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**Social Banking in Practice: an Italian Case for Corporate Social  
Responsibility in Banking**

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1.- We comment herein the articles of association of a new bank incorporated in Italy in May 2007 and recently authorized by the Bank of Italy, whose corporate scope is social banking<sup>1</sup>. This initiative is noticeable in size and in character. Noticeable in size, because the new bank (called “Prossima s.p.a.”) is a fully owned subsidiary of “Intesa San Paolo”, a major Italian player in the national banking industry. As such, it is capitalized over €100 millions and shall operate nationally and internationally also through the existing network of “Banca Intesa San Paolo”. Noticeable in character, because the new venture features a remarkable market response to increasing social demand for more responsible banking model both for the not for profit sector and the communities of the “unbanked” (and/or the “underbanked”). This new venture is thus interesting, from a legal perspective, under several aspects.

2.- First of all, because it has been grounded on the Italian regulatory framework of joint stock companies (rather than on that of cooperatives, as it was the case, e.g., of the pre-existing Italian “Banca Popolare Etica”), whereby making it clear that the bank, notwithstanding its social orientation, is designed to operate as a viable and lasting economic venture for profit. At the same time, however, the articles of association voluntarily and deliberately depart from profit maximization, by explicitly stressing – already in Article 6 – that the company shall necessarily reconcile between its economic and social performance. As stipulated by Article 6:

A servizio delle finalità di cui all'articolo 4, la società effettua i propri impieghi nel pieno rispetto del principio di economicità d'azione e nel perseguimento sia di utili annuali di gestione sia di creazione e accumulazione di valore per la società e i soci avendo tra i suoi obiettivi prioritari l'offerta di favorevoli condizioni di accesso al credito alle imprese sociali e alle altre organizzazioni non profit che svolgano la propria attività in Italia e/o all'estero. La società destina inoltre una quota dei propri impieghi a favorire l'accesso al credito - specie per il sostegno di iniziative di lavoro autonomo e/o imprenditoriale o per esigenze sanitarie e di accompagnamento o educative o per l'acquisto della prima casa - di tutti coloro che, in considerazione della loro razza, provenienza geografica, estrazione sociale, sesso, età o condizione hanno insufficiente accesso al credito. Essa si avvale del proprio patrimonio anche per partecipare a programmi, pubblici o privati, di sostegno, cooperazione e sviluppo e a fondi di garanzia o altri fondi rotativi per il finanziamento e lo sviluppo o partecipare a società di promozione e sviluppo, anche partecipate da terzi, pubblici o privati. La società promuove, in Italia e all'estero, interventi di

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<sup>1</sup> On social banking see, in the Italian literature AA.VV., *Il social banking in Italia: un fenomeno da esplorare*, a cura di Anderloni, Milano, 2003, passim (and here, for legal reasoning, Fauceglia G. and Porzio M.; the contribution of the latter is also re-published in Porzio M., *Orme sulla neve*, Milano, 2006); Antonucci A., *La responsabilità sociale d'impresa*, in *NGCC*, 2007, II, p. 119, especially at 126. See also ABI, *Linee guida sulla responsabilità sociale d'impresa in banca*, Roma, 2005, passim.

microfinanza e microcredito, diretti e indiretti, anche attraverso continuativi programmi di assistenza tecnica volti a sostenere la nascita e il rafforzamento di sistemi di autoaiuto e microcredito.

In turn, the same provision is very explicit in excluding from the bank's corporate scope any confusion between social banking and granting and/or charitable activity.

La società esclude dalle proprie finalità l'attività di mera erogazione a fondo perduto, proponendosi di attuare una gestione economica sostenibile anche nel medio e nel lungo periodo delle proprie risorse idonea ad ampliare costantemente il numero dei clienti e ad accumulare capitale economico e sociale per le finalità di cui al precedente art. 4.

This would in fact contradict economic sustainability in the long run and would "dissipate" in a one shot game resources which, on the contrary, are intended to be accumulated and serve as an intergenerational engine for social change. The bank, in other terms, does not represent a new vehicle set up to concentrate "in a single shop" all the philanthropic and charitable activities that are traditionally carried out by "Intesa San Paolo" (activities which continue to be managed as before). Instead, what is being established is a proper new bank that is willing to profitably operate with the not for profit sector and all those who do not have, or have insufficient recourse to credit, for the benefit of its shareholders, stakeholders (herein included its clients) and the community at large. As set out in Article 4 (which posits the foundations of the bank's social mission):

La società, avendo cura di preservare appieno la propria sostenibilità di impresa e di operare nel pieno rispetto della normativa e del criterio della sana e prudente gestione, ha come obiettivo la creazione di valore sociale, nei limiti e nel rispetto dell'oggetto sociale di cui agli artt. 5 e 6 dello Statuto. A tale fine la società sosterrà con il credito le migliori iniziative non profit per i servizi alla persona, la diffusione della cultura e dell'istruzione, la fruizione e la protezione dell'ambiente e dell'arte, l'accesso al credito e al lavoro.

Another remarkable feature of this ambitious program is its international reach which is not confined to Italian territory. The closing paragraph of Article 4 recognizes indeed that:

La società si impegnerà affinché i prodotti, i servizi e gli schemi di finanziamento che realizzerà in Italia siano applicati, per quanto possibile e consentito e con gli adattamenti necessari, ai paesi stranieri nei quali il gruppo bancario "Intesa Sanpaolo" opera

3.- Secondly, the mediation between the reasons of capital and the expectations of the communities (in other terms: the mechanism that bridges

between the shareholders' expectations for profit and the social expectations of other stakeholders) is translated into an innovative (so, at least, to the best of our knowledge) legal provision concerning the allocation of yearly profits. As it can be read under Article 28 of the by-laws:

L'utile netto risultante dal bilancio, dedotta la quota di riserva legale e salvo ogni ulteriore accantonamento previsto dalla vigente normativa, viene ripartito come segue: a) a riserva statutaria non distribuibile nel corso della società una quota pari al costo del capitale investito dalla Banca, determinato secondo le tecniche finanziarie comunemente in uso nel mercato; b) alle azioni un dividendo determinato dall'Assemblea in misura non superiore al [50] % dell'utile netto annuale quale residuante una volta effettuato l'accantonamento di cui alla precedente lettera a); c) tutto il rimanente alle finalità di solidarietà e sviluppo, tramite destinazione ad un apposito Fondo per lo sviluppo e l'impresa sociale. Tale Fondo garantisce i rischi e fronteggia le perdite - secondo la procedura in appresso descritta - derivanti dagli impieghi per finalità di solidarietà e sviluppo che la società può effettuare a condizioni di tasso agevolato rispetto a quelli correnti di mercato o a favore di soggetti che risulterebbero non avere, o avere insufficiente accesso al credito secondo linee di impiego tradizionali. Qualora, al termine dell'esercizio, la società chiuda il bilancio in perdita e tale perdita sia da attribuirsi, in tutto o in parte, a perdite sugli impieghi per finalità di solidarietà e sviluppo, tali perdite saranno interamente ripianate utilizzando a copertura il Fondo per lo sviluppo e l'impresa sociale. Nel caso in cui siffatte perdite, per la loro entità, non possano essere integralmente coperte mediante utilizzo del detto Fondo, l'utile netto degli esercizi successivi, dedotta la quota di riserva legale, dovrà essere prioritariamente destinato a ripristinare nell'ammontare preesistente l'entità delle poste del patrimonio netto, escluso il predetto Fondo, che siano state incise dalle suddette perdite. Qualora, viceversa, le perdite di esercizio siano da attribuirsi ad altre cause e non dipendano dall'attività di impiego per finalità di solidarietà e sviluppo, il Fondo di cui alla lettera c) potrà essere utilizzato a copertura delle perdite solo dopo che, a tale scopo, siano state utilizzate le altre riserve volontarie e statutarie, ivi compresa la riserva di cui alla precedente lettera a). In caso di utilizzo del Fondo di cui alla lettera c) a copertura di perdite non derivanti da impieghi per finalità di solidarietà e sviluppo, l'utile netto dei due esercizi successivi, dedotta la quota di riserva legale, dovrà essere prioritariamente destinato a ripristinare il detto Fondo nell'ammontare preesistente.

This indicates that yearly disposable profits shall be divided into two principal parts. One part devoted, in a specific amount set by the Articles of association, to the further capitalisation of the bank through a net worth reserve not distributable until dissolution. Whereas the remaining part is virtually shared between shareholders and stakeholders on an equal footing (unless shareholders agree to accept less than the maximum amount of dividends to which they are entitled in principle, leaving more resources to the reserve used for corporate social responsibility operations). Shareholders are indeed free to resolve in their ordinary shareholders' meeting a distribution of dividends up to the 50% of such remaining net profits. Stakeholders shall benefit from all the remaining part through the accumulation of such amount in a specific reserve, the (so called) "fund for the development and social undertakings". This fund does not result in a separate legal entity (as would have been the case if the accumulated amount was segregated in trust or allocated to an external charitable

foundation) but remains under the management of the bank's board of directors. However, this fund is specifically designated to “face the risks and cover the losses” stemming from the social banking activities undertaken by the bank in favour of its social constituencies.

In particular, when the bank, in conformity with the aims set out in Articles 4-6, lends with interest rates which are below custom market interest rates, the “day one loss” (should this loss become a yearly loss) shall be covered by the fund. Similarly, if the bank lends to a person who, according to custom market practices on risk management, is not “bankable” (or is not entitled to receive a loan, according to ordinary practices, in the amount needed), in case of default of such borrower, the loss is covered by the fund. Clearly enough, due to the coexistence of some corporate and non segregated funds for the benefit of shareholders and some other corporate and non segregated funds for the benefit of stakeholders within a single entity, the proper satisfaction of the expectations of all these different constituencies – as well as the fulfilment of the additional corporate mission to perpetuate this banking model through time in an intergenerational bond, on top of that - relies, in this model, on corporate governance devices. It remains, in other terms, under the responsibility of the board of directors to align the behaviour of the company – profitable banking and social banking for the present and the years to come – along the lines of this nexus of multi-stakeholders’ expectations. Losses deriving from for-profit banking and/or social banking are in principle to be resented each by its relevant constituency, as it is shown by the rules concerning coverage of losses which distinguish among the different sources of losses to consistently identify the funds to be used for their coverage. This is true however only if the yearly bottom line is negative (on the contrary it has been set in the Articles that, as long as the company concludes the year with a profit, no constituency should blame the other if profits are less than they would have been if the bank had not operated in the other sector) and it remains true only if and when the constituency being affected by the loss is in condition to face alone such loss or to repay it in due course. This is obviously so, because – as indicated- there is no asset partitioning and segregation.

4.- In order to facilitate the board of directors in duly performing its difficult task – being an active and profitable banker on the one hand and, at the same time, a respectable social banker on the other hand - the corporate governance of the bank is enriched with a new and innovative organ: the committee for the solidarity and development (hereinafter – Committee). This Committee comprises of 6 members with staggered office (in order to ensure continuity of action), 3 of which are appointed by the shareholders’ meeting and the other 3 designated by 3 separate external appointing authorities (the

President of the Republic, the President of the EU Parliament and the President of the supervisory authority for not for profit organizations), all among candidates possessing consistent professional qualifications. Article 29 sets out in fact that:

E' istituito un Comitato per la Solidarietà e lo Sviluppo composto di sei membri di riconosciuto prestigio e indipendenza, scelti tra personalità che abbiano ricoperto incarichi di rilievo in ambito istituzionale o del non profit in Italia o all'estero, accademici, esponenti del mondo imprenditoriale e manageriale che abbiano maturato significative esperienze nel settore del non profit, della cooperazione allo sviluppo, del microcredito o della microfinanza.

The most relevant innovation concerning this new organ refers to its functions. The Committee does not limit itself to advisory functions with respect to the "ethical" profile of the venture (as it is to be found in other cases of corporate social responsibility). Instead, albeit without interfering with the exclusive competence of the board in the management of the company – the Committee provides framework principles and general indications and recommendations to the board with respect to social banking, focussing in particular on the use of the fund for the development considered above. As stipulated by Article 32:

Il Comitato, in coerenza con le finalità di cui all' art. 4 e con quanto previsto all'art. 6, elabora, nel rispetto delle inderogabili competenze del Consiglio di Amministrazione e nel pieno rispetto del principio di sana e prudente gestione, se del caso anche mediante regolamento, gli indirizzi circa le attività di solidarietà e sviluppo di cui la società possa farsi carico, vigila, ferma restando la inderogabile competenza degli organi di controllo interno ed esterno della società, che l'attività di amministrazione sia realizzata, quanto alle attività di solidarietà e sviluppo, nel rispetto dei suoi indirizzi e secondo principi di buona amministrazione, economicità e trasparenza, avendo cura prioritaria che le risorse della società destinate a finalità di solidarietà e sviluppo siano utilizzate in condizioni di duratura sostenibilità economica e escludendo l'erogazione a fondo perduto.

Under Article 33, the same Committee is responsible for the social balance sheet and is subject to a transparency requirement:

Il Comitato informa del suo operato l'Assemblea, almeno una volta all'anno in occasione della approvazione del bilancio di esercizio e provvede, d'intesa con il Presidente del Consiglio di Amministrazione, a dare adeguata informazione periodica al mercato e al pubblico in genere dell'attività svolta e dei progetti approvati. Il Comitato redige e presenta annualmente un rapporto pubblico di fine esercizio sull'efficacia e coerenza degli interventi effettuati.

5.- Having outlined the hallmarks of the articles of association of this new company devoted to social banking, it might prove useful, for its

assessment against the backdrop of current practices on corporate social responsibility, to briefly overview the (still) flourishing debate on corporate social responsibility (hereinafter - CSR).

Empirically, there has been a dramatic growth in social and environmental reporting among corporations, and countless initiatives have been launched by both private and public sector, on regional, national and international levels. Consumers and investors made themselves part of this process, e.g. showing their capacity to influence corporations through consumption preferences and ethical investment choices. New mechanisms, including specialized investment funds and indexes, reporting and auditing standards, codes of conducts and guidelines were created to satisfy the increasing public demand for corporate social responsibility and to facilitate socially responsible investment and consumption. To this end, CSR has become more than a popular buzz word in the corporate world, as it turned into an industry of its own, due to the substantial resources which are poured into socially responsible investment (SRI) funds.

However, it should be reminded that CSR is not a new phenomenon: the role of the corporate entity in capitalist societies has been debated by historians, economists and legal scholars for over a century<sup>2</sup>. The appearance of CSR as a social movement occurred in the 1970's and it strongly reemerged in recent years, especially in reaction to globalization and its consequences. The growing awareness to environmental and social issues has boosted the expansion of the awareness to CSR. To this end, the role of technology and the media cannot be overstated. Past experience shows that information about negative externalities which are often associated with corporate production such as pollution, poverty, exploitation of child labor, poor working conditions, safety hazards as well as violations of human rights in third world countries, can no longer be withheld from the eyes of the media and the public at large. Consequently, social pressure for greater corporate transparency and accountability gained substantial public support and business corporations were forced to revisit their corporate policies. These developments are attracting overwhelming attention, positive as well as negative, in the EU and elsewhere<sup>3</sup>. The academic and public

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<sup>2</sup> See Avi-Yonah, Reuven S., *The Cyclical Transformations of the Corporate Form: A Historical Perspective on Corporate Social Responsibility*, Delaware Journal of Corporate Law, Vol. 30, No. 3, 2005, pp. 767-818

<sup>3</sup> For the state of CSR and social reporting around the world see KPMG *International Survey of Corporate Responsibility Reporting*, Amsterdam, 2005. For a comparative look on CSR see Habisch A.(eds.), *Corporate Social Responsibility Across Europe*, Springer, 2004; OECD, *Corporate Responsibility Practices of Emerging Market Companies - A Fact Finding Study*, 2005

debates over CSR have left their mark on corporate decision making processes and had a significant impact on policy makers all over the world.

6.- While regulating CSR is tough enough, defining it is even tougher. An inquiry into the contemporary literature on the subject reveals that the scope and nature of the social responsibility of firms is subject to various interpretations<sup>4</sup>. As noted by Votaw<sup>5</sup>, the term social responsibility is a brilliant one; it means something, but not always the same thing to everybody. Clearly, what constitutes CSR depends on the particular situation of individual enterprises and on the specific context in which they operate. The EU Commission defines CSR as a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis<sup>6</sup>. There are various interpretations for CSR in the academic literature, most of which describe voluntary integration of social and environmental concerns by corporations in their business operations and interactions with stakeholders. Not surprisingly, some interpretations are extremely narrow while others are very broad. A well known illustration of a narrow definition appears in Milton Friedman's famous piece titled "The social responsibility of business is to increase its profits"<sup>7</sup>. McWilliams, Siegel and Wright<sup>8</sup> define CSR as situations where the firm goes beyond compliance and engages in actions that appear to further some social good, beyond the interests of the firm and what is required by law. Parkinson describes it as a process concept that focuses on the characteristics of the corporate decision making process and not on particular outcomes<sup>9</sup>. Another prominent scholar defines CSR as practices that improve the workplace and benefit society in ways that go above and beyond what companies are legally required to do<sup>10</sup>. According to Baron<sup>11</sup>, CSR exclusively describes corporate

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<sup>4</sup> For an exhaustive description of the evolutionary definition of CSR see Carroll A., *Corporate Social Responsibility – Evolution of a Definitional Construct*, . *Business & Society*, vol. 38/3, 1999, pp. 268-295.

<sup>5</sup> Votaw D., *Genius Becomes Rare*, in D. Votaw and S.P. Sethi (eds), *The Corporate Dilemma: Traditional Values versus Contemporary Problems*, Englewood Cliffs, NJ: Prentice-Hall 1973, pp. 11-45.

<sup>6</sup> Commission of The European Communities, *Promoting a European Framework for Corporate Social Responsibility*, Green Paper COM(2001)366 Final, Brussels 2001

<sup>7</sup> Friedman M., *The Social Responsibility of Business Is to Increase Its Profits*, The New York Times Magazine, September 13, 1970.

<sup>8</sup> McWilliams et al, *Corporate Social Responsibility: Strategic Implications*, Journal of Management Studies, Vol. 43 No.1, 2006, pp. 1-18

<sup>9</sup> Parkinson J.E., *Corporate Power and Responsibility: Issues in the theory of company law*, Oxford University Press, 1993

<sup>10</sup> Vogel D., *The Market For Virtue: The Potential and Limits of Corporate Social Responsibility*, Brookings Institutions Press, Washington D.C. 2005

actions that are motivated by normative principles other than profit maximization. Corporations' engagement in social or environmental activities that is motivated by business considerations and the desire to maximize profits has become known as strategic CSR. Choosing the right terminology is a considerable challenge. The problem with many of the existing definitions is that they consist of elusive normative notions which are difficult to measure and quantify. Therefore, picking the most accurate or sensible definition for CSR is clearly not an easy task, as it depends, among other things, on subjective interpretations of responsibility, sustainability and corporate citizenship. It is important to stress that the term CSR is attached to for profit business corporations rather than other business enterprises and organizations. This reflects the inherent tension between the pursuit for profit and concern over shareholder value on the one hand, and the legitimate interests of other stakeholders which relate to a broader social and environmental context, on the other hand.

7.- Taking into account the fair amount of confusion which characterizes the subject matter, a few clarifying words on the main controversies with relation to CSR might prove necessary.

There are three issues upon which there is no dispute: First, the fact that CSR relates to *voluntary* corporate actions which go beyond legal requirements. Thus, compliance with existing laws and adherence to mandatory regulations does not constitute CSR *per se*. CSR requires the corporation to go beyond the law. For example, in a situation where the government sets mandatory minimum standards on pollution, CSR would imply polluting less than is legally permitted rather than just complying with the standard. Second, it is widely accepted that engagement in CSR is costly to the corporation in terms of resources as it consumes time as well as financial and human capital. Third, evidence shows that corporate engagement in CSR as well as corporate social reporting is constantly growing. Interestingly, the pattern of social reporting varies significantly among countries and between industries. For example, in Japan and the UK social reporting is by far more common than in Continental Europe and the US. Another intriguing finding is the apparent lack of a correlation between investment in CSR and financial performance. A series of empirical studies carried out up to date were not able to confirm the existence of a statistically significant correlation between social and environmental performance and financial performance. More accurately, the results are mixed

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<sup>11</sup> Baron, David P., *A Positive Theory of Moral Management, Social Pressure, and Corporate Social Performance*, Stanford University Graduate School of Business Research Paper No. 1940, 2006, Available at SSRN: <http://ssrn.com/abstract=913808>

and indecisive – few studies indicate that there is a positive correlation, some studies provide evidence for a negative correlation and other studies conclude that there is no correlation whatsoever<sup>12</sup>. Based on these empirical findings and given the considerable costs of CSR, it is unclear why do many corporations choose to invest resources in CSR if the financial outcome of such investment is so ambiguous. According to the traditional theory of the firm, corporations are run to maximize profits and shareholder value. This theory predicts that managers are devoted only to maximize shareholders value and justifies it under the contractarian view of the firm in which shareholders function as residual claimants. According to this view, CSR should not and will not occur unless it increases corporate profits or boosts shareholder value. The problem with this theory is that in the absence of any substantial statistical evidence for a relationship between CSR and financial performance, the current trend of engagement in CSR cannot be easily explained. Several possible reasons for this apparent anomaly, often referred to as the puzzle of CSR, could be found in the literature. Assuming that corporations are indeed rational and profit oriented, the possibility that many of them are acting irrationally is ruled out. It is plausible that CSR somehow enhances financial performance and increases shareholder value in the long run, although it is not clear how it works in practice. It may also be that CSR reflects a corporate response to a growing social pressure which translates to demand among consumers, investors, employees and the general public for greater corporate attention to social and environmental concerns. Studies claim that consumers put a high value on corporate social and environmental performance. Empirical studies reveal a gap between these assertions and data on actual consumer behavior both in Europe and the US<sup>13</sup>. Apparently, the willingness to pay for “green” or “ethical” products is relatively limited.

8.- In turn, the growth of socially responsible investment (“SRI”) funds reflects an increasing level of involvement on behalf of individual and mainly institutional investors, such as pension funds especially in the UK<sup>14</sup>. The

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<sup>12</sup> For an overview of the different empirical studies and their results see McWilliams et al, *Corporate Social Responsibility: Strategic Implications*, Journal of Management Studies, Vol. 43 No.1, 2006, pp. 1-18; Becchetti L. et al, *Corporate Social Responsibility and Corporate Performance: Evidence from a Panel of US Listed Companies*, CEIS Working Paper No. 78, 2005, Available at SSRN: <http://ssrn.com/abstract=871402>

<sup>13</sup> Vogel, D., *The Market for Virtue – The Potentials and Limits of Corporate Social Responsibility*. Harrisonburg, VA, Brookings Institution Press, 2005.

<sup>14</sup> Aguilera et al, *Corporate Governance and Social Responsibility: a comparative analysis of the UK and the US*, Corporate Governance: An International Review, Vol. 14, May 2006 pp. 147-158; Armour J. et al, *Shareholder Primacy and the Trajectory of UK Corporate Governance*, British Journal of Industrial Relations, Vol. 41, 2003, pp. 531-555

demand for CSR among investors is attributed partly to the subjective preferences of individual investors and partly to the belief that these stocks are more immune to market risks in the long run. Corporations that want to gain access to capital held by SRI funds, or wish to be included in selective social indexes such as the Dow Jones Sustainability Index or FTSE4GOOD, must comply with a range of social and environmental requirements and routinely disclose non-financial reports. This creates an additional incentive for corporations to upgrade their social and environmental profile.

9.- Finally, it has been argued that corporations with high social and environmental profile are likely to have an advantage over their competitors in recruiting skilled workforce, particularly in knowledge based industries<sup>15</sup>. Empirical studies show that an organization's social profile matters to employees who have the potential to advance CSR directly, by actively advocating for, leading and participating in CSR initiatives as well as indirectly, by reciprocating socially responsible corporate behavior through better performance and firm loyalty<sup>16</sup>.

10.- In spite of the aforementioned explanations, the possibility that CSR could also be used to disguise shareholder expropriation by management and/or controlling shareholders cannot be *ex ante* dismissed<sup>17</sup>. There is an inherent risk that the motivation behind the engagement of managers or controlling shareholders in certain CSR activities is associated with the possibility to expropriate private benefits of control. For example, when a CEO, an owner or a controlling shareholder decides on a donation to a certain charity, she might be expecting to boost her reputation or receive other perks in return.

11.- Whenever CSR is driven by purely business considerations, the interests of shareholders and other stakeholders coincide. Strategic CSR is the term used to describe corporate actions which are designed to enhance profits and shareholder value, by means of allocating resources in order to meet social or environmental objectives. In those cases the motivation behind corporate

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<sup>15</sup> Vogel, D., *The Market for Virtue – The Potentials and Limits of Corporate Social Responsibility*, Harrisonburg, VA: Brookings Institution Press, 2005.

<sup>16</sup> See Aguilera et al., *Putting the S Back in Corporate Social Responsibility: A Multi-Level Theory of Social Change in Organizations*. *Academy of Management Review*, Forthcoming, 2007, Available at SSRN: <http://ssrn.com/abstract=820466>

<sup>17</sup> Ehrhardt O. et al., *Private Benefits and Minority Shareholder Expropriation (or What Exactly are Private Benefits of Control?)* EFA 2003 Annual Conference Paper No. 809. Available at SSRN: <http://ssrn.com/abstract=423506> or DOI: [10.2139/ssrn.423506](https://doi.org/10.2139/ssrn.423506)

engagement in CSR is to increase rather than sacrifice profits. However, wherever CSR does not serve financial performance, the tension between shareholders and other stakeholders would immediately surface. Sacrificing profits in the social interest is in itself extremely controversial. It raises important questions, normative as well as positive. On a normative level there is disagreement over the question whether corporations *should* and/or *could* sacrifice parts of their profits in the social interest to begin with, and under what conditions they may do so. It is often argued that the sacrifice of profits reflects a moral duty that corporations allegedly have towards society; however (as it was shown almost one century ago in the Ford Dodge controversy<sup>18</sup>), the corporate duty of loyalty towards its shareholders must not be overlooked. More specifically, what qualifies the corporation or any of its organs to decide on non-business issues on behalf of its shareholders? Finally, from a social welfare perspective, how could we determine whether the social benefits derived from CSR compensate for the forgone profits? The methodology used to cope with the abovementioned questions cannot be confined to the framework of corporate governance, law, finance or economics. The context of the normative debate over the nature of CSR, the role of business corporations in society and the corporate objective function is by far broader<sup>19</sup>. Consequently, an interdisciplinary approach is better suited to address the puzzle of CSR and the many questions it brings about<sup>20</sup>. Given the importance of these questions it is obvious why the dispute over CSR is so vivid. Although it is not feasible to go through all the approaches towards CSR, the following maps two of the main attitudes in a nutshell<sup>21</sup>.

a) On one side of the spectrum stands Nobel Prize winner Milton Friedman and his followers who claim that the social responsibility of corporations is to increase their profits and maximize shareholders' value<sup>22</sup>. According to this view, under the assumptions of a perfect market, shareholders' value maximization would result in an increase in social welfare, since shareholders are the residual claimants. Put simply, corporations ought to focus on what they do best, which is maximizing shareholder value rather than attempting to satisfy the interests of multiple stakeholders. Consistent with this view, environmental and social concerns are best left for the government or the

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<sup>18</sup> *Dodge v. Ford Motor Company*, 204 Mich. 459, 170 N.W. 668. (Mich. 1919)

<sup>19</sup> See Licht A., *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, Delaware Journal of Corporate Law, Vol. 29, No. 3, 2004, pp. 649-746

<sup>20</sup> Such an interdisciplinary approach is taken by Hay B. L. et al (eds), *Environmental Protection and the Social Responsibility of Firms: Perspectives from Law, Economic and Business*, RFF Press, Washington DC, 2005

<sup>21</sup> See also, in the Italian literature, Costi R, *La responsabilità sociale dell'impresa e il diritto azionario italiano*, in *La responsabilità dell'impresa*, Giuffrè, Milano, 2006, p. 83

<sup>22</sup> Friedman M., *The Social Responsibility of Business Is to Increase Its Profits*, The New York Times Magazine, September 13, 1970.

non profit sector to deal with. Friedman's attitude towards CSR as a concept features a fair amount of hostility and suspicion. According to his perception, the mere idea that corporations have a social responsibility other than to make as much money for their shareholders might undermine the foundations of the free American capitalist society. Friedman is of the opinion that stakeholder theory and CSR could lead to harmful market distortions and create an obstacle for welfare creation. This belief is based on the assumption that managers cannot be held accountable if they are told to pursue multiple objectives, rather than simply maximize shareholder value. In line with this view, a single measurement criterion is necessary to evaluate manager's performance and hence attain optimal results.

b) On the other side of the spectrum are the proponents of the stakeholder theory<sup>23</sup>, who claim that shareholders need not be seen as the exclusive residual claimants and therefore corporations should address the needs and interests of various stakeholders, such as employees, consumers, members of the community and more generally the environment in which they operate. This approach rejects the neo-classical assumptions about perfect markets and zero externalities and further suggests that value maximization is not a value in itself. In line with this approach, corporations ought to have a moral commitment towards society in return for their so called "license to operate" which allows shareholders to enjoy corporate profits. Although the debate over the maximands of corporate governance is far from reaching an end, lately there have been attempts to converge some of the conflicting approaches. Jensen, for instance, proposes an enlightened stakeholder theory, according to which, corporations should take into account the interests of various stakeholders, as long as it is likely to be in the interest of the shareholders in the long run<sup>24</sup>. Many European member states reflected recently this approach in their description of company purposes<sup>25</sup>

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<sup>23</sup> For an overview of the fundamentals of stakeholder theory see Freeman R.E., *Strategic Management: A Stakeholder Perspective*, Boston: Pitman, 1984. Another parallel theory which shares common features with stakeholder theory has been advanced by Blair M. M., *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century*, Brookings Institution 1995; Blair M. M and Stout L., *A Team Production Theory of Corporate Law*, [Virginia Law Review, Vol. 85, No. 2, 1999](#)

<sup>24</sup> Jensen M., *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, *European Financial Management Review*, N. 7, 2001.

<sup>25</sup> This continental approach – already witnessed e.g. in France and Germany – was recently accepted also in the United Kingdom (see clause 156 of the Bill for company law reform and all relevant preparatory documents of the Steering Group): Birds J., *Reforming UK Company Law in a European Context: a Long And Winding Road*, in *European Company Law in Accelerated Progress*, eds. Bartman, Kluwer Int., 2006, p. 18.

12.- On a positive level, assuming that at least some corporations decide, for whatever reason, to devote resources to CSR and given the fact that this investment has certain costs, the following calls for attention - *Can* corporations sacrifice profits in the social interest on a sustainable basis? CSR is often described as a factor that contributes to competitiveness<sup>26</sup>. However, the competitive environment in which corporations operate plays a key role, since the constraints in product markets, financial markets and the market for corporate control may narrow the corporation's ability to invest in CSR. Corporations that engage in CSR need to finance these activities in one way or the other. For instance, they can charge higher prices from consumers, cut the distribution of dividends, reduce employees' wages or save on marketing, operations and R&D budgets. Consequently, corporations that invest in CSR face the risk of becoming an easy prey for their competitors that do not undertake similar investments. Given this asymmetry, the latter enjoy the potential advantage of being able to offer cheaper products, higher wages and more generous dividends. Moreover, to the extent that corporations that invest in CSR are envisaged as inefficient, the risk of being taken over by their rivals would be significantly higher in the market for corporate control. Conversely, in the absence of perfect competition, corporations that enjoy a degree of market power will be those who could afford investment in CSR. For instance, a monopoly could distribute its monopoly rent to various corporate stakeholders<sup>27</sup> or invest in reputation building that increases public and regulatory support. In other words, engagement in CSR might serve as means to create entry or expansion barriers that deter potential competitors from entering a certain market<sup>28</sup>.

13.- Having touched some of the focal controversies related to CSR, it is evident that many questions remain open and there is plenty of room for future academic research on CSR and corporate governance. In reality, however, more and more people have come to realize that the price associated with various corporate externalities has become too high. For them, the aggregate effect of externalities has become unacceptable in terms of social harms. Since the industrial revolution, market forces and free competition have led to an unprecedented accumulation of wealth in most capitalist societies. Due to a

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<sup>26</sup> See Porter et al., *Strategy & Society: The Link Between Competitive Advantage and Corporate Social Responsibility of Corporate Philanthropy*, Harvard Business Online, 2006

<sup>27</sup> See Roe M. J., *Rents and their Corporate Consequences*, Stanford Law Review, Vol. 53, 2001; Roe M. J., *Political Determinants of Corporate Governance: Political Context, Corporate Impact*, Oxford University Press, 2003

<sup>28</sup> McWilliams, A. et al, *Raising Rivals' Costs: An Application of Resource-Based Theory*, Journal of Management Studies, 39(5), 2002, pp. 707-723

variety of reasons, significant externalities that were generated by corporations remained outside the price equation<sup>29</sup>. Once the externalities and their devastating effect have become known, it was no longer possible to ignore or dismiss them. Trusting the free market to solve the problem of externalities turned to be unrealistic. A *laissez fair* approach that relies solely on market forces to eliminate externalities through Coasian bargaining could work only in theory, under the strict assumptions of perfect markets. To this end, high transaction costs and imperfect information tend to frustrate attempts to reach an efficient equilibrium. Experience shows that alternative techniques to deal with corporate externalities, using state authority, such as command and control regulation are only partially effective, due to information asymmetries, regulatory capture, enforcement problems and high transaction costs. However, CSR, combined with mandatory minimum regulatory standards, has the potential to cope more successfully with corporate externalities and deliver better results. The challenge is to find further ways to make corporations voluntarily bind themselves to this principal effort<sup>30</sup>. The strongest potential incentive for corporations to engage in CSR is financial in its essence. Demand for CSR in itself could not however yield the desired change unless two further conditions are satisfied.

a) First, the screening of corporations with superior social and environmental profile should be facilitated. This depends on the extent and quality of non-financial information that circulates in the market. It is necessary to assure that non-financial information disclosed by corporations is credible and verifiable, by choosing the most suitable reporting form and measurement metrics. At the same time, costs of compliance with any reporting requirements should be kept at a minimal level. Given the fact that social reporting is not mandatory, it is necessary to construct a reporting system that yields reliable and useful information at the lowest possible cost.

b) Second, corporate governance systems that induce CSR without compromising the level of investor protection should be designed. Allen argues that a narrow view of corporate governance to maximize shareholder value leads to an efficient allocation of resources only when markets are perfect and complete<sup>31</sup>. Since these assumptions are hardly ever satisfied in real markets, Allen proposes a broader view, according to which corporate governance is

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<sup>29</sup> See Kapp K.W., *The Social Cost of Private Enterprise*, Harvard University Press, Cambridge, Massachusetts 1950;

<sup>30</sup> On the importance of voluntary corporate action rather than statutory restrictions see Mitchell L. E., *Cooperation and Constraint in the Modern Corporation: An Inquiry into the Causes of Corporate Immorality*, 73 Tex. L. Rev. 477, 1995.

<sup>31</sup> Allen F., *Corporate Governance in Emerging Markets*, Oxford Review of Economic Policy, 2005, 21(2), pp. 164-177

concerned with ensuring that firms are run in such a way that society's resources are used efficiently. Interestingly, recent studies in finance and corporate governance suggest that absolute adherence to the shareholder primacy norm does not necessarily reflect efficiency<sup>32</sup>. Consequently, the great challenge is to design a corporate governance system that will support, rather than constrain, CSR and at the same time fulfill its core financial function, namely to assure the suppliers of finance to the corporation against expropriation of their investment<sup>33</sup>.

14.- The other step that is proposed to ameliorate corporate social behavior involves internalization of a new social norm by corporate insiders. A new social norm which calls for greater corporate social responsibility and accountability is paving its way to the mainstream. This norm has not yet been fully recognized and it is not likely to be endorsed by legislators, although it is rapidly spreading. In the minds of millions of people all over the world the image of the corporation is shifting and more emphasis is given to corporate citizenship as well as social and environmental performance<sup>34</sup>. If this norm would eventually be internalized by corporate insiders, such as dominant shareholders, CEOs, corporate directors and members of senior management, corporations might end up improving their conduct due to internal progression rather than external pressure. There is extensive evidence that shows how powerful social norms could be in the individual context<sup>35</sup>. The argument

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<sup>32</sup> Fisch, J. E., *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, Fordham Law Legal Studies Research Paper No. 105, 2005, Available at SSRN: <http://ssrn.com/abstract=878391>; Elhague E., *Sacrificing Corporate Profits in the Public Interest*, New York University Law Review, Vol. 80 No. 3, 2005

<sup>33</sup> Compare also with Tirole J., *Corporate Governance*, *Econometrica* Vol. 69, No.1 2001, pp. 1-35

<sup>34</sup> See Aguilera et al., *Putting the S Back in Corporate Social Responsibility: A Multi-Level Theory of Social Change in Organizations*. *Academy of Management Review*, Forthcoming, 2007, Available at SSRN: <http://ssrn.com/abstract=820466>

<sup>35</sup> For a general introduction to social norms from a law and economics perspective see Ellickson, R. C., *Order without Law: How Neighbors Settle Disputes*. Cambridge: Harvard University Press 1991; Ellickson, R. C., *The Market for Social Norms*, 3 *American Law and Economics Review* 1, 2001, Cooter, R. D., *The Structural Approach to Adjudicating the New Law Merchant*, 144 *University of Pennsylvania Law Review* 1643, 1996; Elster, J., *Social Norms and Economic Theory*. 3 *Journal of Economic Perspectives* 99-117, 1989. For an overview of the vibrant debate over the effect of social norms on corporate law see *Symposium on Norms and Corporate Law*. 149 *University of Pennsylvania Law Review* 1607, 2001 and also Eisenberg, M. A. *Corporate Law and Social Norms*, 99 *Columbia Law Review* 1253, 1999;; Vandenbergh, M. P., *Beyond Elegance: A Testable Typology of Social Norms in Corporate Environmental Compliance*, 22 *Stanford Environmental Law Journal* 55, 2003; Mitchell, L. E., *Understanding Norms*, 49 *University of Toronto Law Journal* 177, 1999.

suggested here is that social norms have the potential to alter organizational and specifically corporate actions as well. On one level, a social norm internalized by the public could exert external pressure on corporations that wish to satisfy the expectations of current and potential consumers and investors. In turn, such pressure could enhance corporate motivation to engage in CSR. On a different level, a social norm could bring about motivation to engage in CSR from within the corporation rather than as a response to external pressure. The rationale behind this argument is straightforward - the human beings who navigate the corporate entity are not immune to social norms by which they are surrounded. *Therefore, the road to change the way corporations act passes in the minds and hearts of those who run them.*

15.- This is why we believe the articles of association discussed herein mark an unprecedented advance in the field and deserve close scrutiny.