of protections, including control rights, that is possessed by the financiers of the firm, and, consequently, these rights are allocated to the party, namely equity capital providers, to whom they are of the greatest value.

The value of control rights in corporate governance to the financiers of the firm derives from the ability of these rights to solve two key agency problems in joint production. First, the problem of monitoring the contribution of every participant in joint production is solved by assigning residual revenues to the group with control rights so as to motivate its members to monitor the activities of other groups (cf. Alchian and Demsetz 1972). Second, and more important, corporate governance is designed to address the agency problem inherent in the separation of ownership and control in large publicly held corporations (cf. Fama and Jensen 1983, Jensen and Meckling 1976, Hansmann 1996, Williamson 1985). It is by means of the control rights provided by corporate governance that capital providers can, through the board of directors, ensure that the managers monitor each group's efforts and maximize the residual revenues or profits.

Since the aim of all production decisions is maximal efficiency, the rules of corporate governance that emerge in a market through a process of negotiation between a firm and its equity capital providers, which constitute the rules of corporate governance, also have the aim of efficiency. In general, the forms of corporate governance that emerge when corporate constituencies are able to contract freely in a market will be efficient. Insofar as corporate law is established by government legislation, as opposed to private contracting, one of its aims – some claim its only proper aim – is to codify in law the most efficient relationship between firms and its financiers (cf. Easterbrook and Fischel 1991). Indeed, in the Anglo-American system, much of the law of corporate governance is merely default legislation that provides "off-the-shelf" rules that codify the kinds of contracts that private parties would write themselves. If these rules do not conduce to efficient production, firms are generally free, especially in the Anglo-American system, to contract differently. Any mandatory rules of corporate governance established by government that cannot be contracted around may be assumed to introduce some inefficiency into corporate operations (otherwise they would be adopted voluntarily by private contract). However, they may be enacted into law by government in the pursuit of values other than efficiency, such as fairness or social welfare.

In this traditional account of corporate governance, firms are understood to operate within a market in which private economic actors exercise their property rights through economic exchanges or transactions. The market is thus a sphere of activity in which every party – not only profit-oriented shareholders but other investors, employees, customers, suppliers, and other groups – seek to obtain maximal benefit. The market mechanism is utilized in a capitalist economy not only to organize production and distribute the wealth thereby created, but also to determine the rules of corporate governance themselves and the assignment of governance rights. The state or government provides the legal structure for market activity – for example, by protecting property rights and enforcing private contracts – along with making rules for other spheres of civic life through the democratic participation of citizens in the rule-making process. In particular, it is the role of the state to provide public goods and protect individuals' civil and political rights.

The Challenge of the New Governance

The world of the new governance, in which corporations participate in rule making and the administration of rights, challenges and is challenged by this traditional account of corporate governance, from both an explanatory and a normative perspective. A key feature of the traditional account of corporate governance, which is supported by the underlying economic theory of the firm, is that corporations engage in private, self-interested economic transactions while government attends to its public role of rule making and the administration of rights. Advocates of the new governance, as well of corporate citizenship and republican ethics, assume the effectiveness and legitimacy of the market mechanism, and so there is a need for some explanation of why these new corporate roles should arise in a competitive market – if, indeed, they do.

The only explanation offered by advocates of the new governance is that corporations have taken on the tasks of rule making and administering rights in situations where the government has been ineffective because it lacks either the power or the ability to act effectively. However, the existence of a need does not explain why corporations have moved to fill it. As van Oosterhout observes, new governance scholars offer no plausible reasons why corporations would be efficient rule makers or administrators of right or, more important, why they would take up these responsibilities in the first place (cf. van Oosterhout 2005, p. 678). He writes,

> First, the existence of more powerful and more perfectly functioning mechanisms (. . .) will also punish corporations who engage in activities that these markets are not willing to pay for. But, second, even if corporations could get away with such activities in global competitive markets, why should they assume such extensive responsibilities if there is nothing in it for them? (ibid.)

Missing from the discussion of the new governance, then, is any explanation of how the new roles that corporations have allegedly undertaken could possibly be efficient, so that these responsibilities would be voluntarily undertaken by corporations or imposed on corporations by a state government committed to the pursuit of efficiency or any other values. Beyond this problem, the account of the new governance does not provide any well-articulated theory of the firm that would support these roles for corporations.

Explanation aside, the normative justification for corporations as private actors to undertake these roles is questionable. As a consequence, a problem of legitimacy arises that is examined at length by Palazzo and Scherer (2006). They find a solution for this problem by holding corporations to stricter democratic accountability in a "communication-based approach to political theory" that involves "a continuous process of deliberative discourse" (Palazzo and Scherer 2006, p. 79), following Habermas. However, the very existence of a "problem" with legitimacy indicates that the new roles of corporations cannot be understood within the more conventional framework of corporations as economic actors in competitive markets. That

there should be a problem with legitimacy is itself a problem with the new governance. The standard view of firms as private economic institutions operating in a market is too fundamental to both economics and ethics to give up easily merely to solve a normative problem about legitimacy, especially when this does nothing to solve the more fundamental problem of explanation.

A Search for New Foundations

Fortunately, it is possible to understand the development of the new governance in a way that explains how the new roles and responsibilities of present-day corporations are an efficient adaptation to a changed competitive environment for business. Such an explanation, furthermore, does not raise any normative problem about legitimacy that would require discarding the fundamental conception of corporations as economic actors. However, this explanation does alter the underlying theory of the firm in ways that lead to significant changes in corporate governance. The main outlines of this explanation are sketched by Luigi Zingales in his article "In Search of New Foundations". The foundations in question are those for corporate finance: needed, in his view, is a new theory of the firm to support the empirical research, practical applications, and policy recommendations of corporate finance. However, the new foundations that he describes can be applied with equal fruitfulness to corporate governance – and the new governance. Many of the features of present-day firms described by Zingales are also present in what Post et al. (2002a, b) call the "extended enterprise", although these writers do not explore its implication for the theory of the firm or corporate governance.

The world has changed dramatically in the past several decades. The changes noted by advocates of the new governance concern primarily what Mathews (1997) calls the rise of "global civil society", in which national governments have lost autonomy and now share power with corporations and nongovernmental organizations (NGOs). In political theory, this change represents the end of the Westphalian system and the beginning of a system of "global governance" (cf. Kobrin 2008, Wolf 2008). By and large, scholars of the new governance have drawn on the immense political theory literature on global civil society and global governance. However, equally significant changes have occurred in business organizations that are not reflected in this literature.

The visible signs of changes in present-day corporations are, first, the breakup of large conglomerates with their standardized forms of organization in favor of smaller, more nimble companies, which have taken a wide variety of original and still-evolving organizational forms. Second, corporations have abandoned their rigid and closed vertically-integrated structure to adopt more flexible, open forms of collaboration in networks. Both of these developments lead to a blurring of organizational boundaries, which are constantly in flux. Third, corporations are ceasing to be hierarchical with extended formal chains of command and are

becoming more flattened with multiple, informal reporting relationships. Fourth, corporations are being driven to innovate constantly with new produces and services and improve quality rather than merely reducing costs and expanding output of a standard product line. Innovation and quality improvement have replaced the traditional emphasis on economies of scale and market share as the drivers of corporate strategy.

Behind these visible signs are some less obvious changes with profound implications for corporate finance and government. The optimal strategy for a company in any competitive environment is to identify and exploit opportunities for value creation. In the traditional firm, the key elements have been to employ large fixed tangible assets and realize economies of scale to reduce prices and enlarge market share. In such a firm, control over inputs through vertical integration of natural resources and hierarchical command structures for labor are critical. The most critical input or resource is capital. Because large amounts of capital are needed in a traditional, capital-intensive firm, firms must turn to outside investors who can bear the risk of providing capital through diversification. Since these diversified investors still bear considerable residual risk, it is necessary to offer them strong ownership rights. With outside ownership, however, comes the separation of *de jure* ownership and de facto control, which leads to the agency problems that corporate governance is designed largely to solve.

The changed competitive environment of the past several decades has radically altered the strategy that companies must pursue to continue to create value. In his presidential address to the American Finance Association, Michael Jensen (1993) terms the years after 1973 "the modern industrial revolution". In his account, a combination of increasing productivity, technological innovation, declining capital costs, more varied sources of financing, reduced regulation, and the globalization of commerce made the traditional model of growth through expansion and economies of scale counter-productive. Corporations could now create value only by seizing new opportunities that arose mainly from technological innovation and globalization. New and better products were the key to value creation rather than cheaper, more abundant ones.

In this new era, fixed tangible assets are less important than skills and knowledge. Since financial capital is less essential and, in any event, easier to obtain in many different forms, human capital has become more crucial and in demand. At the same time, corporations find that they have less control over employees and other sources of innovation and competitive advantage. Not only can employees easily leave to work for competitors anywhere in the world, but some valuable skills and knowledge are possessed by outsiders in all parts of the globe, who cannot be brought inside the firm. As a result, the resources needed for value creation cannot be owned and controlled in a hierarchical organization as in the past, but need to be mobilized in a collaborative network of people and institutions, both inside and outside the organization. Consequently, Post et al. (2002a) observe that "it is *relationships* rather than *transactions* that are the ultimate sources of organizational wealth" (p. 7; original emphasis; citing Leana and Rousseau 2000).

New Foundations and Corporate Governance

This account of changes in the competitive environment of corporations explains developments in the strategies adopted by companies in recent decades as well as in their organization, management, and financing. What are the implications, though, for corporate governance? Can corporate governance still deal only with "the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" or must it address a broader range of groups and their interests? The traditional account holds that only investors are the subject of corporate governance, not because the interests of other groups are unaffected or unimportant, but because of three related propositions.

First, only shareholders bear *residual* risk. Other constituencies bear some risk from corporate operations, but given that the returns for their investment in a firm are fixed amounts that can be secured with complete, legally enforceable contracts, they do not bear residual risk – which is the risk that comes from having a return based on residual revenues or profits. Corporate governance, moreover, is a solution for residual risk bearers, so that its protection is appropriate only for investors with residual claims. For other groups with different kinds of risk, different protections are more effective. The crucial point here is that every group should receive an appropriate level of risk protection, but the safeguards for non-residual risk bearers may properly be different from those for residual risk bearers and hence need not be the subject of corporate governance.

Second, only shareholders and not other groups are affected by corporate decision making – as long, of course, as a firm remains solvent. Since all non-shareholder constituencies have fixed claims that are negotiated in the process of forming a firm's nexus of contracts, their return is determined by the prices that their inputs command in the appropriate markets for labor, products, commodities, and so on, which are independent of the performance of a firm. By contrast, the return of equity capital providers, who have claims on the firm's residual revenues or profits, depends directly on the decisions made by management. Management decisions affect the level of profits, but not necessarily the solvency of the firm, which is the major source of firm risk for non-shareholder groups. Only shareholders have an interest that a firm be more than solvent, and corporate governance is the means by which this interest is protected.

Third, only explicit contracts form the basis of each group's claim on corporate revenues. Corporate governance constitutes investors' claims, and the claims of every other group are backed by the agreements that occur in the market transactions for their inputs. However, firms also make implicit contracts that induce input providers to commit firm-specific assets that are not guaranteed by a legally enforceable contract. Zingales observes that a firm with a reputation for fair treatment, for example, may be able to induce employees to make a firm-specific contribution that they would not make in a market. He continues,

> If these investments are indeed valuable and could not have been elicited with an explicit contract, the firm's reputation adds value; it is an organizational asset. (Zingales 2000, p. 1633)

Thus, any theory of the firm that captures all sources of value in a firm must consider implicit as well as explicit contracts. However, the standard economic theory of the firm pays scant attention to these implicit contracts.

It is easy to see that these three propositions, which are central to the traditional account of corporate governance, are called into question by the developments that have taken place in present-day corporations.

First, residual risk is now borne by many groups other than shareholders. With the declining importance of large, tangible assets and economies of scale and the new emphasis on innovation and quality, human capital becomes central to a company's strategy. However, employees can no longer be commanded in a hierarchical structure but must be induced to make firm-specific investments with promises that their contributions will be rewarded and not exploited (cf. Blair 1995). Put differently, the value of human capital in modern production leads to greater quasi-rents due to firm-specific investments, which makes employees vulnerable to exploitation by other groups, specifically shareholders. Moreover, the human capital that is valuable to a firm is held not only by employees *inside* the corporation but also by many groups on the *outside* who are part of a firm's network of resources. These sources of human capital must also be induced to cooperate with promised rewards. Thus, the residual risk of firms is spread further as strategic alliances are formed with partners and suppliers and the organizational boundaries of firms become blurred and porous.

Second, non-shareholder groups are now more affected by corporate decision making than before. The sharp line that once existed between the effects of managerial decisions, which extend only to the level of profits, and those of markets, which determine the prices of inputs, has broken down. As human capital becomes more important, employees are no longer merely sellers of labor, the return for which is determined by the labor market. Management decision making now has a profound impact on the value of the employees' contribution and hence their return. Moreover, as relationships replace transactions, employees operate less in a labor market, merely selling their labor for wages, and more in cooperative enterprises, helping to create value by making firm-specific investments that could not be obtained in a market alone. Similarly, other groups have been drawn into the sphere of corporate activity, not merely as market participants or bystanders, but as resources that constitute part of the value or organizational wealth of a firm. Because they share in the production of wealth and also its distribution, the return to these groups is not determined merely by the market price of their inputs but is directly affected by management decision making. Again, as firm boundaries become more blurred and porous, the once sharp distinction between being in a relationship with a firm and merely participating in a transaction with one breaks down.

Third, implicit contracts are now as important, if not more important, to business enterprises than explicit contracts. Explicit contracts are central to market transactions but are less crucial to relationships, which are built more on trust and mutual interests and goals. Implicit contracts are also more important in networks, especially with people and organizations outside a firm, than they are in firms with a hierarchical command structure and the vertical integration of resources. The value

of relationships and networks to a firm reflects the fact that it is human capital – the utilization of the skills and knowledge of people – and not financial capital – which can be used to secure fixed, tangible assets – that is now the key to wealth creation. And the input of human capital, as opposed to financial capital, is better obtained and employed through implicit rather than explicit contracts.

If traditional corporate governance is built on the three propositions – that only shareholders bear residual risk, that only they are affected by corporate decisions, and that only explicit contracts are at issue – and if these propositions no longer apply, then obviously there is a need to rethink the prevailing allocation of control rights and the processes for their exercise. Zingales (2000) admits, "I am not aware of any formal development of the consequences of this approach [that is, the new foundations] for corporate governance" (p. 1636). It is beyond the scope of this chapter to attempt any such development, although a few writers have suggested new directions (cf. Bainbridge 2008, Blair 1995, Blair and Stout 1999, Bottomley 2007). What remains to be shown, though, is how this new foundation is related specifically to the main features of the new governance, namely rule making and the administering of rights. More precisely, how can these developments be understood as a part of the changed competitive environment that motivates the search for new foundations?

New Foundations and the New Governance

It has been established so far that the changed competitive environment of present-day corporations has led them to adopt strategies and structures that challenge the traditional foundations of corporate governance and produce a need to search for new foundations. Left unexamined has been the connection, if any, between this changed competitive environment along with its consequences and the developments that constitute the new governance – or corporate citizenship or republican ethics. The development of the new governance is explained by scholars as due primarily to the inability or unwillingness of governments to discharge their traditional roles and responsibility, thus leading corporations to step into the breach. Left unexplained, however, is the problem, raised by van Oosterhout, of why corporations would do this. What's in it for them?

The characteristic features of today's corporate strategies and structures – the breakup of vertically integrated, hierarchical firms that rely on fixed tangible assets, economies of scale, and market share and the substitution of looser forms of collaboration in networks focused on innovation and quality – can also explain the new governance only if there are some links between the new foundations and the new governance. If there are such links, then it can be shown that the new governance is also an efficient adaptation to a changed competitive environment. This outcome would reconcile the new governance with traditional assumptions about the economic nature of corporations, the legitimacy of shareholder primacy, and the profit motive, which are assumptions too fundamental to be discarded lightly.

The new governance has two defining features that, at first glance, appear to be unrelated, namely participation in rule making, or "democratic will formation" in Habermasian terms, and the administration of civil, political, and social rights. The former feature of participation in rule making is alleged to be the result of corporations operating in a global environment, while reasons for the latter feature are largely unexplained in the literature. However, globalization is an incomplete explanation at best because there is no reason why the traditional vertically integrated, asset-intensive firm seeking economies of scale and market share could not operate globally in a traditionally market-based manner. Globalization alone cannot explain why such corporations could not operate efficiently in markets without getting involved in the kind of non-market collaborative decision making and issue management that constitutes the new governance.

To understand the connection between globalization and the new governance we need to consider what is driving globalization. It is driven, in part, by such standard economic factors as the search for cheaper, more secure resources, such as labor, commodities, and capital, and for larger markets, which fit with the strategy and structure of the traditional firm. However, other drivers of globalization are the same factors that have led to the changed strategies and structures that characterize present-day corporations. Specifically, the need to innovate with its increasing reliance on human capital has led companies to outsource – not merely to use cheaper labor in contract factories, for example, but also to tap creative talent wherever it resides. Furthermore, innovation requires strategic alliances with companies and NGOs that possess different core competencies and capabilities. These alliances take the form of networks of relationships rather than mere market transactions. Innovation also raises social and regulatory issues that would occur even without globalization and inadequate governments and that would attract the concern of other participants in society, including NGOs.

The argument here is that many of the features of today's competitive environment that require corporations to become more political and to engage in public decision making are not distinctive of globalization per se but reflect the shift from the traditional vertically integrated, asset-intensive firm to less hierarchical, relationship-based networks. This shift is itself a driver of a globalized economy in which new strategic opportunities are to be found. Thus, globalization and the new governance are both the consequences of a more fundamental and profound change in the competitive environment of business. One does not cause the other, but they are, instead, the consequences of the same deeper, underlying causes.

Moreover, the shift from transactions to relationships, from market-based activity to networks, has the effect of making the returns that people and organizations receive from participating in the "extended enterprise" (to use the phrase of Post, Preston, and Sachs) a matter to be determined not by the market prices of their inputs in explicit contracts but by implicit contracts negotiated in a non-market, public arena. That is, the distribution of the wealth created by joint production in relationship-based networks is no longer simply a matter for the market to determine; rather this distribution becomes contestable as a matter of public decision making, in which corporations and other constituencies collaborate.

Furthermore, the fact that this return depends on such decision making makes these constituencies residual risk bearers in that the return is not fixed by the market but is variable, depending on firm performance. That is, the people and organizations that participate in a corporation's networks of relationships may receive more or less in return, with the amount to be determined, in part, by the success of the collaboration. This argument contends, then, that in the new competitive environment, other constituencies are residual risk bearers, who are affected by corporate decision making and so demand to participate in it. This participation results mainly in implicit, rather than explicit, contracts. Once again, this outcome is not a consequence of globalization but is instead caused by changes in the strategy and structure of present-day corporations that is also itself a driver of globalization.

The same factors that drive both globalization and the increasing politicization of the corporation also explain, to some extent, the new governance role of administering rights. In traditional corporate governance, the distribution of the wealth created by corporations – as well as the costs or burdens – is determined separately by the market, in the form of the price of each group's inputs, and by government. Thus, there are two distribution mechanisms, each with its own separate domain. In consequence, the goods and services that accrue to individuals in society result from their separate roles as economic actors in a market and as citizens of a state. However, in the new competitive environment, the market no longer plays this distributive role to the same extent, and more goods and services become contestable in the public arena. Insofar as these goods and services are viewed as rights, their administration is no longer a matter purely for government but for corporate decision making as well, and not merely because of the inability of governments to act but because the decisions necessarily involve corporations. Because non-shareholder corporate constituencies are profoundly affected by these decisions, and also because corporate strategies and forms of organization require wide-based collaboration, the corporation becomes involved in the administration of rights.

These arguments support the conclusion that the main characteristics or defining features of the new governance – namely, participating in rule making and administering rights – are not due to globalization alone but are the consequence of deeper, more fundamental changes in the competitive environment of corporations, which have led to profound changes in corporate strategy and organization and are themselves among the drivers of globalization. Thus, both the new foundations and the new governance are linked as consequences of this changed competitive environment.

Conclusion

The aim of this chapter is to inquire into whether the new governance has any implications for corporate governance. The answer is, yes, there are some implications that require a rethinking of the traditional account of corporate governance,

which is based mainly on an economic theory of the firm. The conclusion that some changes in corporate governance are warranted does not follow directly from the development of the new governance as described by scholars. The activities of rule making and administering rights are fully compatible with the prevailing systems of corporate governance, with their doctrines of shareholder primacy and shareholder wealth maximization. The implications are revealed only by understanding the new governance as itself a consequence of the changes in the strategies and forms of organization that have arisen in response to the changed competitive environment of the past several decades. These changes in strategy and organization call into question three key assumptions of corporate governance: that only shareholders bear residual risk; that only shareholders are affected by corporate decisions; and that only explicit, not implicit, contracts matter in corporate governance. Questions about these assumptions prompt a search for what Zingales has called "new foundations". Although this chapter does not attempt to formulate these new foundations or to develop a new theory of the firm, it is apparent that some changes are needed in corporate governance and the theory of the firm – and, more to the point of this chapter, that these changes are related significantly to the development called the "new governance".

References

Alchian, A.A., and H. Demsetz. 1972. Production, information costs, and economic organization. *American Economic Review* 62: 777–795.

Bainbridge, S.M. 2008. *The new corporate governance in theory and practice*. New York: Oxford University Press.

Blair, M.M. 1995. *Ownership and control: Rethinking corporate governance for the twenty-first century*. Washington, DC: Brookings Institution.

Blair, M.M., and L.A. Stout. 1999. A team production theory of corporate law. *Virginia Law Review* 85: 247–328.

Bottomley, S. 2007. *The constitutional corporation: Rethinking corporate governance*. Burlington, VT: Ashgate 2007.

Cutler, A.C. 2003. *Private power and global authority: Transnational merchant law in the global political economy*. Cambridge: Cambridge University Press.

Easterbrook, F.H., and D.R. Fischel. 1991. *The economic structure of corporate law*. Cambridge, MA: Harvard University Press.

Fama, E.F., and M.C. Jensen. 1983. Separation of ownership and control. *Journal of Law and Economics* 26: 301–325.

Hall, R.B., and T.J. Biersteker. eds. 2002. *The emergence of private authority in global governance*. Cambridge: Cambridge University Press.

Hansmann, H. 1996. *The ownership of enterprise*. Cambridge, MA: Harvard University Press.

Jensen, M.C. 1993. The modern industrial revolution, exit, and the failure of internal control systems. *Journal of Finance* 48: 831–880.

Jensen, M.C., and W.H. Meckling. 1976. Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics* 3: 305–360.

Kobrin, S.J. 2008. Globalization, transnational corporations and the future of global governance. In *Handbook of research on global corporate citizenship*, eds. A.G. Scherer and G. Palazzo, 249–272. Northampton, MA: Edward Elgar.

Leana, C.R., and D.M. Rousseau. 2000. *Relational wealth: The advantages of stability in a changing economy*. New York: Oxford University Press.

Mathews, J.T. 1997. Power shift. *Foreign Affairs* 76: 50–66.
Matten, D., and A. Crane. 2005. Corporate citizenship: Toward an extended theoretical conceptualization. *Academy of Management Review* 30: 166–179.
Matten, D., A. Crane, and W. Chapple. 2003. Behind the mask: Revealing the true face of corporate citizenship. *Journal of Business Ethics* 45: 109–120.
Moon, J. 2002. The social responsibility of business and new governance. *Government and Opposition* 37: 385–408.
Moon, J., A. Crane, and D. Matten. 2005. Can corporations be citizens? Corporate citizenship as a metaphor for business participation in society. *Business Ethics Quarterly* 15: 429–453.
Palazzo, G., and A.G. Scherer. 2006. Corporate legitimacy as deliberation: A communicative framework. *Journal of Business Ethics* 66: 71–88.
Pattberg, P. 2005. The institutionalization of private governance: How business and nonprofit organizations agree on transnational rules. *Governance* 18: 589–610.
Post, J.E., L.E. Preston, and S. Sachs. 2002a. Managing the extended enterprise: The new stakeholder view. *California Management Review* 45: 6–28.
Post, J.E., L.E. Preston, and S. Sachs. 2002b. *Redefining the corporation: Stakeholder management and organizational wealth*, Stanford, CA: Stanford University Press.
Reinicke, W.H. 1998. *Global public policy: Governing without government?* Washington, DC: Brookings Institution.
Scherer, A.G., and G. Palazzo. 2007. Toward a political conception of corporate responsibility: Business and society seen from a Habermasian perspective. *Academy of Management Review* 32: 1096–1120.
Scherer, A.G., G. Palazzo, and D. Baumann. 2006. Global rules and private actors: Toward a new role of the transnational corporation in global governance. *Business Ethics Quarterly* 16: 505–532.
Shleifer, A., and R.W. Vishny. 1997. A survey of corporate governance. *Journal of Finance* 52: 737–783.
Steinmann, H., and A. Löhr. 1996. A republican concept of corporate ethics. In *Europe's challenges: Economic efficiency and social solidarity*, ed. S. Urban, 21–60. Wiesbaden: Gabler.
Van Oosterhout, J.H. 2005. Corporate citizenship: An idea whose time has not yet come. *Academy of Management Review* 30: 677–684.
Williamson, O.E. 1985. *The economic institutions of capitalism: Firms, markets, relational contracting*. New York: Free Press.
Wolf, K.D. 2008. Emerging patterns of global governance: The new interplay between the state, business and civil society. In *Handbook of research on global corporate citizenship*, eds. A.G. Scherer and G. Palazzo, 225–248. Northampton, MA: Edward Elgar.
Zingales, L. 2000. In search of new foundations. *Journal of Finance* 55: 1623–1653.

Chapter 9
D&O Deductibles as a New Standard of Responsible Governance

Till Talaulicar

Abstract Listed German stock corporations have to agree a personal deductible if the company has taken out a D&O (directors' and officers' liability insurance) policy for its management board. A deductible rules that, in the event of litigation, portions of the loss have to be borne personally by the insured individuals and aims at fostering responsible behavior. The present chapter analyzes the underlying motivation of this specific governance standard that is still quite unique to the German governance environment, and the development of its regulation.

Keywords Codes of corporate governance · Corporate governance · Directors' and officers' liability insurance policies · Legal regulation · Liability risk · Regulation · Remuneration · Responsibilities · Self-regulation · Soft law

Introduction

Agreeing a deductible in directors' and officers' liability insurance (D&O) policies is a comparably new governance standard that aims at fostering responsible management and supervision. Board members of the German stock corporation are personally accountable with unlimited liability. Although liability proceedings are still rather seldom, the corresponding amounts of damage that have to be restored can easily reach several millions of EUR and eat up the personal savings of the litigated board members. In order to attract eligible candidates to accept board appointments, companies can take out, and do take out, D&O liability insurances that cover, under specified conditions, pecuniary losses that have been caused by the insured board members when they perform their occupational activities. On the one hand, such insurances appear to be in the interest of the enterprise and its various stakeholders as they protect corporate assets and avoid overly conservative courses of action by the board members. On the other hand, these policies have been criticized from the outset as they may relieve board members from their litigation risks and therefore encourage less responsible practices of management and

T. Talaulicar (✉)
University of Erfurt, Erfurt, Germany
e-mail: till.talaulicar@uni-erfurt.de

I. Pies, P. Koslowski (eds.), *Corporate Citizenship and New Governance*,
Ethical Economy. Studies in Economic Ethics and Philosophy 40,
DOI 10.1007/978-94-007-1661-2_9, © Springer Science+Business Media B.V. 2011

supervision. Against this background, agreeing a personal deductible may provide a promising solution to combine the merits of D&O policies and the incentive effects of liability norms. Deductibles rule that in cases of litigation, that are in principle within the scope of the insurance contract, parts of the loss (up to the amount of the agreed deductible) have to be borne personally by the insured individuals. As a consequence, board members are expected to make more diligent decisions in order to avoid cases of litigation that may involve expenses that come out of the board members' personal assets.

The German Corporate Governance Code (GCGC) has seized these considerations right from the start of its establishment. The original version of the Code was adopted on 26 February 2002 and contained the recommendation that a suitable deductible shall be agreed if the company has taken out a D&O policy for the management board and supervisory board. The GCGC did not specify when a deductible has to be qualified as suitable. Moreover, Code recommendations are not mandatory. Companies are therefore not compelled to comply with the recommendation. However, listed corporations have to disclose in an annual statement of conformity whether they have been and are being complied with the Code's recommendations or which of the recommendations are not being applied. The GCGC recommendation therefore granted companies much discretion as listed firms had to decide whether they agree a deductible and if so what kind of deductible they arrange. Prior research that will be shown in more detail below has indicated that this Code recommendation yielded consistently rather low degrees of conformity (see, most recently, v. Werder and Talaulicar 2009). In addition, this research has highlighted that some firms that declared to comply with the recommendation had nonetheless agreed rather low deductibles whose incentive effects appeared to be negligible. In the wake of the financial market crisis and the allegedly deficient diligence of some board members, the German legislator has taken up this regulatory issue. The Act on the Adequacy of Management Board Compensation (Gesetz zur Angemessenheit der Vorstandsvergütung, VorstAG) that was promulgated on 31 July 2009 now stipulates that German stock corporations have to agree a deductible for the management board if a D&O policy has been concluded. This deductible must amount to at least 10% of a loss up to at least 150% of the fixed annual compensation of the management board member. The Law does not require a deductible for the members of the supervisory board.

The present chapter seeks to develop new insights into the governance standard of D&O deductibles, its underpinning as well as its regulation in Germany. Analyzing the arrangements of D&O policies is moreover warranted as the most recent financial crisis has strengthened the interest of governance scholars, practitioners as well as policy makers in appropriate incentive designs and effective risk management. Whereas extant studies, particularly in law and finance, have started to address the subject of D&O liability insurance policies (e.g., Romano 1989, Core 1997, 2000), the agreement of a deductible has not yet been examined in more detail. The standard to agree a deductible in D&O policies is quite unique for the German setting as governance codes and regulations in other countries do not propose such an agreement. As a consequence, a more in-depth analysis

of this specific governance standard and its underpinning may also be informative for governance scholars and policy makers abroad who want to assess the adequacy of incentive structures and risk management arrangements in their governance environment.

Background of the Governance Standard

Directors' and Officers' Liability Insurance Policies

The German stock corporation has a two-tier (or dual board) structure which strictly separates the roles of management and supervision. Whereas the management board is responsible for directing the enterprise, the supervisory board appoints, supervises and advises the members of the management board. Members from both boards face strict liability rules. According to Article 93 para. 1 of the German Stock Corporation Act, members of the management board have to observe the due care and diligence of a prudent and conscientious managing director. If they infringe their duties, they are liable for the damages that are caused by this behavior. The board members are jointly and severally liable (Article 93 para. 2 of the German Stock Corporation Act). These diligence standards and the corresponding liability norms refer analogously to the supervisory board (Article 116 of the German Stock Corporation Act). In contrast to other occupational groups like, for instance, auditors and lawyers, board members of German corporations are personally accountable with unlimited liability. Hence, if litigation procedures succeed, these verdicts can have the potential to eat up the personal savings of the board members.

The perceived liability risk of directors and officers of German listed companies has increased since the beginning of the 1990s (Vetter 2000, Dreher 2001, Kiethe 2003). A number of new laws has been enacted that specify the responsibilities and tasks of the board members and hence impose additional obligations on them. The new laws that have been passed since 2004 and that address issues of corporate governance include the Act on Improving Investor Protection (Gesetz zur Verbesserung des Anlegerschutzes, AnSVG) of 28 October 2004, the Accounting Law Reform Act (Bilanzrechtsreformgesetz, BilReG) of 4 December 2004, the Financial Statements Monitoring Act (Bilanzkontrollgesetz, BilKoG) of 15 December 2004, the Act on Disclosure of Management Board Remuneration (Gesetz über die Offenlegung der Vorstandsvergütungen, VorstOG) of 3 August 2005, the Capital Markets Test Case Act (Gesetz zur Einführung von Kapitalanleger-Musterverfahren, KapMuG) of 16 August 2005, the Act on Enterprise Integrity and Modernization of Rescission Law (Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts, UMAG) of 22 September 2005, the Act on Electronic Commercial Registers, Registers of Cooperatives and Business Registers (Gesetz über elektronische Handelsregister und Genossenschaftsregister sowie das Unternehmensregister, EHUG) of 10 November 2006, the Act Implementing the Transparency Directive

(Transparenzrichtlinie-Umsetzungsgesetz, TUG) of 5 January 2007, the Risk Limitation Act (Gesetz zur Begrenzung der mit Finanzinvestitionen verbundenen Risiken, Risikobegrenzungsgesetz) of 12 August 2008, the Act to Modernize Accounting Law (Bilanzrechtsmodernisierungsgesetz, BilMoG) of 25 May 2009, the Act Implementing the Shareholders' Rights Directive (Gesetz zur Umsetzung der Aktionärsrechterichtlinie, ARUG) of 30 July 2009 as well as the Act on the Adequacy of Management Board Compensation (Gesetz zur Angemessenheit der Vorstandsvergütung, VorstAG) of 31 July 2009 to which reference has already been made above. In addition, some spectacular cases of corporate scandals due to neglectful executives have demonstrated that the risk of litigation proceedings is not only a theoretical one. Although the number of proceedings is still somewhat limited and a significant portion of the claims made has been settled, the number of litigation proceedings has increased and even settlements can be associated with considerable payments by the involved board members.

If the litigation risk is perceived to be rather high, promising candidates can either decline invitations to serve on boards because of liability concerns or accept these offers only under the condition that the corresponding risks are adequately compensated (cf. Core 1997). Apparently, such compensations may call for extraordinary high remunerations (cf. Dreher 2001). In any case, however, the still remaining liability risk may lead to overly conservative courses of action by board members who may be reluctant to utilize promising business opportunities if the related chances to become liable cannot be excluded with sufficient certainty. The fate of board members, particularly of members of the management board, is closely related to the fate of the enterprise. Board members are in general more risk averse than shareholders because the latter can better diversify their risks (e.g., Amihud and Baruch 1981, Kraakman 1984, Hoskisson and Turk 1990). Against this background, D&O liability insurance policies can provide a reasonable way to avoid intensified risk aversion of managers as well as disproportionately high levels of board compensation.

D&O liability insurances cover, up to the agreed annual policy limit, pecuniary losses which have been caused by the insured individuals when they perform their occupational activities. The insurance coverage applies to claims made during the policy period ("claims made" principle). In addition to compensating damages caused by failures of the insured persons, these policies provide legal protection in order to defend accusations and cover the corresponding defense costs (Lange 2002, Kiethe 2003, Plück and Lattwein 2004). The insured persons are the members of the management and the supervisory board. Sometimes, further executives as well as top managers in subsidiaries are also covered (Dreher 2001, Lange 2005, Lutter and Krieger 2008). Usually, the insurance contract is taken out on behalf of the enterprise. Whereas the enterprise concludes the contract with the underwriter and expends the insurance premiums, the beneficiaries of the insurance contract are the insured board members because they can claim to defend allegations and to restore damages in the event of litigation.

Critique of D&O Policies

D&O policies have been criticized as they may excessively release board members from liability risks. Through the device of insurance, board members may therefore evade their duties. Litigation norms are a special form of sanction norms. In general, sanctions aim at prevention as well as retribution. Theories of deterrence (prospectively) justify sanctions if they deter actors from norm violations. These (consequentialist) theories suggest that actors are the more deterred from breaking norms, the more severe and the more certain norm offenders are punished (Geerken and Gove 1975, Gibbs 1975, Beyleveld 1979). Sanction theories have shown that it is not the objective amount of these determinants that matter. Rather, the preventive effects of sanction norms depend on the subjective perceptions of the norm addressees (e.g., Grasmick and Bryjak 1980, Hollinger and Clark 1983, Paternoster 1987). Hence, the deterrent effect of sanction norms is affected by the fact whether or not the norm addressees perceive the severity and certainty to be sufficiently high (rather than by the fact how these determinants are designed indeed). On the contrary, retributivist theories are retrospective. They justify sanctions because the preceding norm violation deserves punishment in order to restore corrective (or retributive, respectively) justice. Theories of retribution therefore suggest that sanctions have to be strictly conditional on a preceding wrongdoing and proportional to this wrongdoing (Walker 1991, von Hirsch 1992, Kershnar 2001).

If D&O policies have been concluded, covered damages are compensated by the insurer. With regard to prevention effects, one may suppose that D&O policies diminish the motivation of board members to ensure compliance insofar as potential damages are restored by the insurer. As a consequence, D&O policies may reduce the deterrent effect of litigation (Baker and Griffith 2009) and board members may be less attentive to their obligatory duty of care. From the perspective of retributive justice, the compensations which are covered by the insurer may be viewed as inappropriate because justice considerations may demand to obligate board members to pay these damages (or at least the covering insurance premiums) from their personal assets. In sum, D&O policies could be interpreted as an abdication of board members' responsibility.

At the same time, however, D&O policies are in the interest of the enterprise as they can protect corporate assets (cf. Dreher 2001). In many cases, claims can be made on behalf of the enterprise that has suffered from non-diligent board behavior. In the absence of D&O policies, the compensation of the corresponding damages depends on the solvency of the board members who may be unable to award damages that amount to several million EUR. In addition, in the case of suits that are brought by shareholders, the enterprise may have to bear the losses that the board members are not able to cover (cf. Thümmel 2008). In consideration of the extraordinarily high amounts of loss that can be caused by non-diligent board behavior, D&O policies may therefore provide a prudent means to protect the assets of the enterprise.

Foundations of the Governance Standard

Agreeing a deductible in D&O policies can contribute to avoiding some of the problems associated with these insurance contracts. Personal deductibles rule that parts of a loss have to be borne by the insured persons from their personal assets. These deductibles can be designed in very different ways. Their calculation can refer to characteristics of the damage or to characteristics of the insured persons, or – more precisely – of their board appointments. In both cases, they can be defined in absolute or relative terms.

The arrangement of a D&O deductible can be expected to foster the prevention and retribution effects of litigation norms that are mitigated when D&O policies are in place. The agreement of a deductible aims at maintaining the prevention effects of litigation norms (Baums 2001, Lutter and Krieger 2008, Ringleb et al. 2008) because board members are expected to be better motivated to avoid cases of litigation if they otherwise fear to pay their personal deductible. If D&O policies contain personal deductibles, board members have to restore at least part of the damages that they have caused from their own pockets. These out-of-pocket payments (cf. Black et al. 2006) may thus nurture the expectation that board members are more willing to take their duties seriously and to avoid cases of litigation. Agreeing a personal deductible shall therefore align the interests of the board members to the interest of the company. Additionally, such a deductible serves retributive considerations as board members have to compensate at least portions of the damages that have emerged from their wrongdoing. These personal compensations can be viewed to contribute to corrective justice.

In order to maintain these effects of prevention and retribution, deductibles have to be sufficiently high. If the deductible appears to be negligible, its agreement is unlikely to influence the motivation of the board members. Similarly, insignificant deductibles will less likely contribute to retribution effects as corrective justice will hardly benefit from extraordinarily low compensations made by the board members. At the same time, however, companies are also ill-advised to agree decidedly high deductibles. Such agreements will crowd out the virtues associated with the arrangement of D&O liability insurance policy. If the board members perceive the deductible to be prohibitive, they may search for alternative appointments as well as overly conservative courses of action that may not be in the interest of the firm and its shareholders. Deductibles may therefore have positive effects. However, the realization of these effects depends on the adequate design of the deductible.

Code Regulation of D&O Deductibles

Background of the German Corporate Governance Code

The German Corporate Governance Code was presented to the public in December 2001 for the first time and adopted in February 2002 (the English version of the Code is available at: http://www.corporate-governance-code.de/index-e.html,

as of 20 January 2010). Contrary to other countries, a code of corporate governance for German firms has long been regarded as dispensable, since essential governance aspects that are typically tackled by these codes (see, for instance, Gregory and Simmelkjaer 2002) are already mandatory under German law. For instance, the aforementioned two-tier system of the stock corporation guarantees that the roles of chairman and CEO are separated. However, following some private initiatives (competing rather than converging) drafts for a voluntary corporate governance code were drawn up (Berliner Initiativkreis German Code of Corporate Governance 2000, Grundsatzkommission Corporate Governance 2000). Subsequently, the Federal Ministry of Justice appointed a Government Commission "German Corporate Governance Code" to develop a uniform code for German listed companies in order to further strengthen the governance quality and to consolidate German corporate governance rules and make them transparent for both national and international investors (e.g., v. Werder and Talaulicar 2003).

The Code provisions are not stipulated by law. Rather, they can be characterized as a form of soft law (cf. Chinkin 1989, Shelton 2000, Kim 2001) and are thus not legally binding (for the distinction between hard and soft law, their characteristics, assets and drawbacks, see, for instance, Abbott and Snidal 2000, Schäfer 2006, Karlsson-Vinkhuyzen and Vihma 2009). The GCGC is intended to be applied by means of self-regulation. The Code has however a legal basis after Article 161 of the German Stock Corporation Act was amended by the Transparency and Disclosure Act (Gesetz zur weiteren Reform des Aktien- und Bilanzrechts, zu Transparenz und Publizität, TransPuG) to demand a declaration of conformity with the Code's recommendations.

The GCGC primarily addresses listed corporations. With respect to their obligatory nature, three kinds of Code rules have to be distinguished. First, the GCGC recapitulates selected provisions that firms are compelled to observe under applicable law ("must provisions"). The remaining categories ("shall recommendations" and "should or can suggestions") both consist of rules which are not obligated by law. As a consequence, companies can deviate from these rules. However, deviations from recommendations which are marked in the text by use of the word "shall" must be disclosed in the annual declaration of conformity ("comply or explain"). Third, the Code contains suggestions which are marked in the text by use of the words "should" or "can" and which can be deviated from without disclosure. These suggestions are intended to encourage progress without inhibitory requirements. In sum, the status of the Code rules which go beyond the law enables companies to reflect sector- and enterprise-specific requirements. Thus the GCGC contributes to more flexibility and more self-regulation in the corporate constitution.

The Code is structured in seven sections. In a foreword, some basics of German corporate governance and the GCGC are explained. This foreword also clarifies the obligation of the management and the supervisory board to ensure the continued existence of the enterprise and its sustainable creation of value in conformity with the principles of the social market economy. The management and the supervisory board are both committed to the interest of the enterprise and thus have to take into account the interests of the shareholders, the employees and other

stakeholders of the firm. The Code norms refer to shareholders and the general meeting (section 2.), the cooperation between the management board and the supervisory board (3.), the management board (4.), the supervisory board (5.), transparency (6.) as well as reporting and audit of the annual financial statements (7.).

Content of the Code Recommendation

The original version of the GCGC of 2002 has already contained the standard to agree a suitable deductible if the company has taken out a D&O policy for the management board and the supervisory board. The standard was comprised from the outset as a recommendation in section 3.8 of the GCGC. Therefore listed companies had to disclose in their statement of conformity whether they comply with this specific standard of the GCGC. The status as a recommendation (rather than as a suggestion) is notable, as D&O deductibles do not reflect internationally recognized and proven standards of good governance. Rather, D&O policies abroad, and particularly in the UK or the US, typically contain either no or unsuitably low personal deductibles (Bhagat et al. 1987, Finch 1994, Chalmers et al. 2002). In addition, the prevalence of such deductibles was very limited in Germany, too (e.g., Baums 2001). In other respects, the Government Commission has adopted standards as suggestions to propose rather innovative measures to develop corporate governance in Germany further. The status of a suggestion also grants the Commission possibilities to increase the bindingness of the standard, without revising its content, by upgrading the norm to the group of the recommendations. The Commission has utilized these options when the decisions were made to upgrade the suggestions to disclose the compensation of the management board and the supervisory board on an individual basis in 2003 (v. Werder et al. 2004) as well as the Code provisions to limit severance payments in 2008 (v. Werder and Talaulicar 2009).

The GCGC did not recommend to take out D&O liability insurance policies. Rather, the Code only recommended that if such policies have been concluded for the members of the management board and/or the members of the supervisory board, a personal deductible shall be agreed. In addition, the GCGC stated that this deductible shall be a suitable one. The Code did not substantiate when a deductible has to be assessed as a suitable one. Based on the considerations above, the deductible should be high enough to affect board members' motivation to exercise reasonable care. In other words, the deductible should be non-trivial and therefore noticeable to board members. Such a deductible may also provide positive effects of retribution. If the company agrees an insignificant deductible, the deductible would be devoid of meaning. At the same time, the deductible should not be too high to crowd out the willingness to become a board member or to take up corporate activities with reasonable risks.

The Code recommendation therefore left much discretion to the board members who had to decide whether or not and how they shall comply with this Code norm. The corresponding design decisions that had to be made did not only refer to the

amount of the deductible and the procedure of its calculation. In accordance with the GCGC, the deductible could be devised in absolute or in relative terms. Determining the deductible with reference to characteristics of the loss was as compatible with the Code recommendation as referring to characteristics of the board members and their appointments to define the deductible. The Code recommendation was also complied with if different deductibles were agreed for the management and the supervisory board. However, the recommendation was violated if the deductible only referred to the members of the management or the supervisory board whereas the D&O policy covered the members of both boards. Moreover, the Code recommendation did not require to arrange the deductible with the insurer and to revise the insurance contract. Rather, the Code recommendation could also be obeyed by individual agreements with the members of the board (Ringleb et al. 2008). In this case, however, the unwillingness of one board member to make such an agreement was sufficient to break the Code recommendation and did therefore entail to disclose in the statement of conformity that this Code standard had not been (fully) applied.

The lack of concreteness of this Code standard is not uncommon for the GCGC but in line with its basic regulatory philosophy (cf. Ringleb et al. 2008). In general, the Code follows a principle-based rather than a rule-based mode of regulation. Principle-based regulations have been utilized in various areas such as accounting (e.g., Walker 2007), environmental policy (e.g., Gunningham and Sinclair 1999) or securities regulations (e.g., Ford 2008). Rules and principles are qualitatively different kinds of norms (Dworkin 1977, Alexy 1994, Borowski 1998). In short, rules are definite obligations, whereas principles obligate to approximate ideals. This distinction mirrors the concreteness of the norms. More specifically, rules tend to be more concrete because they explicitly define which conduct the norm addressees have to apply. In contrast, principles remain more general. Their ideals cannot be applied straightforward. Rather, the addressees have to balance the factual and normative circumstances in order to decide in specific situations which degree of fulfillment of the ideal is deemed appropriate. As a result, principles tend to leave a higher degree of discretion to the addressees and require higher capabilities of these individuals because they have to be willing as well as able to take the factual and normative circumstances adequately into consideration (for details, see Talaulicar 2006).

This principle-based character is by no means unique to the recommendation to agree a suitable deductible in D&O policies. Rather, many Code provisions leave much discretion on how they are to be implemented in the firm. Examples include the recommendations to specify an age limit for members of the management board (section 5.1.2 para. 2 sentence 3 GCGC), to pay attention to the international activities of the enterprise, potential conflicts of interest, an age limit to be specified for the members of the supervisory board and diversity when nominations for the election of members of the supervisory board are made (section 5.4.1 sentence 2 GCGC) or to include what the supervisory board considers an adequate number of independent members in order to permit the supervisory board's independent advice and supervision of the management board (section 5.4.2 sentence 1 GCGC). These recommendations have in common that the GCGC leaves it to the judgment of the

supervisory board to decide upon their adequate implementation, i.e., to specify the age limits for members of the management and the supervisory board and to substantiate the appropriate number and proportion of independent supervisory board members.

The principle-based character of the GCGC in general and of the recommendation to agree a suitable deductible also rests upon the fact that the Code cannot cover every detail of every single issue. Therefore, the GCGC provides a framework which the individual companies will have to fill in. The corresponding discretion can be, and should be, utilized by the companies and their boards to specify the application of the Code provisions in a way that reflects and acknowledges the peculiarities of their specific situation. In general, the GCGC does not tend to recommend and suggest a detailed one-size-fits-all approach. Rather, the recommendations and suggestions of the Code tend to allow firms to form sector- and company-specific governance arrangements. This regulatory approach may also contribute to the development of best practices that are discovered and proven in the corporate sector. Due to this flexibility of the GCGC and its compatibility with a broad range of solutions that may vary in details, the GCGC can be characterized as a "softer soft law" and distinguished from "harder soft laws" that go also beyond mandatory stipulations and shall be implemented by means of self-regulation. However, harder soft laws provide more rule-based provisions that contain clear-cut verbalized guidelines which can be complied with by a simple "yes" or "no".

Principle-based norms have the virtue that they can initiate reflections by their addressees. The norm addressees cannot simply apply an ex-ante provided problem solution. Rather, they have to deliberate on the appropriate way how to implement the principle in the context of their firm. Principle-based norms of good governance can therefore stimulate fruitful debates within the firm on the adequate mode of their implementation. These stimulations have the potential to lead to problem solutions that better reflect sector- and company-specific peculiarities and to increase awareness of issues of good governance among the board members. At the same time, however, the quality of the corresponding problem solutions does also largely depend on these reflections by the board members and their sincerity. If board members do not have the willingness, or the capabilities, to deliberate on suitable ways of Code implementation that follow the spirit rather than the letter of the Code provisions, principle-based norms and softer soft law tend to lead to inferior problem solutions as the eventually practiced governance arrangements do – inadvertently or intentionally – not fulfill the purpose of the underlying Code regulation. Principle-based norms have thus the shortcoming that the granted flexibility can also be misused to install ineligible governance practices. The intention to misuse this flexibility tends to be the more pronounced, the more the interests of the board members are (negatively) affected by the corresponding Code provisions (cf. v. Werder and Talaulicar 2003). In addition, this intention tends to be pursued more actively if board members have even more discretion due to the lack of effective control by the owners of the firm (e.g., Daily et al. 2003) or market pressures (Jensen and Ruback 1983, Walsh and Kosnik 1993, Dalton et al. 2007). In this constellation, the boards may have so much discretion to entrench themselves and to

adopt governance arrangements that may diminish overall governance effectiveness (cf. Sundaramurthy et al. 1996).

Empirical Evidence

The acceptance of the GCGC is analyzed in annual studies by the Berlin Center of Corporate Governance (v. Werder et al. 2003, 2004, v. Werder and Talaulicar 2005, 2006, 2007, 2008, 2009). These studies, the "Kodex Reports", are carried out on behalf of the Government Commission German Corporate Governance Code and can fairly be characterized as the "official" reports on compliance with the GCGC. Since 2004, data have been collected by a questionnaire that referred to every recommendation and suggestion of the GCGC and contained additional items on how selected Code provisions have been implemented. Respondents had to declare for every single recommendation and suggestion (a) if their company already complies with the norm, (b) plans to implement the standard, or (c) does not apply the norm at all. Tests for non-response-bias and data validity have been conducted to corroborate the quality of the gained data. The most recent study was finalized in spring 2009 (v. Werder and Talaulicar 2009). The then valid Code version of 6 June 2008 contained a total of 84 recommendations and 19 suggestions. The study's sample consisted of all 656 companies listed on the Frankfurt Stock Exchange. Some 203 useable questionnaires were returned.

The study shows that (i) overall the GCGC meets with great approval, (ii) its acceptance tends to increase with the size of the companies and (iii) the Code continues to contribute to corporate governance changes particularly due to the Code provisions that have been added or revised more recently by the standing Code Commission whereas the acceptance of the more established Code standards remains rather stable. The positive association between code compliance and firm size has also been found in other governance environments (e.g., Clifford and Evans 1996, Conyon and Mallin 1997, Mallin and Ow-Yong 1998) and can be explained by lower relative compliance costs (Dedman 2000) as well as greater visibility of larger firms that attract more public attention (cf. Fombrun and Shanley 1990, Luoma and Goodstein 1999, Pollock et al. 2002).

The average compliance rate with the recommendations of the GCGC is 83.9% (v. Werder and Talaulicar 2009). The companies that belong to the DAX, that is the blue chip index in Germany which includes the 30 largest German securities in terms of market capitalization and order book turnover from classic and technology sectors, apply 94.9% of all recommendations. By the end of 2009 the compliance rate will approach 85.3% (or for the DAX companies, 95.8%).

Compared with the Code recommendations, the "should" or "can" suggestions show a lower level of acceptance (amounting on average to 64.0% for all companies and to 86.1% for the DAX). This result is hardly surprising in so far as the companies may ignore the suggestions without being compelled to disclose this deviation in their declaration of conformity. Thus, the public pressure to implement

the suggestions is less. Nonetheless, the compliance rate of the suggestions will increase, too. By the end of 2009, the average (DAX) company will comply with 65.5% (87.0%) of the suggestions (v. Werder and Talaulicar 2009).

Three recommendations and three suggestions are rejected by the majority of the companies (v. Werder and Talaulicar 2009). The group of the recommendations that are not being complied with by more than 50% of the firms includes the Code standard to agree a suitable deductible if the firm has taken out a D&O policy for the management and the supervisory board. Across the whole sample, the acceptance of this recommendation amounts to 47.0%. With regard to the different segments of companies, it can be noticed that the acceptance of Code section 3.8 indeed is generally low but still different depending on the considered index. In the DAX, 81.5% of the firms have disclosed to agree with this standard. In the MDAX and the TecDAX the recommendation is complied with by 69.7 and 66.7% of the companies, respectively. The corresponding compliance rates in the SDAX, the remaining prime standard and the general standard amount to 35.0, 23.7 and 38.6%, respectively.

In contrast to the first acceptance study that had rested on the information disclosed in the statements of conformity (see v. Werder et al. 2003, 2005), the companies did only very rarely announce to implement the standard in the future. In 2009, only one TecDAX company responded to introduce a D&O deductible shortly (v. Werder and Talaulicar 2009). This indicates that the companies which intended to comply with the provision meanwhile had made the necessary contract adjustments whereas the rest of them seemed to maintain their deviation. As a consequence, these quite low compliance rates have turned out to be rather stable during the last years. The acceptance studies did not provide any clues to expect a significant increase of the number of firms that comply with this Code recommendation. The corresponding compliance rates of the recommendation to agree a D&O deductible are depicted in Fig. 9.1 for the years 2004–2009. Figure 9.1 also shows that over the whole sample as well as in the DAX the compliance rates are significantly lower than the average compliance rates of all recommendations. With regard to the whole sample, the Code recommendation to agree a suitable D&O deductible has persistently been ignored by the majority of the surveyed companies.

The Kodex Report has also collected data on the design of the D&O deductible. In this regard, a broad range of different responses had to be observed. Based on the most recent findings (v. Werder and Talaulicar 2009), it is intriguing to note that more than 40% of the firms that have disclosed to comply with this Code standard declined to provide any in-formation on how they have implemented this recommendation and what kind of deductible has been arranged. Four companies only assured that they assess their deductibles as suitable. This discretion and closeness is in no way incompatible with the GCGC as the Code neither recommends nor suggests to reveal further details on the arranged deductible.

With reference to those companies that have accepted this Code standard and disclosed additional information on the concrete design of their deductibles, the majority of these firms (62.3%) has arranged identical deductibles for the members of the management and the supervisory board. Almost two thirds of the firms

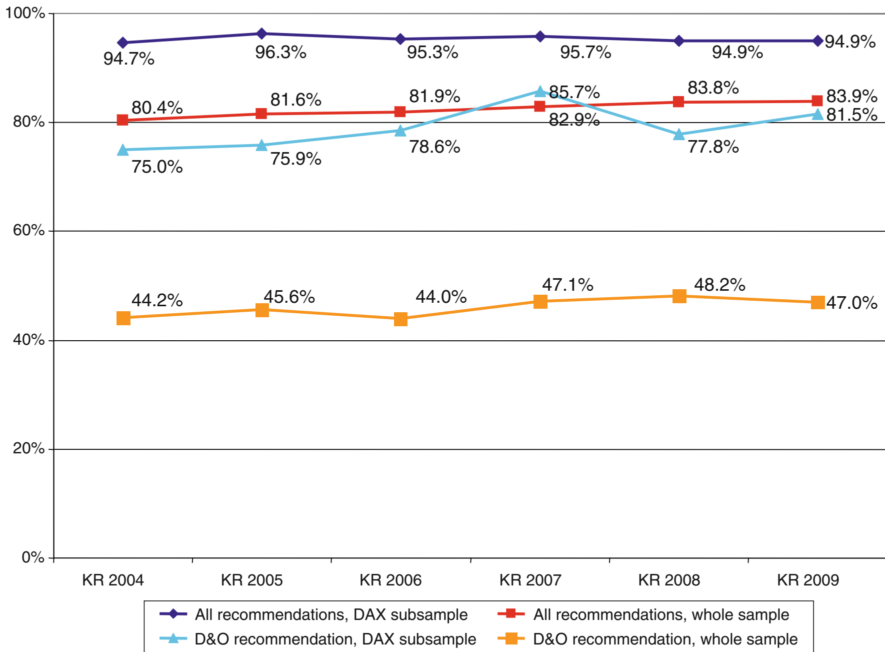

Fig. 9.1 Average compliance rates of all recommendations and the recommendation to agree a suitable D&O deductible based on the Kodex Reports 2004–2009

have defined their deductibles in absolute terms. However, the agreed amounts differ significantly across companies with a minimum of 2,500 EUR and a maximum of 100,000 EUR per person or 3 million EUR per loss, respectively. The remaining companies have defined their deductibles in per cent of the compensation of the board members, most frequently in per cent of their fixed remuneration. Again, a broad variety of agreements could be observed that ranges from 7.5% of the fixed annual salaries to 100% of the total annual compensation. The majority of this group of companies has limited the deductible for the management board to 25% and for the supervisory board to 100% of the fixed annual compensation.

Legal Regulations of D&O Deductibles

In the meantime, the German legislator has taken up this regulatory issue. In the wake of the financial market crisis and allegedly misaligned incentives of executives, the Act on the Adequacy of Management Board Compensation (Gesetz zur Angemessenheit der Vorstandsvergütung, VorstAG) has been enacted. According to the legislator, one of the lessons to be learned from the financial market crisis is that misaligned incentive structures that relate large compensation components to rather short term parameters tend to lead to dysfunctional behavioral effects. Such

remuneration packages may entail that executives are willing to engage in excessive risks rather than to strive for sustainable value creation. For this reason, the legislator intended to strengthen the long term components of the management board's salaries and the corresponding responsibility of the whole supervisory board to establish adequate compensation systems for the management board of the company. In addition, the legislator intended to enhance transparency of the management board remuneration.

The original draft of this Act that was released on 17 March 2009 did not deal with the issue of D&O liability insurance policies and the agreement of D&O deductibles. The passage was later supplemented in a synopsis of the governing parties on 15 May 2009 that was delivered to experts whose statements were heard during the corresponding meeting of the Committee on Legal Affairs of the German Bundestag (i.e., the Parliament of the Federal Republic of Germany). Based on the parliamentary hearings and discussions of the draft, the Committee recommended to add a corresponding stipulation on D&O deductibles for the members of the management board. The final recommendation and report of the Committee to the Parliament was passed on 17 June 2009. The eventually promulgated Act amends Article 93 of the German Stock Corporation Act and states that companies must agree a deductible if they take out a D&O policy for the members of their management board. The stipulation applied with immediate effect to all newly concluded D&O insurance contracts. For existing insurance contracts, there is a 1-year transitional period. These policies have to be amended with effect from 1 July 2010 at the latest. The only exception is given to those companies that have concluded a contractual obligation from an individual employment agreement with the management board member to grant D&O insurance coverage without deductible. In those cases, the policy terms may remain unchanged until the appointment of the management board member, and the underlying service agreement, expire.

The required deductible must cover at least 10% of the loss up to at least the amount of 150% of the fixed annual compensation of the insured management board member. Whereas other norms enacted by the VorstAG only refer to listed companies (i.e., the norms that the compensation structure must be oriented toward sustainable growth of the enterprise, that management board members may not become members of the supervisory board of the company within 2 years after the end of their appointment unless they are appointed upon a motion presented by shareholders holding more than 25% of the voting rights in the company and that the general meeting can make an advisory, i.e. nonbinding, vote on its approval of the management board compensation system), the requirement of a deductible applies to all German stock corporations. The Act also clarifies that such a deductible is only stipulated for the members of the management board. If the company has concluded a D&O policy for the supervisory board, a deductible is not mandatory. Rather, the legislator left this issue to the German Corporate Governance Code.

In the most recent revision of the GCGC that was adopted on 18 June 2009, these legal changes have been taken into account. The corresponding passage of the Code reiterates the legal requirement to agree a deductible for the management board members as a must provision. In addition, the Code contains a newly captured

recommendation that a similar deductible shall be agreed upon for the members of the supervisory board if they are also covered by a D&O policy that has been concluded by the enterprise. Apparently, this leaves open what a similar deductible is and may support the impression that identical lower limits shall also apply to the supervisory board. This interpretation, however, ignores the differences between the two boards, their different tasks and compensation schemes. In contrast to appointments to the management board, the supervisory board mandate is a part-time office (Lutter and Krieger 2008). Furthermore, the portion of fixed compensation components can be expected to be much more pronounced in the compensation system of the supervisory board. According to the Kodex Report 2009, about 10% of the surveyed DAX companies and more than one quarter of all firms included in the study have indicated that the members of their supervisory boards do not receive performance-related compensations (v. Werder and Talaulicar 2009). Against this background, it may have been more expedient to retain the original wording of the GCGC unchanged and to recommend a suitable deductible for the members of the supervisory board.

Discussion

The enactment of the VorstAG poses some questions on the dynamics of the relation between hard law and soft law regimes. The primacy of hard law and governmental decisions is indisputable. The legislator may therefore re-delegate competences that have previously been granted to some self-regulatory bodies (with reference to the GCGC, cf. Seibert 2002). If the legislator is dissatisfied with the problem solutions that are proposed by the Code or with the corresponding concrete arrangements that are established in practice, the legislator has the right and the responsibility to make new laws to regulate and resolve these sources of dissatisfaction. Sometimes, the legislator may perceive to be almost compelled to do so, if dissatisfaction with prevailing modes of corporate governance is widespread within the society, and hence among voters. Nonetheless, revoking regulatory issues from the authority of self-regulatory bodies like the Government Commission GCGC has also the potential to unsettle the standing of these bodies and the persuasiveness of their self-regulatory provisions. In general, Code standards provide greater flexibility and can induce innovative problem solutions. However, companies and their board members may be less motivated to search sincerely for new solutions and appropriate ways to fill in the Code framework if there is the perception that Code standards will be – frequently and in the near future – substituted by legal norms. At the same time, this reluctance by larger portions of the addressed firms to apply the Code in a suitable manner fosters the intention of the legislator to make mandatory rules and regulations on these matters.

In short, the relation between the two regimes of regulation is rather complex and includes multiple facets. The stipulation on D&O deductibles for the management board is by no means the first instance that the legislator took over a regulatory issue that had been dealt with in the GCGC before. Rather, the first instance in

this regard was the regulation on reporting the salaries of the members of the management board individually. Both cases have in common that a greater number of companies deviated from the corresponding Code recommendations and that politicians, as well as parts of the media and the public at large, were disgruntled with the comparably low levels of compliance. At the same time, however, the two cases differ in important aspects. The provision to disclose individualized figures of the management board compensation was included in the original version of the GCGC as a suggestion and upgraded to the status of a recommendation in 2003. Due to this upgrade, and additional influences like for instance increased public scrutiny and a corresponding Recommendation of the European Commission (Recommendation of the European Commission of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies, 2004/913/EC, L 385/55), the rate of compliance with this Code norm increased significantly. Among the DAX companies, the acceptance amounted to 28.6% in 2004 and increased to 39.9% in 2005 and to 74.1% in 2006. With regard to all firms listed at the Frankfurt Stock Exchange, the corresponding compliance rates increased from 17.5% in 2004 to 23.8% in 2005 and to 39.4% in 2006 (v. Werder et al. 2004, v. Werder and Talaulicar 2005, 2006). Nonetheless, some firms had disclosed that they were disinclined to obey this standard. There was no guarantee, however, that this opposition was irrevocable. Rather, the wider diffusion of the standard, corresponding reputation effects and peer pressure may have led to new assessments of the pros and cons of conformity with this specific governance provision. The legislator did not intend to await such potential developments. Although compliance rates were on the rise, the Act on Disclosure of Management Board Remuneration (Gesetz über die Offenlegung der Vorstandsvergütungen, VorstOG) was compiled and promulgated on 3 August 2005. The Act stipulates that the total compensation of each one of the members of the management board is to be disclosed by name, divided into fixed and variable compensation components. The same applies to promises of benefits that are granted to a management board member in case of premature or statutory termination of the function of a management board member or that have been changed during the financial year. These passages were largely borrowed from the corresponding Code recommendation. The amendments became effective for the accounting year starting after 31 December 2005 and therefore required to disclose individualized compensation figures in 2007 at the earliest. In addition, the Act allowed an opting-out clause. Accordingly, disclosure may be dispensed with if the general meeting has passed a resolution to this effect by three-quarters majority. For this reason, there remains eventually, and by all means intentionally, a significant part of the listed firms that do not provide individualized figures on the compensation of their management boards.

In contrast, the provision to agree a suitable deductible if the company has taken out a D&O policy for the members of its management and its supervisory board has already been captured as a recommendation in the original version of the GCGC. As shown above, the corresponding compliance rates have moreover remained stable on rather low levels. One has to be aware though that high compliance rates are by no means an assurance of good governance. Rather, the GCGC rests on the

idea to provide companies the necessary discretion to implement those governance arrangements that promise the best fit with the peculiarities of their specific situation. Therefore, deviations from specific Code provisions could also lead to superior governance solutions in comparison to uncritically adopting each and every Code norm without reflecting the purpose of the norm and the specifics of the company and its sector (cf. Talaulicar and v. Werder 2008). The appropriateness of these deviations basically depends, however, on the appropriateness of the reasons that substantiate the decision not to comply with the specific Code standard.

Based on the explanations put forward by the companies, the basic reservations towards this Code recommendation could not (only) be traced back to the uncertainty about what precisely makes a deductible suitable. Rather, it was assumed that a higher deductible does not have a positive impact on the board members' motivation but merely rises the expenses for the insurance fees since, on the one hand, insurance companies hardly reduce the fees for policies with a deductible and, on the other hand, the board members may cover their deductibles on their own (see Lange 2003, Peltzer 2004, Ringleb et al. 2008). Furthermore, companies often referred to already existing group insurance coverages for their executives, announced that deductibles were unusual abroad and that an unequal treatment between board members and employees did not seem adequate.

These explanations did apparently not convince the legislator. The legislator agreed with the assumption of the Code Commission that deductibles can exert incentive effects and foster responsible behavior. In addition, the legislator came to the conclusion that a more precise definition of the deductible was warranted in order to avoid the agreement of decidedly negligible deductibles. Presetting the minimum levels of the deductible does not come without problems though. To begin with, the broad range of agreed deductibles that were induced by the GCGC and also included apparently inappropriate ones, was not necessarily also to be expected if the Act stipulated to agree a suitable deductible without substantiating its required amount in more details. Rather, legal norms are by all means more binding than Code provisions whose observance remains in principle voluntary. Furthermore, giving the lower limits of the deductible can be expected to entail a much narrower range of agreed deductibles. More specifically, it appears to be rather unlikely that a significant number of firms will utilize the allowed option to agree deductibles that are higher than the required minimum. Evoking a rather small variety of problem solutions appears to be promising if the adequate problem solution is well known in advance. One may doubt though that this is indeed the case for D&O deductibles as empirical insights into their design and effects are still rather limited. In this regard, the Code regulation had the potential to generate more knowledge on the various forms of deductibles, their underpinnings and potential consequences. However, the Code did not exhaust this potential due to the lack of an additional recommendation to disclose details of the agreed deductible.

The VorstAG refers to the fixed annual compensation of the management board member in order to specify one of the two minimum levels of an appropriate deductible put forward in the Act. This reference results from somewhat pragmatic considerations as the total compensation cannot be assessed with sufficient validity

when the insurance contracts are concluded. Rather, the amount of the total compensation can only be determined with some time lag, particularly with regard to variable compensation elements that are based on a multi-year assessment. The reference to the fixed remuneration has, however, the negative side effect that the complexity and the various dimensions of management board compensation systems are not taken into account in sufficient depth. Variable compensation packages can compose a large portion of the management board remuneration. At the same time, there are also firms that try to establish a more balanced ratio of fixed and variable compensation components. It is even the case, and according to some scholars advisable (cf. Frey and Osterloh 2005), that some management board compensation systems only comprise fixed elements. As a result of the specification proposed in the VorstAG, management boards with high portions of fixed remunerations are at a disadvantage compared to those boards that have established a larger portion of variable compensation components. This is noteworthy as the corresponding stipulation does not only address the (about 700) firms that are listed on a regulated stock ex-change but has to be observed by all (approximately 14,000) German stock corporations.

Finally, one could also come to the – rather counterintuitive – conclusion that the intervention by the legislator could have even strengthened the standing of the GCGC and its Commission since the legislator has largely transcribed the passages of the Code into legal norms. Hence, the legislator took the position that the content of the Code standards provided well founded governance solutions and were not to be fundamentally revised. Rather, merely the bindingness of these standards deserved to be intensified and reinforced. Whereas this procedure may have contributed to the authority of the Commission as the lawmaker benefited from and utilized the Commission's spadework and its foregoing thoughts, the imperative to have a GCGC is nonetheless unsettled as the Code would eventually contain primarily must provisions and widespread governance practices if the remaining Code regulations that gain less acceptance in practice are transformed into legal norms.

This division of labor between the legislator and the Code Commission is legally admissible. However, the potential and the benefits that may be associated with a self-regulatory code of best practice would not be exhausted. These advantages will only be realized if the addressed firms do not misuse the flexibility that the Code grants them. Rather, the vast majority of firms needs to reflect on the most eligible governance arrangement under their specific circumstances and utilize the flexibility of the GCGC to sincerely implement these arrangements. Thus, various actors have to get involved with the Code in order to make its idea of self-regulation succeed. These actors also include the owners of the firm and its various stakeholders that have to demand adequate information and to restore to activism if the established governance arrangements do not appear to be convincing. Last, but not least these governance practices come furthermore under scrutiny by the media and the public at large (for the corporate governance role of the media, see Dyck et al. 2008). In this regard, focusing compensation issues may be one important, but surely by no means the most important aspect of good governance. This scrutiny therefore needs to be impartial and sufficiently broad. In short, one may

assume that various actors influence the effectiveness and viability of self-regulatory regimes of corporate governance. This involvement is a critical component to make these self-regulations succeed. Otherwise, self-regulation may be deemed to fail and substituted by alternative modes of regulation like mandatory norms.

Conclusion

The German legislator shares the view that agreeing a personal deductible can contribute to the prevention of wrongdoings as officers are expected to prepare their decisions more thoroughly in order to avoid cases of litigation. This view has not remained unchallenged. Many firms doubt that deductibles will positively influence the motivation of their executives. One has to concede that D&O policies generally exclude coverage for cases of consciously negligent conduct and often also of grossly negligent conduct. Willful acts or acts against criminal law are not covered by liability insurance (Kiethe 2003, Sieg 2004, Seibt and Saame 2006). In addition, cases of litigation as well as D&O policies represent rather complex phenomena. It is therefore difficult to anticipate whether, and under which conditions, suits will be filed, how they may succeed and whether D&O policies do indeed cover the corresponding loss. D&O policies only protect against pecuniary losses (Dreher 2001, Plück and Lattwein 2004, Seibt and Saame 2006). Furthermore, these policies contain many exclusions relating to various aspects of wrongdoing (Scheifele 1993, Ihlas 1997, Lange 2005). Irrespective of a deductible, board members may fear to be prosecuted because such allegations will burden their time and attention (Kesner and Johnson 1990), can have a negative impact on firm value (Cross et al. 1989), may damage their reputation and harm their career (cf. O'Sullivan 1997). According to Bhagat et al. (1987), litigation may still be an important control device, even if all direct costs are paid by the insurer, if there are reputation costs associated with losing lawsuits. Nonetheless, deductibles may strengthen the consciousness of board members' responsibilities and foster the diligence of their behavior. In addition, they may contribute to restoring corrective justice as board members have to bear the deductible when they have caused a loss.

Personal deductibles may therefore be a prudent means to align the interests of the board members to the interest of the enterprise. Although these effects still need to be investigated empirically and litigation regulations differ significantly across countries, the standard to agree personal deductibles that have to be borne by the board members appears to be worth to consider in other governance environments, too. At the same time, however, one has also to emphasize that deductibles may be an important characteristic of D&O policies, but by no means the only important one. The amount of the agreed deductible will be insufficient to assess the compatibility of the policies with good governance. Additional elements of these insurance contracts that may be related to the eligibility of the corporate governance of the firm include the fees, the coverage and the exclusions of the policy. There is some reluctance to provide too many details of D&O policies as this may attract predatory plaintiffs because disclosed coverage may motivate to file a liability

lawsuit (cf. Ihlas 1997). Nonetheless, external constituencies should be able to evaluate the adequacy of the D&O policies that have been taken out by the enterprise. Corresponding regulations deserve caution. This cautiousness, however, should not induce to neglect the complexity of the subject of D&O policies by focusing only the issue of a personal deductible.

References

Abbott, K.W., and D. Snidal. 2000. Hard and soft law in international governance. *International Organization* 54: 421–456.

Alexy, R. 1994. *Theorie der Grundrechte*. 2nd ed. Frankfurt am Main: Suhrkamp.

Amihud, Y., and L. Baruch. 1981. Risk reduction as a managerial motive for conglomerate mergers. *Bell Journal of Economics* 12: 605–617.

Baker, T., and S.J. Griffith. 2009. How the merits matter: Directors' and officers' insurance and securities settlements. *University of Pennsylvania Law Review* 157: 755–832.

Baums, T. 2001. *Bericht der Regierungskommission Corporate Governance. Unternehmensführung – Unternehmenskontrolle – Modernisierung des Aktienrechts*. Köln: Otto Schmidt.

Berliner Initiativkreis German Code of Corporate Governance. 2000. German Code of Corporate Governance (GCCG). *Der Betrieb* 53: 1573–1581.

Beyleveld, D. 1979. Identifying, explaining and predicting deterrence. *British Journal of Criminology* 19: 205–224.

Bhagat, S., J.A. Brickley, and J.L. Coles. 1987. Managerial indemnification and liability insurance: The effect on shareholder wealth. *Journal of Risk and Insurance* 55: 721–736.

Black, B., B. Cheffins, and M. Klausner. 2006. Outside director liability. *Stanford Law Review* 58: 1055–1159.

Borowski, M. 1998. *Grundrechte als Prinzipien: Die Unterscheidung von prima facie-Position und definitiver Position als fundamentaler Konstruktionsgegensatz der Grundrechte*. Baden-Baden: Nomos.

Chalmers, J.M.R., L.Y. Dann, and J. Harford. 2002. Managerial opportunism? Evidence from directors' and officers' insurance purchases. *Journal of Finance* 57: 609–636.

Chinkin, C.M. 1989. The challenge of soft law: Development and change in international law. *International and Comparative Law Quarterly* 38: 850–866.

Clifford, P.W., and R.T. Evans. 1996. The state of corporate governance practices in Australia. *Corporate Governance: An International Review* 4: 60–70.

Conyon, M.J., and C.A. Mallin. 1997. A review of compliance with Cadbury. *Journal of General Management*, 22: 24–37.

Core, J.E. 1997. On the corporate demand for directors' and officers' insurance. *Journal of Risk and Insurance* 64: 63–87.

Core, J.E. 2000. The directors' and officers' insurance premium: An outside assessment of the quality of corporate governance. *Journal of Law, Economics & Organization* 16: 449–477.

Cross, M.L., W.N. Davidson, and J.H. Thornton. 1989. The impact of directors and officers' liability suits on firm value. *Journal of Risk and Insurance* 56: 128–136.

Daily, C.M., D.R. Dalton, and N. Rajagopalan. 2003. Governance through ownership: Centuries of practice, decades of research. *Academy of Management Journal* 46: 151–158.

Dalton, D.R., M.A. Hitt, S.T. Certo, and C.M. Dalton. 2007. The fundamental agency problem and its mitigation: Independence, equity, and the market for corporate control. *Academy of Management Annals* 1: 1–64.

Dedman, E. 2000. An investigation into the determinants of UK board structure before and after Cadbury. *Corporate Governance: An International Review* 8: 133–153.

Dreher, M. 2001. Der Abschluss von D&O-Versicherungen und die aktienrechtliche Zuständigkeitsordnung. *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* 165: 293–323.

Dworkin, R. 1977. *Taking rights seriously*. London: Duckworth.
Dyck, A., N. Volchkova, and L. Zingales. 2008. The corporate governance role of the media: Evidence from Russia. *Journal of Finance* 63: 1093–1135.
Finch, V. 1994. Personal liability and corporate control: The role of directors' and officers' liability insurance. *Modern Law Review* 57: 880–915.
Fombrun, C., and M. Shanley. 1990. What's in a name? Reputation building and corporate strategy. *Academy of Management Journal* 33: 233–258.
Ford, C.L. 2008. New governance, compliance, and principles-based securities regulation. *American Business Law Journal* 45: 1–60.
Frey, B.S., and M. Osterloh. 2005. Yes, managers should be paid like bureaucrats. *Journal of Management Inquiry* 14: 96–111.
Geerken, M.R., and W.R. Gove. 1975. Deterrence: Some theoretical considerations. *Law & Society* 9: 497–513.
Gibbs, J.P. 1975. *Crime, punishment, and deterrence*. New York: Elsevier.
Grasmick, H.G., and G.J. Bryjak. 1980. The deterrent effect of perceived severity of punishment. *Social Forces* 59: 471–491.
Gregory, H.J., and R.T. Simmelkjaer, II. 2002. *Comparative study of corporate governance codes relevant to the European Union and its member states*. Brussels: Weil, Gotshal & Manges.
Grundsatzkommission Corporate Governance. 2000. Corporate Governance-Grundsätze ("Code of Best Practice") für börsennotierte Gesellschaften. *Der Betrieb* 53: 238–241.
Gunningham, N., and D. Sinclair. 1999. Integrative regulation: A principle-based approach to environmental policy. *Law & Social Inquiry* 24: 853–896.
von Hirsch, A. 1992. Proportionality in the philosophy of punishment. *Crime and Justice: A Review of Research* 16: 55–98.
Hollinger, R.C., and J.P. Clark. 1983. Deterrent in the workplace: Perceived certainty, perceived severity, and employee theft. *Social Forces* 62: 471–491.
Hoskisson, R.E., and T.A. Turk. 1990. Corporate restructuring: Governance and control limits of the internal capital market. *Academy of Management Review* 15: 459–477.
Ihlas, H. 1997. *Organhaftung und Haftpflichtversicherung*. Berlin: Duncker & Humblot.
Jensen, M.C., and R.S. Ruback. 1983. The market for corporate control. The scientific evidence. *Journal of Financial Economics* 11: 5–50.
Karlsson-Vinkhuyzen, S.I., and A. Vihma. 2009. Comparing the legitimacy and effectiveness of global hard and soft law: An analytical framework. *Regulation & Governance* 3: 400–420.
Kershnar, S. 2001. *Desert, retribution, and to*rture. Lanham, MD: University Press of America.
Kesner, I.F., and R.B. Johnson. 1990. Crisis in the boardroom: Fact and fiction. *Academy of Management Executive* 4(1): 23–35.
Kiethe, K. 2003. Persönliche Haftung von Organen der AG und der GmbH – Risikovermeidung durch D&O-Versicherung? *Betriebs-Berater* 58: 537–542.
Kim, H.-J. 2001. Taking international soft law seriously: Its implications for global convergence in corporate governance. *Journal of Korean Law* 1: 1–50.
Kraakman, R.H. 1984. Corporate liability strategies and the costs of legal controls. *Yale Law Journal* 93: 857–898.
Lange, O. 2002. Praxisfragen der D&O-Versicherung (Teil I). *Deutsches Steuerrecht* 40: 1626–1631.
Lange, O. 2003. D&O-Versicherung: Innenhaftung und Selbstbehalt. *Der Betrieb* 56: 1833–1837.
Lange, O. 2005. Auswirkungen eines Kontrollwechsels (change of control) auf die D&O-Versicherung. *Die Aktiengesellschaft* 50: 459–473.
Luoma, P., and J. Goodstein. 1999. Stakeholders and corporate boards: Institutional influences on board composition and structure. *Academy of Management Journal* 42: 553–563.
Lutter, M., and G. Krieger. 2008. *Rechte und Pflichten des Aufsichtsrats*. 5th ed. Köln: Schmidt.
Mallin, C., and K. Ow-Yong. 1998. Corporate governance in small companies – The alternative investment market. *Corporate Governance: An International Review* 6: 224–232.
O'Sullivan, N. 1997. Insuring the agents: The role of directors' and officers' insurance in corporate governance. *Journal of Risk and Insurance* 64: 545–556.

Paternoster, R. 1987. The deterrent effect of the perceived certainty and severity of punishment: A review of the evidence and issues. *Justice Quarterly* 4: 173–217.

Peltzer, M. 2004. *Deutsche Corporate Governance. Ein Leitfaden*. 2nd ed. München: Beck.

Plück, R., and A. Lattwein. 2004. *Haftungsrisiken für Manager. Deckungskonzepte und Praxisbeispiele für Geschäftsführer und Vorstände*. 2nd ed. Wiesbaden: Gabler.

Pollock, T.G., H.M. Fischer, and J.B. Wade. 2002. The role of power and politics in the repricing of executive options. *Academy of Management Journal* 45: 1172–1182.

Ringleb, H.-M., T. Kremer, M. Lutter, and A. v. Werder. 2008. *Kommentar zum Deutschen Corporate Governance Kodex*. 3rd ed. München: C. H. Beck.

Romano, R. 1989. What went wrong with directors' and officers' liability insurance? *Delaware Journal of Corporate Law* 14: 1–33.

Schäfer, A. 2006. Resolving deadlock: Why international organisations introduce soft law. *European Law Journal* 12: 194–208.

Scheifele, B.H. 1993. *Die Vermögensschaden-Haftpflichtversicherung für Manager in den Vereinigten Staaten von Amerika. Das haftungsrechtliche Bezugsfeld, die Ausgestaltung und das Zusammenwirken der Directors' and Officers' Liability Insurance mit anderen, dem Schutze der Directors und Officers vor persönlicher Haftung dienenden Vorsorgeeinrichtungen*. Karlsruhe: VVW.

Seibert, U. 2002. Im Blickpunkt: Der Deutsche Corporate Governance Kodex. *Betriebs-Berater* 57: 581–584.

Seibt, C.H., and C. Saame. 2006. Geschäftsleiterpflichten bei der Entscheidung über D&O-Versicherungsschutz. *Die Aktiengesellschaft* 51: 901–913.

Shelton, D. 2000. Introduction: Law, non-law and the problem of "soft law". In *Commitment and compliance: The role of non-binding norms in the international legal system*, ed. D. Shelton, 1–18. Oxford: Oxford University Press.

Sieg, O. 2004. D & O-Versicherung. In *Münchener Anwalts-Handbuch Versicherungsrecht*, ed. M. Terbille, 1194–1253. München: Beck.

Sundaramurthy, C., P. Rechner, and W. Wang. 1996. Governance antecedents of board entrenchment: The case of classified board provisions. *Journal of Management* 22: 783–799.

Talaulicar, T. 2006. *Unternehmenskodizes: Typen und Normierungsstrategien zur Implementierung einer Unternehmensethik*. Wiesbaden: DUV/Gabler Edition Wissenschaft.

Talaulicar, T., and A. v. Werder. 2008. Patterns of compliance with the German Corporate Governance Code. *Corporate Governance: An International Review* 16: 255–273.

Thümmel, R.C. 2008. *Persönliche Haftung von Managern und Aufsichtsräten. Haftungsrisiken bei Managementfehlern, Risikobegrenzung und D & O Versicherung*. 4th ed. Stuttgart: Boorberg.

Vetter, E. 2000. Aktienrechtliche Probleme der D & O Versicherung. *Die Aktiengesellschaft* 45: 453–458.

Walker, N. 1991. *Why punish?* Oxford: Oxford University Press.

Walker, R.G. 2007. Reporting entity concept: A case study of the failure of principles-based regulation. *ABACUS* 43: 49–75.

Walsh, J.P., and R.D. Kosnik. 1993. Corporate raiders and their disciplinary role in the market for corporate control. *Academy of Management Journal* 36: 671–700.

v. Werder, A., and T. Talaulicar. 2003. Der Deutsche Corporate Governance Kodex: Konzeption und Konsequenzprognosen. *Zeitschrift für betriebswirtschaftliche Forschung, Special Issue* 50/03: 15–36.

v. Werder, A., and T. Talaulicar. 2005. Kodex Report 2005: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex. *Der Betrieb* 58: 841–846.

v. Werder, A., and T. Talaulicar. 2006. Kodex Report 2006: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex. *Der Betrieb* 59: 849–855.

v. Werder, A., and T. Talaulicar. 2007. Kodex Report 2007: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex. *Der Betrieb* 60: 869–875.

v. Werder, A., and T. Talaulicar. 2008. Kodex Report 2008: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex. *Der Betrieb* 61: 825–832.

v. Werder, A., and T. Talaulicar. 2009. Kodex Report 2009: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex. *Der Betrieb* 62: 689–696.

v. Werder, A., T. Talaulicar, and G.L. Kolat. 2003. Kodex Report 2003: Die Akzeptanz der Empfehlungen des Deutschen Corporate Governance Kodex. *Der Betrieb* 56: 1857–1863.

v. Werder, A., T. Talaulicar, and G.L. Kolat. 2004. Kodex Report 2004: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex. *Der Betrieb* 57: 1377–1382.

v. Werder, A., T. Talaulicar, and G.L. Kolat. 2005. Compliance with the German Corporate Governance Code: An empirical analysis of the compliance statements by German listed companies. *Corporate Governance: An International Review* 13: 178–187.

Chapter 10
Competitive Markets, Corporate Firms, and New Governance—An Ordonomic Conceptualization

Ingo Pies, Markus Beckmann, and Stefan Hielscher

Abstract The purpose of this chapter is to develop an ordonomic conceptualization of corporate citizenship and new governance that (a) provides a framework for positively explaining the political participation of companies in new governance processes and (b) does not weaken but instead strengthens the functional role of corporations as economic actors in the market system of value creation. To this end, we develop our ordonomic approach in a critical discussion of Milton Friedman's stance on the social responsibility of business in three steps. (1) The ordonomic perspective on the economics ethics of competitive markets argues that the social responsibility of business does not lie in maximizing profits but in addressing societal needs through the mutually advantageous creation of value. (2) The ordonomic approach to the business ethics of corporate actors claims that corporate firms can use moral commitments as a factor of production. (3) The ordonomic perspective on the process ethics of new governance holds that companies can act not only as economic actors but also participate as political and moral actors by taking ordo-responsibility in processes of new governance. This role of corporate citizens in the new governance does not weaken but, instead, strengthens the role of business firms as economic agents for value creation.

Keywords New governance · Corporate citizenship · Value creation · Economic ethics · Business ethics · Process ethics · Ordonomics · Stakeholder theory · Sustainability · Aristotle · Milton Friedman · Corporate social responsibility

Introduction

(1) It used to be that the business of business was business. In the age of globalization, however, this does not seem so true or even obvious. Companies increasingly engage in a broad spectrum of activities that are far removed from those discussed in

---

I. Pies (✉)
School of Law, Business and Economics, Martin-Luther-University Halle-Wittenberg, 06108 Halle (Saale), Sachsen-Anhalt, Germany
e-mail: ingo.pies@wiwi.uni-halle.de

I. Pies, P. Koslowski (eds.), *Corporate Citizenship and New Governance*, Ethical Economy. Studies in Economic Ethics and Philosophy 40,
DOI 10.1007/978-94-007-1661-2_10, © Springer Science+Business Media B.V. 2011

traditional management textbooks. Corporations participate in public-private partnerships with the purpose of jointly providing public goods (cf. Edwards and Zadek 2003). They engage in forms of cross-sector cooperation for settling disputes and creating commonly accepted rules. A case in point is the Forest Stewardship Council (cf. Hollenhorst and Johnson 2005). Transnational companies implement corporate codes of conduct that contribute to "upholding labor standards in third world countries" (Frenkel and Scott 2002, p. 30). Other corporations play an active part in political initiatives such as the Oslo-based Extractive Industries Transparency Initiative (cf. Eigen 2006).

(2) Two closely related concepts, each of which emphasizes the seemingly changing role of business in society, have gained prominence in the academic literature: the idea of new governance and the notion of corporate citizenship.

New governance refers to the changing *process* of societal coordination and cooperation between states, civil society organizations, and the private business sector. The concept deals with the development of rule-making and rule-implementation on a global scale, which is seen as "no longer a task managed by the state alone" (Scherer et al. 2006, p. 505). In the new governance, business firms, especially transnational corporations, together with civil-society organizations and government actors, "participate in the formulation and implementation of rules in policy areas that were once the sole responsibility of the state" (ibid).

Closely related to the work on new governance is the discussion about *corporate citizenship*. While "new governance" is focused on a process level, "corporate citizenship" focuses on the *actor* level and looks at the role of business corporations as societal actors. According to Moon et al. (2005, p. 448), the concept of corporate citizenship is based on the idea that corporations "act 'as if' they were metaphorically citizens in that their engagement in society resembles that of citizens." Moon, Crane, and Matten identify two dimensions along which corporations fill this citizenship role. First, corporate citizenship "describes the role of the corporation in administering citizenship rights for individuals" (Matten and Crane 2005, p. 173). Second, "corporations can participate in governing" (Moon et al. 2005, p. 444) thus "contributing to societal governance" (p. 440).

New governance and corporate citizenship are thus closely related. In fact, the literature discusses the changing role of business and new governance processes as two sides of the same coin. As Palazzo and Scherer (2006, p. 76) argue, the new "politicization of the corporation is an unavoidable result of the changing interplay of economy, government and civil society in a globalizing world." Similarly, Matten and Crane (2005, p. 172) suggest that the corporate administration of citizenship rights is a reaction to a failure of traditional state governance.[1] According to Moon

[1] Matten and Crane (2005, p. 172, emphasis in original) hold: "Where *government ceases to administer citizenship*, this leaves open space for corporations to enter (or not to enter) the arena as administrators of citizenship. . . . Corporations also enter the arena where *government has not as yet administered citizenship rights*. This is particularly the case in developing countries. Globalization raises awareness of these 'vacuums' and exposes western MNCs in particular to charges that they are 'responsible' in some way for administering citizenship rights in such situations."

et al. (2005, p. 448), "in their engagement in 'new governance' . . . , corporations are sharing in the *doing* of government 'like' citizens."

(3) The link between new governance and corporate citizenship seems obvious at first glance, but becomes a little less so upon closer inspection. In particular, it is not clear why companies would participate as corporate citizens in new governance processes. As Matten and Crane (2005, p. 174) observe, the ideas of corporate citizenship and of new governance suggest that corporations "have taken over considerable responsibility from governments." But why would companies accept such additional responsibility? A central argument put forward by new governance advocates is that companies need to adopt a new corporate role in order to "fill the vacuum of global governance" (Scherer and Palazzo 2008, p. 425). As Scherer and Palazzo (2008, p. 414) argue, the "global framework of rules is fragile and incomplete. Therefore, business firms have an additional political responsibility to contribute to the development and proper working of global governance."

According to Scherer and Palazzo (2008, p. 414), taking on this additional political responsibility is necessary because under the conditions of poor state regulation, the "sole emphasis on economic rationality will not contribute to public welfare, but rather may worsen the situation." At the same time, Palazzo and Scherer (2006), as well as Scherer and Palazzo (2007), argue that the political participation of companies in new governance processes raises issues of legitimacy. In addressing this issue, Palazzo and Scherer (2006) advocate a "communicative framework" that seeks to politicize the corporation.[2] As Scherer and Palazzo (2008, p. 426) explain, corporations become politicized in two ways. First, "they operate with an enlarged understanding of responsibility and help to solve political problems in cooperation with state actors and civil society actors." Second, "they submit their growing power and political engagement to democratic processes of control and legitimacy."

(4) Prominent advocates of corporate citizenship and new governance thus argue for a fundamental change in business's role in society. However, although work on this topic has led to valuable research and the discovery of important empirical phenomena, two critical questions remain unanswered, one with regard to positive analysis and one having to do with normative analysis.

In terms of *positive* analysis, a conceptualization of corporate citizenship and new governance needs to be able to explain why companies would engage in tasks such as rule-making and the administration of rights in situations where state-centric governance is ineffective. Scherer and Palazzo (2008, p. 414) may be right when they argue that "in as much as the state apparatus does not work perfectly, there is a demand for business to be socially responsible," but simply identifying this societal demand does not explain why individual companies would step in to meet it (see also Boatright 2009, p. 7). In fact, the literature on public goods is rife with examples of societal demands that have not been addressed, by corporations or anyone else. The critical issue here would appear to be one of incentives and yet, in at least some of

[2] Palazzo and Scherer (2006, p. 81) explain that a "discursive approach to organizational legitimacy leads to a politicized concept of CSR."

the literature, there is a certain normativistic tendency to simply call for extended responsibility on the part of the business community without acknowledging the role of incentives and the issue of implementation. But, as van Oosterhout (2005, p. 678) points out, "why should [corporations] ... assume such extensive responsibilities if there is nothing in it for them?" This is a question that any positive theory of new governance and corporate citizenship needs to take seriously: Since companies do engage in new governance processes, a theoretical conceptualization must be able to explain *why*.

In terms of *normative* analysis, the work on new governance and corporate citizenship raises a second critical question, one closely related to the issue of implementation. That is, it is not clear how some of the normative concepts that call on corporations to engage in "a continuous process of deliberative discourse" and that call for the corporation to take a political role can be reconciled with firms' economic role in the market system of value creation. The normative calls to transform the corporation's role in society could result in a risk of unintentionally undermining the market system and weakening the functional role of the business firm as an economic actor (cf. Boatright 2009, p. 8). Scherer et al. (2006, p. 524) are not unaware of this risk. In their outlook on further research, they write:

> [I]t seems that the economic concept of the firm and the political role of the firm as advanced here are antagonists. However, our case is not to abandon market society or to reject the economic objective of the firm. Instead, we take the imperatives of market competition and the price system as a precondition of efficient coordination in modern societies.

Despite this reference to the importance of market competition, however, Scherer, Palazzo, and Baumann fail to explain how the politicization of corporations would leave their economic role in competitive markets unscathed. In fact, they state that "much work must still be carried out in order to completely understand the implications of politically embedded ... corporate citizenship."

(5) The purpose of this chapter is to develop an ordonomic conceptualization of corporate citizenship and new governance that (a) provides a framework for positively explaining the political participation of companies in new governance processes and (b) does not weaken but instead strengthens the functional role of corporations as economic actors in the market system of value creation. We show that the logic behind win-win-processes of new governance is the same logic that characterizes the daily business of economic value creation.

The ordonomic research program that we draw on in this chapter is still fairly young.[3] Instead of presenting the ordonomic perspective in a theoretical, rather

---

[3] The "ordonomic" approach builds upon the German tradition of an "economic theory of morality" (Homann and Pies 1994) that was originally restricted in a more narrow sense to discussing matters of business and economic ethics. This ordo-theoretical approach to economic ethics argues that the incentive properties of social institutions play an important role in implementing moral concerns. This research program was originated by Karl Homann. Cf. Homann (1990, 2002, 2003). Meanwhile, there are numerous publications available that specifically refer to this intellectual tradition. Cf. Habisch et al. (2008), Hirsch and Meyer (2009), Lin-Hi (2009), Lütge (2005, 2007), Schönwälder-Kuntze (2008), Suchanek (2007), Suchanek and Lin-Hi (2007), Waldkirch (2001)

abstract way, we develop our conceptual framework presented in this chapter in a critical discussion of Milton Friedman's classical position. There are two reasons why Friedman (1970) provides a useful starting point for our analysis. First, the Friedman position is well-known in the debate about business in society. Second, the ordonomic approach can use Friedman to focus attention on an important, but less often discussed, methodological standard: business ethics theory should not start from the exceptional case of corporate scandals or economic crises, but have a firm foundation in the normal case of mutually advantageous value creation.

We develop our argument in several steps. In the first three steps, we critically discuss the Friedman position and apply the ordonomic perspective to three types of ethics: (1) the ethics of competitive markets (economic ethics), (2) the ethics of the corporate firm (business ethics), and (3) the ethics of new governance (process ethics).

In the first step (1), we look at the economic system of competitive markets. Here, we start with the proposition that business firms are economic actors with the societal mandate to solve social problems through value creation. From an ordonomic point of view, this is the domain of "economic ethics" (as a win-win heuristics for the economic system).

In the second step (2), we focus on the core business of business. Here, our proposition is that corporate firms as economic actors fulfill their societal mandate of value creation with the help of moral commitments. The idea is that companies can use moral commitments as a factor of production, since day-to-day value creation requires an institutional management of social dilemma structures. From an ordonomic point of view, this is the domain of "business ethics" (as a win-win heuristics for corporate actors).

Third (3), we look at the new governance. Here, our proposition is that business firms as economic actors fulfill their societal mandate of value creation by employing moral commitments in political processes of finding and setting rules for market competition. From an ordonomic perspective, this is the domain of "process ethics" (as a win-win heuristics for new governance processes). We show that from an

---

as well as Waldkirch et al. (2009). Ordonomics advances the "economic theory of morality" to a general social and organizational theory that takes a rational-choice perspective on the analysis of interdependencies between institutions and ideas or, more specifically, on the analysis of interdependencies between social structure and semantics. In ordonomics, "social structure" (institutions) refers to the incentive properties of formal and informal rule arrangements, whereas "semantics" (ideas) refers to the terminology of public and organizational discourse and the underlying thought categories that determine how people perceive, describe, and evaluate social interactions and, in particular, social conflicts. The ordonomic approach is interested in interdependencies between ideas (semantics) and institutions (social structure), i.e., in the question of how certain mental models and ways of interpreting social reality shape our thinking and communication and, vice versa, how our thinking and communication shape the social rules that coordinate human interactions and thus ultimately channel our behavior. For an application of the ordonomic approach to business ethics, see Pies et al. (2009b) as well as Pies et al. (2010). For a comprehensive overview of applications of the ordonomic approach to the domain of business and economic ethics, see Pies (2009a, b). For a more general discussion of the ordonomic methodology, see Pies et al. (2009a) as well as Beckmann (2010).

ordonomic perspective, the role of corporate citizens in new governance processes is just win-win oriented value creation writ large. Because it lays the groundwork for value creation, participating in political rule-setting processes and rule-finding discourse does not weaken, but instead strengthens the firm economically, thus providing an incentive to so engage.

After thus specifying the societal role of the business firm from three different perspectives, the fourth step (4) concludes and briefly discusses some implications of our argument.

Competitive Markets and the Ordonomic Approach to Economic Ethics

According to Milton Friedman (1970), profit maximization is an ethical obligation of business corporations: "The social responsibility of business is to increase its profits." This unapologetic dictum has provoked sharp reactions and strong disapproval. To *constructively* criticize it, however, we begin by asking how Friedman's argument looks from an ordonomic perspective.

From an ordonomic point of view, the question as to whether the profit principle can be justified needs to be answered from the system perspective of economic ethics. According to such a system perspective, the profit principle can only be justified if it fulfills a desirable social function in the economic system. The ordonomic approach to economic ethics starts with the awareness that on a system level, certain, possibly all, aggregate manifestations, for example, aggregate growth rates, (un-)employment, or innovation, are the unintended social results of the intentional behavior of many individual actors (cf. Becker 1976, 1993, Coleman 1990, pp. 1–23, Popper [1945] 1966, chapter 14, pp. 89–99). This is particularly true in the case of competitive markets. The ordonomic perspective highlights that given a functional institutional framework, the pursuit of self-interest in the marketplace can lead to highly desirable social results. In functioning competitive markets, profit seeking by competing firms is a key driver for innovation, growth, and economic prosperity (Baumol 2002). Profits signal that a company has successfully created value. That is, in a competitive market system, a company can make a profit only if customers are willing to pay more for its product than the cost of producing that product. Profits are thus an epiphenomenon of successful value creation. In short, making a profit is evidence that a company is giving more to society than it is taking from it. Seen this way, profits are an important incentive in motivating companies to best fulfill their raison d'être as societal actors: to organize the creation of value (cf. Mises [1951] 2008, pp. 7 et passim, Jensen 2002, p. 239).

Seen from this perspective of value creation, it is now possible—and, arguably, necessary—to address Friedman's profit-as-ethical-obligation position not by flatly rejecting it, but by stating it more *precisely*. From an ordonomic perspective, companies have a societal mandate to create value. This is, of course, not a new idea. As early as 1949, Ludwig von Mises ([1949] 1996, p. 217) made the case that "the

owners of the material factors of production and the entrepreneurs are virtually mandataries or trustees of the consumers, revocably appointed by an election daily repeated." The ordonomic idea is that companies are agents with a mandate to create value for consumers and, in a substantial extension of von Mises's position, for other stakeholders, too.

To systematically understand the societal purpose of business, therefore, requires starting the analysis by looking at the economic ethics of competitive markets, a perspective that, in contrast to Friedman, does *not* claim that the "social responsibility of business is to increase its profits." Profits are simply not an end but just a, albeit powerful, means. As a result, ordonomics reconstructs Friedman's famous dictum and argues: "The social responsibility of business is to solve societal problems through value creation."

It might not be immediately obvious why redefining the societal purpose of business in terms of value creation is so important. Yet, in fact, doing so is absolutely vital for understanding the limitations of Friedman's argument. The fundamental point is that the profit maximization Friedman argues for does induce companies to fulfill their societal mandate, but *only under very specific conditions*. If and only if the institutional framework of the market is perfect do companies automatically fulfill—possibly without knowing or even intending it—their societal mandate of value creation by maximizing profits. However, as soon as the market becomes less than perfect, Friedman's position is not only imprecise but outright misleading. By focusing on profits instead of value creation, Friedman restricts his argument to fairly idealized conditions and as a consequence, he is not able to deal with the case when institutional conditions in a market are deficient and adequate rules need to be created in order to harness the profit motive for societal value creation. Friedman presupposes perfect "moral markets" (Boatright 1999), but in so doing fails to reflect the conditionality of his argument.

Corporate Firms and the Ordonomic Approach to Business Ethics

Milton Friedman (1970, p. 122) argues that companies best fulfill their moral obligation to society by maximizing their profits and he thus strongly opposes the "doctrine" of corporate "social responsibility" and sees no need for a systematic preoccupation with business ethics. Yet, contrary to Friedman's (implicit) assumptions, companies never operate within a perfect, i.e., complete, framework of functioning formal institutions; the formal institutional rules of any competitive market as well as the contracts between market participants are always incomplete.

This necessary incompleteness of institutions and contracts provides the jumping-off point for the ordonomic approach to business ethics and yet the ordonomic perspective is fully aware that situational conflicts between profit and morality cannot be solved by simply giving morality supremacy over profit. Any approach to business ethics that situationally suspends the profit principle will be in

conflict with the ordonomic perspective of economic ethics as discussed above, not to mention the way competitive markets actually work.

To guarantee compatibility between business ethics and economic ethics and thus to ensure that business ethics is compatible with the real-world market system, we believe that business ethics must be thoroughly grounded in economic ethics, i.e., business ethics must be founded on the fact that companies are societal agents for mutually advantageous value creation. Starting from the idea of value creation, the ordonomic approach to business ethics focuses on how corporate firms can use moral commitments to create a functional framework for win-win interactions with their stakeholders.

We argue that business ethics are relevant to economic value creation because formal institutions and private contracts are always necessarily incomplete. One fundamental consequence of this incompleteness is that any company first needs to be viewed as a "moral actor" before it will be able to successfully fulfill its societal mandate of mutually advantageous value creation. In an ideal world of costless, complete, and perfectly enforceable contracts, even anonymous players could cooperatively interact to create value. However, in the "real" world, no player in the marketplace—including employees, customers, suppliers, creditors, and debtors—is willing to cooperate with a firm unless the player knows or believes that the company is trustworthy and reliable. This is why any company that wishes to engage in societal value creation needs to first constitute itself as a moral actor of integrity. The corporation needs to provide itself with an organizational framework in which it can build up its corporate "character," reputation, and perceived trustworthiness. *Taking seriously the idea of value creation as the realization of win-win solutions with interaction partners, a corporation's license to operate is—properly understood—in effect a license to co-operate.*

An important implication of value creation as the starting point for an ordonomic approach to business ethics is that companies can use moral commitments as a systematic *factor of production*. The underlying idea is that prudent moral commitments can trigger a powerful win-win outcome for the company by convincing its stakeholders of its reliability (and even its "goodness"), thus inducing them into a productive cooperation that would not be possible in the absence of such trust. In short, moral commitments can be a factor of production in that they signal that the firm is interested and considerate of others, a signal that can be immensely important to the firm's successful value creation.

It is important to note that the ordonomic win-win perspective is not theoretical wishful thinking. On the contrary, it is routine practice of any company to create value by taking into account the interests of others. As John Mackey (2006) put it, business is indeed a "win-win-win-win" constellation for all actors involved in the value creating interactions: for the investors, employees, customers, and suppliers. Otherwise, none of these stakeholders would cooperate with the company in the first place. Businesses do use moral commitments and they do take into consideration the interests of their stakeholders and of the communities in which they operate.

Interestingly, the idea of "moral commitments as a factor of production" is not alien to Milton Friedman. In fact, Friedman (1970) himself explicitly talks about

the fact that companies can play an active role in providing amenities to their communities, for example, in order to create favorable conditions for the social process of value creation.[4] Yet, Friedman adamantly refuses to view such corporate strategies as acts of "responsibility" or of "moral commitment." His point is that at the end of the day such corporate behavior is not motivated morally but purely as a means to generate more profit.[5] From an ordonomic perspective, this is a fundamental flaw in Friedman's position. His argument rests on a serious—although popular—misconception. Ultimately, Friedman conceptualizes the role of the firm in terms of an implicit tradeoff between profit seeking and the moral consideration of the interests of others. His argument suggests that a corporate strategy cannot be called "socially responsible" if it eventually serves the profit principle. By claiming that corporate behavior can be *either* morally motivated *or* just a "cloak" for profit-oriented "expenditures that are entirely justified in its own self-interest," Friedman draws on popular semantics that see morality as some sort of sacrifice. According to such trade-off thinking, "true" morality necessarily requires some sacrifice of self-interest.

However, a semantics that understands moral commitments as a sacrifice is out of touch with the real-world social structure of functioning markets. To think of morality in this fashion is a win-lose way of looking at it. Such semantics therefore fail to do justice to the "mutualistic" win-win logic inherent in the mutually advantageous processes of market-based value creation (cf. Hazlitt [1964] 1994, Ch. 13). As a result, Friedman's attempt to justify the profit principle runs the risk of backfiring. His argument actually does a disservice to the legitimacy of the profit principle in two ways. First, Friedman, ironically and inadvertently, perpetrates the prevailing view that the pursuit of profit has no moral value. It thus appears that Friedman is unintentionally denying the moral quality of genuine value creation. Second, *within* companies, the Friedman position does not offer a powerful heuristic for guiding the process of creating value. His rhetoric obscures the fact that moral commitments do not have to be a sacrifice but can be a valuable investment. A win-lose semantics falls short of constructively guiding those processes that aim at finding creative ways for using moral commitments as a factor of production.

In a nutshell, the ordonomic criticism of Friedman's argument with regard to business ethics (that the pursuit of self-interest has no moral quality) unintentionally—and unnecessarily—runs the danger of undermining his argument with regard to economic ethics (that the pursuit of self-interest *does* have a moral quality).

---

[4] Friedman (1970, p. 124) argues that "it may well be in the long run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government."

[5] Friedman (1970, p. 124) contends: "Of course, in practice the doctrine of social responsibility is frequently a cloak for actions that are justified on other grounds rather than a reason for those actions. . . . In each of these . . . cases, there is a strong temptation to rationalize these actions as an exercise of 'social responsibility'. [Yet, in effect, they are simply] expenditures [of the corporation] that are entirely justified in its own self-interest."

New Governance and the Ordonomic Approach to Process Ethics

Milton Friedman develops his justification of profit maximization in an idealized world where markets are embedded in a perfect institutional framework. In this capitalistic Eden, creating and implementing rules is the exclusive responsibility of government. For Friedman, the state's primary role is to promote the common good through an adequate institutional order and, moreover, state government is seen as the *only* authority that can legitimately set and enforce rules. According to Friedman (1962, p. 15), it is *government* that serves as the "forum for determining the 'rules of the game' and as an umpire to interpret and to enforce the rules decided on." Friedman thus promotes a clear division of labor: the state is the exclusive rule-*maker*; business firms, in contrast, are mere rule-*takers* who optimize their individual moves "within the rules of the game" (Friedman 1962, p. 133).[6]

Contrary to Friedman's idealized assumptions, however, corporations often do operate within a context where situational conflicts between profit and morality arise because the institutional framework is deficient. Take the example of companies that are stuck in a quagmire of corruption (cf. Pies 2008). In the case of endemic corruption, companies are collectively trapped in a social dilemma. It is a *social* dilemma not because the companies cause harm to society in general, but because they also collectively harm each other. Endemic corruption amounts to collective self-damage for the companies involved—they are forced to pay expensive bribes, they run the risk of serious damages to their reputation, they exist in fear of judicial sanctions—and at the same time, no company gains any individual competitive advantage as all firms in its sector are engaged in dealing with corruption. In this case, the "basic game" of business competition is heavily characterized by perverse incentives. Consequently, individual profit maximization *within* the existing rules of the basic game does not enable companies to adequately fulfill their societal function of value creation.

The case of corruption illustrates an important point: in the face of dysfunctional incentives and deficient rules in the basic game, companies can be faced with moral conflicts that are not solvable by simply changing their own behavior. For example, if a company makes an individual decision to fight against endemic corruption in its industry sector, it runs the risk of suffering severe competitive disadvantage without even coming close to solving the social dilemma of corruption at the group level. In this situation, we suggest a change of perspective that will reveal more constructive options for solving the problem. If dysfunctional incentives drive a race-to-the-bottom competition in the basic game, then companies can fulfill their societal mandate of value creation only by taking *ordo-responsibility*, i.e., by contributing to reforming the rules of the game (cf. Beckmann and Pies 2008a, b).

---

[6] Friedman (1962, p. 27) indeed feels that *only* government can provide market interactions with functional rules. He contends (emphasis added): "The role of government just considered is to do *something that the market cannot do for itself, namely, to determine, arbitrate, and enforce the rules of the game.*"

The idea of ordo-responsibility highlights that in many instances it is important to distinguish between two levels of responsibility: "within-game responsibility" and "context-of-game responsibility." We hold that companies can—and judged by their own self-interest *should*—take responsibility for the shared *order* of the game if the basic game is defunct. In short, companies trapped in a social dilemma have a strong self-interest in overcoming this dilemma and thus playing a better game.

Companies can take ordo-responsibility on two levels (Fig. 10.1). In the *meta-game,* companies can take responsibility for the order of institutional rules (social structure). The meta-game concerns the societal rule-setting processes that form and reform the institutional framework governing the basic game. In this meta-game, companies can take *governance responsibility*: they can contribute to establishing functional commitments and thus to creating the necessary conditions for mutually advantageous value creation in the basic game. There are manifold instruments companies can use here, including industry codes of conduct, public-private partnerships, and cross-sectoral alliances (cf. Buttkereit 2009). In the case of corruption, they can cooperate with organizations such as Transparency International and work collectively toward a sector-wide integrity pact.

The second level on which companies can take ordo-responsibility is in the societal meta-meta game. In this meta-meta-game, companies can take responsibility for the "order of thought" and the paradigms that shape public discourse (semantics). The purpose of this meta-meta game is to enable a common rule-finding discourse. The point is that the players in a *meta*-game will never agree to institutional reforms and binding commitments unless they first concur that these new rules are necessary and desirable. From an ordonomic perspective, creating such an awareness of common interests is what discourse in the societal meta-meta-game is about. What is a useful focal point for such discourse? The ordonomic answer is straightforward:

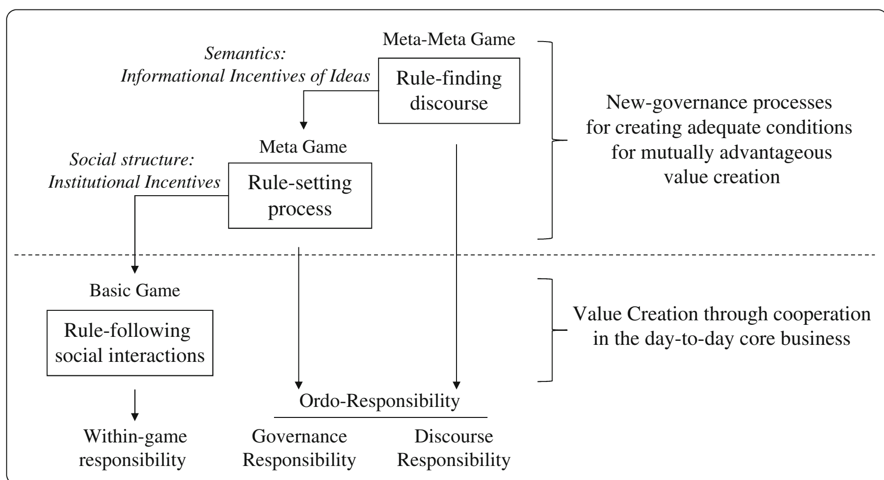

Fig. 10.1 The ordonomic perspective on the new governance

mutually advantageous value creation. Accordingly, companies can take *discourse responsibility* and contribute to identifying common interests. To this end, companies may organize multi-stakeholder dialogues, participate in learning networks like the UN Global Compact, become active members in their industry associations, or contribute to parliamentary hearings and public debates.

Figure 10.1 illustrates how the ordonomic perspective can be enlarged to include a "process ethics" for the new governance. Focused on the idea of mutually advantageous value creation, process ethics serves as a win-win heuristics for new governance processes. We hold that in addition to creating value in their day-to-day activities, businesses can—and, judged by their own self-interest, should—participate in the new governance. By contributing to rule-setting processes (meta-game) and rule-finding discourse, they can improve the conditions for business so as to make it a mutually advantageous basic game. From the perspective of process ethics, it makes sense to view corporations as no longer merely economic actors, but also as political and moral actors, in short, as *corporate citizens.*

In his classic criticism of "corporate social responsibility," Milton Friedman strongly opposes the idea that corporations can play a constructive role as political actors. In his view, it is the exclusive task of the government to establish the rules of the societal game. Present-day scholars such as Henderson (2001, 2004), Jensen (2002), Sundaram and Inkpen (2004), and Vanberg (2007) agree. However, from an ordonomic point of view, all these scholars miss two critical points. First, in a globalizing economy, companies increasingly operate in contexts where the state either fails to set adequate rules or falls short of enforcing them. And second, in many cases, these regulatory vacuums negatively affect the companies themselves. In effect, companies have a vested interest in functioning rules of the game. New governance processes that harness this interest may benefit not only the company but also society at large.

The ordonomic perspective of process ethics is critical of Friedman's heuristics for two reasons. First, Friedman employs here a "methodological nationalism" (Beck 2002, pp. 84ff.) that advocates idealized notions of the nation-state and, ultimately, handicaps societal learning processes. This makes it difficult to develop a constructive understanding of the new governance as a system that does not always view corporations as part of the problem, but can just as often see them as part of the solution. Second, Friedman's position has nothing to offer when it comes to preparing (future) managers for the real-life challenges of the new governance and yet, in this age of globalization, these new governance processes are becoming increasingly important for societal self-organization. What is more, new governance processes are becoming ever more relevant for the strategic management of businesses: in the face of regulatory deficits, they allow corporations to sustain, extend, and invest in an environment conducive to value creation and profit realization: *The competence to take on ordo-responsibility—through corporate citizenship in processes of new governance—is increasingly important for managers to earn and secure their companies' license to (co-)operate and thus to foster successful value creation.*

Economic Ethics, Business Ethics, and Process Ethics in Perspective: Summary and Outlook

(1) In this chapter, the ordonomic approach is developed in a critical discussion of Milton Friedman's stance on the social responsibility of business. The key propositions can be summarized as follows. (a) The ordonomic perspective on the economics ethics of competitive markets argues that the social responsibility of business does not lie in maximizing profits but in addressing societal needs through the mutually advantageous creation of value. (b) The ordonomic approach to the business ethics of corporate actors claims that corporate firms can use moral commitments as a factor of production. (c) Finally, the ordonomic perspective on the process ethics of new governance holds that companies can act not only as economic actors but also participate as political and moral actors, i.e. as corporate citizens, by taking ordo-responsibility in processes of new governance.

Our analysis of Milton Friedman's position finds that three elements of his argument can be criticized and, indeed, be stated more precisely by taking an ordonomic perspective. However, we also believe that Friedman's position is still extremely relevant today in that it can serve to create awareness of an important methodological standard for building theory in the field of business ethics. Friedman develops his approach to business ethics not from the exceptional case of corporate scandals or economic crises, but from the systematic win-win logic that characterizes the *normal case* of successful value creation within a market economy.

There is an important lesson to be learned here. To understand the paradigmatic raison d'être of business in society, it makes sense to *start* the analysis with a rather idealized concept of the market system. In theory building, one often needs to start with the abstract on the road to a more practical statement. In a way, Friedman's problem is that his argument is not abstract enough and that he fails to appreciate value creation as justifying the profit principle. Still, Friedman does state that one has to explain the functionality of profits in terms of the more general win-win logic of competitive markets.

The relevance of this methodological argument can best be illustrated by looking at alternative approaches to business ethics that start their theory building by observing a situational conflict between profit and moral objectives, then (mis-) take this conflict to be the general rule, consequently losing sight of the important case of mutually advantageous value creation. When an approach to business ethics fails to acknowledge the societal function of businesses as agents for value creation, it runs the risk of jeopardizing its compatibility with the market economy and of advocating policies that ultimately threaten to undermine the societal purpose of the business firm.

Our ordonomic conceptualization aims at understanding the business firm as an *economic* agent for value creation. More specifically, we hold that corporate citizenship and the participation of business firms in processes of new governance need not be seen as a fundamental change in the business of business. Rather, the ordonomic approach to process ethics maintains that in many cases companies can fulfill their

societal mandate of value creation only if they learn to participate constructively in the new governance processes of rule-finding and rule-setting. Put differently, we conceptualize new governance as a domain in which companies extend their win-win strategy of managing social dilemmas through moral commitments to problems that traditionally have been within the purview of the state. Our point is that this economic win-win strategy has not changed and that it can be applied to political spheres, too. In our ordonomic view, corporate citizenship does not weaken but, instead, strengthens the role of business firms as economic actors in their capacity to fulfill their societal mandate of value creation: In the face of poor regulatory frameworks, companies need to adopt a political role in new governance in order to better fulfill their role as economic actors. By participating in processes of new governance, business firms, as corporate citizens, conduct themselves in the political sphere just the same as they do in their day-to-day business: they engage in individual and collective commitments that improve the rules of the economic game. In a nutshell, the ordonomic understanding is that the *role of corporate citizens in processes of new governance is just win-win oriented value creation writ large.*

(2) It is somewhat unusual to distinguish between economic ethics, business ethics, and process ethics. However, the fruitfulness of such an ordonomic approach lies in its ability to shed new light on important problems that have a specific significance of their own and thus deserve to be distinguished. For each domain, we illustrate the analytical power of the ordonomic approach with innovative insights. These insights concern the interdependencies between social structure and semantics, which illustrate the specific perspective of the ordonomic approach.[7] To illustrate, we briefly discuss three examples.

a) *Economic Ethics.* The ordonomic approach interprets economic ethics as a system ethics of market competition. From this perspective, ordonomics views competition as an instrument of social cooperation. This leads to a new understanding of value creation, from which it is possible to critically assess the literature on stakeholder theory: The strength of this literature is that it aids in understanding the challenge of value creation as a question of managing social relationships. From an ordonomic point of view, however, there is also a significant weakness in this literature. Traditional stakeholder theory fails to take into account *all* social relationship that matter for the process of value creation. Its biggest blind spot is its neglect of competitors as relevant stakeholders. From an ordonomic perspective, this is a problem because stakeholder theory tends to overlook the importance of collective commitments among competitors entered into to overcome social dilemmas.
b) *Business Ethics.* The ordonomic approach interprets business ethics as an organizational ethics of corporate actors. From this perspective, ordonomics offers

[7] Economic approaches primarily deal with an analysis of social structures. Philosophical approaches primarily deal with semantics. What makes ordonomics special is a theory perspective that focuses on interdependencies—and, more specifically, even on discrepancies—between social structures *and* semantics.

a conceptual framework for understanding corporate citizenship. This framework can best be illustrated by an analogy from the Aristotelian approach to ethics. According to Aristotle, one can realize oneself—in the sense of self-perfection—both as a person and as a citizen through acquiring virtue by habit. Ordonomics, in turn, argues that a corporate actor can realize itself—in the sense of self-perfection—both as a person and as a citizen through acquiring virtue by moral self-commitments: the corporate constitution shapes the organization's "character." Just as Aristotle argues that the individual is rewarded for his or her moral virtues by social recognition, ordonomics holds that an organization is rewarded for being a trustworthy interaction partner by productive cooperation with its stakeholders. Aristotle argues that a human being needs the respect of the community for his or her self-development as a person; ordonomics maintains that moral commitments are necessary for endowing an organization with a "license to co-operate," which is crucial for productive interactions with partners. Aristotle argues that moral virtues are conducive to self-perfection; ordonomics claims that moral commitments are conducive for the self-perfection of the business firm as a societal agent of value creation. In the Aristotelian case, the actor is rewarded with greater happiness (eudaimonia); in the ordonomic case, the actor is rewarded with higher profit. Taking the analogy one step further: for Aristotle, virtue qualifies the person to be a political citizen of the polis; ordonomics argues that the "virtue" of moral commitments qualifies the organization to become a political actor, or a corporate citizen, meaning that the firm acquires the right to constructively participate in rule-finding discourses and rule-setting processes.

c) *Process Ethics.* The ordonomic approach interprets process ethics as an ethics for new governance. Thus, ordonomics provides a fresh perspective on the debate over sustainability. We hold that sustainability is a normative concept well suited for political processes, especially at the global level. The heuristic quality of this concept can be summarized in three points. First, in contrast to traditional normative concepts such as justice, solidarity, or responsibility, sustainability is a cosmopolitan category sui generis. Instead of extending a normative idea from small groups to ever more encompassing social contexts, sustainability starts at the global level and then can be applied to regional, national, or even local contexts. Second, the semantics of sustainability provides a new heuristic quality. To ask from without whether social results can be qualified as "just" or "solidary" is to employ a normative outcome criterion that is external to the social process. In contrast, the procedural criterion of sustainability addresses the potential for self-continuation of a social process. It asks from within whether a development can be prolonged in the future and thus draws on an internal criterion. Third, the semantics of sustainability discourages taking perceived tradeoffs at face value and instead encourages critically reflecting on how seemingly conflicting aims can be reconciled. Take the case of the 1970s discussion that in large part saw ecological and economic objectives as incompatible. In contrast, the semantics of sustainability takes a long-term view and focuses on the conditions under which ecological, social, and economic objectives can be harnessed to mutually advance each other. Thus, the sustainability semantics is a powerful

heuristic for reforming social structures. This illustrates the constructive interplay of ideas and institutions that is necessary for the societal learning processes of new governance.

References

Baumol, William J. 2002. *The free-market innovation machine. Analyzing the growth miracle of capitalism*. Princeton and Oxford: Princeton University Press.

Beck, Ulrich. 2002. *Macht und Gegenmacht im globalen Zeitalter. Neue weltpolitische Ökonomie*. Frankfurt a.M.: Suhrkamp.

Becker, Gary S. 1976. *The economic approach to human behavior*. Chicago: University of Chicago Press.

Becker, Gary S. 1993. Nobel lecture: The economic way of looking at behavior. *Journal of Political Economy* 101: 385–409.

Beckmann, Markus. 2010. *Ordnungsverantwortung. Rational-Choice als ordonomisches Forschungsprogramm*. Berlin: Wissenschaftlicher Verlag Berlin.

Beckmann, Markus, and Ingo Pies. 2008a. Ordo-Responsibility—Conceptual reflections towards a semantic innovation. In *Corporate citizenship, contractarianism and ethical theory: Philosophical considerations of business ethics*, eds. Jesus Conill, Christoph Lütge, and Tatjana Schönwälder, 87–115. Aldershot and London: Ashgate.

Beckmann, Markus, and Ingo Pies. 2008b. Sustainability by corporate citizenship. *Journal of Corporate Citizenship* 31: 45–57.

Boatright, John R. 1999. Does business ethics rest on a mistake? *Business Ethics Quarterly* 9(4): 583–591.

Boatright, John R. 2009. The implications of the new governance for corporate governance. Paper prepared for the conference "Corporate Citizenship and New Governance," Lutherstadt Wittenberg, November 2009, included as Chapter 8 in this volume.

Buttkereit, Sören. 2009. *Intersectoral alliances: An institutional economics perspective*. Berlin: Wissenschaftlicher Verlag Berlin.

Coleman, James S. 1990. *Foundations of social theory*. Cambridge, MA: Harvard University Press.

Edwards, Michael, and Simon Zadek. 2003. Governing the provision of global goods: The role and legitimacy of nonstate actors. In *Providing global public goods*, eds. Inge Kaul, Pedro Conceição, Katell Le Goulven, and Ronald U. Mendoza, 200–224. New York: Oxford University Press.

Eigen, Peter. 2006. Fighting corruption in a global economy: Transparency initiatives in the oil and gas industry. *Houston Journal of International Law* 29: 327–354.

Frenkel, Stephen J., and Duncan Scott. 2002. Compliance, collaboration, and codes of labor practice: The Adidas connection. *California Management Review* 45(1): 29–49.

Friedman, Milton. 1962. *Capitalism and freedom*. Chicago and London: University of Chicago Press.

Friedman, Milton. 1970. The social responsibility of business is to increase its profits. *New York Times Magazine*, September 13, 32–33, 122–126.

Habisch, André, René Schmidpeter, and Martin Neureiter. 2008. *Handbuch corporate citizenship: Corporate social responsibility für manager*. Berlin and Heidelberg: Springer.

Hazlitt, Henry. [1964] 1994. *The foundations of morality*. New York: The Foundation for Economic Education.

Henderson, David. 2001. *Misguided virtue. False notions of corporate social responsibility*. Wellington: The Institute of Economic Affairs.

Henderson, David. 2004. *The role of business in the modern world—Progress, pressures and prospects for the market economy*. London: The Institute of Economic Affairs.

Hirsch, Bernhard, and Matthias Meyer. 2009. Integrating soft factors into the assessment of cooperative relationships between firms: Accounting for reputation and ethical values. *Business Ethics: A European Review* 19(1): 81–94.

Hollenhorst, Tirza, and Chris Johnson. 2005. *Tools for corporate social responsibility*. Atlanta: Forest Stewardship Council.

Homann, Karl. 1990. Wettbewerb und Moral. *Jahrbuch für Christliche Sozialwissenschaften* (31): 34–56.

Homann, Karl. 2002. *Vorteile und Anreize*. Tübingen: Mohr Siebeck.

Homann, Karl. 2003. *Anreize und Moral: Gesellschaftstheorie—Ethik—Anwendungen*. Münster: LIT.

Homann, Karl, and Ingo Pies. 1994. Wirtschaftsethik in der Moderne: Zur ökonomischen Theorie der Moral. *Ethik und Sozialwissenschaften (EUS)* 5(1): 3–12.

Jensen, Michael C. 2002. Value maximization, stakeholder theory, and the corporate objective function. *Business Ethics Quarterly* 12(2): 235–256.

Lin-Hi, Nick. 2009. *Eine Theorie der Unternehmensverantwortung. Die Verknüpfung von Gewinnerzielung und gesellschaftlichen Interessen*. Berlin: Erich Schmidt.

Lütge, Christoph. 2005. Economic Ethics, Business Ethics and the Idea of Mutual Advantages. *Business Ethics: A European Review* 14(2): 108–118.

Lütge, Christoph. 2007. *Was hält die Gesellschaft zusammen?* Tübingen: Mohr Siebeck.

Mackey, John. 2006. Winning the battle for freedom and prosperity. *Liberty* 20(6): 17–22.

Matten, Dirk, and Andrew Crane. 2005. Corporate citizenship: Toward an extended theoretical conceptualization. *Academy of Management Review* 30(1): 166–179.

Mises, Ludwig von. [1949] 1996. *Human action*. Irvington: Foundation for Economic Education.

Mises, Ludwig von. [1951] 2008. *Profit and loss*. Auburn, AL: Ludwig von Mises Institute.

Moon, Jeremy, Andrew Crane, and Dirk Matten. 2005. Can corporations be citizens? Corporate citizenship as a metaphor for business participation in society. *Business Ethics Quarterly* 15: 429–454.

Oosterhout, Hans van. 2005. Corporate citizenship: An idea whose time has not yet come. *Academy of Management Review* 30(4): 677–681.

Palazzo, Guido, and Andreas G. Scherer. 2006. Corporate legitimacy as deliberation: A communicative framework. *Journal of Business Ethics* 66: 71–88.

Pies, Ingo. 2008. *Wie bekämpft man Korruption? Lektionen der Wirtschafts- und Unternehmensethik für eine "Ordnungspolitik zweiter Ordnung*". Berlin: Wissenschaftlicher Verlag Berlin.

Pies, Ingo. 2009a. *Normativität als Heuristik. Ordonomische Schriften zur Wirtschaftsethik*. Berlin: Wissenschaftlicher Verlag Berlin.

Pies Ingo. 2009b. *Moral als Produktionsfaktor. Ordonomische Schriften zur Unternehmensethik*. Berlin: Wissenschaftlicher Verlag Berlin.

Pies, Ingo, Markus Beckmann, and Stefan Hielscher. 2009a. Sozialstruktur und Semantik—Ordonomik als Forschungsprogramm in der modernen (Welt-)Gesellschaft. In *Moral als Heuristik. Ordonomische Schriften zur Wirtschaftsethik*, ed. Ingo Pies, 282–312, Berlin: Wissenschaftlicher Verlag Berlin.

Pies, Ingo, Stefan Hielscher, and Markus Beckmann. 2009b. Moral commitments and the societal role of business: An ordonomic approach to corporate citizenship. *Business Ethics Quarterly* 19(3): 375–401.

Pies, Ingo, Markus Beckmann, and Stefan Hielscher. 2010. Social value creation, management competencies, and global corporate citizenship—An ordonomic approach to business ethics in the age of globalization. *Journal of Business Ethics* 94(2): 265–278.

Popper, Karl R. [1945] 1966. *The open society and its enemies*, Vol. 2. New York: Hegel and Marx, Routledge.

Scherer, Andreas G., and Guido Palazzo. 2007. Toward a political conception of corporate responsibility: Business and society seen from a Habermasian perspective. *Academy of Management Review* 32(4): 1096–1120.

Scherer, Andreas G., and Guido Palazzo. 2008. Globalization and corporate social responsibility. In *The Oxford handbook of corporate social responsibility*, eds. Andrew Crane, Abagail McWilliams, Dirk Matten, Jeremy Moon, and Donald Siegel, 413–431. Oxford: Oxford University Press.

Scherer, Andreas G., Guido Palazzo, and Dorothée Baumann. 2006. Global rules and private actors: Toward a new role of the transnational corporation in global governance. *Business Ethics Quarterly* 16(4): 505–532.

Schönwälder-Kuntze, Tatjana. 2008. "Corporate citizenship" from a (systems)-theoretical point of view. In *Corporate citizenship, contractarianism and ethical theory. On philosophical foundations of business ethics*, eds. Jesus Conill, Christoph Lütge, and Tatjana Schönwälder-Kuntze, 49–65. Aldershot and London: Ashgate.

Suchanek, Andreas. 2007. *Ökonomische Ethik*. Tübingen: Mohr Siebeck.

Suchanek, Andreas, and Nick Lin-Hi. 2007. Corporate Responsibility in der forschenden Arzneimittelindustrie. *Jahrbücher für Nationalökonomie und Statistik* 227(5+6): 547–562.

Sundaram, Anant K., and Andrew C. Inkpen. 2004. The corporate objective revisited. *Organization Science* 15(3): 350–363.

Vanberg, Viktor J. 2007. Corporate social responsibility and the "game of catallaxy": The perspective of constitutional economics. *Constitutional Political Economy* 18(3): 199–222.

Waldkirch, Rüdiger W. 2001. Prolegomena for an economic theory of morals. *Business Ethics: A European Review* 10(1): 61–70.

Waldkirch, Rüdiger W., Matthias Meyer, and Karl Homann. 2009. Accounting for the benefits of social security and the role of business: Four ideal types and their different heuristics. *Journal of Business Ethics* 89: 247–267.

Index

A
Actor, 56, 60, 69, 126, 172, 174, 178, 185
Administration, 3, 133, 137, 143–144, 172–173
Agent, 60, 67, 69, 73, 101, 104, 110, 120, 183, 185
Alliance, 2, 109, 141, 143, 181
Analogy, 2, 4, 185
Approach, 2–3, 5–6, 9, 13, 20–21, 23, 25, 32, 35, 48–50, 56, 60–61, 66, 68, 75–76, 78, 82–83, 85, 92–97, 101, 103, 110, 112, 118, 120, 127–129, 137, 142, 156–157, 173, 174–185
Autonomy, 60, 66, 87, 138

B
Behavior, 24, 35, 61, 67, 70, 75, 81, 87–88, 94, 103, 149, 151, 163, 165, 175–176, 179–180
Board, 5, 20, 48, 50, 62, 109, 136, 147–165
Business case, 4, 22–24, 26–30, 91–113
Business ethics, 2–5, 7, 12, 35–36, 40, 48, 60–64, 68, 70, 72, 81, 84–86, 89, 93, 110, 112–113, 127, 129, 134, 175, 177–185
Business firm, 1–4, 111, 172–176, 180, 183–185
Business strategy, 4, 24, 28, 30

C
Capacity, 8–9, 25, 27, 32–34, 43, 59–61, 68, 73, 79, 86–89, 99, 184
Capital, 5, 21, 23, 25, 34, 37, 112, 121, 135–136, 139–143, 149
Character, 4, 60–61, 66–67, 71, 73, 155–156, 178, 185
Child labor, 1
China, 11–12, 16
Civil society, 2, 4, 11, 24–25, 29, 31, 35–37, 43, 54, 92, 100, 110, 112, 117, 133, 138, 172–173
Clarification, 3, 78, 84
Commitment, 23, 25, 27, 29, 33, 42, 47, 55, 59–61, 65–67, 72, 75–77, 80–84, 87–88, 90, 102–109, 111–112, 119, 121–122, 124, 127–128, 179
Commitment service, 105, 107, 112
Communication, 13, 21, 23, 26–27, 33, 36, 59, 63, 77, 80–81, 87–88, 94, 109, 137, 175
Community, 10, 13–14, 19–20, 30–31, 33, 42, 47, 49, 59–60, 66, 68, 70, 74, 77, 82, 104–106, 121, 174, 179, 185
Company, 1, 3–5, 11, 21–37, 47, 60, 62, 64, 69–71, 73–84, 87, 89–90, 109, 111, 118–125, 127, 129–130, 139, 148, 152, 154, 156–158, 160, 162–163, 176, 178, 180, 182
Compatibility, 36, 156, 165, 178, 183
Compensation, 81, 148, 150–152, 154, 159–164
Competition, 1–2, 4, 23, 29, 40–41, 46, 72, 77, 95, 106–108, 127, 130, 174–175, 180, 184
Compliance, 9, 12, 40, 42–44, 47–48, 51–54, 61, 74–75, 84–85, 87, 89, 151, 157–159, 162
Concept, 2–4, 11, 20, 21, 23–24, 29, 36, 47, 54–55, 59–62, 64–78, 80, 84–87, 89, 92–93, 96–97, 100–101, 110, 134, 172–173, 183, 185
Conceptualization, 59, 171–186
Conflict, 9, 11, 36, 67–68, 79–80, 82–83, 88, 94, 102, 127–129, 134, 178, 183
Constitution, 5, 20–21, 134, 153, 185
Contract, 48, 69, 107–108, 122, 136, 140, 143, 148, 150, 155, 158

I. Pies, P. Koslowski (eds.), *Corporate Citizenship and New Governance*, Ethical Economy. Studies in Economic Ethics and Philosophy 40, DOI 10.1007/978-94-007-1661-2, © Springer Science+Business Media B.V. 2011

Cooperation, 3–4, 21, 25–26, 33–34, 42, 60, 66, 73, 86, 94–96, 102–103, 112, 118–123, 127, 129, 154, 172–173, 178, 181, 184–185
Corporate actor, 56, 185
Corporate citizenship, 1–5, 19–37, 39–56, 59–90, 93, 110–112, 134–135, 137, 142, 172–174, 184–185
Corporate firm, 175
Corruption, 1, 9, 12, 60, 95, 112, 117, 180–181
Cost, 27, 32, 35, 45, 47–48, 50, 60, 88, 102, 106–107, 109, 124–125, 127, 139, 144, 150, 157, 165, 176, 178
Coverage, 150, 160, 163, 165
Credible commitment, 105, 107
Criticism, 5, 14, 63, 65, 68, 117, 179, 182
CSR, 3–4, 10, 13, 15, 20–21, 24, 27–28, 35, 42, 47, 49, 55, 118–119, 130, 173
Culture, 7, 12, 28, 30, 35, 71, 74, 84–85, 89, 129

D

Debate, 1–3, 15, 69, 91, 93, 156, 175, 182, 185
Decision, 5, 10, 17, 25, 30, 40, 43, 45, 47–49, 51, 53, 56, 60, 66, 73, 77–78, 80–85, 88–90, 128, 134, 136, 140–145, 148, 154, 161, 163, 165, 180
Deductible, 5, 147–165
Deficit, 3, 7, 24, 182
Deliberation, 2, 66
Demand, 67, 72, 81, 104, 107, 117, 129, 139, 144, 151, 153, 164, 173
Democracy, 2, 134
Development, 1, 5, 10, 12, 16–17, 19–20, 25, 28, 31–34, 40–45, 47–55, 63–64, 71–73, 75, 80, 87–88, 91, 100, 110, 133, 135, 138, 140–142, 145, 156, 162, 172–173, 185
Dignity, 65–66, 77
Dilemma, 4–5, 7–17, 25, 36, 62, 78–80, 82–85, 92–93, 101–110, 118–122, 130, 175, 180–181, 184
Discourse, 1–2, 92–94, 96, 98, 100–101, 112, 137, 174–176, 181–182, 185
Discussion, 2, 14–15, 17, 19–20, 26, 31, 36, 41, 45, 49, 82, 84, 87–88, 93, 100, 104, 110, 118–119, 137, 160–165, 172, 175, 183, 185
Disposition, 66–67, 70–71
D&O, 5, 147–166

E

Eco-Efficiency, 32–33
Economic ethics, 3, 5, 93, 118, 128, 174–179, 183–186
Economics, 20, 96–97, 128, 134, 138, 183
Efficiency, 32–33, 42, 56, 73, 77, 128, 136–137
Entrepreneurship, 37, 91–112
Environment, 1, 21–23, 25, 27, 30, 32, 36, 47–48, 63, 72–73, 77, 85, 110, 118, 130, 135, 138–140, 142–145, 149, 182
Equity, 48, 135–136, 140
Ethics
  individual, 61, 64–76, 112
  office, 87
  organizational, 84, 184
Europe, 3, 10–11, 13, 19–37, 104, 109
European Union, 10, 13
Extractive companies, 10

F

Factor of production, 4, 6, 117, 130, 175, 178–179, 183
Fairness, 43, 61, 66, 80, 83–84, 88, 136
Flexibility, 66, 82, 153, 156, 161, 164
Foundation, 9, 24, 29, 33–34, 41, 44, 59–61, 66, 73, 84, 87–88, 90, 92, 95, 105, 142, 175
Framework, 1, 4, 8, 10, 14–16, 26, 28, 36, 47, 54–55, 61, 70, 85–86, 88, 92, 94, 96–97, 108, 134, 137, 156, 161, 173–178, 180–181, 185
Function, 14, 25, 43, 51, 82, 133–134, 162, 176, 180, 183

G

Game
  basic, 92, 94–98, 100–101, 103–104, 112, 180–182
  meta, 94–98, 100–101, 112, 181–182
  theory, 94
GCGC, 5, 148, 153–158, 160–164
Germany, 3, 18–21, 31, 33, 39, 71, 109, 119, 127, 148, 154, 157, 160
Globalization, 1, 5, 7–8, 13, 20, 29, 47, 118, 130, 139, 143–144, 171–172, 182
Governance
  corporate, 3, 5, 12, 40, 47–49, 133–145, 148–149, 152–154, 157, 160–161, 164–165
  new, 1–6, 39–56, 93, 110–111, 133–145, 147, 171–186
  responsible, 147–166

Government, 1, 8–11, 13–17, 20, 25, 41, 43–49, 53–55, 97, 112, 133–134, 136–139, 142–144, 153–154, 157, 161, 172–173, 179–180, 182
GRI, 24, 50
Growth, 23, 27, 45, 95, 139, 160, 176

H
Human capital, 5, 121, 139, 141–143
Human rights, 3, 7–17, 28, 46, 49, 54–55, 63

I
Idea, 41, 63–64, 67–69, 70, 73–74, 83, 92, 99–102, 128, 134, 163–164, 172, 175–178, 181–182, 185
Identity, 24, 37, 51, 60, 64, 66–67, 70, 72–73, 76–77, 85, 87
Impact, 11–12, 17, 21–25, 32–35, 52–53, 85–86, 100–101, 111–112, 120, 122, 141, 163, 165
Implementation, 20, 23–25, 30, 40, 42–45, 50, 53, 74, 87, 104, 110, 117, 133, 156, 172, 174
Incentive, 94–95, 102–103, 106–107, 118, 120–121, 126, 148–149, 159, 163, 174–176
Inclusion, 29, 35, 99
Individual, 4, 13–14, 33, 52, 61–62, 64–75, 77–78, 84–85, 95–96, 100–110, 120–122, 129, 154–156, 160, 173, 176, 180, 184–185
Innovation, 3–5, 23, 25, 27, 31, 54, 92–93, 96, 98–100, 104, 108–110, 112, 117, 119, 121, 123, 126, 139, 141–142
Institution, 4, 10, 19–20, 25, 33, 47, 64, 86, 92–96, 118, 138–139, 174–175, 177
Insurance, 5, 118–119, 122–124, 126–127, 130, 147–155, 160, 163–165
Integrity
  corporate, 60, 74–75, 77–78, 87–90
  organizational, 4, 59–89
Interaction, 21, 87, 92, 95–97, 102–103, 106–107, 118, 122, 127, 178, 185
Interdisciplinary, 2–3, 20
Investment, 9–10, 16, 19, 23, 34–35, 45, 47, 71, 121, 125, 135, 140, 179
ISO, 4, 12, 14, 44, 46, 49–54

J
Judgment, 4, 60–62, 67–68, 71, 78, 84–89, 155
Justice, 15, 61, 80–81, 84, 112, 151–153, 165, 179, 185

L
Labor, 1, 3–4, 9, 117, 139, 141, 143, 164, 172, 180
Leadership, 4, 17, 27, 60, 62, 69, 72–75, 78–85, 88–89
Legitimacy, 2, 4, 40–41, 43–47, 49, 51–53, 55, 63, 134, 137–138, 142, 173, 179
Liability, 5, 53, 147–152, 154, 160, 165
License to operate, 178
Litigation, 147–152, 165

M
Majority, 158–159, 162, 164
Management
  board compensation, 148, 150, 159–160, 162, 164
  resource, 4
Manager, 3, 48, 61, 69, 71, 82, 87, 104, 123
Mandate, 10, 161, 175–178, 180, 184
Market
  competition, 1–2, 4, 174–175, 184
  economy, 1, 22–23, 36, 111, 128, 153, 183
Mechanism, 16, 106, 122, 136–137
Metaphor, 3, 73–74, 79, 172
Method, 30, 32, 86, 99, 121–122
Moral commitment, 60, 66, 102, 124, 179
Morality, 4, 47, 55, 61, 65–67, 69, 84–85, 93, 112, 117–130, 174–175, 177, 179–180
MSI, 13–14
Mutualistic, 179

N
Nation, 1, 8, 45, 182
Network, 11, 33, 76, 139
NGO, 15, 52, 55
Norm, 8, 50, 66, 151, 154–157, 162–163
Normativite, 5, 15, 21, 54–55, 93, 95, 112, 137–138, 155, 173–174, 185

O
Objective, 22, 28, 30, 41, 44, 47–51, 69, 75, 79–80, 89, 95, 97, 104, 109, 111–112, 125–126, 151, 174, 183, 185
OECD, 10, 14, 17, 49
Ordonomic(s), 2–5, 91–112, 118, 120, 128–130, 171–186
Ordo-responsibility, 2, 6, 180–183
Organization
  business, 63, 134, 138
  integrity-based, 76
  international organization for standardization, 44, 46, 52, 54
Orthogonal position, 128

P
Person, 27, 65–68, 159, 185
Philosophy, 20, 27, 61–62, 65–66, 80, 129, 155
Policy, 7–17, 25, 62–63, 77, 79, 82, 119, 122, 133, 138, 148–150, 152, 154–155, 158, 160–162, 172
Political role, 1–7, 24, 36–37, 39, 174, 184
Politics, 1, 24–25, 36, 61, 63, 95
Pollution, 33–34
Population, 29, 74
Poverty, 1, 7, 31, 97
Price, 21, 105–108, 139–141, 143–144, 174
Principal, 4, 101, 120
Principle, 9–10, 12, 49, 51, 54, 60–65, 67–68, 70, 72–74, 76–77, 85–86, 88, 104, 107, 122, 148, 150, 153, 155–156, 176–177, 179, 183
Private, 2–4, 9, 29, 36–56, 110, 112, 127–128, 134, 136–138, 153, 172, 178, 181
Private regulatory regimes, 3–4, 39–56
Process
  ethics, 3, 6, 175, 180–186
  societal rule-setting, 2, 7, 39, 181
Production, 3–4, 8–9, 23, 29, 32, 46–47, 55, 107, 117–130, 134–136, 141, 143, 175, 178–179, 183
Profit, 35, 41, 62–63, 75, 98, 100, 104, 111–112, 123, 125–129, 136, 142, 176–185
Public, 1–2, 5, 11–12, 21, 26–27, 29, 31, 33, 36–37, 40–56, 62–63, 67, 75, 78, 86, 88, 94, 109, 112, 122, 127–129, 134–137, 143–144, 152, 157, 162, 164, 172–173, 175, 181–182

R
Ranking, 3, 21–37
Rational-choice, 2, 5, 92, 94–95, 118, 175
Rationality, 60, 128, 173
Reason, 26, 45, 48, 51–52, 63, 67–68, 70–71, 83, 85, 99, 106, 134–135, 137, 143, 150, 154, 160, 162–163, 175, 179
Recommendation, 138, 148, 153–163
Reflection, 7, 59, 86, 156
Regulatory regimes, 3–4, 39–56, 165
Reputation, 16, 35, 42, 74, 77, 109, 140, 162, 165, 178, 180
Research, 3, 19–21, 23, 32–33, 37, 39, 41, 55, 69, 92–93, 138, 148, 173–174
Respect, 8, 10, 15–17, 25–26, 29–30, 37, 43–44, 46, 54, 63–65, 67, 77, 81, 84, 88, 90, 153, 185
Right(s), 3, 5, 7–37, 46, 49, 54–55, 63, 73, 88–89, 129, 133–137, 139, 142–145, 150, 160, 172–173
Risk management, 3, 5, 117–130, 148–149
Risk protection, 140
Rule-discussion, 14–15
Rule-finding, 2, 92, 94, 96, 176, 181–182, 184–185
Rule-giving, 1
Rules, 1–2, 5, 13, 23–24, 37, 40–45, 47, 49–50, 56, 70, 75, 84–85, 87, 89, 92–96, 100–102, 110–112, 133–136, 149, 153, 155, 161, 172–173, 175, 177, 180–182, 184
Rule-setting, 2, 4, 7, 15, 39, 92, 94–95, 101, 112, 176, 181–182, 184–185
Rule-taking, 1, 110, 180

S
Sacrifice, 129, 179
Sector, 9, 14–15, 19, 25–26, 31, 43–44, 49–52, 109, 153, 156–157, 163, 172, 180–181
Semantic(s), 4, 92–94, 96, 98–101, 110, 112, 118, 175, 179, 181, 184–185
Service, 27–28, 46–48, 62, 76, 97–99, 103–108, 111–112, 122, 127, 139, 144, 160, 179
Shareholder, 5, 23, 48, 63, 69, 86, 90, 111–112, 119–120, 136, 140–142, 144–145, 150–154, 160
Social case, 4, 22, 24–27, 31–34, 91–113
Social entrepreneurship, 4, 37, 91–113
Social ordering, 40
Social policy, 25, 119, 122
Social structure, 93–96, 101–103, 106, 112, 118, 128, 175, 179, 181, 184, 186
Society, 1–2, 4, 11, 14, 22–33, 35–37, 43, 47, 49, 54, 60–63, 66, 69, 72, 81, 86, 89, 92–93, 95, 97, 99–100, 110–112, 117, 127–129, 133–134, 138, 143–144, 161, 172–177, 180, 182–183
Soft(er) law, 153, 156, 161
Stakeholder, 4–5, 8–9, 11–14, 20, 23, 29–31, 35–36, 40, 42–43, 47–52, 54–55, 59, 61, 63, 73–74, 76–77, 84, 86, 88–89, 104, 107, 110–112, 117–118, 120, 122, 134, 147, 153, 164, 177–178, 182, 184–185

State, 1–2, 4, 8–17, 24–28, 33, 37, 40–45, 54, 56, 63, 65, 69, 110, 133, 136–137, 144, 172–173, 180
Stewardship, 4, 23, 26–27, 33–34, 42–44, 46, 48, 50, 52, 172
Strategic management, 26–30, 182
Strategy, 4–5, 20, 23–24, 28, 30, 34, 36, 47, 62–64, 73–76, 79–84, 86–89, 91, 93, 100, 104–105, 109–110, 118, 122, 124, 129–130, 139, 141, 143–145, 179, 184
Supervision, 5, 147–149, 155
Supply, 8–9, 12, 17, 110
System ethics, 184

T
Theorizing, 2
Transparency, 5, 9, 14, 22–23, 26–27, 34–37, 54, 77, 112, 117, 149, 153–154, 160, 172, 181
Trustworthiness, 60, 66, 178

U
United Nations, 8, 10, 12–16, 42, 45, 49, 54
USA, 9–11, 45, 133

V
Value chain, 8
Value creation, 2, 4–5, 20, 22–24, 27, 47, 92–93, 99, 107, 112, 117–120, 126, 128, 130, 139, 160, 174–185
Virtue, 59–61, 64–67, 70, 73–74, 77, 84–85, 87, 152, 156, 185

W
Wealth, 99, 136, 139, 141–145
Welfare, 118–120, 122, 124, 126–127, 129, 136, 173
Win-lose, 99–100, 110, 128, 179
Win-win, 2, 36, 92–93, 97–112, 120, 127–129, 174–176, 178–179, 182–184
Worker protection, 42