Sustainable Corporate Governance and a New Law and Economics

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Long Abstract

In this essay, we consider the regulatory changes at the European level regarding sustainable corporate governance, particularly the reform of the directive on non-financial reporting and the directive on sustainable corporate due diligence. We highlight a change in approach and we seek an interpretative framework that offers some coherence and intelligibility to what is emerging in terms of a business model. To this end, we present a new definition of Law and Economics.

This definition is a contribution that could stand alone, but it seems appropriate to present it in a context where its functionality for interpreting, explaining, and possibly justifying existing and future norms (de jure condendo) is simultaneously demonstrated. According to this definition, the essential concepts of economic analysis of legal institutions (and institutions in general) are those of equilibrium and equilibrium selection. Before legal norms can be efficient, they must be "effective", which requires the property of equilibrium. In this perspective, the law serves two purposes. On the one hand, it is an external determinant (the others being the state of nature and technology) of the rules of the game that define the interactive situation (game) within which an institution can emerge. On the other hand, it is part of the solution of the game, meaning it plays a role in selecting the specific equilibrium that will become an institution.

The central theme of the new Law and Economics is how and which norms (legal or pre-legal) determine the convergence to equilibrium (i.e., the creation of a legal institution). It's easy to see that the influencing property for convergence may not be efficiency. In fact, the Pareto efficiency condition can be satisfied by a wide variety of alternative equilibria, completely different in terms of the distribution of payoffs among the agents (and, therefore, in terms of ideas of justice). So, it does not select any particular equilibrium (institution) by itself. Moreover, efficiency is not unique because it depends on the pre-existing institutional context that sets the status quo, against which mutual advantage is calculated. What matters is what the players expect and believe that others will do, and whether there is a focal factor that can focus expectations on an outcome that can serve as the basis for an agreement. If we interpret fairness as a "fair agreement" or what everyone expects each person would do in a given situation, then a notion of fairness seems like the obvious candidate because it allows the selection of an equilibrium among the many that may satisfy the efficiency condition.

Since there are typically multiple possible equilibria and potential institutions, the processes of equilibrium selection, along with shared mental models or frames that can guide the convergence process, play a significant role. This mental model or shared frame is not only a cognitive constraint on what we consider possible but also a prescription for how to play the game, leading to the belief that every other player is likely to play it the same way, narrowing down the set of possible equilibria. This is why we believe that the law can have an essential role. As a legal norm represents the result of a collective choice supported by a certain consensus and possesses normative content, it can activate a frame in the minds of agents and induce the belief that the mental representation of other agents aligns with one's own and defines a path of equilibrium selection. In the emergence of an institution, the normative meaning of the rule plays a significant role in guiding how the game is played and generates the expectation that others will do the same. The normativity (of the mental model or frame) is part of the explanation and goes beyond the limited prescriptiveness that is always present in every equilibrium but is only realized ex post when the equilibrium is reached.

From the idea that the key factor is a mental model sufficiently accepted a priori, before particular institutional outcomes have consolidated – and that contributes to their emergence – and from the hypothesis that this model can be reflected in a legal norm in fieri (de jure condendo), not just in informal social norms, we conclude that

the predominant device for activating the frames we are concerned with is an idea of the social contract – typically, the idea of a foundation for legal norms. A shared idea of a social contract is the mental schema, the pattern by which we recognize the game and influence the convergence dynamics to reach equilibrium. In the simplified representation of the game, it extracts its essential, abstract, and general characteristics, making them symmetrical among players and omitting a multitude of details about individual players. This leads us to identify which equilibrium outcomes could be subject to an impartial and impersonal agreement.

Although there could be more than one version, we state that the best account of this idea, or at least the one most suitable for our case, is the Rawlsian one. Based on this, we provide an account of the reasons for the ongoing institutional change, viewed as functional to the progressive emergence of the institutional model of socially responsible businesses. In this model, those in positions of authority within the company have extended fiduciary duties towards stakeholders beyond the owners. The foundation of this model of business is the possibility of explaining and justifying it in line with the idea of a *social contract* among stakeholders.

Finally, we propose a comparative analysis of how from two competing models of the firms - aiming at the selection of different institutional models of *corporate governance* - the norms of sustainable corporate governance can be deduced. On the one hand, the "Copernican" model of the socially responsible multi-stakeholder corporation, extending fiduciary duties to the corporate stakeholders beyond the owners. As it is grounded on the social contract of the firm (at micro level, at constitutional level, and as social contract agreed in a state of nature-like situation), it simply allows to reconstruct in its proper terms and consistently with its concepts the current regulatory European developments. Additionally it also permits to predict testable new fact about the endogenous conformity attitudes that an approval of social contract-based norms of corporate governance would activate. On the other hand, the "Ptolemaic" model of "shareholder value" only by means of quite stranger *ad hoc* hypotheses can force the theory of reputation effects in repeated game – significantly adapted to the context of incomplete contracts and hierarchical firms – to support the idea that the norms of corporate sustainability are simply strategies that uniquely serve as an instrument of profit maximization.

Therefore, the social contract regains its relevance by drawing attention to the functioning of capitalism and corporate governance mechanisms. It now appears possible that companies must respond to multiple interests and contribute to sustainable development goals, which naturally balance with the profit objective. This vision is an equilibrium selector, but it is an ongoing process.