EURAM 10th conference
Rome
19-22 May 2010

The Firm as a Nexus of Promises

Pierre-Yves GOMEZ

French Corporate governance Institute. EMLYON business School

Harry Korine

French Corporate governance Institute. & INSEAD

The Firm as a Nexus of Promises

Abstract.

In this paper, we articulate the meaning of understanding the firm as nexus of promises, showing how the tendency towards null contracts in a world of increasing complexity makes promises central to governing the firm. Based on the specific case of the promise to increase return on equity in the publicly listed firm, we work out the structural determinants of the hierarchy of promises where the interests of employees and shareholders are contradictory, developing propositions about the relationship between the organization and composition of employees, on the one hand, and the organization and composition of shareholders on the other, and the propensity of firms to make promises. In the concluding discussion, we move beyond a structural explanation to explore how executives choose to ally with employees or shareholders, drawing on a discussion of the recent history of the financial services industry.

Introduction.

In the tradition of Coase (1937), Demsetz (Alchian and Demsetz, 1972), and Williamson (1975) the firm is understood as a nexus of contracts. The difficulty in fully specifying contracts in all cases means that contracts are often incomplete (Grossman and Hart, 1986; Hart and Moore, 1999). When relationships between stakeholders are complex, null contracts become common (cf. Hart and Moore, 1999), and promises play an important role in maintaining the cohesion of the firm and in confirming its position. In addition to contracts with its stakeholders, then, the firm also makes promises, e.g. about the duration and development of contractual relationships, or about price levels to be expected in the future. Hence, the firm can also be understood as a nexus of promises.

Whereas contracts engage the liability of the firm and its executives, promises engage the credibility of the corporate actors who make them. Contracts try to leave as little room for interpretation as possible and are governed by a strict legal hierarchy of claims on the firm that clearly defines who gets paid first, second, and third. Promises, on the other hand, leave more space for manoeuvre; the hierarchy of promises is not clearly defined ex ante. If promises to different stakeholders make up an important proportion of the engagements of the firm, then it is necessary to develop an understanding of the factors that determine the hierarchy of promises. Indeed, the firm and its executives may make contradictory promises to different stakeholders, for example promising job security to domestic employees and, at the same time, promising heavy investments overseas to clients and shareholders. Which of these promises is more likely to be kept, in the event that the firm is unable to honour all of them?

A particularly good fulcrum for analyzing the logic of the hierarchy of promises in the firm is the publicly listed firm's promise of an increase in return on equity (ROE), as practiced by numerous financial institutions (banks, insurance companies) in recent years. Promising an increase in ROE has significant implications for both shareholders and employees. Unlike quarterly earnings forecasts that provide immediate *feedback* on the performance of management and are therefore taken by the financial markets as a proxy for the health of the firm (cf. Graham, Harvey, and Rajgopal, 2005), increases in medium-term ROE targets represent a statement of intent concerning the future direction of the firm. Given that a focus on achieving a higher ROE has implications for both risk and long-term sustainability, employees are being told that their prospects in the firm are likely to be more unstable and of shorter duration. In other words, the promise to shareholders of an increase in ROE may contradict growth and career promises made to employees, quite apart from the employment contract.

Taking the promise of an increase in ROE as a test case for exploring the hierarchy of promises in the firm has the additional feature of allowing us to distinguish between different types of shareholders and different types of employees. An increase in the ROE target does not affect all shareholders and all employees in the same way; whereas for some types of shareholder an increase in the ROE target is not welcome (i.e. long-term shareholders who eschew risk), for some types of employee it is (i.e. those employees who are most likely to benefit financially from the increase in ROE and who are least dependent on the firm for their long-term prospects). Thus, we can use the particular case of an increase in the ROE target as a basis for discussing how a hierarchy of promises gets established both between shareholders and employees and within those two stakeholder groups.

In the first section of the paper, we articulate the meaning of understanding the firm as nexus of promises, showing how the tendency towards null contracts in a world of increasing complexity makes promises central to governing the firm. In the second section, the heart of the paper, we work out the structural determinants of the hierarchy of promises in the case of an increase in the ROE target. We build on this argument to develop propositions about the relationship between the organization and composition of employees, on the one hand, and the organization and composition of shareholders on the other, and the propensity of firms to make promises to increase the ROE target. In the final section, we move beyond a structural explanation to explore how executives of the firm choose to ally with employees or shareholders. This last part of the paper draws on a discussion of the recent history of the financial services industry.[1]

I. From contracts to promises

The focus on ROE is entirely consistent with many similar attempts to characterize the relationship between shareholders and the firm in terms of a simple measure of performance. The bases of these efforts at simplification can be found in economics. Since the pioneering work of Jensen and Meckling (1976), agency theory has made a critical distinction between two types of claimants. On the one hand, there are the contractual claimants, that is to say those parties who can call on a contract to enforce their claims in front of a third party (the judge): employees, clients, or bond holders. On the other hand, there are the residual claimants, essentially the shareholders, who are not tied to the firm by contract, but instead obtain a variable return on their investment that, by definition, cannot be known ex ante. Shareholders are the beneficiaries of a more or less precise promise that can be cashed in at the end of the year, when results are definitely established.

The legitimate power of shareholders over the firm stems from the risk of non-renumeration (or inadequate remuneration) that they assume and which leads them to want to make sure that the executive maximizes the profit of the firm. As outlined above, the distinction between contractual stakeholders and non-contractual stakeholders (namely shareholders) that only benefit from promises is at the heart of the financial

[1] More than any other industry, financial services, and especially banks, have made the ROE target a focus of their promise to shareholders. This started with Walter Wriston, Chief Executive and later Chairman of Citicorp (1976 to 1984), who succeeded in shifting the principal strategic objective of first his own bank and then, by mimesis, of the broader banking world, from size of assets to return on equity (Zweig, 1996).

economics approach to the role of the shareholder (Fama and Jensen, 1983). According to Williamson (1975), however, economic actors prefer contracts to promises. Why don't shareholders also benefit from contracts, just as the other stakeholders of the firm ?

Economic theory states that it is difficult to sign contracts when indescribability, assymetric information (Grossman et Hart 1986, Ayres et Gertener 1989, 1992) and unverifiability (Schwartz 1992) limit the possibility of complete contracting. The first limitation, indescribability, refers to cognitive restrictions on the rationality of actors that prevent them from anticipating all future conditions at the time of creating contracts. In the case of the second limitation, information may be assymetric at the time of signing contracts, because not all stakeholders have the same level of information nor an interest in revealing the information they possess. The third limitation, finally, states that certain contractual clauses may be unverifiable because the conditions according the which they are executed are contingent upon situations that are very complex to describe at the time of signature (Schwartz 1992 ; Hart 1990). Under this limitation, the contracting parties have no interest in signing a contract that may never be executed (Macho-Sadler and Pérez-Castrillo 1997).

Economic theory has demonstrated that when the above three limitations on contracting are strong, the elaboration of sophisticated contracts is not useful and, moreover, entails high transactions costs. In such situations, it is more rational for the actors to sign null contracts (Hart and Moore, 1999), that is to say contracts that merely guarantee price and quantity and can be renegotiated on the market. Payment of the promised price functions as a guarantee for the good realization of the contract, and the renegotiation of the contract obliges the contracting parties to respect its terms. In this way, one can also explain the propensity of firms to reduce the expression of performance to simple financial ratios such as ROE. Given the complexity of the conditions involved in realizing profit, only a *null contract* allows for the establishment of a rational relationship between firms and shareholders.

Some publicly listed firms, and among them quite a large number of financial institutions, have adopted the practice of announcing an increase in medium-term return on equity (ROE) targets.

> September 4, 2003: Josef Ackermann, Spokesman of the Board of Managing Directors and Chairman of the Group Executive Committee (Deutsche Bank), will confirm at an investor conference the bank's target pre-tax return-on-equity of 25 per cent in the medium term.
>
> 29 Feb 2008: Today, Swiss Re reported a strong net income for 2007 of CHF 4.2 billion and a return on equity of 13.5%, "With these opportunities in mind, we are confident in Swiss Re's growth prospects. We remain focused on our medium-term objective of 10% growth in earnings per share and have increased our return on equity target to 14% over the cycle", said Jacques Aigrain, Swiss Re's CEO.

The fact that executives repeatedly insist on the higher ROE target and cling to it even under dramatically changed conditions suggests that management views the increase in ROE target as a promise to shareholders. Significantly, the promise of an increase in ROE is not made in a vacuum, but backed up by concrete resource allocation decisions, such as, in the case of Deutsche Bank referred to above, a clear strategic refocus in the early years of this decade on investment banking and trading activities, to the detriment of traditional retail banking.

If the announcement of an increase in the ROE target can be considered as a promise to shareholders and is backed by credible commitments (cf. Williamson, 1975), then the shareholders' place in the hierarchy of claims on the corporation needs to be re-examined (cf. Barclay and Smith, 1995). Unlike employees and bond holders, shareholders do not have contracts with the corporation, but, in this case, the promise that has been made to them may be worth as much in practice, if not more.

In the preceding argument, we have isolated the relationship between the firm and shareholders from the other relationships between the firm and its stakeholders. Shareholders were considered to be residual claimants to whom promises are made, while the other stakeholders were treated as contractual claimants who are tied to the firm by *governing contracts* such as work agreements (employees), covenants (bond holders) or guarantees (customers). This, the classical distinction that forms the basis for the economic theory of property rights, has long been questioned in the broader organizational and marketing literatures. The basic problem is the inability to specify complete contracts over the life of the relationships, both with employees and with customers. In the following and for the rest of the paper, we will focus on the relationship between the firm and its employees; a similar line of argument can be taken for the relationship between the firm and its customers.

As Simon (1951) showed many years ago, the employment contract is incomplete, because, by definition, it allows for a zone of discretion within which the hierarchy can adjust the task of the employee as conditions change. In this sense, the employment contract is evolutionary (Williamson, 1975) and cannot be totally specified ex ante. Since the 1980s, an important literature has developed around understanding the employer's zone of discretion as a domain of promises towards employees. In effect, a psychological contract is established between employer and employee (Argyris 1960; Schein 1965 ; Rousseau et al. 1989 ; Rousseau and McLean Parks 1993). In exchange for his/her loyalty, time and energy, the employee receives promises of job security, career oppotunity, and training (Gordon and Lee, 1990, Shapiro and Tune 1974, Rousseau 1990, Schwoerer and Rosen 1989). Thus, the employment contract consists in no small part of promises that are the subject of interpretation, based on written documents like handbooks and organization charts, but also on communication and official language as pronounced in the statements of senior management (Guest and Conway 2002). The more important human capital is for the firm, the more promises made to employees constitute an important factor of firm performance (Morrison and Robinson 1997 ; Robinson 1996). Not keeping these promises impacts how employees perceive the level of *orgnizational support* they receive from the firm and hence conditions their efforts and loyalty (Robinson 1996 ; Kiewitz et al 2009).

The development of the organizational literature suggests that the modern firm cannot adequately be characterized as the *nexus of contracts* described by property rights and agency theorists (cf. Alchian and Demsetz, 1972). Contracts reinforce or clarify the boundaries of stakeholder relationships, but the *governing system* consists largely of promises. Indeed, the more complex the relationships among stakeholders become, the stronger the tendency towards null contracts, and the greater the importance of promises in the governance of the firm. The modern firm can therefore be seen as a *nexus of promises*. If promises to different stakeholders make up an important proportion of the engagements of the firm, then it is necessary to develop an understanding of the factors that determine the hierarchy of promises. Which of the promises is more likely to be kept, in the event that the firm is unable to honour all of them?

II. Structural determinants of the hierarchy of promises

The promise of an increase in return on equity (ROE), as practiced by numerous financial institutions represents a null contract and crystallizes the contradictions that promises can create, both between shareholders and employees as well as within those groups. As stated in the introduction, the promise to shareholders of an increase in ROE may contradict security and career promises made to employees, quite apart from the employment contract. How to determine which promises take precedence in practice? The way to shed light on this puzzle is to examine the balance of power among the various stakeholders of the firm and to examine which stakeholders are better able to respond in the event that the promises made to them are not kept (Gomez and Korine, 2008).

The Discretionary Power of the Executive

In the nexus of promises constituting the firm, the role of the executive is crucial. The executive stands behind the announcement of and guarantees the execution of promises. In other words, he/she is doubly engaged, making promises in the name of the firm and assuming responsibility for realizing or violating the promises made. This is different from the contractual approach, in which the executive only ensures the correct execution of contracts that can be contested in front of a judge in case of disagreements about their realization. The result of promises made cannot be legally contested. This allows the executive to choose a strategy that breaches the promise of job security or fails to achieve a certain level of ROE without having to face aggrieved stakeholders in a court of law. More than engaging the *liability* of the executive, promises made engage the *credibility* of the executive.

In a firm considered as a nexus of promises, it is critical for the executive to maintain his/her credibility – the credibility of the executive is the basis upon which stakeholders accept or reject his/her promises. In the best of all worlds, the executive can honour all of the promises made; in practice, contradictions between promises made to different stakeholders imply that the executive chooses to honour some and violate others. Four criteria influence the executive's preferences towards the economic actors to whom he/she makes promises.

(1) The executive prefers to honour promises made to those stakeholders who represent a credible threat of leaving the firm and thereby diminishing the resources at the executive's disposal.

(2) The executive relies on his/her principal supporters to maintain his/her credibility. By making sure to honour promises made to those stakeholders who support him/her, the executive avoids losing legitimacy and maintains power.

(3) The executive prefers to honour promises made to those stakeholders who pose a legitimate threat to his/her position and his/her job in case of breach of the promise.

(4) The executive prefers to honour promises that maximize his personal revenue. Ceteris paribus, he/she will choose to keep the promise most closely aligned with his own remuneration. This is the principle behind the compensation schemes developed on the basis of the predictions of agency theory (Barkema and Gomez-Mejia, 1998; Baker, Jensen, Murphy, 1988).

In a firm considered as a nexus of promises, the executive has a large amount of discretion in deciding which promises to honour, provided that he/she can maintain sufficient credibility in the eyes of stakeholders. However, he/she also takes the risk of disappointing stakeholders and eventually being removed from office by them, without the legal protection afforded by a contractual relationship. In order to understand how the balance of power in the firm affects the choices of the executive, it is necessary to weigh the cohesion and importance of the stakeholders the executive is working with. In the case of the promise to increase ROE, two sets of stakeholders are central, employees and shareholders. We will discuss each of them in turn.

Organization of Employees

As stated earlier, the promise to increase ROE may contradict promises about job security and career development made to employees. How the executive weighs the risk to his/her position of not honouring these promises and disappointing employees will depend on the cohesion of employees. Employee interests will be weakly represented if the firm's labour unions are co-opted or otherwise limited in reach; in this case, threats to respond if promises are not met are not credible. For example, if the firm is constituted of multiple recently merged entities in which employees and their unions have not yet had a chance to coalesce; and if the bulk of employees (in number) work far from the centre of corporate power. In the financial services industry as a whole, employee organization and interest representation was already weak in the 1980s and has further weakened over the last twenty-five years.

Proposition 1: Organization of Employees

→ Ceteris paribus, firms that have a lesser degree of employee organization are more likely to promise to increase ROE.

Importance and Firm-Specificity of Human Capital

For the purposes of Proposition 1, we assumed all employees to be equal in terms of their human capital endowment. In fact, however, employees do not all possess the same level of human capital. For the executive, it is rational to keep promises towards those employees whose human capital has a determining effect on the performance of the firm. This argument is even stronger in the case where especially talented employees do not depend on the resources of the firm for the results they produce and can easily find work elsewhere. Their loyalty is essential to the performance of the firm, and they have a credible threat of retaliating if the promises made to them are not met. These employees are in a position to capture a part of the entrepreneurial rent (Rajan et Zingales 2000). In fact, promises made to them can be linked to the achievement of a high ROE. In this way, the executive *aligns* the interests of certain employees with the interest of shareholders, reinforcing the promise focused on ROE.

At the limit, certain employees whose expertise is unique and easily redeployable outside the firm may consider the contract that ties them to the firm as a kind of type *null contract*, given the difficulty of establishing all of the conditions necessary for them to meet their objectives. They then will focus their *expectations* on the promises of *compensation* made to them, in the same way as do certain shareholders. The clearest example of this kind of arrangement is that of traders in banks who benefit from bonus payments that are based on the financial results of the firm.

Proposition 2: Importance and Firm-Specificity of Human Capital

2a) → Ceteris paribus, firms in which non-firm specific human capital is more important for performance are more likely to promise to increase ROE.

The case of a *firm specific* human capital works against a null contract based on ROE. To the extent that the most highly performing employees rely on firm resources to produce results, they will be more interested in the longer term promises of security and opportunity. This is the case of scientists working in large, resource intensive labs in the major pharmaceutical companies, for example. For the executive of this kind of firm, it is rational to honour the promises implicit in the employment relationship.

2b) → Ceteris paribus, firms in which firm specific human capital is more important for performance are less likely to promise to increase ROE.

Organization of Shareholders

In a context of weak employee organization, it does not take much for a management-shareholder coalition to impose its preferred strategy. In fact, a close alignment of financial interests between management and shareholders can produce a strong coalition of circumstance that holds as long as results are good. Paradoxically, then, a promise to increase ROE may provide the focal point around which widely dispersed shareholders and a powerful management temporarily coalesce to establish a primary claim on the corporation. This is the effect of the preference for null contracts, as explained in the previous section.

Proposition 3: Organization of Shareholder Interests

→ Ceteris paribus, firms that have a higher divergence of shareholder interests are more likely to promise to increase ROE.

Importance and Firm-Specificity of Financial Capital

In theory, all shareholders would welcome the promise of an increase in ROE, because it is costless to them and because it indicates closer alignment between the interests of management and shareholders, to the potential detriment of other claimants. In fact, not all shareholders will react the same way: some will decide that the firm does not have the means to reach the new target ROE without taking undue risk and will therefore sell, others who prefer riskier assets will buy the share for the first time or add to their existing holdings. Shareholders who are constrained from selling or buying by size or institutional commitments will stand pat.

In order to fine-tune the argument, we differentiate between shareholders whose capital moves freely in search of the best available investment opportunity and shareholders whose capital is specific to the firm, that is to say family capital, employee capital, and any other long-term capital source. Analogous to Proposition 3, in cases where capital that moves freely is most important to the funding of the firm, it will be rational for the executive to propose a null contract based on ROE.

> Proposition 4: Concentration and Firm-Specificity of Financial Capital
>
> 4a) → Ceteris paribus, firms in which non-firm specific financial capital is more important to funding are more likely to promise to increase ROE.

If family, employee, or other long-term capital is critical to the funding of the firm, however, other promises, such as reputation, job security, or longevity become more important. In these kinds of firms, the executive has to consider a wider range of possibilities and meet promises that go beyond the null contract, as represented by the focus on increasing ROE.

> 4b) → Ceteris paribus, firms in which firm specific financial capital is more important to funding are less likely to promise to increase ROE.

In this section we have treated the hierarchy of promises in a rather mechanical manner, arguing that the executive of the firm bases the decision to promise to increase ROE on a purely rational evaluation of the balance of forces in the relationships between the firm and its stakeholders. If we relax the assumption of mechanical calculation and admit the possibility of a process of choice by the executive, then the argument becomes more nuanced. The last section is presented as a discussion, exploring the sociological processes behind the executive's choice of which promises to honour.

III. Discussion: The agent chooses which promises to honour

Our argument has emphasized the discretionary power of the executive. In our model of the firm as a nexus of promises, the executive in effect chooses which principal to align with – employees or shareholders. We have stated that the executive makes the choice according to his/her interests. The interests of the executive are ultimately financial and professional, but, in order to attain these financial and professional objectives, the executive will only want to promise what he/she can credibly deliver and, in the case of contradictions between promises, honour those promises that he/she can credibly defend. This implies that working with promises involves the executive in processes of social mobilization. Rather than merely taking the cohesion and importance of various stakeholders as given, the executive is likely to work with them, mobilizing one group while undermining others, depending on the situation. Honouring promises made to the stakeholder group rallied to his/her support strengthens the executive, reinforcing the coalition of his/her choice.

Following Davis and Thompson (1994), we distinguish between four determinants of a group's capacity to act collectively: interests; social infrastructure; mobilization processes; and political opportunity structure; the first three of these, in turn, stem from Tilly's (1978) historical discussion of social movements, while the last was first presented in McAdam's (1982) description of Black American political mobilization.

Rather than using the Davis and Thompson framework of social movement to look at the case of a particular firm, we propose to apply it in an exploratory manner to the study of the evolution of the financial services industry over the last twenty-five years. Recall that the financial services industry has witnessed a striking change in success metric, from asset size to ROE over these years. Not all firms, but a great many in the financial services industry, have made steps in the direction of focussing on ROE. The economic explanation behind this change is deceptively simple – profitability is more important than size alone. We also know the economic limitations of this explanation – it ignores the risk component and alters the time horizon of investment. But what are the social forces behind the shift from asset size to ROE? In order to come to grips with this question, we will try to map out how the relationships between the various stakeholders, executive, employees (non-firm specific and firm specific human capital) and shareholders (non-firm specific and firm specific financial capital) have changed over time. The following is a first brush.

- Interests: Tilly (1978) argues that the degree to which interests are few and the number of actors is small has a decisive influence on the strength of collective action. Applying this principle to the financial services industry, we can see that the number of actors who have a clear preference for a focus on an increase in ROE, namely the owners of important non-firm specific human capital and the representatives of non-firm specific financial capital is small and that their interests are narrowly focused (on extracting maximum gain from the firm in the shortest possible time). By contrast, employees in general and the representatives of firm specific financial capital are generally greater in number and, especially, harder to focus on a single common denominator. The financial services executive seeking to build a basis for collective action on interests therefore was likely to find it easier to collaborate with the owners of important non-firm specific human capital and the representatives of non-firm specific financial capital. The availability of a simple measure around which to unite – performance related compensation – made this the obvious choice for many.

- Social infrastructure: the degree to which actors are socially connected or can easily become connected also influences the formation of social movements of the kind we are describing here. Whereas in the past executives were likely to be more closely connected to employees and large, firm specific financial capital, the last twenty years have in all likelihood weakened these ties and brought executives closer to the owners of important non-firm specific human capital and the representatives of non-firm specific financial capital. On the one hand, financial service executives have increasingly been recruited not from traditional banking jobs, but from the ranks of traders with weaker ties to the breadth of employees in the firm and stronger ties amongst each other (starting with Dennis Weatherstone at JP Morgan in the 1980s and continuing to this day with Oswald Gruebel of UBS). At the same time, banks and insurance companies have themselves become increasingly important providers of non-firm specific financial capital as actors in the stock markets. Whereas these firms could put a haughty distance between themselves and mere traders in the past, today they are key players in the game and hence also socially tightly connected. The social connectedness among employees at large and between employees and the providers of firm specific financial capital, by contrast, has suffered from repeated mergers in the financial services industry. These mergers have uprooted employees and reduced the importance of firm specific financial capital.

- Mobilization processes: the capacity to mobilize resources is increased by interaction and close ties. Without further documentation, it is difficult to comment on how this factor has played out in the transformation of financial services. The changes in social infrastructure referred to above would seem to indicate that it has become easier, over the years, for executives, the owners of important non-firm specific human capital and the representatives of non-firm specific financial capital to find each other and interact, suggesting that informal groups could form, but this is clearly a topic for further research.

- <u>Political opportunity infrastructure</u> 'NnfrB@strHktGB(r: changes in the basic infrastructure of an industry or a social entity make it easier to launch social movements. The financial services industry has experienced an almost complete remake of its infrastructure over the last twenty-five years: deregulation (particularly the tolerance for commercial and investment banking to exist side by side), globalization, electronic trading and communication, and securitization have hit the industry with full force. As a result, there have been numerous mergers and re-orderings of industry rivalry. The business is not the same as it was. In any case, the historic changes in the infrastructure of the industry have also represented a unique opportunity for stakeholders to realign and for promise hierarchies to change.

This brief exploration of the factors giving rise to new coalitions in the financial services industry cannot provide definite results. It does seem clear, however, that the last twenty-five years have offered a unique opportunity for stakeholders to rearrange their relationships. On the whole, it would seem that executives are more likely today to collaborate with the owners of important non-firm specific human capital and the representatives of non-firm specific financial capital than their predecessors might have been. As brief and partial as it is, this historical review suggests that relationships among stakeholders have become more complex and less easily predictable. This reinforces the importance of viewing the firm not only as a nexus of contracts, but also as a nexus of promises.

IV. Conclusion

In this paper, we described the firm as a nexus of promises, showing how the tendency towards null contracts in a world of increasing complexity makes promises central to governing the firm. We worked out the structural determinants of the hierarchy of promises where the interests of employees and shareholders are contradictory and developed propositions about the relationship between the organization and composition of employees, on the one hand, and the organization and composition of shareholders on the other, and the propensity of firms to make promises. In the concluding discussion, we moved beyond a structural explanation to explore how executives choose to ally with employees or shareholders.

Clearly, the next step in developing research on the firm as a nexus of promises would be to test the propositions presented here on the basis of data. Although the propositions are stated in a manner that implies testing at a particular point in time, the relationships among the stakeholders are dynamic, and it would therefore be most interesting to collect data and test the propositions at multiple points in time. Given how the structural balance of power in many publicly listed firms has shifted, over time, from firm specific human and financial capital to non-firm specific human and financial capital, we would expect that the tendency of firms to promise an increase in ROE has gone up over the last twenty years.

Of course, more work also needs to be done to document the social mobilization processes that occur between the executive and the different stakeholders, as well as among the stakeholders. On this question, historical and ethnographic research methods can be brought to bear to document how stakeholder relationships are built and maintained (or severed) over time. Viewing the firm as a nexus of promises does not replace research on the firm as a nexus of contracts, but it does provide an alternative, essentially political perspective on organizational relationships. Inasmuch as the principles of corporate governance in the firm are subject to the social dynamic of diverging interests, viewing the firm as a nexus of promises among stakeholders may offer new insights on the implementation of best practice codes. If, for example, independent directors fail to act in the long-term interests of the firm, this may be because the firm's hierarchy of promises is slanted towards short-term interests, and the independent directors' very independence prevents them from confronting this hierarchy. – As societies and firms co-evolve in increasingly complex interactions, it is essential that research in corporate governance opens up to a political view of the firm.

References

Alchian, A.A., and Demsetz, H. (1972). Production, Information Costs, and Economic Organization**,** *The American Economic Review*, Vol. 62, No. 5, 777-795

Argyris, C. (1960). Understanding organizational behavior, Homewood, IL: Dorsey.

Ayres, I. and Gertner, R. (1989). Filling gaps in incomplete contracts: An economic theory of default rules. *The Yale Law Journal*. Vol: 99, 87-130.

Ayres, I. and Gertner, R. (1992). Strategic Contractual Ineffciency and the Optimal Choice of Legal Rules. *The Yale Law Journal*. Vol: 101, 729-772.

Baker, G.P., Jensen, M.C. and Murphy, K.J. (1988). Compensation and Incentives: Practice vs. Theory *The Journal of Finance*, Vol. 43, No. 3, 593-616.

Barclay, M.J. and Smith, C.W. Jr. (1995). 'The Priority Structure of Corporate Liabilities'. *The Journal of Finance,* 50, 3: 899-916

Barkema, H.G, and Gomez-Mejia, L.R. (1998).Managerial Compensation and Firm Performance: A General Research Framework, *The Academy of Management Journal*, Vol. 41, No. 2, 135-145

Coase, R.H. (1937). The nature of the firm, *Economica*, 4, 386-405.

Davis, G.F. and Thompson, T.A. (1994). A social movement perspective on corporate control, *Administrative Science Quarterly*, 39, 141-173.

Dogan K. (2010). Transparency and political moral hazard, *Public Choice*, Vol. 142, 1-2, pp. 215.

Fama. E. and Jensen, M. (1983). 'Agency problems and residual claims'. *Journal of Law and Economics*, 26, 2: 327-349.

Gomez, P.-Y., and Korine, H. (2008) Entrepreneurs and Democracy: A Political Theory of Corporate Governance. Cambridge: Cambridge University Press.

Gordon, M.E. and Lee, B.A. (1990) Property rights in jobs: Workforce, behavioral and legal perspectives. *Research in personnel and human resources*

Graham, J.R., Harvey, C.R. and Rajgopal, S. (2005). 'The economic implications of corporate financial reporting'. *Journal of Accounting and Economics*, 40: 3–73.

Grossman, S.J. and Hart, O.D. (1986). The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration *The Journal of Political Economy*, 1986, vol. 94, no. 4, 691-719.

Guest D. and Conway, H. (2002). Communicating the psychological contract: An employer perspective. *Human Resource Management Journal*, 12, 2, 22-38.

Hart, O.D. (1990). Is “bounded rationality” an important element of a theory of institutions? *Journal of Institutional and Theoretical Economics*. 16: 696-702.

Hart, O.D., and Moore, J. (1999). Foundations of incomplete contracts. *Review of Economic Studies*. 66: 115-138.

Jensen, M.C. and Meckling, W.H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure *Journal of Financial Economics*, Volume 3, Issue 4, 305-360.

Kiewitz C., Restubog S. Zagenczyck T. and W. Hochwarter (2009). The Interactive Effects of Psychological contract Breach and Organizational Politics on Perceived Organizational Support: Evidence from two longitudinal Studies, *Journal of Management Studies,* Vol 46, 5, 806-834.

Lee D., Moretti E. et M. Butler (2004). Do voters affect or elect policies? Evidence from the U.S. House, *The Quarterly Journal of Economics*, Vol. 119, 3, pp. 807-859.

Macho-Stadler, I. and Perez-Castrillo, D. (2007). An introduction to the economics of information: Incentives and contracts. New York: Oxford University Press.

McAdam, D. (1982). Political process and the development of black insurgency 1930-1970. Chicago: University of Chicago Press.

Morrison, E.W. and Robinson, S.L. (1997). When Employees Feel Betrayed: A Model of How Psychological Contract Violation Develops, *The Academy of Management Review*, Vol. 22, No. 1 pp. 226-256.

Rajan, R. G., and Zingales, L. *(2000).* The tyranny of inequality, *Journal of Public Economics*, Vol. 76, 3, 521-558.

Robinson, S.L. (1996). Trust and Breach of the Psychological Contract, *Administrative Science Quarterly*, Vol. 41: 574-599.

Rousseau, D.M. (1989). Psychological and implied contracts in organizations. *Employee Responsibilities and Rights Journal*, Vol. 2, 2:121-139.

Rousseau, D.M. (1990). New hire perceptions of their own and their employer’s obligations: A study of psychological contracts, *Journal of Organizational Behavior*, 11: 389-400.

Rousseau, D.M., and McLean Parks, J. (1993). The contracts of individuals and organizations, in LL Cummings and Barry M. Staw (eds.), Research in Organizational Behavior, 15: 1-43. Greenwich, CT: JAI Press.

Schein, E.H. (1965). Organizational Psychology. Oxford: Prentice-Hall.

Schwartz, A. (1992). Legal contract theories and incomplete contracts, in L. Werin and H. Wijkander (eds.), Contract Economics, 76-109. London: Blackwell.

Schwoerer, C. and Rosen, B. (1989). Effects of employment-at-will policies and compensation policies on corporate image and job pursuit intentions. *Journal of Applied Psychology*. Vol 74(4), 653-656.

Shapiro J. and J. Tune (1974) Implied contracts rights to job security, *Stanford Law Review*, 26, 335-369.

Shleifer, A., and Vishny, R.W. (1989). Management entrenchment: The case of manager-specific investment, *Journal of Financial Economics*, 25:123-139.

Simon, H.A. (1951) A formal theory of the employment relationship. *Econometrica*, Vol. 19, 3, 293-305.

Tilly, C. (1978). From mobilization to revolution. New York: Random House.

Williamson, O.E. (1975). Markets and Hierarchies. New York: Free Press.

Zweig, P.L. (1996). Wriston: Walter Wriston, Citibank, and the Rise and Fall of American Financial Supremacy. New York: Crown.