

Corporate Governance and Firm  
Organization:

*Microfoundations  
and  
Structural Forms*

*Edited by*

ANNA GRANDORI

OXFORD  
UNIVERSITY PRESS  
2004

## *Myopic Opportunism and Joint Production: A Relational Approach to Corporate Governance*

SIEGWART LINDENBERG

The cost of mistrust has become painfully evident in very concrete ways during the last few years: reduced share prices, lost jobs, shrunken pension funds. At the same time, the potential competitive advantage of trustworthy companies is becoming clearer. Benefits include reduced costs of capital, retention of longer-term investors, distinctive brands and strong reputations.

(Mark Moody-Stuart, 'The measure of a good company', *Herald Tribune*, 25-6 January 2003)

### Introduction

Governance, notably also corporate governance, is mostly about reducing opportunistic behavior. The message of this chapter is that reducing opportunistic behavior is mainly a matter of relational effort and only for the smallest part a matter of control and interest alignment. Seen this way, corporate governance consists of three parts: (i) owners establishing a certain relationship with each other; (ii) owners establishing a certain relationship with their managers; and (iii) owners holding managers accountable for how they manage relations with stakeholders. Clearly, I will not have institutional designs ready for these three parts. However, I will argue that the relational approach will lead to a search for institutional designs for corporate governance that is different from the mode that presently dominates the design discussion.

Why such an emphasis on relations? The answer to this question comes from relatively new research on opportunistic behavior. The by now classical view of opportunistic behavior in the fields of organization studies and corporate governance comes from the principal-agent approach in which the principal attempts to increase control and, failing that, chooses incentives in such a way that the interests of the agent align with those of the principal. This has proved to be a powerful approach. Enriched with transaction cost theory, which drew specific attention to *ex post* problems with contract execution, it has permeated the views of what governance is all about.

More recently, research on combined motivational and cognitive influences on opportunistic behavior has introduced a new element into the discussion. First of all, there is a new conception of opportunistic behavior. In day-to-day conduct, opportunistic behavior consists mainly of responding to unanticipated *short-term* opportunities and pressures. This opportunism is not strategic but myopic.<sup>1</sup> For example, 'golden' opportunities present themselves, seemingly too good to let go, and yet they are against the contractual agreements or against agreed-to rules and principles. Similarly, problems often arise quite suddenly in an unexpected way and motivate 'cutting corners'. For example, time pressure to make use of a golden opportunity often also reduces the intensity of safety checks. Thus, at first blush, the books of the company that can be taken over for a good price (if one is quick) look acceptable. Why not skip the laborious procedure of a thorough check this time round? There are also unforeseen mishaps. For example, it might happen that many employees are ill just at a time when the delivery deadline approaches and everyone is under great stress. So why not skip quality control only this once, to get over this tight spot? Another important factor subject to myopic opportunism is intelligent effort. It is needed in so many modern jobs but it is difficult to gauge and thus difficult to monitor. Knowledge, needed for intelligent effort, is often also only tacit and its use can by definition not be enforced contractually.<sup>2</sup> For these reasons, higher-intensity intelligent effort often cannot even be informally monitored and short-term temptations to apply it to goals unrelated or even hostile to the principal's interests are great. For instance, managers may be tempted to put more intelligent effort into their own career than into the company's longer-term growth. Day-to-day myopic opportunistic behavior creates its own path dependencies and cumulative effects which, in turn, demand more short-term crisis management and thereby also myopic opportunism. For example, at a certain moment, the books may have to be 'adjusted' to cover up these cumulative effects, officials may have to be bribed, and further corners may have to be cut in quality control as the financial situation worsens. In addition, the accumulation of myopic opportunism in an organization is likely to normalize increasing margins of deviance, stretching the boundaries of what is acceptable and possibly blinding agents to danger signals. All this can happen with interest-aligning instruments in place. There does not seem to be much sinister, farsighted calculation (that is, strategic opportunism) involved in the bulk of corporate deviance.<sup>3</sup> The control and alignment instruments are

<sup>1</sup> By 'strategic opportunism' I mean the rational pursuit of longer-term self-interested goals in interaction with others without ethical constraints about lying, cheating, and so forth. By 'myopic opportunism', I mean the rational pursuit of short-term self-interested goals in interaction with others without ethical constraints about lying, cheating, and so forth.

<sup>2</sup> This point about tacit knowledge has been made by Orestich and Frey (2000).

<sup>3</sup> See Vaughan 1999 for a review of these kinds of phenomena related to the cumulative effects of myopic opportunism that involve the normalization of deviance.

important and they do curb strategic opportunism, but they are too crude to deal with most of the short-term temptations and their cumulative effects, or with the subtle allocation of intelligent effort away from the principal's interests.

Second, myopic opportunism is the consequence of a combined motivational and cognitive process called 'framing' (see Lindenberg 1998). What happens is that a strong goal (the motivation) triggers cognitive processes in such a way that certain aspects of the situation are pushed into the foreground and others into the background. For example, a golden opportunity may lead to a situation in which a CEO is caught up in a strong feeling of loss by the thought of letting this opportunity slip away. Loss avoidance is a strong motivator and it is likely to lead to the salience of aspects that help avoid the loss. It is also likely to lead to a cognitive and motivational veiling of aspects that tell against taking advantage of the golden opportunity.

Myopic opportunism comes about through a process of framing, but the curbing of myopic opportunism does not lie in the suppression of the framing process (that will never work). Rather, as I will try to show, it lies in the use of the very same process of framing for cooperative purposes. The governance of myopic opportunism boils down to governing the framing process. In this chapter, I will elaborate on the framing process and its governance, and I will apply both to the question how corporate governance can be improved by taking these processes into account.

#### A Framing Approach to Sustainable Relationships

The term 'sustainable' is used in many different ways in the literature on corporate governance. The meaning attached to this term (in conjunction with relationships) in this chapter is equivalent to 'cooperative over time in situations of joint production', meaning that a relationship does not break up as long as it is potentially advantageous for both in the longer run. By 'gain-driven behavior' we mean behavior that is calculative (including opportunistic behavior for which lying, cheating, and manipulating are not excluded as possible strategies) and oriented towards the increase of one's control over scarce resources. *The basic idea of the framing approach is that even potentially profitable relationships are rarely sustainable over the longer term if they are not accompanied by a partial suspension of gain-driven behavior.*<sup>4</sup> The exception consists of situations in which behavior can easily be monitored and when

it involves little tacit knowledge and intelligent effort. Then the interaction partners can easily predict each other's behavior and can even deal *ex ante* with possible predictive failures. The relationships of the shareholders to each other and to the management of the corporation, and the relationships of the corporation to its stakeholders, are not of this kind. Rather, most of these relationships are riddled with uncertainties and difficulties of monitoring; they require much intelligent effort, and lead potentially to much damage when things have gone wrong.

As I have argued above, even when interests are broadly aligned, there is, in such relationships, much room for opportunism. Mutual dependability requires something in addition to knowledge of the other's constraints and interest alignment. It also requires the *alignment of commitment to the relationship*, which partially suspends the instrumental use of the relationship, creates trust, and directs intelligent effort towards joint goals. This is something of a paradox.<sup>5</sup> Certainly in the business world relationships should either be instrumental in reaching economic goals or be broken up. Yet, paradoxically, their instrumentality (in terms of economic gain) is enhanced if the interaction is *not* guided by the goal to maximize the instrumental value of the relationship. For example, in a recent study of the better dress sector of the apparel industry in New York, Uzzi (1997) found that manufacturers with long-term relationships with contractors believed that the contractors would not act in their self-interest at the manufacturers' expense, and vice versa. This showed up in concrete actions such as resource pooling among partners and, when transactions had to be done fast, *post hoc* pricing. As one CEO put it, 'we do first and fix price after'; another CEO would say, 'the contractors know that they will not lose'. The partial suspension of gain-driven behavior was beneficial for both parties. Uzzi could also show that this was not true for all business relationships in this industry. Certain relationships were long-term with partial suspension of gain-driven behavior, but there also were transactions with changing 'arm's-length' (or pure market) partners, without any suspension of gain-driven behavior. Seemingly, the two served different purposes and possibly one influenced the other in the sense that the committed relationships were stabilized by the availability of arm's-length partners.

How does this kind of commitment alignment work? Where does the 'relational concern' come from? Very likely, relational concern derives from the mutual perception of the partners that they are engaged in a *joint production* (see, for example, Scott and Cherrington 1974). At times, it is assumed in the economic literature of organizations and management that an allocation is efficient only if it maximizes the total value of the parties involved and

<sup>4</sup> This is different from but compatible with Osterloh and Frey's approach (Chapter 8, this volume) based on research on intrinsic motivation, but it contrasts with important contemporary approaches that have not (yet) incorporated research on myopic opportunism, especially with the 'self-interest' and social bonding approaches. The former are close to the control and align paradigms (including credible commitment approaches, reputation and learning approaches, and reciprocal altruism approaches, see for examples Buskens 2002; Raub and Weesie 2000; Williamson 1993). The latter are close to the 'social preference'

approaches because they focus on stable changes in people's preferences (through liking, see for examples Lawler and Yoon 1993; Sabel 1993; Tyler and Degory 1996).

<sup>5</sup> It has been called 'the by-product paradox' (see Lindenberg 1986).

that, under the assumption of efficient bargaining (for dividing the costs and benefits), the parties involved will behave so as to jointly maximize the total value (see, for example, Milgrom and Roberts 1992: 36 ff.). However, the whole point about opportunism is that 'efficient bargaining' cannot be assumed, not even with transaction cost-lowering instruments of interest alignment. The willingness to see the transaction as a cooperative effort, as a *joint* production, and to signal this perception to the other is the only way we can come even close to the maximization of total value. Principal-agent theory is based on the opposite assumption, namely, that principal's and agent's interests are in conflict unless the agent's interests are aligned with those of the principal as an act of governing his or her behavior. There is not even a place for the perception of joint production in principal-agent theory.

Relational concern is not a matter of stable preferences for being 'nice' to transaction partners. As we saw in Uzzi's research, the same manufacturers and contractors that had a relational commitment also had other business relations with pure (that is, blatantly gain-driven) market transactions. Nor was it pure 'prudence' of business partners to behave cooperatively in their own self-interest. Again, Uzzi found that relationally committed business partners helped each other far beyond the call of self-interest. For example, when there is a hull in the market, they would help each other out. In the words of a production manager, 'We will put a dress into work to keep the contractor going. We'll then store the dress in the warehouse.' By contrast, in the pure market relations the other would 'push the price down when the contractor tells of his production problems'. It is very likely that what is going on in the committed relationships is a partial suspension of gain-driven behavior. The sustainability of the relationship is not maintained by the partners deciding against being opportunistic (because they think it is prudent to do so), but *by their not even considering the strategically opportunistic alternative*. With the help of cognitive psychology, one can trace how such a partial suspension of gain-driven behavior is possible (see Lindenberg 2000) and why it has the positive effect it is said to have.

Seemingly, there are overriding goals that govern how people 'frame' a situation, that is, how they perceive it; what alternatives they see, what aspects they consider important, what pieces of knowledge are being activated, and so on. The overriding goal 'frames' the situation in a particular way. For example, if the overriding goal is to make as much money as possible, the alternatives perceived are instrumental for this goal and they include what, from the point of view of a relational concern, would be called 'opportunistic' alternatives. The knowledge being activated includes information of opportunities that can be exploited, of the weaknesses of the other, of the probability of being found out. By contrast, if the overriding goal is a relational concern, the alternatives perceived pertain to the goal of sustaining the relationship, and the knowledge that is being activated includes

information of opportunities to advance joint goals, of threats to the relationship, of possibilities to help, and so on (see also Kahneman, Knetsch, and Thaler 1986).

A frame is not a stable preference that keeps steering behavior in the same direction. It comes about through the situational dominance of a certain goal. If that goal is replaced by another, the frame switches, say, from making money to relational concern or the other way around. Thus, in the framing process certain concerns are pushed into the foreground and others into the background, but none vanishes. There is no fundamental change of preferences taking place. For example, in a market economy, the goal of making money will rarely be suspended altogether. It is essential for corporations to make money. However, the crucial question is whether relational concern as a goal is strong enough ever to push making money as a goal into the background. If it is, gain-driven behavior is, for the time being, partially suspended. How does it happen?

Foreground and background goals are dynamically interdependent. When people are in a certain frame, their actions may be so contrary to the background goal that the latter's salience (that is, its relative strength) increases to the extent that it becomes the new frame. For example, going after making as much money as possible, a person may do things that come step by step closer to hurting the other's legitimate interests and his own interest in keeping the relationship in good order. He may increase the price a bit more than is justified by inflation, put the customer's order on the back-burner in order to accommodate a new and well-paying customer, skip the quality control to save some time, and so on. If there is a relational concern in the background, the increasing violations in the person's pursuit of making money may strengthen it to the degree that it takes over as the new frame. In that frame, the alternatives for sustaining the relationship become prominent, and he may offer late payment, rapid delivery of the new order, and so on. Dyer (1997) reports from Japan that more than 75 per cent of the suppliers of large firms interviewed indicated that, if an inequity occurred in the present transaction, it would be 'remembered' and corrected in the future. Conversely, when the pursuit of the relational concern costs increasingly more money, the goal 'to make money' (in the background) will increase in relative strength and may displace relational concern as a frame. This seesawing of making money and relational concern in time to avoid great harm to either concern has been called *weak solidarity* (see Lindenberg 1998) to contrast it with the kind of solidarity found in tight-knit groups in which making money from the other is a good reason to break off the relationship altogether. This is to say that, in strong solidarity relationships, the relational concern is so strong that it is not displaced by concerns for making money. Similarly, in 'pure' market relationships, the concern for making money is so strong that it is not displaced by relational concerns. In such a relationship, even cooperation is perceived in terms of weakness

rather than relational commitment (see Sartler and Kerr 1991). Weak solidarity can occur and be sustained only if relational concern and making money are not diametrically opposed. It takes an economy in which there are no strong in-group-out-group animosities that foster strong solidarity inside the group and pure opportunism between groups. In turn, such an economy can thrive only when the delivery of law does not much depend on being inside or outside a group.<sup>6</sup> In addition, as already mentioned, transactions must be complex enough to render pure power strategies ineffective. They are complex in this sense when performance in transactions cannot be easily monitored and when it involves much tacit knowledge and intelligent effort (see Lindenberg 2002, 2003). Making money and being concerned about the relationships with business partners are then compatible enough to allow weak solidarity but still incompatible enough in the short run to create problems that need special attention, as we will see in the next section.

### Joint Production and Institutional Design

The application of the framing approach to institutions implies that institutions do not regulate behavior just by incentives but also by affecting frames (see Lindenberg 1992). In the case of institutions that govern cooperative relationships, this means that they must be designed to encourage weak solidarity by creating the preconditions for joint production as a guiding principle of interaction. This contrasts sharply with the major approaches to corporate control, in both the US and Europe. There are important differences between various institutional settings (such as whether there are one or two boards) but, by and large, they all are guided by the principal-agent paradigm of 'control and align', mostly in the US, somewhat less so in Europe. In the relational approach, control and interest alignment are not superfluous but they are secondary in institutional design that concentrates on establishing overlapping sets of 'joint productions'. We thus search for potentially relevant contexts of joint production in corporate governance.

Three such interrelated contexts stand out as obviously relevant (see Fig. 9.1). First, for the shareholders, the major task is corporate governance and it can be (but mostly is not yet) seen as joint production of all shareholders (within the framework of legal provisions which may itself be the target of shareholder activism). Second, even if we assume that profitability of investment is the major 'goal' of corporate governance, this goal

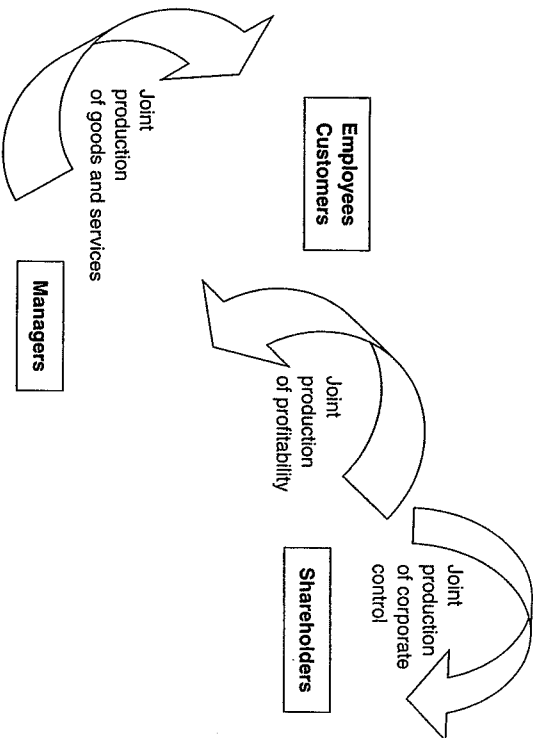


Figure 9.1 Relationships between shareholders among themselves, shareholders and managers, and managers with other relevant stakeholders, all built on joint production (of corporate governance, profitability, and goods and services, respectively).

cannot be achieved by the shareholders alone. Rather than viewing the relationship of shareholders (as principals) to managers (as agents) as one of control, this relationship could be seen as a joint effort to maximize sustainable profitability. Control (say, in terms of accountability of managers) and interest alignment between shareholders and managers are then only two instruments among a variety of other instruments to aid this joint effort. They are not the main target of institutional design, but flanking arrangements for joint production. Third, profitability, in turn, largely depends on how the corporation interacts with relevant stakeholders, such as employees and customers. Here too, potentially profitable relationships should not break down because of gain-driven behavior by the corporation. In fact, the production and distribution of goods and services can be seen as joint efforts by the management and employees on the one hand, and by the management and customers on the other. Shareholders would do well to hold managers accountable for their relational management with employees and customers, for two reasons. First of all, this relational management is important for sustainable profitability. Second, the relational management would also be a good indicator of a weak solidarity approach of the managers. In all likelihood, if managers treat employees and customers with relational concern, they will do the same with shareholders, which, in turn, would make joint

<sup>6</sup> Of course, even in advanced Western capitalism, in-group effects in the courts cannot be completely avoided (see Galanter 1974). However, relatively speaking, the system of law in most Western economies does not contribute much to the creation of strong in-group/out-group boundaries.

production of profitability more likely.<sup>7</sup> Let me briefly go into each one of these contexts of joint production in more detail, even though I cannot offer worked-out suggestions for institutional design, nor do I go through a critical review of existing institutions and design suggestions. Rather, with the relational approach I will offer a heuristics for the search for institutional design and for the evaluation of existing suggestions.

One of the problems of corporate governance seen from the relational perspective is that the owners are not often 'partners' for the managers to establish a relationship with. In terms of institutional design, shareholders who wish to govern the managers of their assets would have to find a way to establish relationships with these managers. In the principal-agent paradigm, this was not necessary because, in this approach, control is so central that the owners can hire a controlling agent to sit on the board of the corporation and can add control and interest alignment measures (such as establishing an auditing committee and making the CEO and CFO personally responsible for the corporation's compliance with bookkeeping rules). But the first concern for institutional design is that, before shareholders can establish a relationship with managers, they would have to establish a relationship among themselves, and become a potential partner in joint production with the managers.

There are many obstacles to this endeavor because shareholders are often widely dispersed and ill-informed. There have been various suggestions on how to deal with these problems, ranging from giving institutional investors a larger say in governance issues to making it mandatory for institutional investors to attend the annual general meeting, to allow shareholders to vote remotely, or to allow proxy voting by advisory firms. From a relational point of view, making a difference between investors in terms of rights (for example, by giving institutional investors a larger say) is probably not a good idea. It makes it much more difficult to come to any conception of joint production.<sup>8</sup> Compulsory attendance of institutional investors at annual general meetings is also not a good idea, for the same reasons. The way to go is probably more in the direction analogous to informational systems for political voters (see, for example, Laham 2003) and communication and voting systems analogous to Internet communities. In addition, periodic opportunities for face-to-face meetings would offer the social basis for creating and maintaining an orientation of joint production of corporate

<sup>7</sup> For this reason, the behavior of managers towards the environment is also an indicator of the management's relational approach, extending the relational concern to future generations (also of employees and customers). From the literature on corporate deviance, we learn that corporations charged with non-minor violations (concerning the treatment of workers, product quality and agreement violations against customers, environmental violations) are mostly multiple offenders (see Clinard and Yeager 1980).

<sup>8</sup> There are other good reasons to doubt the wisdom of giving institutional investors a larger role in corporate governance. See, for example, Webb, Beck, and McKinnon (2003).

governance. These meetings would not be used for voting because that again would punish minority investors who are too dispersed to be able to attend.

Second, sustainable profitability can be seen as a joint effort between shareholders and managers, not just a task for managers. From a principal-agent point of view, a takeover threat is a strong form of managerial discipline (see Jensen 1986). From the point of view of joint production of profitability, hostile takeovers are destructive and have bad effects on the entire system of shareholder-manager relationships. Even before the takeover might take place, managers will take defensive measures, many of which are presumably against sustainable profitability. For example, managers may stagger the terms of directors and afford themselves golden parachutes or other forms of severance pay, and shield themselves from liability. In addition, the threat of a hostile takeover is likely to create mutual protection of various managers in an organization, a form of cooperation that will also aid in stretching the boundaries of what is deemed acceptable practice. If governments enact anti-takeover laws in order to protect firms from hostile takeovers, this may have the beneficial effect of reducing the defensive measures but it will do nothing against gain-driven (and therefore also opportunistic) behavior by managers. In order to check this behavior, voluntary or law-enforced restraints on takeovers would have to be flanked by increased rights by shareholders to underline the jointness of the production of profitability, for example by voting on directors and bylaws, by removing directors whose performance is below the acceptable level, to establish codes and require accountability and so on. Recently, Gompers, Ishii, and Metrick (2003) have shown that the combination of weak defensive measures by managers and participatory measures for shareholders has positive effects on profits and sales growth, and lowers capital expenditures.<sup>9</sup> Managers' accountability is a key element in making joint production possible. It can be used in control approaches and in joint production approaches, and in most cases it will have some measure of both. But their relative weight can differ. In the US, accountability is mainly phrased in control language (see, for example, the Sarbanes-Oxley law). By contrast, in Europe in recent times there has been an increase in codes that managers are expected to follow (such as the Combined Code in Britain, the Cromme-Kodex in Germany, the proposed Code-Tabakshat in the Netherlands). They contain a new element of transparency and disclosure that boils down to 'comply or explain'. They offer managers the chance to provide good reasons for deviating from a 'best practice' because it is well-known that best practices are very sensitive to situation and context. Even though this accountability

<sup>9</sup> The authors provide some evidence that the causal direction is not the other way around. Note that to speak, as the authors do, in this case of the 'right' power balance between managers and shareholders is still using the imagery of control-and-align approaches, neglecting joint production with different but complementary tasks for achieving profitability.

measure is linked to supervisory boards, it can be interpreted as a first approximation to a shareholder-manager dialogue in the light of joint production. The British have gone one step further by making the board collectively responsible for the success of the corporation. These are beginnings of an institutional evolution away from the 'control and align' approach to the creation of the conditions for joint production of profitability with weak solidarity.

Third, sustainable profitability can never be guaranteed. However, there are certain ways managers can act that pretty much prevent sustainable profitability, if they behave opportunistically towards key stakeholders, especially shareholders, employees and customers. We have already discussed the relationship with shareholders. But in the relationships with employees and customers, gain-driven behavior has also to be partially suspended in order to prevent a break-up of potentially profitable relationships due to mistrust and opportunism. For this reason, corporate governance would advance in the right direction if managers were held accountable for their relational management towards employees and customers, and if the standard of judgment were weak solidarity. France has recently enacted a law that requires companies to disclose details of their social responsibility practice (effective 2004). The standards are not very exacting yet—they are along the lines of the Global Reporting Initiative (GRI 2000)—but the idea is that these social reports allow shareholders and financial markets to evaluate the company better, and, from a joint production point of view, this makes sense (see Spencer and Taylor 1987; Wood 1991). It is another matter whether such reporting should be required by law or be a matter of negotiation between shareholders and managers. For the creation and maintenance of an orientation of joint production, it would be better to leave this reporting to the voluntary initiative of shareholders and managers. Once such reporting is required by law, it may lose its signal value. Until now, companies that provided such reporting sent a signal to the investors by the very fact of offering social reports. As we will see in the following and final sections, signaling becomes especially important from a framing point of view because frames are precarious. They are not equivalent to stable preferences.<sup>10</sup> Governments thus should be careful not to interfere in this signaling. In the next and last sections, I will briefly deal with the question of what signals are particularly important in joint production.

<sup>10</sup> This strongly distinguishes the framing approach from approaches that work with types, some of which have social preferences and others not. The problem with types is that interaction partners want to know whether they are one or the other, and people either signal what type they are or try to fool the other, as the case may be. Once they have been found out, interaction partners don't have to worry. They know exactly what they can expect: social or egoistic preferences. By contrast, frames can change if they are not reinforced and it will thus always matter how people behave towards others.

### Relational Signals

In a market economy, it is especially the relational frame that is precarious. It may easily be displaced by a gain (that is, money-making) frame without any guarantee to the partner that the relational frame will kick in in time. For this very reason, partners in a relationship will monitor each other's behavior for signs that the other is still in a frame that partially suspends gain-driven behavior. For the same reason, they will send *relational signals* to indicate to the other that they are still driven by relational concern (see Lindenberg 2000). Collective actors are not people but they are run by people and one can monitor whether these people give off the 'right' relational signals. For each context of joint production, these signals are important. For this reason, I will report in this section on the relational signals that have been worked out in the context of a project on monitoring social corporate performance.<sup>11</sup>

When parties are engaged in joint production, what signals are particularly important to convey partial suspension of gain-driven behavior and commitment to the relationship for its own sake?

First of all, there are *direct relational signals* that indicate the partial suspension of gain-driven behavior to the stakeholder. For example, the commitment to keep to agreements (even when it takes extra sacrifices) signals to the partner that the corporation partially suspends gain-driven (including opportunistic) behavior towards the other. Second, sustainable relationships need some reliable ground rules (*rules*) that shield the relationship from certain forms of gain-driven behavior, especially in the face of power differences. For example, certain power-related problems (such as non-sustainable agreements, exploitation, and suppression of complaints) undermine the sustainability of weak solidarity relationships and, therefore, a corporation that commits to ground rules that ban power-related problems signals to the partner in joint production that it is relationally committed and makes a serious effort to avoid opportunistic behavior due to power differences. Third, power differences do not just invite gain-driven behavior, they also lead to unintended negative side effects on the weaker party. For example, power differences create moral hazard problems. Without relational concern, the more powerful party can afford to pay little attention to negative side effects on the weaker party. Cumulative negative side effects undermine the sustainability of a relationship and thus need to be monitored and avoided. We call this *care*.

<sup>11</sup> This project of Groningen University, coordinated by Siegwart Lindenberg, consists of a social science group (Lindenberg and Steg) responsible for the social reporting part. It also contains a group of environmental scholars (Gerbens, Moll, and Schot-Uiterkamp), and a group of economists (Groot [Free University Amsterdam] and Van Witteeloostuijn). The overall goal is to develop assessment tools for all three dimensions of corporate performance. See Steg *et al.* (2003).

In sum, the three kinds of relational signals are:

- *direct relational signals*: signaling partial suspension of gain-driven behavior;
- *granted rights*: signaling commitment to ground rules and to the avoidance of the gain-driven exploitation of power differences; and
- *care*: signaling commitment to the relationship by reducing or avoiding negative side effects of power differences.

I will briefly elaborate on each of them with regard to the specific signals and therefore the specific principles involved.

#### *Direct Relational Signals*

From the sociological and social-psychological literature about weak solidarity relationships, a number of direct relational signals can be extracted. This list may not be exhaustive but it is likely to contain the most important signals. Space does not allow a thorough discussion of each of these signals. Direct relational signals convey a dual message: (a) that one is not all out gain-driven in one's behavior because (b) one also values the relationship for its own sake (that is, not just as a resource). First, probably the most basic direct relational signal vis-à-vis the other is to be *open and honest in one's communication to the other* (in the context of corporate governance this is at times referred to as 'transparency and disclosure'). Failure to do so will quickly raise suspicion that information was withheld in order to manipulate the other in the pursuit of gain. This open and honest communication plays an important role in all three joint-production contexts. Examples are: disclosure of (proxy) votes among shareholders; disclosure of relevant information on various dimensions of corporate performance by the management towards shareholders and potential investors; open communication towards employees and customers about issues relevant to their well-being. Second, promises that are made for strategic reasons in the pursuit of gain are also expected to be broken for the same reasons. Commitment to *keep to agreed rules and promises* (even if that entails a sacrifice) is thus an essential relational signal. Deviation from rules and promises needs special and believable explanation (such as mishaps and accidents, see below), embedded in an open dialogue. For example, if employees' wages have to be cut while managers' wages and bonuses are grossly increased, it is difficult to find believable explanations. As a consequence, there may be stonewalling, which damages the relationship. In a relational approach, deviations that cannot be explained or compensated are a sign of gain-driven behavior. For this very reason, the 'comply or explain' clause of many new codes is a step in the relational direction. Third, when scarce resources have to be divided or distributed among the partners of a relationship, the *fairness* of the division or distribution is a strong relational signal. If one obviously tries to get more of the rewards and/or less of the costs than one's fair share, it is clear

that one's gain-driven behavior is not suspended and that the value of the relationship was in any case not large enough to keep gain-driven behavior in check. This issue is mostly relevant to the relationships between managers and shareholders (for example, about management's claims to compensation, and about insiders' trading which leads to an unfair distribution of windfall gains), between managers and employees (for example, regarding wages), and between managers and customers (for example, regarding the sharing of rising or falling costs). Fourth, things can go wrong and look like gain-driven behavior although they are not. They happen because of mishaps, misunderstandings, accidents, wrong conceptions about the other's interests and constraints, and so forth. For this reason, the commitment to an *open dialogue* is a clear signal that the other's intentions and restrictions are taken seriously in their own right and seen as an essential part of the ongoing relationship. The possibility that such situations can arise can hardly be overestimated. Given the importance of relational signals, there is little that can damage a relationship so quickly as the wrong interpretation of signals. An open dialogue is important for all three contexts of joint production, but probably most important for shareholders and managers, and for managers and employees.

#### *Granted Rights*

Ground rules set the basic parameters of interaction. Like constitutions (see Buchanan 1990), they must be exempt from change through negotiation because, if they were open to negotiation, they would be in danger of being affected by power differences. Power differences can make partners agree to arrangements they find degrading or make them accept dictates without the right to be heard, both of which are incompatible with sustaining joint production.

What are the relevant ground rules for relationships engaged in joint production? First, every potential partner must have the right not to be excluded from joining the joint production on the basis of a characteristic that is functionally non-essential, such as gender, race, sexual preference, nationality, or status (*non-discrimination*). Second, a basic ground rule that must be granted in sustainable relationships is the right to have those norms observed that protect the other's moral identity. These are *general and local norms of decency*. For example, sexual harassment of employees goes against this basic right, as do attempts at corruption, or orders to lie or cheat. Power differences may render this non-negotiable right additionally important because people in desperate situations may be willing to waive norms of decency for certain rewards. Third, because things can go wrong, a relationship cannot be sustained if there is no basic *right to issue a complaint and be heard*. Again, without strong commitment, this right may be simply taken away by the more powerful actor or it may be bargained away by a weak partner. Either

way, without this right, infractions against other basic rights and other such negative relational signals are likely to accumulate and undermine sustainability. For specific actors in joint production, there may be specific rights, such as the right not to be forced into labor service (this includes a prohibition of child labor under the assumptions that children up to a certain age cannot negotiate a labor contract for themselves). Another example is the right of employees in discussions about management-employee relationships, they are just as relevant in the other contexts of joint production. We are just not used to looking at shareholders as jointly producing corporate governance and at shareholders and managers as being engaged in a joint effort to increase and sustain profitability. Therefore, issues of barring certain investors from being heard or orders to lie and cheat in supervisory boards are not often subject of deliberation regarding basic rights.

#### Care

Remember that the basic heuristics that guided our search for signals is weak solidarity. This does not contain charity in the sense of contributing to a worthy cause. 'Care' as used here is related only to cushioning the possible negative consequences of power differences. The more asymmetric the relationship of the one party to another, the more the sustainability of this relationship requires the more powerful partner to show care for the 'well-being' of the less powerful partner. If not, negative externalities of the power difference are likely to undermine the sustainability of the relationship. This asymmetry in power can, for example, be found in institutional investors vis-à-vis minority investors, or by employers vis-à-vis employees and customers. The most general signal of relational commitment via care is to show commitment to *decrease the power difference* by helping to advance the situation of the weaker partner. This can take different forms, depending on the partner. For shareholders, this would mean special institutional arrangements for representing minority investors' interests. For managers, it would mean offering employment and insurance security, job training, and career development to employees, and health and safety provisions to both employees and customers.

#### Informal Sanctions

Criminalizing deviant behavior by managers does not deliver the expected results of conformity to ethical standards. Criminalizing emanates from a control approach, such as the principal-agent approach. A scholar on criminal justice recently observed about criminalization of corporate crime: 'criminalization is uninformed by the empirical literature. It is "bad science" and therefore "bad policy"' (Simpson 2002: 159). By contrast, it has often

been observed that informal sanctions may work much better than formal sanctions (see, for example, Gramnick and Bursik 1990; Nee 1998). When people can be shamed into conformity to norms of business ethics, when they care about their ethical reputation and identity, when they care about what significant others think of them, then behavior is sensitive to small informal mutual sanctioning and the disadvantages of a formal sanction system (it requires observability and fairly high standards of proof) can be avoided. However, there are rarely concrete suggestions on how one gets these informal sanctions to work and, if they work, how one can prevent them from having perverse effects. There are at least two prominent perverse effects of informal control. First, when people gossip behind your back or complain to higher-ups, it will lead to animosity and relational breakdown, lowering or preventing the potential advantages of informal sanctions (see Wittek, Van Duijn, and Snijders 2003). Second, informal control can lead to 'old-boy networks' or defiant sub-groups in which members help each other in reaching deviant goals which undermine organizational goals (Flache and Macy 1997). In this chapter, the answer to the question how to prevent the perverse effects from occurring can be found in relational signaling. As we have just seen, these signals are in part institutional commitments (such as basic rights) and in part signals in daily interaction (such as keeping to agreements), both premised on joint production and the alignment of relational commitment. The claim here is that whatever makes relational signals work will also make informal sanctions work because then informal sanctions become themselves relational signals.<sup>12</sup> If management and workers both perceive their interrelation as joint production, then the likelihood of perverse effects of informal sanctions among and between them is small.

#### Consistency

Relational signals convey a certain orientation towards partners in joint production. Because of framing effects, such an orientation also conveys what is in the foreground and what in the background of people's minds, what overriding goal is being pursued, what kind of alternatives are being considered, and so forth. For this very reason, an actor in joint production cannot afford to stand for some of the signals and neglect the others if he is committed to sustainability of the relationship. Partners will interpret the other's actions in the light of consistent relational signals. If, for example, a corporation keeps to agreed rules and promises but shows no commitment to basic rights or to standards of fairness, then it is likely that the employees will interpret the keeping to agreed rules and promises not as a relational signal but as a strategy that might change the moment it suits the corporation

<sup>12</sup> See Wittek (1999), which investigates the relation between relational signaling and informal control.

to do so. In other words, selective neglect of relational signals is likely to work against sustainability of relationships. Of course, not all detailed signals weigh equally heavily. For example, because of the asymmetry between gains and losses (see Kahneman and Tversky 1984), it is likely that failing to abstain from harming the other will be more damaging to sustainability than failing to reduce the power difference. If this relational approach is at least in part correct, then relational signals would have to be incorporated into codes of corporate governance in all three contexts of joint production. They would have to be monitored and made the basis of the dialogue between partners of joint production. In addition, they would lend themselves well as criteria for shareholders holding managers accountable for their relationship with employees and customers.

### Conclusion

Corporate governance, as all governance, is to a large extent directed at reducing opportunistic behavior. The approach to corporate governance taken in this chapter is a relational one. It is based on new research on opportunism. In the principal-agent approach, opportunistic behavior is 'strategic', that is, in interaction it is farsighted and calculating and needs to be checked by control and interest alignment. By contrast, research on motivational and cognitive processes shows that people are often strongly guided by short-term interests, even if they thereby go against their longer-term interests ('myopic opportunism?'). Thus, control and interest alignment are not enough by themselves to check opportunistic behavior. What is worse, the control approach often leads to an escalation of protective measures (to avoid control) and increased control (to break through the protective measures) with increasingly adverse side effects of both. The same research on motivational and cognitive processes (that is, framing) that identified the power of 'myopic' opportunism suggests that the same mechanisms can be used against it. Framing effects combine dominant goals with processes of selective attention, pushing opportunity costs into the cognitive background. When a person's frame is linked to a dominant goal of gain (in terms of scarce resources, such as money and status) this person is unlikely to be able to sustain a cooperative relationship with others. Such a relationship depends on the partial suspension of gain-driven behavior and a clear interest in the relationship for its own sake. When this interest is strong enough, it can displace a gain frame in favor of a relational frame whenever the former becomes too incompatible with sustaining the relationship, and vice versa. People who are aware of being engaged in *joint production* can develop and sustain such relationships, given that they can convincingly signal their relational concern through relational signals. When these signals work, informal sanctions will also work to keep the various parties focused on the joint tasks.

Having tools for the workings of informal sanctions in place becomes increasingly important as the limits of stronger controls and punishments (criminalization) become widely recognized. Governance in the sense of checking opportunistic behavior is then first and foremost the governance of framing processes that allow potentially advantageous relationships not to break up for reasons of mistrust and myopic opportunism. For corporate governance, this means a change in institutional design, away from control and alignment as the major emphasis, and towards joint production and the relational management that goes along with joint production. The three obvious and interrelated foci of joint production for corporate governance are the shareholders themselves, the relationship of shareholders with managers, and the relationship of managers with employees and customers. In order to establish a relationship with the managers, shareholders would first have to establish a context in which they see themselves jointly producing corporate governance. Second, profitability can be seen as a joint effort of shareholders and managers. Third, profitability depends to a large extent on the production and distribution of goods and services, and that can be seen as joint production of the corporation with relevant stakeholders (such as employees and customers). In all three foci, the overriding heuristics for institutional design would not be control and interest alignment but possibilities for joint production. There are some encouraging signs in some of the new European codes in the direction of joint production. But there is still a long way to go to get away from the old guiding idea that corporate governance is corporate control.

### References

- Buchanan, J. (1990). 'The Domain of Constitutional Economics', *Constitutional Political Economy*, 1: 1-18.
- Buskens, V. (2002). *Social Networks and Trust*. Boston, Dordrecht, London: Kluwer.
- Clinard, M. and Yeager, P. (1980). *Corporate Crime*. New York: Free Press.
- Dyer, J. (1997). 'Effective Interfirm Collaboration: How Firms Minimize Transaction Costs And Maximize Transaction Value', *Strategic Management Journal*, 18: 535-56.
- Flache, A. and Macy, M. (1997). 'The Weakness of Strong Ties: Collective Action Failure in a Highly Cohesive Group', *Journal of Mathematical Sociology*, 21: 3-28.
- Galanter, M. (1974). 'Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change', *Law and Society Review*, 9: 95-160.
- Gompers, P., Ishii, J., and Metrick, A. (2003). 'Corporate Governance and Equity Prices', *Quarterly Journal of Economics*, 118: 107-55.
- Grasmick, H. and Bursick Jr., R. (1990). 'Conscience, Significant Others, and Rational Choice: Extending the Deterrence Model', *Law and Society Review*, 24: 837-61.
- GRI (Global Reporting Initiative) (2002). *Sustainable Reporting Guidelines on Economic, Environmental and Social Performance*. Boston, MA: GRI.

- Jensen, M. (1986). 'Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers', *American Economic Review*, 76: 323-9.
- Kahneman, D. and Tversky, A. (1984). 'Choices, Values, and Frames', *American Psychologist*, 39: 341-50.
- Kahneman, D., Knetsch, J., and Thaler, R. (1986). 'Fairness as Constraint on Profit Seeking: Entitlements in the Market', *American Economic Review*, 76: 728-41.
- Latham, M. (2003). 'Democracy and Informalities', *Corporate Governance*, 11: 91-101.
- Lawler, E. and Yoon, J. (1993). 'Power and the Emergence of Commitment Behavior in Negotiated Exchange', *American Sociological Review*, 58: 465-81.
- Lindenberg, S. (1986). 'The Paradox of Privatization in Consumption', in A. Diekmann and P. Mitter (eds.), *Paradoxical Effects of Social Behavior: Essays in Honor of Anatol Rapoport*. Heidelberg/Vienna: Physica-Verlag.
- (1992). 'An Extended Theory of Institutions and Contractual Discipline', *Journal of Institutional and Theoretical Economics*, 148/2: 125-54.
- (1998). 'Solidarity: Its Microfoundations and Macro-dependence: A Framing Approach', in P. Doreian and T. Fararo (eds.), *The Problem of Solidarity: Theories and Models*. Amsterdam: Gordon and Breach.
- (2000). 'It Takes Both Trust and Lack of Mistrust: The Workings of Cooperation and Relational Signaling in Contractual Relationships', *Journal of Management and Governance*, 4: 11-33.
- (2002). 'Governance Seen from a Framing Point of View: The Employment Relationship and Relational Signaling', in B. Nooteboom and F. Six (eds.), *The Trust Process Within Organizations*. Cheltenham: Edward Elgar.
- (2003). 'The Cognitive Side of Governance', *Research in the Sociology of Organizations*, 20: 47-76.
- Milgrom, P. and Roberts, J. (1992). *Economic Organization and Management*. Englewood Cliffs: Prentice-Hall.
- Nee, V. (1998). 'Norms and Networks in Economic and Organizational Performance', *The American Economic Review*, 88: 85-9.
- Osterloh, M. and Frey, B. (2000). 'Motivation, Knowledge Transfer, and Organizational Form', *Organization Science*, 11: 538-50.
- Raub, W. and Weesie, J. (2000). 'The Management of Durable Relations', in J. Weesie and W. Raub (eds.), *The Management of Durable Relations: Theoretical Models and Empirical Studies of Households and Organizations*. Amsterdam: Thela Thesis.
- Sabel, C. (1993). 'Studied Trust: Building New Forms of Cooperation in a Volatile Economy', in R. Swedberg (ed.), *Explorations in Economic Sociology*. New York: Russell Sage Foundation.
- Sartier, N. and Kerr, N. (1991). 'Might versus Morality: Motivational and Cognitive Bases for Social Motives', *Journal of Personality and Social Psychology*, 60: 756-65.
- Scott, W. and Cherington, D. (1974). 'Effects of Competitive, Cooperative, and Individualistic Reinforcement Contingencies', *Journal of Personality and Social Psychology*, 30: 748-58.
- Simpson, S. (2002). *Corporate Crime Law and Social Control*. Cambridge: Cambridge University Press.
- Spencer, B. and Taylor, G. (1987). 'A Within and Between Analysis of the Relationship between Corporate Social Responsibility and Financial Performance', *Akron Business and Economic Review*, 18: 7-18.
- Steg, L., Vlek, C., Lindenberg, S., Groot, T., Moll, H., Schoor-Lieterkamp, T., and Van Witteloostuijn, A. (2003). *Towards a Comprehensive Model of Sustainable Corporate Performance*. Groningen: Departments of Economics, Environmental Sciences, Management Science, Psychology, and Sociology, University of Groningen.
- Tyler, T. and DeGoeij, P. (1996). 'Trust in Organizational Authorities: The Influence of Motive Attributions on Willingness to Accept Decisions', in R. Kramer and T. Tyler, *Trust in Organizations*. Thousand Oaks: Sage.
- Uzzi, B. (1997). 'Social Structure and Competition in Interfirm Networks: The Paradox of Embeddedness', *Administrative Science Quarterly*, 42: 35-67.
- Vaughan, D. (1999). 'The Dark Side of Organizations: Mistake, Misconduct, and Disaster', *Annual Review of Sociology*, 25: 271-305.
- Webb, R., Beck, M., and McKinnon, R. (2003). 'Problems and Limitations of Institutional Investor Participation in Corporate Governance', *Corporate Governance*, 11: 65-73.
- Williamson, O. (1993). 'Calculativeness, Trust, and Economic Organization', *Journal of Law and Economics*, 36: 453-86.
- Wittck, R. (1999). *Interdependence and Informal Control in Organizations*. Amsterdam: Thela Thesis.
- Wittck, R., Van Duin, M., and Snijders, T. (2003). 'Frame Decay, Informal Power, and the Escalation of Social Control in a Management Team: A Relational Signaling Perspective', *Research in the Sociology of Organizations*, 20: 355-80.
- Wood, D. (1991). 'Corporate Social Performance Revisited', *Academy of Management Review*, 16: 691-718.

