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► **To cite this version:**

Benoît Pigé. Institutions and corporate governance, integrating stakeholders' expectations. 2014.
hal-04642878

HAL Id: hal-04642878

<https://hal.science/hal-04642878v1>

Preprint submitted on 10 Jul 2024

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Institutions and corporate governance, integrating stakeholders' expectations

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I am very grateful to Kenneth Euske for his careful review of the manuscript.

Abstract

Due to imperfect and incomplete institutions, firms have to consider the externalities they generate. The firm's residual risk is not restricted to shareholders. We propose to define stakeholders as economic actors who simultaneously hold a resource used by the firm and are exposed to the risk of the firm's activity. Risk exposure is a dynamic concept that results from institutions and corporate governance mechanisms. This definition has normative, instrumental and positive implications since it helps to define and to identify the analysis of policies that adapt stakeholders' compensation or insurance to their risk exposure and that contribute to the long-term involvement of stakeholders. One can argue that corporate governance voice mechanisms ought to favor the representation of stakeholders according to their risk exposure level. Moreover, with this model we contribute to fulfilling the gap between an economic approach of the firm based on institutions and the expectations for sustainable development.

Keywords: freedom, ethics, corporate governance, moral values, top executives.

Togo, December 2010 and 2011, the main road from Lomé to Cotonou that follows the seaside crosses the industrial park of Lomé's port. The road is jammed and the air is polluted with exhaust fumes. On the right side the docks; on the left side industrial sites; among them, CimTogo, a subsidiary of HeidelbergCement. Outside CimTogo's grinding plant, there is a layer of dust; the factory itself seems covered by a mantel of dust¹. Local university students claim that pollution is high and that factory workers and neighbors suffer from the inhaling of

¹ The picture of CimTogo plant in the web site (Heidelberg, 2008 : 22) is a reminiscent of the Potemkin villages or of the most contemporaneous custom of window-dressing.

BP, le 21/08/2014

cement dust. Meanwhile, HeidelbergCement claims to be the leading cement company in West Africa². It also claims to assume high social and environmental responsibility: “In our day-to-day-work, we apply the highest standards in quality, environmental protection, and occupational safety. (...) Social responsibility has a long tradition and is ranked highly at HeidelbergCement. We play an active role in the cities and communities where our production sites are located. We maintain an open dialogue with the neighbours, the local citizens and politicians, and any other stakeholders.”³

In developed countries, the industrial landscape observed in Togo was the norm a century or fifty years ago. Since then, environmental and social standards have been enacted and enforced. Firms have had to comply. In the neoclassical economic theory, norms and standards are supposed to correct externalities so that market prices reflect all the information about resources consumption. However, in the meantime, there is a growing pressure to attain higher levels of profit. Norms and standards have to be respected but profit has to be maximized, and profit results from the use of market prices not from moral values (Freeman, 1962). Therefore, if a country has fewer exigencies as regard norms and standards, firms cannot have a higher moral agenda or they would lose profits. This is the neo-classical model and it is widely applied in modern firms. Moreover, some institutions are dedicated to enforce this model. For instance, distribution of stock options to the firm’s top executives leads to a strong focus on the market value of the firm. Therefore, questions are whether “past policy initiatives to encourage collective action that were based primarily on externally changing payoff structures for rational egoists may have been misdirected – and perhaps even crowded out the formation of social norms that might have enhanced cooperative behavior in their own way.” (Ostrom, 2000: 154).

We address the question of the firm’s economic, social and environmental responsibility. We argue that due to imperfect and incomplete institutions, firms have to consider the externalities they generate. Since formal contracts cannot provide adequate solutions for all externalities, firms have to rely on informal engagements and social norms that need to be meshed with corporate governance mechanisms. Therefore, stakeholders’ involvement in a firm’s corporate governance should be related to the stakeholders’ net risk exposure to the firm’s activity. This article contributes to the working out of a stakeholder

Similar stories can be drawn from various multinationals that exhibit strong ethical involvement. See for example the analysis of Shell’s case in the 1990s (Donaldson and Dunfee, 1999).

² http://www.heidelbergcement.com/global/en/company/group_areas/africa_medbasin/africa.htm. Access Jun. 26, 2013.

³ http://www.heidelbergcement.com/global/en/company/about_us/profile.htm#Sus. Access Jun. 26, 2013.

BP, le 21/08/2014

theory (Freeman, 1984; Donaldson and Preston, 1995, Parmar et al., 2010). It relies on different approaches to develop a theoretical path toward a stakeholders' definition. The article adopts the following path of demonstration.

First, we observe that institutions (considered as rules: Ostrom, 1986) not only are imperfect (they do not encompass all externalities), but they are also conflicting and they are permeable to the players' acting. Consequently, institutions are not the rules of the games that ought to be independent of the players; players can influence them. Firms can intent to play a game by changing the rules or by applying only the rules that support it. Economic actors can arbitrate between competing inside a set of institutions and competing by modifying or contesting the current institutions.

Second, we challenge the neo-classical economic assumption that shareholders are the only economic actors that bear the firm's residual risk and that all the economic actors are appropriately insured or compensated for the risk they support (Fama and Jensen, 1983). Financial economic theory considers that most economic actors are risk adverse. However, it supposes that formal contracts can rightly compensate or mitigate this risk exposure. Since risk exposure is usually very contingent on specific situations, informal contracts that tie economic and social dimensions (Ostrom, 2000) can adequately provide sustainable solutions to risk exposed economic actors. Firms are not only a nexus of formal contracts. They also encompass informal contracts (Jones, 1995) that mix a complex set of incentive, compensative, and protective schemes (Fort and Noone, 1999). To grasp these schemes, *we propose to define stakeholders as economic actors who simultaneously hold a resource used by the firm and are exposed to the risk of the firm's activity.*

Third, we suggest that the classical distinction between voice mechanisms and exit mechanisms (Hirschman, 1970) is fundamental to elaborate a set of corporate governance institutions that would permit the development of economically and socially sustainable firms. In the same way as democracy cannot be reduced to universal voting right but needs to rely on a complex set of balanced local, national, and international institutions (Aron, 1957), so sustainable development has to rely on economic actors that adopt not only sustainable strategies but that conform to sustainable principles in their own structure. Corporate governance cannot be restricted to the mechanisms of maximizing the firm's market value and efficiency; corporate governance is the whole of mechanisms that allow stakeholders' representation, stakeholders' information, and stakeholders' participation to the firm's definition of the objectives to be pursued.

BP, le 21/08/2014

This article does not intent to define precisely the set of corporate governance's mechanisms that should be applied. We restrict it to proposing an approach to the firm's part in a globalized human society where public governments do not have the capacity to arbitrate between conflicting expectations from their own constituents and constituents from other territories all across the earth. The concept of nation, that was enacted in the 19th century and that equalized the public government with the game ruler, is no more adequate. In the 21st century, in a globalized economic world, public governments are one actor among many others; the rules of the economic game are more complex since each economic actor can favor the adoption of specific rules that will be a competitive advantage in the economic competition.

We suggest that institutions can be grasped at two different levels. One level considers firms as autonomous actors. Institutions are laws, customs, culture ... that set the rules for the economic competition between the firms. These are the classical economic assumptions. The other level is the firm's level. Institutions integrate corporate governance mechanisms that regulate the game inside the firm. They also encompass legal, contractual, usual, cultural rules and they apply to all the economic actors that have a stake in the firm's activity, those named stakeholders. Classic economics dissociate these two levels⁴. Economic studies usually hypothesize that the other level of institutions is perfectly fitted to its task and is adequately operating.

We consider that a stakeholder approach can be theoretically grounded only by incorporating the two levels of institutions (North, 1981). Stakeholders are the object of corporate governance mechanisms since other institutions cannot guarantee that they are adequately compensated or insured against the risk of the firm's activity. A stakeholder theoretical approach of the firm is fundamental in the 21st century, not only because the corporate governance model of shareholding is no more than a highly simplified model of the firm; but also because institutions surrounding corporate governance cannot be considered as complete and perfect. Due to the globalization of the world, nations are no longer the referees that enforce and regulate rules of the game; nations are players in the game. Global economic competition is more seemingly a collective sporting competition, where each actor would claim to play with his or her own rules: football, soccer, baseball, basketball...

Therefore, two trends exist, one toward globalization and isomorphism (DiMaggio and Powell, 1983), and the other toward differentiation and local cultures. This article

hypothesizes that these two trends need to be addressed simultaneously and that corporate governance cannot be studied independently from existing institutions in a territory.

1 Institutions, regulation and standards

Regulations, norms and standards are designed to limit or compensate externalities (Coase, 1960). Ideally, they would delimit the playing field (Demsetz, 1967). Economic actors are free⁵ to act according to their wishes so long as they respect the regulations, the norms, and the standards that set the rules of the game. However, this utopian situation is neither realized nor desirable for four different reasons. First, some regulations, norms and standards may not be enforced. Second, they may be conflicting. Third, they are not necessarily representative of the common good, they may also be used to address a given situation, to impede the arrival of competitors, or to give an advantage to a specific actor. Fourth, if they were perfectly respected and if they were covering all the cases of externalities, they would destroy human ontological freedom.

1.1 Some formal institutions have failed to be applied and enforced

Some countries are notoriously known to have failed to apply and enforce legal institutions. More generally, there are a number of territories of different size and legal statute where legal institutions are ignored. These territories can be in remote regions (for instance, parts of South or Central America, Africa or Asia, where guerrillas or war lords have established their own institutions) or some districts of big international cities (e.g., Marseille in France or Mexico D.F. with local mafias). The classic solution is to reinforce national and international norms and standards and to establish enforcement agencies. A simple method seems to disseminate the norms and standards already existing in developed countries. Unfortunately, if local economic and social actors are not taking part in the regulative process, those norms and standards are due to fail (Kashaigili, Kadigi, Sokile and Mahoo, 2003).

More generally, many externalities are not regulated. Market institutions were initially designed for two parties of equal power in the hypothesis of perfect markets. Since transactions involve power struggles (Weber, 1947), not just agreements among a variety of different products or services, institutions have to compensate for the disequilibrium.

⁴ For Friedman (1962), this possibility results from the perfect operation of markets that helps integrate the diversity of everyone's aspirations.

⁵ Sen (1999) has extensively discussed this necessity of freedom to enter markets and to interchange.

1.2 *Institutions may be conflicting*

Institutions are always conflicting. For instance, in the Bible, the Decalogue can be assessed as one of the most old-fashioned institutions to which we can refer. Among the Ten Commandments are “Thou shalt not commit murder. Thou shalt not commit adultery. Thou shalt not steal.” (Deuteronomy 5, 17-19). Of course, to limit theft or to forbid murder, human punishments are necessary. At least two books of the Bible (Leviticus and Deuteronomy) are devoted to describe how to legally proceed with all possible cases of conflicting institutions. Nevertheless, solutions are far from being perfect as was underlined in the Gospel (Luc 13, 10-16) where Jesus infringes upon the Shabbat law to cure a diseased woman.

In the modern world, causes of institutions’ conflicts are far more numerous. A main reason is the multiplicity of legacy (Platteau, 2009). In old times, specific legislators had all the authority to edict rules, laws, standards and norms. In those times, they were forced to try to give coherence to or explain their various enactments. Today, given the great complexity of modern world, this is far from easy. For instance, rules can be designed to promote economic growth, while other rules are enacted to promote social protection or pollution’s limitation. These rules can be conflicting; emblematic cases are oil exploration in Alaska or bituminous sands’ exploitation in Alberta. One rule can favor exploration and exploitation while another can restrict or impede such exploration or exploitation.

Nevertheless, conflicting institutions emanating from a single hierarchized normalizer is far from being the main problem. More complex are the conflicts resulting from the rules, laws, standards, and norms emanating from diverse and competing normalizers. In a globalized world, many legislatures concur to set their own rules, and it is sometimes difficult to define a hierarchical predominance (Okpala, 1979). Conflicts do not only emerge from the formal hierarchy of laws, standards and norms, they first emerge from the competing legitimacies of normalizers (Fallers, 1955; Rosen, 1978). As regard international American firms, conflicts may arise between the standards and norms enacted by the US federal government and those enacted by international organizations or foreign governments. All firms are confronted with conflicting imperatives emanating from competing international agencies (Savall and Zardet, 2013).

Alongside formal institutions, conflicts may also arise from informal institutions like customs or religious beliefs (Torre-Castro and Lindström, 2010). For instance, if a social norm prohibits or enforces a specific custom while a law takes the opposite stance. Should the firm enforce the law or should it comply with the social norm? As a specific case, if a law prohibits the employment of employees having specific customs; should the firm comply with

BP, le 21/08/2014

the law if there is a strong social norm that justifies these customs; or what about the laws of racial segregation? Firms are integrated in human communities. Therefore, firms cannot get free of ethical questions arising from institutions' conflicts or negative externalities. Institutions interrelate with each other. "We need to carefully state which other rules are in effect which condition the relationships produced by a change in any particular rule" (Ostrom, 1986: 16). The multiplication of formal institutions may not be the best way to limit and constrain firms' externalities (Bessire, Cappelletti and Pigé, 2010). This multiplication can also concur to an increasing of firms' externalities.

1.3 *Institutions can be diverted toward specific interests*

Some actors may influence the enactment of regulations. For instance, while it is recognized that global warming is partly due to private transport, gasoline has a much smaller taxation in the United States than in Europe due to the lobby of both major petroleum companies and American Automobile Association. In the same way, the legislation on gas drilling is very divergent in the United States and in European countries. Externalities are not necessarily regulated and market prices do not incorporate all the relevant economic and social information since part of the information is not transcribed in a market price.

A few firms may dominate some market segments. Then, these firms have a strong interest in lobbying legislators and normalizers to enact regulations and standards that not only protect their rights but also extend their ability to increase their profit. Institutions may also be progressively modified to favor the economic actors that infringe upon the economic rules of a competitive market. Bribery may be the result of a competitive game where institutions have been deprived of their ethical dimension (Ufere, Perelli, Boland and Carlsson, 2012).

In neo-classic economics, shareholders are supposed to receive residual revenues to compensate for the residual risk they support. In 2006 and 2007 when top executives of Lehman Brothers decided to invest in subprimes, they expected a huge reward for taking positions when prices were very low due to the market' contraction (Valukas, 2010). Top executives decided that the reward was worth the risk and they implemented a highly risky highly profitable strategy. In September 2008, when Lehman Brothers was no longer able to meet its refinancing obligations, classic economic theory implied that shareholders should have assumed the firm's failure. They did it. Shares lost all value. Unfortunately, the extent of the firm's failure bypassed its capital and consequences extended far beyond its shareholders. Some employees lost their jobs, most saw their remuneration plunging but the worst was yet

BP, le 21/08/2014

to come. Lehman Brothers' bankruptcy had side effects on states, firms, and peoples who were not supposed to assume Lehman Brothers' risk of failure.

1.4 Perfect and complete institutions are neither attainable nor desirable

Even if a supreme legislator could enact perfect institutions regulating externalities, it is far from being sure that such a situation would be desirable. The homogeneity and coherence of all institutions is probably the dream of all dictatorial powers. To set and enforce all the rules is the dream of the perfect bureaucracy. It is also the negation of human moral values. Arendt (1963) has highlighted this with her analysis of the judgment of the Nazi Eichmann in Jerusalem. Eichmann was a German bureaucrat who manages to climb up the hierarchy to become the main responsible of the logistic for the trains that convoy European Jews to the Nazi death camps. Arendt underlines that Eichmann was far from being a fanatic; he was only a very conscientious bureaucrat willing to satisfy his superiors. Eichmann had made a clear separation between his personal feelings and his duties. The overall rule for his duties were his participation to the Third Reich objectives, whatever may be the moral value of his acts.

Therefore, perfect institutions would be the negation of human freedom. While the human being is constrained and limited by her physical environment, she also retains her ability to change the course of her mind or of her actions. Moreover, the person always keeps the possibility to infringe upon institutions. This is an ontological condition of any human life (Tillich, 1951: 182-183).

If perfect and complete institutions are not desirable, they are neither attainable for the following reasons:

- They hypothesize perfect, complete, and competitive markets. In fact, modern markets are usually dominated with some big international firms that are far from being atomized. The firms have the power to set their conditions and their market price (Galbraith, 1952).
- They suppose a perfect rationality of the actors but also a perfect information. This hypothesis has been dismissed, notably by Simon (1945).
- They suppose that one actor will get the reward but will also assume the residual risk. 2008's financial crisis has been a crucial blow to this belief (Krugman, 2009).
- They have never existed; economic actors have always intended to take advantage of the institutions' inability to catch all externalities. For instance, in 1925, when making a trip across central Africa, the French author André Gide (1927) observed that international firms were already taking advantage of the institutions to increase

BP, le 21/08/2014

their profits without any real commitment to the interest of both local populations and France's reputation.

Instead of two separate levels, one which is the rational and free individuals and the other the institutions that set the rules of the game, we adhere to "the idea of interactive and partially malleable agents, mutually entwined in a web of partially durable and self-reinforcing institutions" (Hodgson, 1998: 175).

2 The risk exposure to the firms' activities

If institutions cannot cover all externalities generated by firms, some actors will be exposed to the risk of a negative externality without receiving adequate compensation. As was discussed in the previous section, not only institutions are not perfect but they will never be perfect. Externalities are a byproduct of any firm's activities. Therefore, the main classic economic postulate that the profit is the reward for the firm's risk assumed by the shareholders cannot be assumed. Other stakeholders support some of the firm's risk without being compensated or insured for it. We posit that risk exposure is the key determinant of ownership, considered as a pre-social natural right, and that ownership can differ from legal property rights.

2.1 A stakeholders' definition

We refer to the concept of risk to define stakeholders (Clarkson, 1995) and we use Pigé's (2010) definition. Stakeholders are economic actors with two key attributes. First, they hold a resource used by the firm. For instance, shareholders hold capital (cash, equipment or patents) that is used by the firm. Employees hold their social and human capital. Suppliers hold key resources, goods, or services that are required to complete the firm's process and activities. Clients hold cash to pay for the goods or services. Public communities hold public services such as road maintenance, schools, and security. Financial institutions hold cash they have lent to the firm. And so on. "Shareholders are one of several parties that make a contribution and so should not be the only residual claimants of the firm" (Lan and Heracleous, 2010: 300).

Second, stakeholders are exposed to the risk of the firm due to the resource they hold. However, risk exposure is sometimes difficult to observe. As regard shareholders, it is theoretically well accepted that shareholders are exposed to the firm's risk of investment. Employees are also exposed to the risk of bankruptcy or to the risk of an economic lay-off due to bad investments or operational failure. Suppliers are exposed to the risk of bankruptcy.

BP, le 21/08/2014

Clients are exposed to the risk of the loss of guarantee and after-sale if the firm stops an activity, sells it, or is bankrupted. Public communities may be forced to close schools, to fire public employees or to raise taxes if a firm closes a local factory or office. Of course, financial institutions may lose their credit if the firm is unable to pay back outstanding loans.

Classic economic theory supposes that stakeholders' risk exposures are compensated or insured and that only shareholders bear the residual risk (Fama, 1980). Most bankruptcies reveal that this hypothesis is not adequate. As regard Enron, not only did the employees lose their jobs, but retirees also lost a significant part of their pensions, and a large audit firm disappeared. As regard Lehman Brothers, consequences were far more important since even car producers were significantly affected a few months later due to the worldwide wave of economic panic of local consumers. The resource used by Lehman Brothers could be labeled "the trust in the international financial system".

Thus, we adhere to Orts and Strudler's (2002: 218) narrow definition of stakeholders that "placing some property or other asset at risk in a business firm must be considered a key characteristic of a proper conception of stakeholder", but with a meaningful difference: the risk exposure is not necessarily a voluntary action, it may result from the firm's action or from outside events. For instance, we posit that members of the community in which the firm operates are regarded as stakeholders if they hold a resource (a communal land, a river, some common real estate ...) used by the firm and if they are exposed to a significant risk due to the use of this resource by the firm.

Therefore, our definition departs from Freeman (1984: 46): "A stakeholder in an organization is any group or individual who can affect or is affected by the achievement of the organization's objectives". Freeman suggests two possibilities "who can affect **or** who is affected". We limit stakeholders to those that affect (through their holding of a resource used by the firm or the organization) **and** who are affected (through their risk exposure). The relation is bijective. A stakeholder is an active actor of the firm if he contributes to the firm's activity and if he is simultaneously exposed to the risk of this activity.

2.2 Pre-social natural right and property rights

"Property rights theory is able to extend these strategic management theories by relaxing implicit assumptions that resources are secure due to the inherent attributes of the resources as well as being effectively protected by third-party enforcement and self-enforcing agreements" (Kim and Mahoney, 2002: 227). Two kinds of arguments can justify the

BP, le 21/08/2014

insistence on risk exposure to justify any claim to property rights and, therefore, to the participation in the firm's corporate governance.

The first arguments are instrumental. If actors are exposed to the risk of a firm without being adequately compensated, they will feel dissatisfied and they can compromise the long-term development or survival of the firm. If the firm was nothing more than a nexus of formal contracts, then one should be obliged to strictly comply with the terms of the contract. However, if we consider that a firm is not and cannot be explained only by its set of formal contracts (Zingales, 2000), then the respect for institutions and informal contracts extends beyond a purely formal obligation to encompass some form of trust. A firm's efficiency not only depends on the fair conception of covenants; it also depends on the reciprocal engagement of each party and on the capacity to honor one's engagements (Chapman, 1993). Therefore, a breach of trust can lead to the failure of informal obligations and contracts. Such a breach can occur when one considers that the other party has already violated the spirit of the agreement. Risk exposure can be such a consideration.

Moreover, free riding is an inherent possibility of informal engagements. One can comply with the formal covenants of the contract without complying with the spirit of the contract. Usually firm's efficiency is also dependent on the expectation that stakeholders will do more than their strict obligations. Traditionally, these expectations were enforced by social counterparts (Aoki, 2010) and by interactions between the economic and the social spheres of common activity. For instance, interactions can result from the implication of economic actors in the governance of the community (Ostrom, Schroeder and Wynne, 1993).

The second arguments are normative; they rely on the distinction between ownership as a pre-social natural right and property rights as the rights instrumentally created to fulfill an economic or social goal (Becker, 1976, 1977). Property cannot be considered as only one right but, instead, it needs to be considered as a bundle of rights: "*What is owned are rights to use resources, including one's body and mind, and these rights are always circumscribed, often by the prohibition of certain actions. ... It is not the resource itself which is owned; it is a bundle, or a portion, of rights to use a resource that is owned*" (Alchian & Demsetz, 1973: 17). Some authors suggest that these rights are of two different natures: specific rights and residual rights (Grossman and Hart, 1986: 692).

Specific rights are restrictions to the possibility of use by the owner of the residual rights. While most economists (Fama and Jensen, 1983; Grossman and Hart, 1986) consider that residual rights can be priced, we suggest that only specific rights are priced and only they can be transacted. We even go one-step further by considering that residual rights are an

BP, le 21/08/2014

abuse of language. One can have property rights only in something that already exists and that is already recognized by the society. Residual rights are an easy metaphor to point to the fact that some parts of the use of a thing have not already been assessed by the community and by common law or customs. Residual rights are equivalent to the pre-social natural right. They include all the unknown or undefined dimensions of an asset, their fundamental value is ethical which cannot be priced. Residual rights are the infinite dimension of the relations between a person and a thing or between a person and a firm. They have not the characteristics of legal rights, they are claims, i.e. expectations that an ethical claim to possess some specific rights will one day or another be recognized by the society.

We go one-step farther by considering that risk exposure is the foundation of residual rights, i.e. of any legitimate claim to the recognition of new specific rights. Since residual rights include all uncertainties of the asset's nature, and since risk exposure results from the asset's uncertainty, legitimate claims can derive from one's risk exposure to the use of an asset. By extension, we assume that economic actors are stakeholders with a legitimate claim to be integrated in the corporate governance process when they are exposed to the risk of the firm (Clarkson, 1995).

For instance, common law recognizes property rights to the shareholders. Nevertheless, in most countries their property rights are restricted. In France, shareholders cannot decide to close a factory without first consulting with employees' representatives and without informing public administration. In Germany, employees' representatives are members of the board of trustees and they have their say, along with shareholders, to the main strategic decisions. Therefore, shareholders do not hold residual rights. They only hold specific property rights. So do employees. However, both shareholders and employees may hold legitimate claims to their firm's corporate governance if they have a net risk exposure to their firm.

2.3 Externalities, risk exposure and compensation

Theoretically, in a classical economic approach, any stakeholder who is exposed to a risk generated by the firm's activities should be compensated. Risk exposure is the by-product of any firm's process. It ought to be either priced by the market or regulated and compensated through various mechanisms. Moreover, risk exposure is not necessarily the voluntary part of a transaction. For instance, a nuclear plant can have visible externalities such as heating the air or the water; but nuclear plants also expose local communities to the risk of a nuclear meltdown or to the risk of radioactivity's release. Sometimes risk exposure is

BP, le 21/08/2014

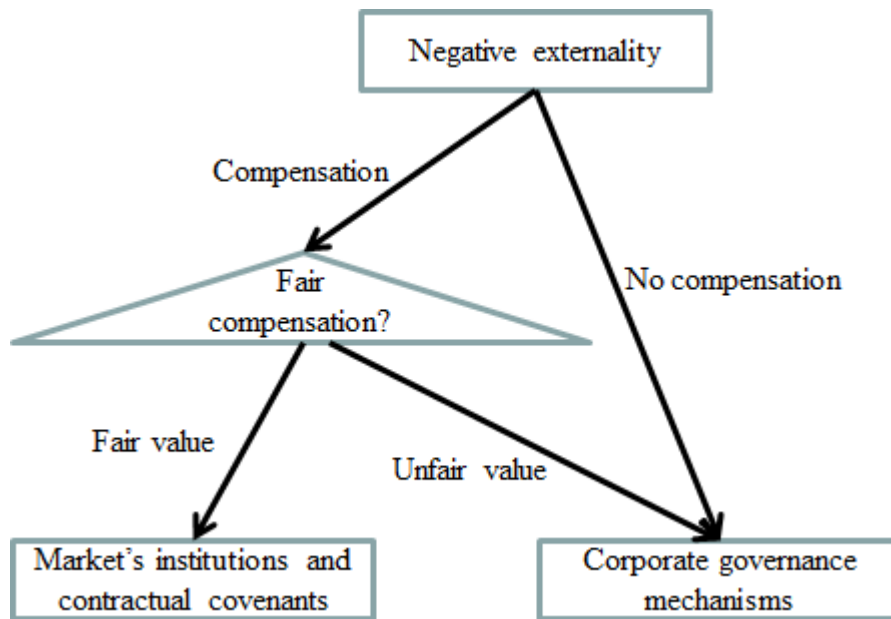
a hidden part of a transaction. If institutions (and markets) were perfect, the assumption of both shareholders that assume all the residual risk of the firm and of other stakeholders that are perfectly compensated or insured for their risk exposure should be accepted. Those (usually the shareholders) who hold specific property rights on the firm would have the legal obligation to compensate any other person who supports externalities due to the activity of the firm. Since shareholders have limited responsibility, legal institutions already recognize that other economic actors assume some part of the residual risk without being necessarily adequately compensated. Thus, what are the consequences of this net risk exposure?

Figure 1: Imperfect knowledge of the future and reliance on market mechanisms. A figure freely inspired from Knight (1921: 198).

	All alternative possibilities can be priced	Some alternative possibilities cannot be priced
The occurrence of each alternative can be accurately ascertained	Market price	Discussion
The occurrence of some alternative cannot be accurately ascertained	Discussion	Discussion

We suggest that when risk exposure cannot be perfectly priced and when no one is perfectly assuming the residual risk, only discussion can set the rules that regulate the residual risk's repartition (Figure 1). Corporate governance is the set of mechanisms that regulate the repartition and the compensation of the firm's residual risk. It is not only concerned with the maximization of the firm's market value but, more emphatically, it is concerned with the discussion between all stakeholders. Therefore, if an economic actor is not fairly compensated for his risk exposure, he has an ethical claim for participating to the firm's corporate governance (Figure 2).

Figure 2: Corporate governance mechanisms for settling negative externalities



The bundle of specific rights attached to a resource mitigates the risk exposure of the resource holder. In antiquity, slaves had no property rights on their own human and social capital. Therefore, their risk exposure was very high. By contrast, in big public firms in Europe, employees have legal protections. They cannot be easily fired or transferred to another job. The law recognizes and protects the specific rights of employees. The risk exposure of European employees in big firms is low⁶. Even inside a category of stakeholders, risk exposure can strongly differ. For instance, research employees, who invest their mind to discover new products or applications, have varying degrees of risk exposure, depending on legal or contractual arrangements. If research employees have no ownership rights to their inventions and have no job protection, they have a high-risk exposure. By contrast, if they receive royalties from their discoveries and benefit from job protection, they have a low-risk exposure.

Risk exposure depends on institutions' enforceability. If institutions exist that protect specific rights of stakeholders but if they are not enforced, real risk exposure is much higher than the theoretic risk exposure. Therefore, real risk exposure is strongly related to territories and to their sets of institutions. Firms can devise (and usually do) international policies to deal with each category of stakeholders but there is always a complex mix of local institutions and firms' specific rules (Gifford, Kestler and Anand, 2010). For instance, expatriates may be better (or worse) insured and compensated against their risk exposure than local employees.

⁶ The European crisis may be changing this assumption, particularly in Mediterranean countries.

3 A new approach for corporate governance

“With uncertainty absent, man’s energies are devoted altogether to doing things; it is doubtful whether intelligence itself would exist in such a situation; in a world so built that perfect knowledge was theoretically possible, it seems likely that all organic readjustments would become mechanical, all organisms automata. With uncertainty present, doing things, the actual execution of activity, becomes in a real sense a secondary part of life; the primary problem or function is deciding what to do and how to do it. ... When uncertainty is present and the task of deciding what to do and how to do it takes the ascendancy over that of execution, the internal organization of the productive groups is no longer a matter of indifference or a mechanical detail.” (Knight, 1921: 268).

If there were no uncertainty, corporate governance would be unnecessary. Therefore, corporate governance is twofold concerned with risk exposure. First, since uncertainty is the matter of corporate governance, both its origins and its consequences are its concern. To arbitrate between increasing or decreasing the risk assumed by some of its stakeholders and increasing or decreasing the expected pay-off is a strong concern of corporate governance.

“During the course of 2006, Lehman’s management and Board made the deliberate business decision to increase the firm’s risk profile generally, and to take more risk specifically with respect to principal investments with the firm’s capital. This new strategy was directed by Lehman’s highest officers after significant internal debate” (Valukas, 2010: 58-59). “In a January 2007 Board meeting, the directors were informed of the large increase in the risk appetite limit for fiscal 2007, and of the firm’s intention to expand its footprint in principal investments, and they agreed with Lehman’s senior officers that Lehman needed to take more risk in order to compete” (Valukas, 2010: 76).

Lehman Brothers’ case is particularly instructive since the Board was informed of the aggressive strategy of investing in risky asset. According to the classic economic model of corporate governance, the strategy was a clear arbitration to augment the firm’s risk exposure in order to increase its profitability. Our model suggests that the fundamental flaw of the Lehman’s approach was its incapacity to address the resulting increase in the risk exposition of all its other stakeholders. This failure derives from Lehman’s model of corporate governance that only addressed the concerns of the financial market (to get higher profitability) and of its top executives (to exceed the profitability’s objective). The consequences of this strategy on all other stakeholders were totally neglected.

BP, le 21/08/2014

Nevertheless, the question is why did the other stakeholders not manifest before the catastrophe? Why did they not try to modify the course of the Lehman's strategy? The answer is simple: other stakeholders had no access to Lehman's governance; Lehman's corporate governance mechanisms were not designed to facilitate the integration of other stakeholders' concerns. Moreover, most stakeholders were not conscious of their sudden exposure increase to Lehman's risk.

Therefore, how could corporate governance mechanisms integrate the stakeholders' risk exposure? We suggest that an evolution of corporate governance should rely on three main points: first, to identify the net risk exposure of the stakeholders; second to model the interactions between the social and the economic fields; and third to develop voice mechanisms that should have precedence over exit mechanisms (Kostant, 1999).

3.1 A search for legitimacy: Arbitration between compensation, insurance and participation to corporate governance

Stakeholders affect and are affected by the firm's activity. The risk exposure is therefore the main feature of our model. Nevertheless, "The use of risk to denote stake appears to be a way to narrow the stakeholder field to those with *legitimate claims*, regardless of their power to influence the firm or the legitimacy of their relationship to the firm. This search for legitimacy, we argue later, is necessary to understand fully a firm's stakeholder environment, but it also can be a powerful blinder to the real impact of stakeholder power and claim urgency." (Mitchell, Agle and Wood, 1997: 857).

We suggest that legitimacy emerges from the stakeholders' net exposure to the risk of the firm. This net risk exposure is the foundation for the legitimate claim to participate in the firm's corporate governance. In the next section, we discuss stakeholders' power and urgency, the two other stakeholder attributes according to Mitchell et al. (1997).

Stakeholders' net risk exposure is a function of their risk exposure, the compensation they receive, and the various mechanisms of insurance that can alleviate some part, or the totality, of their exposure to the firm's risk. Consequently, the legitimacy of a stakeholder is not an attribute independent of the managerial activity. Top executives can manage the net risk exposure of their stakeholders.

The agency approach of the firm assumes that only shareholders have a net exposure to the risk of the firm: "The residual risk – the risk of the difference between stochastic inflows of resources and promised payments to agents – is borne by those who contract for the rights to net cash flows" (Fama and Jensen, 1983: 328). This hypothesis is far from being always

BP, le 21/08/2014

verified. A given stakeholder can accept to bear uncertainty but most of the time, uncertainty will have diffuse effects and guarantees are far from being perfect. The financial model of the firm is just a specific case, an ideal-type (Weber, 1947) that is not a real firm. Moreover, this ideal-type is often confused with the real firm and potentially disastrous consequences are neglected. As regard Lehman Brothers, the strategic management of the risk was implemented such as if Lehman Brothers conformed to the ideal-type.

The management of a stakeholder's risk exposure involves three main possibilities:

- A stakeholder can be compensated for her risk exposure. If the risk is measurable, contracts or institutions can be enforced to ensure a perfect compensation. However, since future situations cannot be perfectly assessed (Taleb, 2007: some very improbable situations can happen) and since some risk cannot be measured (Knight, 1921), compensation will usually be under or over compensating the risk assumed. For instance, one could claim that some international investors that take advantage of social and fiscal loopholes in the international regulation are over compensated for the capital they invest in local assets. Paradoxically, the proposed model suggests that these international investors, while contributing to the efficiency of capital markets, have no legitimacy to interfere with firms' corporate governance. Their playing field is not the firm; it is the market.
- A stakeholder X can be insured against her risk exposure to a firm Y. The uncertainty is shifted to another economic actor Z. Financial economy supposes that diversification may neutralize the risk. Unfortunately, some corporate governance problems arise since the legitimate relation between the firm and some of its stakeholders is becoming fuzzy. Insurance is never a perfect mechanism because it widens the possibility of free riding and opportunism. This was particularly evident with the subprime crisis and the apparent mechanisms of insurance due to the issuance of derivatives (The Financial Crisis Inquiry Commission, 2011). The financial crisis of 2007 revealed that final investors were exposed to a net residual risk they had ignored.
- Some neglected stakeholders can be neither compensated nor insured against their risk exposure. This implies a failure of institutions and market mechanisms, since the stakeholder's resource is used by the firm and the stakeholder is neither compensated nor insured against the risk that the firm's activity may generate to her. For instance, firms and citizens located a few miles away Fukushima should

BP, le 21/08/2014

have had their say in the nuclear plant's operating. Local representatives have to be part of the firm's corporate governance. This also applies to local communities in the Gulf of Mexico with petroleum companies or to local communities around shale gas' exploitation.

Our model underlines that legitimacy is a complex concept that ought to be managed by firms' top executives. Legitimacy is not static, it evolves according to the firm's processes, to institutions and to the firm's management of compensation and insurance. Legitimacy helps explain why some neglected stakeholders may disrupt the firm's activities when they become conscious of having a high net exposure to the risk of the firm. Legitimacy is simultaneously an input (the legitimacy of stakeholders to participate in corporate governance), a result (the consequence of corporate governance mechanisms that set compensation and insurance), and a feedback (neglected stakeholders gain legitimacy).

3.2 Power and legitimacy, an interaction of economic and social fields

Mitchell et al. (1997) consider that legitimacy is not sufficient to characterize the stakeholder-manager relationship. Relying on Weber (1947), Salancik and Pfeffer (1974: 3), they assume that another main stakeholder attribute is power, i.e. "the ability of those who possess power to bring about the outcomes they desire" (Mitchell et al., 1997: 865). However, this definition is far from being faithful to Weber's (1947: 152) own definition: "the probability that one actor within a social relationship would be in a position to carry out his own will despite resistance, regardless of the basis on which this probability rests." For Weber, power is not a static attribute; it measures rather a dynamic process, which introduces a probability of success. Therefore, both legitimacy and power are dynamic attributes and the third attribute proposed by Mitchell et al., i.e. urgency, appears unnecessary to "explain the degree of attention paid to them by managers" (1997: 684).

If we only focus on legitimacy and power, we can conceive legitimacy as the point of view of stakeholders and power as the point of view of managers. Managers will pay attention to stakeholders so long as these stakeholders have power to impose their will, to have a high "probability that a command with a given specific content will be obeyed by a given group of persons" (Weber, 1947: 152). A positive approach of the firm could consider only power to describe the intricate relationships of stakeholders inside the firm. Nevertheless, to pay attention to legitimacy can help design corporate governance mechanisms that balance existing power relations and that support a more harmonious operation of the firm.

BP, le 21/08/2014

“Corporate governance is ultimately the outcome of interactions among multiple stakeholders” (Aguilera and Jackson, 2003: 449). However, corporate governance is not only the outcome; it is also the framework of these interactions. Corporate governance’s mechanisms are both mechanisms that result from the relative power of playing stakeholders and mechanisms that set and curb the relative power of the stakeholders. This is particularly evident as regard the consequences of the approach to gender on corporate governance. The institutions that set the rules are modified to impose a more egalitarian access of women to the Board. Stakeholder can play inside the game, i.e. by considering corporate governance mechanisms as given, or they can play outside the game by trying to modify institutions that set corporate governance mechanisms. The firm is not a game where a supreme legislator, which should be the markets or the public administration, sets rules. Firm’s profitability emerges less from its perfect efficiency than from its ability to exploit conflicting institutions and to shape new ones that fit some particular interests (Galbraith, 1952). The firm is a field game where stakeholders can play the rules or try to modify the rules of the game.

An obvious consequence of this approach is the intricacy between economic, social and environmental fields. Actors cannot be grasped as playing only on a specific field, they are always acting on simultaneous fields and usually they are using the interactions between these diverse fields. Only a strong theoretic economic approach, that wants to study economic efficiency independently of its social and environmental consequences, can leave out these interactions. Obviously, economic efficiency is not the ultimate objective of any human society. Therefore, if we consider that economic, social and environmental dimensions interact and that due to markets and institutions’ incompleteness and imperfections, these interactions are not perfectly reflected in market prices, then an action that is economically justified may have strong environmental or social side-effects and the firms’ performance ought not to be only grasped through economic efficiency.

Identifying the legitimacy and power of firm’s stakeholders enables managers to grasp these economic, social, and environmental interactions that result from the firm’s actions. Risk exposure is not restricted to the economic field, it encompasses social and environmental aspects. For instance, suppose that a firm decides to exploit a geological resource that is located on a sacred place for a given community. If institutions and markets were perfect, a price could emerge to integrate the spiritual dimension of the soil. Unfortunately (or fortunately), some things have no price. If one is strongly committed to a given dimension of her environment, one can refuse to give up for whatever amount of money. Obviously, no solutions may emerge except renunciation or legal violence to enforce what is perceived as a

BP, le 21/08/2014

common good. If the community is small, poor, and badly represented politically, the firm can lobby to get the authorization to exploit the geological resource. The solution is a Manichean solution. One gets all, while the other loses everything.

The proposed model suggests that a third possibility exists. A situation where the firm and the local community are not two opposing actors but where the local community is regarded as a stakeholder of the firm and is therefore entitled to participate to its corporate governance. "Social norms may lead individuals to behave differently in the same objective situation depending on how strongly they value conformance with (or deviance from) a norm." (Ostrom, 2000: 144). Economic, social or environmental dimensions do not exist *in abstracto*. They always refer to persons. A nuclear explosion in Mars or in the sun is not a matter for any individual. Only a nuclear explosion on earth is an environmental matter. Therefore, through its various constituencies, a firm that adopts a stakeholder approach is necessarily involved in integrating the various dimensions of human life.

Of course, institutions set the general rules that delimit the game field; but the local solution is up to the stakeholders of the firm: its shareholders, employees, clients, suppliers and local communities directly exposed to the risk generated by the firm's activity. This approach differs from the agency model of the firm by refusing to limit firm's contracts to a single monetary approach. For instance, the approach developed by Sen (1999) can be integrated in a stakeholder model where some economic actors will not receive only monetary incentives and compensations but they will also enhance their capabilities and their freedoms.

As a case of application, a firm is supposed to pay for education and learning when the individual is becoming more efficient and when the supplementary output outweighs the learning costs. Paraphrasing Sen (1999: 37), we set that the improvement of stakeholders' capabilities is not only a mean to the improvement of the firm's efficiency; it is also a corporate governance objective. Firms' corporate governance should integrate a more enlarged definition of value creation. Value encompasses market value but it also encompasses values that have no well-defined market price but that enhance stakeholders' capabilities and freedoms. Since, some persons' capabilities have no market price, but they have a cost, a firm can arbitrate between cash compensation and compensation in nature. Obviously, all firms already practice this exercise. All firms integrate the development of their stakeholders' capabilities. A firm that is committed to teaching courses, child care centers, jobs' guarantee, etc. is not only improving its efficiency, it also contributes directly to the enhancement of their stakeholders' welfare.

3.3 *Exit and voice, the quest of loyalty*

Perfect contracts are not supposed to include voice mechanisms. If firms were a nexus of formal contracts where each one would have to fulfill her engagements, voice mechanisms would be unnecessary. Even if contracts included institutions that regulate each one's attitudes and comportment, voice mechanisms would be unnecessary. Voice mechanisms exist only when actors have some discretionary space, when they can depart from their previous engagements (opportunism) or when, confronted with uncertainty, their decisions and their acts cannot be perfectly anticipated and defined.

The ideal-type of the agency firm relies on a central agent that sets the contracts (Alchian and Demsetz, 1972; Jensen and Meckling, 1976). Contracts are supposed to realize efficient transactions based on their market price by mimicking market transactions with smaller transaction costs (Coase, 1937; Williamson, 1996). Therefore, exit mechanisms are fundamental for any contractual approach of the firm. One is supposed to have always the ability to abstain from participating to a transaction or a contract. Then, a firm is supposed to be efficiently managed when resources are allocated according to their highest bidding use (Kaldor-Hicks efficiency; Scitovsky, 1941); the visible hand of the manager replaces the invisible market's hand (Chandler, 1977).

When some dimensions of contracts cannot be adequately priced by markets, the visible hand of the manager may be misdirected by the markets. In particular, uncertainty may be partially (or totally) shifted to some stakeholders without an adequate compensation, and they will be worse after contracting with the firm. Moreover, the agency model supposes that the agent has an objective, to maximize the firm's market value (Jensen, 2001). In a purely contractual approach, where each one's obligations are strictly defined, any top executives' discretionary space is considered a free space for opportunism.

By contrast, a stakeholder model implies that the central agent has a multitude of objectives that cannot be prescribed with a technical measure. These objectives are sometimes conflicting and they involve some discretionary space from top executives to arbitrate between the stakeholders' interests. No simple rule can be set to govern this discretionary space since no single objective exists. Nevertheless, "having to answer to multiple constituencies will increase accountability rather than mitigate it" (Phillips, Freeman and Wicks, 2003: 484). The stakeholder approach recognizes the importance of engagements and, therefore, advocates voice mechanisms. "Extensive fieldwork has by now established that individuals in all walks of life and all parts of the world voluntarily organize themselves so as to gain the benefits of trade, to provide mutual protection against risk, and to create and

BP, le 21/08/2014

enforce rules that protect natural resources.” (Ostrom 2000: 138). Therefore, top executives’ discretionary space is governed by voice mechanisms, i.e. by the involvement of stakeholders. This involvement can be facilitated and reinforced by institutions, or it can be restricted, but it still exists.

Unfortunately, stakeholders’ effective involvement does not depend on their legitimacy, their risk exposure, but it depends on their relative power. Therefore, corporate governance should aim at facilitating the implication of highly exposed stakeholders while diminishing the relative power of stakeholders with little risk exposure. This objective is desirable for both normative and instrumental reasons. Normatively, to facilitate the voicing of stakeholders with strong risk exposure is legitimate and morally desirable (Jones, 1991): “For most corporate constituents other than shareholders, exit from the corporation is usually the remedy of last resort, not the first” (Blair and Stout, 1999: 252). Ethically, stakeholders should get a big compensation for their risk exposure or to be insured against it. Risk exposure ought to be considered as a hypernorm and to contribute to the setting of firms’ norms (Donaldson and Dunfee, 1994, 1999).

Instrumentally, if a stakeholder with little risk exposure has access to voice mechanisms and can set the firm’s agenda, she may try to enforce policies that increase her rewards without integrating consequences of risk exposure on other stakeholders. Today’s situation of multinationals in developing countries is highly representative of these situations. Multinationals exploit local raw goods to answer the need for manufactured products in developed countries, but they may pay little attention to local communities and to their environment⁷. For the firm, the risk is a brutal disruption of its activities when the highly risk exposed stakeholders protest and try to get more compensation or less risk exposure.

Alternatively, a stakeholder with a high-risk exposure will try to enforce policies that increase her rewards or decrease her risk exposure. Obviously, such a stakeholder may become over-compensated for her final risk exposure (Harrison and Bosse, 2013). Therefore, the balance of stakeholders’ interests is not a static game but a dynamic one. It is a game where learning is fundamental (Ostrom, 1968) but where loyalty (Hirshman, 1970) is the foundation of firm’s survival and development. To ensure the firm’s survival and development, top executives need to pursue the legitimate equilibrium without ever attaining it, since it is always modified by current actions. This situation is the well-known situation of

⁷ In Togo, the exploitation of phosphate is the main provider of currency for the country. However, simultaneously it was also the cause of environmental damage: pollution of the drinking water but also of the seaside where fishermen used to get their living.

BP, le 21/08/2014

public choices where there is an arbitration between immediate efficiency and long-term efficiency: “Rather than leaving formulation of the proposed regulation to agency staff, it (negotiated rulemaking) establishes a procedure whereby representatives of conflicting interest groups meet together and attempt to reach consensus on the proposal” (Rubin, 2001: 73).

CONCLUSION

Why are the industrial units of HeidelbergCement so clean in Europe and less tidy in some African countries? Of course, an explanation is formal institutions that are applied in Europe as compared to those applied in Africa. However, a complementary explanation resides in the integration of stakeholders, and more specifically of local communities. In Europe, no firm can ignore its local communities and neglect pollutions that result from its activity. Therefore, any firm will contact local officials and discuss the matter with them. These contacts may be informal. Nevertheless, they exist and they are indispensable. In Africa, these informal contacts may also exist but they may also be neglected. Moreover, due to some failure of local political institutions, local officials may not assume the interests of the local community. Similar plants with identical procedures but located in different territories cannot complete exactly the same processes (Aoki and Dore, 1994; Hofstede, 1980; Liker and Hoseus, 2008). Our model helps to understand why.

The agency model of financial corporate governance underlines the fact that someone cannot have two masters. Obviously, if top executives are serving the employees, or their clients, or their local communities without paying attention to their other stakeholders, the situation may be worse. Nevertheless, top executives are not agent of a specific constituency; they are agents of the firm: “The function of management is to oversee the contracts among factors and to ensure the viability of the firm” (Fama, 1980: 292). A policy that is dividing a country, or pushing the interest of one kind of stakeholder above all the other ones, may only lead to the disintegration of the country or of the firm. Not only it is a morally bad policy but it is also an instrumentally bad policy if one envisions the survival and the development of the community or of the organization.

The model also helps to grasp corporate governance mechanisms that do not emerge from a top-down decision but that result from the local action of economic actors exposed to the risk of a firm. “When the users of a resource design their own rules that are enforced by local users or accountable to them using graduated sanctions that define who has rights to withdraw from the resource and that effectively assign costs proportionate to benefits,

BP, le 21/08/2014

collective action, and monitoring problems are solved in a reinforcing manner.” (Ostrom, 2000: 151). Moreover, some economic models of firm’s efficiency require a strong implication of stakeholders. This implication cannot be sustained in the long term if the stakeholders are not adequately compensated for their efforts and insured for the risk they assume. For instance, Lean Management (Womack and Jones, 2003) can be conceived as a technical device to improve operational efficiency but to achieve long-term efficiency it requires some forms of guarantees from top executives. These guarantees can only be obtained with corporate governance mechanisms (Pigé, 2012).

Stakeholders’ risk exposure to the risk generated by a firm’s activity emerges from a complex mixture of institutions, firm’s processes, and corporate governance mechanisms. Only an approach that helps to bring together strategic politics with specific and local situations may promote long-term economic efficiency and social justice (Ostrom, Schroeder, Wynne, 1993).

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BP, le 21/08/2014

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BP, le 21/08/2014

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