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The Internal Morality of Contracting: Redeeming the Contractualist Endeavor in Business Ethics

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The Internal Morality of Contracting: Redeeming the Contractualist Endeavor in Business Ethics[a]

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Abstract
Integrative Social Contracts Theory (ISCT) is arguably the most promising theory of business ethics to date, but it is often criticized for its inability to produce substantive norms. Rather than abandoning the contractualist endeavor in business ethics altogether, we undertake to redeem it by exploring the internal morality of contracting. We demonstrate that substantive norms for guiding and constraining business conduct can be produced without relying on sources of normality that are external to the contractualist framework

Key words: Contractualism & contractarianism, Business ethics, Integrative social contracts theory, Internal morality, Institutional safeguards

[a] All authors contributed equally to this manuscipt

Business ethics scholars have searched several decades for a unified and comprehensive theory capable of providing moral guidance to managers responsible for business decisions with the potential to affect others (Badaracco, 1997; Boatright, 1993; DeGeorge, 1999; Frederick, 1995; Hartman 1996; Kaler, 2000; Margolis & Phillips, 1999; Zadek, 2001). Some have proposed to ground this theory in virtue ethics, because its focus on the moral actor and emphasis on excellence resonate well with the business community (Solomon, 1992). Others have argued for a Kantian perspective, emphasizing the self-cleansing capacities of business due to the self-defeating nature of immoral practices (Bowie, 1999). Nevertheless, social contract theory in general (Donaldson, 1982, 1989; Dunfee, 1991; Keely, 1988), and Integrative Social Contracts Theory (ISCT) in particular (Donaldson & Dunfee, 1994, 1999, 2002), appear to have the best hand for providing the basic conceptual structure of the much sought-after theory. The main attraction of ISCT derives from the close connection between its contractualist logic[1] and its field of application. Since management scholars often conceive of organizations as nexuses of contracts (Alchian & Demsetz, 1972; Jensen & Meckling, 1976; Williamson, 1990), the extrapolation of the contractualist framework into the domain of business ethics assures a certain degree of theoretical continuity (Boatright, 2002).

Yet there are also problems with ISCT, as well as with the contractualist project more generally. The most serious critique pertains to the moral substantiation of ISCT (Soule, 2002). According to many (Hartman, 1996; Husted, 1996; Mayer, 1994; Mayer & Cava, 1995;

Rynning, 1996; Shaw, 2000), the theory runs into severe trouble once it is used to substantiate norms capable of providing managers with the moral guidance they need for making everyday business decisions. The gist of the problem is that it is not clear why certain norms—and not others—spring from the contractualist well. As a result, some appear inclined towards abandoning ISCT and the contractualist framework altogether in favor of alternative approaches (Lavengood, 2001; Rowan, 2001; Shaw, 2000; Soule, 2002).

Although we sympathize with the critique that the contractualist logic underlying ISCT is consistent with many possible substantive norms and therefore does not uniquely determine any particular consistent set of them, we believe that the contractualist project in business ethics is worth redeeming on account of its theoretical fit with its domain of application. Our plan is to come to the aid of the contractualist project in business ethics by focusing on what we call "the internal morality of contracting," in analogy to the way Fuller (1964) saved the moral qualities of law from the a-moral claws of legal positivism by focusing on the normative principles immanent to the concept of law itself.

We uncover the internal morality of contracting in four steps. First, we sketch the present state of the contractualist project in business ethics and briefly recapitulate the oft-heard critique that this project fails because it is unable to produce substantive action-guiding norms. Second, we present the main argument of our paper, which is that substantive norms for guiding day-to-day business conduct can be derived from the basic argumentative structure of the contractualist model itself. The internal morality we intend to uncover is fully enclosed within the concept

and practice of contracting, consists solely of endogenous norms, and is completely independent from any external source of normativity. Third, we use a subsequent discussion section to explain the relationship between the proposed internal norms and the ISCT concept of hypernorms. In this section we also discuss the institutionalization of these endogenous contractual norms in society. The paper is then brought to a finish by means of a brief concluding section.

THE CONTRACTUALIST ENDEAVOUR IN BUSINESS ETHICS

Social contract theory in general is grounded in the intuitively appealing idea that human interaction and association should be guided and constrained only by those norms, principles and institutions that freely consenting agents could and possibly would agree to if they had the choice (for more elaborate reviews see: Hampton, 1993; Heugens, van Oosterhout, & Vromen, 2003; and Lessnoff, 1990). The main attraction of social contract theories is that they build on the notion of "content-independent" normative commitment (Hart, 1982; Hobbes, 1651/1968; Raz, 1986). Rather than proceeding from some typically disputable set of substantive first principles, social contract views are based on whatever norms, principles, and institutions agents choose to live by at a given point in time. The central premise of contractualism is therefore that individuals are only bound by those normative and institutional constraints that they collectively find worth committing to. Content-independent commitment hence coheres well with liberal democracy and an economic system of free market exchange.

In spite of this common theoretical foundation, social contract theories are widely acknowledged to embrace two separate streams of thought (Freeman, 1990; Hampton, 1993). The Hobbesian view is strictly agent-centered and proceeds from whatever preferences free and autonomous agents may have. It is typically assumed that Hobbesian agents rationally seek to maximize the satisfaction of these preferences in selecting the norms they aim to live by (Binmore, 1994, 1998; Gauthier, 1986; Hampton, 1986, Skyrms, 1996). The standard objection to this view is that an appeal to unmediated preferences may be an insufficient foundation for morality, since there is no *a priori* way to exclude pertinently immoral preferences. In contrast, theorists working in the Kantian tradition of social contract theory have emphasized that reasons rather than blunt preferences should inform the choice of mutually acceptable norms in human association (Kant, 1793/1991; Locke, 1689/1993; Rawls, 1971; Rousseau, 1762/1994; Scanlon, 1982, 1998). In this view, reasons are often understood as a kind of second-order preferences—as desires to have or not to have certain more basic desires (Cf. Frankfurt, 1971; Dworkin, 1991). In some views, such second-order preferences already require or presume some form of existential (Freeman, 1990) or virtual (Rawls, 1971; Habermas, 1985) community in which these reasons are jointly developed and brought to bear on whatever first-order preferences are held by its individual members.

In a courageous intellectual effort to construct a unified and comprehensive theory of business ethics, Donaldson and Dunfee (1994, 1995, 1999, 2002) have attempted to reconcile both streams of social contract theory. Arguably the most interesting aspect of their contribution

is the recognition that preserving the efficiency of the economic realm in liberal democracies requires "the freedom of individuals to form or join communities and to act jointly to establish moral rules applicable to the members of the community" (Donaldson & Dunfee, 1999: 38). The authors label this constitutive presumption of their theory "moral free space." It is not difficult to see the theoretical continuity between the concept of moral free space on the one hand, and the rational choice-inspired Hobbesian stream of thought in social contract theory on the other.

In spite of the central presumption of moral free space in their work, Donaldson and Dunfee appear well aware of the shortcomings of the Hobbesian intellectual tradition. They acknowledge that moral free space must further be confined to guard against potentially immoral norms and institutions that may result from the unhindered rule of preference in contracting for morality. They constrain potential norm-generating agreements in moral free space by postulating that the resulting norms will have to be compatible with the "thin universal morality" (Donaldson & Dunfee, 1999: 43) of principles that are so universal that they can be subscribed to by any contractor, irrespective of his or her cultural, religious, or philosophical convictions. In ISCT, these principles are named "hypernorms" which "constitute principles so fundamental that, by definition, they serve as 'second-order' norms by which lower-order norms are to be judged" (1999:50). Their decision to rely on these "second-order" norms to further constrain practices of social contracting in moral free space clearly echoes the Kantian tradition in social contract theory

with its claim that our reasonable and social nature requires that we test our actual agreements against certain irreducible moral notions.

The Contractualist Fallacy

While ISCT has received much well deserved praise, it has also met some serious criticism—in particular with regard to the centrality of substantive hypernorms in the theory (Boatright, 2000; Husted, 1996; Shaw, 2000). At least three arguments have been advanced for rejecting the "imperial role" (Soule, 2002: 117) hypernorms play within ISCT. Some have argued, first, that identifying hypernorms is by no means a straightforward exercise (Husted, 1996; Mayer & Cava, 1995). Soule (2002) points out that many of the sources Donaldson and Dunfee (1999: 69-73) have suggested as important points of departure for the discovery of hypernorms are neither readily accessible to managers, nor readily interpretable for them. Second, it has also been claimed that by focusing on the convergence of the opinions of religious leaders, NGOs, professional philosophers, and practicing business managers around certain norms as a method for identifying hypernorms, Donaldson and Dunfee seem to equate morality with mere convention (Mayer, 1994; Rynning, 1996). A third point of criticism is that hypernorms are not substantially grounded in either of the two social contract traditions that comprise ISCT (Douglas, 2000). This supposedly makes ISCT "less of a social contract theory than most other projects in that tradition of political philosophy" (Soule, 2002: 117), because the hypernorms that do the

moral "heavy lifting" within ISCT are actually derived from sources that are external to the contractualist endeavor itself.

Although this critique of ISCT is not groundless, it fails to acknowledge that there is a broader argumentative fallacy at work here that threatens not just the status of ISCT as the flagship of the business ethics discipline, but in fact also the appeal of contractualist ethics in general. What we call the "contractualist fallacy" involves the erroneous assumption that the contractualist argumentative structure will uniquely determine the primacy of a single set of action-guiding substantive norms and principles over all other possible sets of normative claims.[2] A number of contractualists in economics (Buchanan, 1975; Sugden, 1990) have already demonstrated that this assumption is untenable, because the contractualist argument or methodology is typically consistent with many sets of competing social norms—some of which may even be mutually exclusive.[3] Again, contractualism aims to identify norms that free and autonomous agents could and possibly would agree to if they had the choice. Such content-independent commitment is the main attraction of contractualism, but one cannot have one's cake and eat it too. Either one submits to the attraction of contractualism and accepts that the selection of relevant norms will typically be problematic, or one discards contractualism altogether as a viable theory for business ethics in favor of an alternative theoretical perspective. Some commentators appear to be inclined towards the latter position (Lavengood, 2001; Rowan, 2001; Shaw, 2000; Soule, 2002). In contrast, we choose for the former option because we believe that the contractualist project is worth redeeming on

account of its superior connection with its field of application (Boatright, 2002).

Redeeming the Contractualist Endeavor in Business Ethics

Our hopes that the contractualist endeavor in business ethics can be redeemed derive from a powerful precedent in legal theory. This precedent involves a contribution in the debate on the moral content of law between the (modern) natural law tradition on the one hand (dating back to Grotius (1625/1853) and Pufendorf (1673/1991)), and legal positivism on the other (which can be traced to Bentham (1782/1970) and Austin (1832/1995)). The natural law tradition in legal thought holds that the law must have a firm rooting in human morality. Although this basic idea is intuitively appealing, a major problem haunting this school of thought involves the question whose morality and which moral doctrine in particular should provide the moral foundations of legal order. In sharp contrast, legal positivism—epitomized in Hans Kelsen's *Pure Theory of Law* (1960/2003)—rejects the moral foundations of law. It holds that only those norms are to be considered laws that that have been "posited" as such by a lawful legislature—regardless of their moral standing. The core problem of legal positivism is how to prevent clearly immoral laws—such as the Nazi racial laws—from being posited.

In what is now a classic contribution to this debate, Lon Fuller (1964) has argued for a morality of law that is consistent with both legal positivism and the natural rights tradition. The gist of his contribution is that the concept of law is not a morally neutral idea, as there are certain

practices that are inconsistent with any law—positive or natural. Racial discrimination (1964: 159ff) is an example of such a practice; the application of retroactive laws (1964: 35ff) is another. Now it is not that Fuller rejects these practices on account of their immoral nature. He rejects them instead because they contradict the very idea of law and lawfulness as such. In his view, these practices constitute a violation of what he sees as the *internal* morality of law, the morality implied in the conception of law itself. This is to be contrasted with the *external* morality of law, the moral aims the law attempts to express and realize. Examples of moral principles internal to the conception of law are that laws should be: (a) general, (b) made publicly known, (c) prospective rather than retroactive, (d) clear, and (e) without contradictions. They also should: (f) not demand the impossible, (g) not be changed too often, and (h) be congruent and consistent with official action. In Fuller's view, these principles involve "a morality of aspiration" (1961: 5); a striving for legal excellence more or less in the same way that carpenters strive for excellence in carpentry regardless of whether they are making an orphanage or a hideout for thieves (1964: 155).[4]

Fuller's observation, in sum, is that one need not embrace an external morality of law, as is argued by the natural law tradition of thought, in order to believe that there is more moral substance to law than legal positivists are willing to admit. In our view the same holds true for contractual approaches to business ethics. One need not commit the contractualist fallacy in order to unveil the substantive morality that should guide and constrain managerial decisions in the realm of business. The contractualist fallacy can be circumvented and the contractualist

endeavor in business ethics redeemed as long as substantive norms for the regulation of business conduct are derived from the basic argumentative structure of the contract model itself rather than from sources exogenous to this structure.

THE INTERNAL MORALITY OF CONTRACTING

To uncover the internal morality of contracting, we will resort to the basic argumentative structure underlying all social contract theory (See Heugens, van Oosterhout & Vromen, 2003). This basic contractual argument typically appeals to some hypothetical pre-contractual condition (e.g. a 'state of nature' or 'original position') in which there is no or very little cooperation. It then sets out to demonstrate that each individual actor can improve his lot by cooperating with others. A Pareto improvement is a familiar form in which the basic contractualist argument is being put to work, but there are many other ways in which the basic contractualist argument can be applied without in some way importing the welfare-optimizing connotations of rational choice theory.

Thomas Hobbes' (1651/1968) use of the basic contractualist argument is well known and has become more or less paradigmatic for the tradition as a whole. Hobbes describes his hypothetical pre-contractual condition as a state of nature characterized as a war "of every man, against every man" (p. 185), where life is "solitary, poore, nasty, brutish, and short" (p. 186) because no man can be sure to consume the fruit of his own efforts. In this light, surrendering to the authority of an almighty sovereign that can put an end to this war is subsequently proposed as a

significant and attractive improvement. A more contemporary example in political theory makes use of a hypothetical "original position" in which contractors do envisage the potential of improving their lot by cooperating, but where they are deprived of any potentially fairness-distorting information on their relative position versus all others by a "veil of ignorance" (Rawls, 1971). Tom Donaldson (1982) has introduced a similar argument to the field of business ethics. In *Corporations and Morality*, he invites us to imagine how life would be like in what he calls a state of individual production; a society without productive organizations. In his words, it would be "to imagine society without factories, banks, hospitals, restaurants, or railroads" (p. 45). Since rational persons would find that many of their social and economic needs would remain unfulfilled as long as they stayed in this condition, they would try to escape the state of individual production by entering a contract allowing for the emergence of productive organizations.

Although it is not necessary to make use of a hypothetical state of nature in applying the contractualist argument,[5] we will make use of this "methodology" to unveil what we conceive to be the internal morality of contracting. Following Simon (1955: 99-100), we hold that the key to better theory-building in the social sciences is to enrich theories of human behavior and decision-making with behavioral assumptions that are compatible with the characteristics of the context in which the actors to whom they apply have to act and decide. As explained, we conceive of the world of business and economic organization in terms of first-order contracting processes (Boatright, 2002; Dunfee, 1991). The second-order normative constraints to these contracting processes are then discovered

by constructing a hypothetical condition, in which premises that depict the nature of contractual commitment are juxtaposed with premises depicting contractors' behavioral limits as they impact on first-order contracting processes. The conjunction of the two kinds of premises then produces four ideal-typical (Weber, 1949) contracting problems, which depict a 'state of nature' with regard to first-order contracting.

We subsequently argue that this state of nature can be avoided if contractors were to accept and respect the second-order commitments they implicitly make whilst engaging in first-order contracting practices. These implied commitments hence constitute the internal morality of contracting, which is the morality as it is *immanent* (or transcendent for Kantians) to contracting practices.[6] After having staged our version of the contractualist argument, we proceed by uncovering the internal morality as it is implied in everyday business and economic organization. It must be clear, though, that our ambition here is not to give an exhaustive account of the norms, principles and institutions that should guide and constrain contracting practices in the realm of business. Our main aim is to demonstrate the potential of the argumentative structure underlying contractualist theory as an epistemic procedure for unveiling substantive endogenous norms that guide and constrain business conduct (compare Donaldson and Dunfee, 1999: 54-61).

The Nature of Contractual Commitment

We hold that there are two general patterns of normative expectations underlying all forms of contractual commitment, the first of which involves

expectations of *mutual advantage*. The normative expectation of mutual advantage is a *conditio sine qua non* for contracting, because contractors will not commit themselves to contractual obligations if they do not perceive some kind of mutual benefit (i.e., private benefits for all of the involved parties) deriving from such commitment. We conceive of mutual benefit as including a broad variety of possible mutually satisfactory relationships (Pettit, 1996: 298-299). The strongest form of mutual benefit, on the one extreme, exists when *shared reasons* underlie contractors' mutual commitment. This form of mutual benefit typically results in strong and stable ties, and is associated with the Kantian perspective within the contractualist paradigm. Different forms of *accommodation* (Pettit, 1996: 299) constitute the other extreme. Here parties agree to a settlement only because it is the most optimal solution given the circumstances. This form of mutual benefit is typically neither strong nor stable precisely because of its dependence on contingent conditions, and it is reminiscent of Hobbesian contracting in line with blunt preferences. In-between the two extremes we find the *compromise* position (Pettit, 1996: 299), which characterizes the typical free market exchange situation. Here both parties have different but complementary reasons for committing themselves to contractual obligations. Compromises can be self-enforcing when (a) all contractors benefit substantially from their mutual commitment, while (b) no individual contractor—or group of contractors—can improve upon their private situation by unilaterally defecting on the commitment made.[7]

r second proposition is that all contractual commitments entail expectations of *effectiveness*: contractors will only consent to a

cooperative scheme if they expect their partners to live up to the terms of the agreement (van Oosterhout, 2002). The norm of effectiveness is perhaps most manifest in the legal context. It is a central dogma of contract law that a failure to live up to the terms of a contract by one party relieves the others of their obligations (Treitel, 1999). Even Thomas Hobbes, arguably the most radical contractarian in political thought because of his view that individuals ought to relinquish everything to the sovereign by means of the social contract in return for his protection of their lives, explicitly made provision for the effectiveness of that contract. In his view, the social contract loses its bindingness on the stairs to the scaffold, or when a neighbor is to be feared more than the sovereign (Hobbes, 1651/1968). It is important to note that both patterns of expectations do not just entail *positive* beliefs about how two or more parties will behave, but also unabashedly *normative* expectations concerning how each of these parties should behave when they enter a contract together. In other words, contractors are not just right but also justified in expecting reciprocity and effectiveness when entering a contractual commitment (Sugden, 1998).

Behavioral Limits to Contracting

All theorizing in the social sciences implicitly or explicitly builds upon conceptions of human behavior (North, 1990). These behavioral assumptions do not serve the purpose of sketching the most veracious picture of the human condition as such, but rather enable theoreticians to highlight certain stylized aspects of human behavior that are likely to be

important explanatory factors in the relevant theoretical context (Williamson, 1996). To understand which aspects of human behavior are important for the contractualist endeavor in business ethics, we return once again to its two constitutive pillars: the preference-based Hobbesian project and the reasons-guided Kantian enterprise.

Kantian scholars often accuse Hobbesians of painting an overly simplistic picture of the human condition, one in which self-interest plays a disproportionately large role. Hobbesians are blamed in particular for leaving too little room for other- and process-regarding concerns (Ben-Ner & Putterman, 1998; Pettit, 1995, 1996). The Hobbesian retort is that Kantians are too optimistic about the extent to which human actors will voluntarily abide by mutually agreed-upon contractual norms, since "Covenants without the Sword are but Words, and of no strength to secure a man at all" (Hobbes 1651/1968: 223). Although it is beyond the scope of the present project to explore the fairness of these accusations, they do direct our attention to two behavioral assumptions that economic organization theory has identified as highly relevant in the context of contracting (Williamson, 1985). The first is that contractors may sometimes be subject to overly self-regarding or *opportunistic* tendencies that lead them to exploit the freedom they enjoy in moral free space by unjust means (Williamson, 1985). The second is that contractors are subject to *bounded rationality* (Simon, 1945/1998, 1955) or cognitive limitations that interfere with their ability to rationally devise norm-generating contracts within and second-order constraints (hypernorms) to moral free space.

Although both the empirical tenability and the normative

implications of the assumption of opportunism are highly disputed in the field of management (Goshal & Moran, 1996; Perrow, 1986; Pettit, 1995), we believe that this assumption still has instrumental value for our theory-building efforts. In the next section we will use it in combination with the assumption of bounded rationality to produce an idealized set of four contracting problems. These problems are obtained by confronting the two patterns of substantive normative expectations that guide all contracting practices with the two behavioral conditions that may negatively impact first-order contracting practices in everyday life. In combination, these four problems represent our version of the state of nature: the predicament in which contractors will find themselves when there is no adequate internal morality of contracting in place to guide and constrain their behavior in the realm of business.

Four Contracting Problems

Desolation. The characteristic of mutual benefit holds that a contract will not come into being unless all potential contractors anticipate private gains deriving from it, yet the behavioral condition of bounded rationality may limit the ability of potential contractors to envision such gains. Contractors may suffer from a lack of partner-specific information, experience difficulties in imagining how particular relationships could benefit them, or fail to make sense of the full scope of cooperative

options. Bounded rationality may therefore introduce frictions in the process of translating shared interests into cooperative schemes, because contractors may be unable to select the most beneficial relationship from the spectrum of options available to them (Donaldson & Dunfee, 1994, 1999). We have labeled this contracting problem *desolation*, since it may leave those that are looking for like-minded parties in a state of solitude.

Deception. The extent to which contractual relationships are mutually beneficial can also be impeded by the calculated efforts of one or several of the contracting parties to mislead or confuse the others (Williamson, 1985). Contractors are typically vulnerable to partner opportunism as a consequence of *ex ante* information problems (Akerlof, 1970; Arrow, 1985a): a form of information asymmetry whereby one party (the opportunistic contractor) is better informed about its own motivations and qualifications than the other contractors. Opportunists can exploit this information asymmetry by concealing clues that could reveal their inability or unwillingness to comply with the terms of the contract once it is in place. We have used the term *deception* to describe the whole of a party's deliberate attempts to mislead its contracting partners before they commit themselves to a binding contractual agreement.

Defeasance. Bounded rationality is also likely to frustrate the realization of the normative expectation of effectiveness. Because of their limited anticipatory capacities, contractors may end up being bound to a contract they cannot reasonably comply with. Such is the case, for example, when the conditions under which actors became party to a contract have changed dramatically while the contract itself provides no

provisions for such contingencies. It is widely recognized that all contracts are incomplete in this sense, because no contract can take all possible future events into account (Macauley, 1999/1963; Williamson, 1991). As Macneil states, "The limited extent to which it is possible for people to consent to all the terms of a transaction, even a relatively simple and discrete one, soon forces the development of legal fictions expanding the scope of 'consent' far beyond anything remotely close to what the parties had in mind" (1978: 883). Ultimately, the central question becomes whether a contract can still be considered binding under dramatically changed circumstances. We have reserved the term *defeasance* for the possibility of a contract becoming maladapted to contractor interests and preferences because of unforeseen contingencies.

Defection. One or several of the parties to a contractual scheme may also threaten the normative expectation of effectiveness by acting opportunistically once the contractual scheme is in place. The effectuation of a contractual scheme creates incentives for each of the individual contractors to "shirk" or "free ride" on the efforts of the parties that are complying with the terms of the agreement. This problem becomes more pressing in the presence of *ex post* information problems (Akerlof, 1970). Such problems exist when it is difficult to observe whether a partner's efforts to live up to the terms of a contractual scheme are sincere. If the behavior of opportunistic actors cannot adequately be assessed, it is often worthwhile for them to defect on existing commitments (Axelrod, 1984; Hardin, 1982). We have used the term *defection* to designate the problem of exploiting *ex post* information asymmetries.

Having constructed our own version of the state of nature by identifying four idealized contracting problems, we will turn our efforts towards identifying four corresponding sets of norms and principles that are endogenous to the process of contracting and to which contractors must strive in order to secure the success of their contractual endeavors (cf. Fuller, 1964: 41-43). Without claiming to be exhaustive, these four sets instantiate what we have called an internal morality of contracting. As such, they provide a normative ground for evaluating the content of what Donaldson and Dunfee (1999) call microsocial contracts, and can be instrumental in weeding out immoral contractual alternatives from moral free space. Yet, their evaluative capacity is limited because these norms and principles are not concerned with external conceptions of morality, implying that they are neutral over a wide range of substantive contractual aims (in line with the notions of content-independent commitment; Raz, 1986, and moral free space; Donaldson & Dunfee, 1999). The internal morality of contracting can therefore not rule out the pursuit of evil aims by contractual means (Rawls, 1971: 263), but it does subject contractors to greater public scrutiny by forcing them to be more transparent about their objectives and their intended means for reaching them. Adherence to these norms therefore reduces the number of morally undesirable but nonetheless viable contractual alternatives in moral free space by reducing the likelihood that contractors can get away with pursuing wicked ends that cannot carry the seal of public approval.

Identity matters. Neoclassical economics conceives of market transactions as taking place in a frictionless universe, in which the identity of the contracting parties—"a set of logically connected propositions that a

person uses to describe himself or herself to himself/herself and to others" (Rowley & Moldoveanu, 2003: 208)—is irrelevant to the realization of economic exchange. This discrete transaction paradigm—"sharp in by clear agreement; sharp out by clear performance" (Macneil, 1974: 738)—has long inspired both law and economics. But there is an increasing awareness amongst management and organizational scholars that no such frictionless universe exists, and that the identity of economic actors matters in everyday business life (Granovetter, 1985; Uzzi, 1997). We focus on organizational identity in relation to the idealized contracting problem of desolation.

Identity matters, first, because the problem of desolation may obstruct the identification of the most attractive exchange partner. The sterile economic facts of quantity and price often form an insufficient informational basis for selecting the most successful exchange relationship. For exchange characteristics that are less readily observable, such as quality, reliability, and organizational capability, the organizational identity of the supplier acts as an important informational signal or proxy that guarantees the continuity of the collective as well as a certain minimal level of performance (Hannan & Freeman, 1984). Organizational identity also matters, second, because the properties of collective actors—which are endemic to the world of business—are not adequately reflected in the private identities of the natural persons who act as their agents (Dan-Cohen, 1986). Unless organizations contextualize and endorse the behavior of their agents, the revealed identity of private persons remains an insufficient informational basis for overcoming the problem of desolation.

The thrust of the issue is that the problem of desolation points out a domain in normative space consisting of norms, principles, and institutions that require economic actors to reveal their identities in their daily interactions. This identity not only pertains to what is central to the self from a first person's perspective, but also to what distinguishes one from others as seen from a third person's perspective (Hatch & Schultz, 2002). As the business universe is largely inhabited by 'artificial' corporate 'personalities', the temporal dimension of organizational identity is particularly relevant (Albert & Whetten, 1985). Only a mutual recognition that identity matters allows contractors to locate attractive exchange partners in a world in which artificial agents are dissolved and brought to life almost at will.

Market failure is moral failure. The dominant view in the fields of strategic management and industrial organization economics is that private information must be protected at all cost in order to sustain competitive advantages. In competitive industries, a certain fraction of a contractor's private information will be proprietary in kind, implying that its disclosure can reduce the present value of the cash flows of the contractor endowed with the information (Dye, 1986). But a host of recent corporate scandals have shaken investor, consumer, and business partner-confidence in many areas of the corporate world. The dramatic lack of confidence in the economies of the United States, Japan, and Western Europe that resulted from corporate scandals such as Enron, WorldCom, and Ahold demonstrates that the contracting problem of deception—which is fostered by conditions of *ex ante* information asymmetry between contractors (Akerlof, 1970)—may well represent a

bigger threat to corporate prosperity than the loss of proprietary information. The veil of competitive secrecy seems to have created a business climate in which corporate failure is more likely to be produced by moral failure than by insufficiently shielding privileged information.

Reasoning along these lines, the contracting problem of deception indicates that dysfunctional *ex ante* information asymmetries ought to be alleviated up to a point where it becomes possible for contractors to make an adequate assessment of the true intentions and capabilities of a prospective partner. Soliciting contractors may not be expected to reveal such proprietary information *pro bono* of course, because free and unrestricted disclosure of corporate information may well lead to the deterioration of a firm's competitive position. But this does not relieve contractors of some minimal obligation to subject themselves to certain forms of screening activities by their partners (Pettit, 1996). Screening combats the deception problem by reducing information asymmetries up to a certain threshold level, and thereby reduces the probability that parties will become the victim of partner dishonesty. At the same time, screening may also increase the allocative efficiency of the economy as a whole by matching partner competence and task complexity more effectively.[8]

The gist of the argument is that the problem of deception locates a domain in normative space inhabited by norms, principles, and institutions that invite contractors to disclose the type of privileged information that could help secure the commitment of potential partners. Alternatively, an uncompromising commitment to corporate privacy may well contribute to market failure, because it can create an economic climate in which moral

knaves enjoy legal protection and unrestricted room to maneuver. Under these conditions, a crowding-out effect will occur through which well-intending investors, consumers, and business partners are driven out of the market (cf. Brennan & Hamlin, 2000; Frey, 1998). Only a joint commitment to the endogenous contracting norm of pro-active information disclosure provides parties with the confidence they need to operate in a market in which at least a fraction of the potential contractors harbors opportunistic tendencies.

Forgiveness over litigation. The increased importance of the private law contract in modern societies is the "legal reflex" of ongoing trends towards the specialization of labor and the proliferation of market-oriented exchange relationships (Weber, 1978). For many types of standardized transactions, market exchange via private contracts, backed up and if necessary enforced by classical contracting law, is the first-best solution for the transfer of goods and services between legally independent parties. Under this conception, market contracts serve primarily as devices that protect each party against opportunism by his opposite. Disputes under this discrete transaction paradigm are strictly settled via litigation—not by means of voice or arbitrage—because the relationship between the contractors is not valued independently of the exchange (Williamson, 1985).

For at least two reasons, however, litigation-centered contract law appears to fall short in backing up a business environment that facilitates nonstandardized, complex exchange. First, many long-term exchange relationships become "infused with value beyond the technical requirements of the task at hand" (Selznick, 1957: 17), which makes that

the contractors begin to value the relationship over and above the economic exchange value it incorporates. Litigation then loses much of its disciplining potential, because it is too crude and has too many "transaction-rupturing features" (Williamson, 1985: 75). Second, because it is impossible to 'presentiate' all relevant future contingencies into a complete contract (Macneil, 1980), all legal contracts will over time begin to show a less than optimal fit between the letter of the agreement and the factual situation of the exchange. This misfit enables ill-intending parties to prey on the limited capacities of their partners to foresee "acts of God" and other contingencies that disrupt the practice of committing to obligations that extend into the future.

The upshot of this issue is that the problem of defeasance demarcates a domain in normative space consisting of norms, principles, and institutions that demand of contractors to practice greater forgiveness than the law requires them to do. Fruitful economic cooperation with an orientation towards the longer term would be impossible if competition between contracting parties would not be moderated by contractual solidarity (Macneil, 1980). Only a mutual adherence to contractual forgiveness can entice actors to enter into contracts together that are inevitably open-ended due to the boundedness of their abilities to foresee relevant future contingencies.

Taming the agent. Contracting, by definition, is a process that involves coordination between two or more parties to accomplish some form of exchange or mutual commitment to the conditions facilitating it. Yet, in all cases in which reciprocation is not simultaneous, the production and sustenance of the exchange also requires cooperation amongst the

two parties and the transaction then effectively becomes a co-production between two legally independent but materially increasingly interdependent actors. Williamson refers to this process, by which faceless *ex ante* contracting turns into personified *ex post* contracting as "the fundamental transformation" (1985: 61). What is crucial about this transformation is that a party that enjoyed unconstrained choice prior to the contractual commitment is relinquishing some degree of control over its value-adding processes to another party (Arrow, 1985b). The new dependence relationship is characterized by *ex post* information asymmetries (Akerlof, 1970), in the sense that the other party always enjoys better information concerning the degree of sincerity and level of effort with which it attempts to live up to its contractual obligations than the dependent contractor. We will specifically discuss the importance of such *ex post* information asymmetries in reference to the idealized contracting problem of defection.

Contractors who are about to enter into a non-simultaneous exchange relationship have every reason to fear the problem of defection. They are therefore likely to insist upon the provision of *ex ante* remedies against defection as one of the preconditions for entry. At a minimal level, soliciting contractors will ask aspiring partners to expose themselves to positive and negative sanctioning mechanisms that serve the purpose of aligning the interests of all the parties in the contractual scheme by putting a penalty on defection and/or an incentive on cooperation. Such sanctions "operate on the set of options before an agent, making some options more attractive or less attractive than they would have been had the sanctions not been in place" (Pettit, 1996: 57). Well-designed

sanctioning schemes succeed in altering the relevant incentives that apply to all the parties to a contract, such that the strategies which allow them to achieve their private ends are identical to those that are necessary to reach the collective goals of the agreement (Eisenhardt, 1989). Contractors may even insist on a set of more concrete safeguards and include rules in the contract that require the aspiring party to restitute damages resulting from potential defection or demand various levels of "specific performance" in case of breach (Shavell, 1984).

The crux of the matter is that the problem of defection refers to a domain in normative space consisting of norms, principles, and institutions that admonish economic actors to allow any incompliant behaviors on their part to be corrected by means of appropriate sanctioning provisions. It is often argued that legal contracts in general and sanctioning clauses in particular may lead to a breach of trust between contractors (Dyer & Singh, 1998), but since the risk of defection is often mutual in contractual situations, all of the involved parties to a contract are realistically likely to benefit from a proficient *ex ante* settlement of *ex post* information problems. Seen from this perspective, effective sanctioning clauses do not drive a wedge between contracting partners but in fact build bridges of confidence between them upon which trust can be built (Nooteboom, Berger, and Noorderhaven, 1997).

DISCUSSION

Meta-Contractual Norms and Hypernorms

There is an important parallel between procedural and structural hypernorms as identified by Donaldson and Dunfee (1999:51-52) and the norms and principles constitutive of the internal morality of contracting we generated: both act as a set of trumps over actual contractual consent and extant microsocial contracts (Dunfee, 1991). Procedural hypernorms allow individuals to exercise the rights of voice and exit, such that they can challenge the authenticity of specific microsocial norms or opt out of microsocial communities of which they no longer want to be a member. Structural hypernorms establish and support essential background institutions in society, such that economic communities can preserve the efficiency of their mutual transactions by not having to reproduce at the microsocial level all legal, political, and economic requirements for facilitating exchange. The endogenous norms and principles we uncovered share with procedural hypernorms that they enable individuals to enter communities easier and abandon them with less residual obligations, and with structural hypernorms that they put penalties on deeds that are strictly aimed at the advancement of private rather than shared interests.

But there are also two important differences to be reported, the first of which is directly related to the ultimate source of morality from which the norms and principles under investigation derive. None of the hypernorms identified by Donaldson and Dunfee appear to derive from the process of contracting itself (Soule, 2002). Granted, structural and procedural hypernorms are endogenous in the sense that they are specified or implicit in the macrosocial contract, but they do not constitute a genuine internal morality. The acid test in this respect is that if they would be endogenous to the practice of contracting itself, they would not

only have been part of the macrosocial contract, but also of all microsocial contracts (which they are pertinently not). In contrast, the four norms we uncovered are internal to the practice of contracting and therefore apply to all contracts, whether macro- or microsocial in kind. The second difference relates to substantive hypernorms alone, which represent "fundamental concepts of the right and the good" (Donaldson & Dunfee, 1999:53). In other words, some hypernorms refer to universal ethical principles and other external sources of morality. In comparison, the four sets of norms and principles we identified are strictly internal to the contracting process and do not appeal to any external source of morality. They apply with equal force to communities of contractors whose objective it is to deliver humanitarian aid to war-struck countries as they do to groups of contractors conspiring to engage in organized crime.

Institutionalizing Meta-Contractual Norms

By itself, the picture that we painted of the internal morality of contracting is highly fragile. It is one thing to demonstrate the importance of certain norms and principles, but it is quite something else to explain how they can be upheld. There is a classic problem of collective action at work here, because each individual contractor will realize that efficient microsocial contracts cannot come about if the other contractors do not abide by the internal morality of contracting, but none of the individual contractors may have sufficient incentive to abide by the norms and principles it specifies. In other words, when each contractor chooses the option with the largest expected individual payoff, a suboptimal solution for the group as a whole

is likely to obtain (Holm, 1995). The classical response to such collective action problems is to design and build institutions that compel everyone into compliance by aligning individual and collective interests (Bates, 1988). It is interesting to see that modern market economies have long recognized the importance of upholding the internal morality of contracting, and that they have produced a resilient set of institutions for the enforcement of its norms and principles (North, 1990).

First, the idea that identity matters is by no means alien to contemporary business practices in many modern market economies, and is in fact well connected to existing institutions. In a relatively formal manner, chambers of commerce facilitate business transactions between unacquainted parties by recording statements of purpose and contact information in administrative registers. Similarly, charters of incorporation provide interested stakeholders with relevant informational cues concerning the aims and principles of corporate actors. Other examples of institutions that alleviate the desolation problem by facilitating partner search and revealing contractors' identities include, but are by no means limited to: trade associations, product boards, "yellow pages" service agencies, and web-domain registration offices.

Second, the international business community and the professions have long recognized the principle of allowing selected partners access to private information. The fact that one needs a certified Ph.D. degree (preferably from a respected and accredited institution) in order to qualify for an academic job is only a first example. Certification by standardization agencies like the International Organization for Standardization (ISO) is an example of an organization-level informational

cue that serves to exemplify the reliability of an actor as a business partner. Other illustrations of the institutional embeddedness of the principle of revealing private information include, but are again not limited to: the public licensing of physicians and lawyers, the due diligence research preceding a merger or acquisition, and requirements for bearers of fiduciary duties to provide information on relevant events and decisions pro-actively.

Third, there is ample evidence to suggest that the principle of contractual solidarity is strongly embedded in many industry covenants, and even in the legal systems of numerous jurisdictions. For example, many systems of law allow for the dissolution of contractual obligations when *force majeure* or unforeseen "acts of God" make it unreasonable to expect further abidance by the agreement by one or several of the contractors. Another example is that the U.S. Uniform Commercial Code explicitly resorts to course of performance, course of dealing, and usage of trade as sources of contractual interpretation (§2-208) and good faith as a baseline obligation (§§1-201(19), 1-203, 2-103(1)(b)). A final but telling example is the court protection offered under Chapter 11 of the U.S. Bankruptcy code. This prominent feature of U.S. corporate bankruptcy law protects financially distressed but viable firms from creditors that have an incentive to seek immediate bankruptcy proceedings rather than await the postponed revenues associated with financial recovery. Bankruptcy laws are therefore a solidarity-enhancing set of institutional norms, which enable potentially viable firms to renegotiate and continue where they would otherwise be liquidated (Mooradian, 1994).

Fourth, and finally, the principle of allowing the correction of incompliant behavior is almost universally recognized by collaborative associations in modern and historical times, and is well embedded in relevant institutions. A prominent example is the guaranteed consumer good, for which a certain minimal level of performance is specified by the selling party and often secured by a third party (arbitrator or court) in a warranty contract. At the business-to-business level, franchising is an example of a contractual form that incorporates provisions for the correction of incompliant behavior. Franchising agreements involve the transfer of the right to use a certain business concept from a franchisor to a franchisee, in return for the latter's payment of a franchising fee and a proportion of the sales in royalties. The crucial point is that franchise contracts typically involve dispute resolution clauses, which may involve fines, administrative penalties, and even revoking the franchisee's license by the franchisor in case the former breaches the franchise contract. Additional illustrations of institutions that have explicitly been designed to counteract the effects of *ex post* information asymmetries include, but are again not limited to: subjection to binding arbitrage, economic hostages (Williamson, 1983), product branding, and investments in credible corporate reputations.

CONCLUSION

The contractualist endeavor in business ethics represents an often-misunderstood body of work. Many scholars have looked at contractualism with great hope, believing that they could derive substantive, action-

guiding norms for business conduct by analyzing extant business contracts or by applying a contractualist framework to firm-stakeholder relations. We have argued that these ambitions are somewhat misguided and indicative of what we have called the contractualist fallacy: an erroneous belief that contractualism produces a unique and comprehensive set of action-guiding substantive norms, which could help managers make morally sound decisions. Some contributors have proven disappointed by contractualism's limited abilities in this respect, and seem to be inclined towards abandoning the contractualist endeavor in business ethics altogether (Lavengood, 2001; Rowan, 2001; Shaw, 2000; Soule, 2002). Yet we have argued that it is important not to throw the baby out with the bathwater, and that the contractualist project in business ethics is worth redeeming on account of its superior connection with its field of application (Boatright, 2002). In an attempt to preserve the contractualist endeavor whilst escaping the contractualist fallacy, we have focused on the internal morality of contracting. Recognizing that external morality in business can take many different forms depending on the particular circumstances of time and place, we have tried to identify some instantiations of norms and principles that are internal to the practice of contracting and therefore implied with engaging in contractual practices.

We have demonstrated that the contractualist endeavor in business ethics can be seen as a fruitful epistemic procedure that can uncover such norms and principles as: (1) contractors must have a discernable identity; (2) contractors must allow partners access to private information; (3) contractors must open themselves up to contractual solidarity; and (4) contractors must allow corrections of incompliant behavior. These

endogenous principles cannot completely rule out the pursuit of evil ends by contractualist means, because they acknowledge and respect the fundamental contractualist concepts of content-independent commitment (Raz, 1986) and moral free space (Donaldson & Dunfee, 1999). What these principles do represent, however, is a morality of aspiration (Fuller, 1964), with which contractors can calibrate their intentions. Furthermore, these principles do not provide an exhaustive account of the internal morality of contracting, as there are many more implicit normative principles underlying everyday contracting practices in business and organization. In closing, we propose that the discovery of contractualism's internal morality represents a noteworthy step for business ethicists, because it alleviates one of the most significant barriers that has thus far challenged contractualism's status as a key provider of the basic argumentative structure for a comprehensive, action-guiding theory for the field.

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ENDNOTES

[1] It is common use to distinguish between "contractarianism" and "contractualism." Scholars that focus on the rational choice foundations of contractual schemes are usually referred to as "contractarians." The views of Hobbes (1651/1968), Buchanan and Tullock (1962), and Gautier (1986) are exemplary for this tradition of thought. Scholars who focus on the reasonable and normative foundations of contractual schemes are often called "contractualists." This view is most strongly associated with the work of Kant (1793/1991), and Scanlon (1982, 1998). We use the latter term but intend to refer to both strands of thought simultaneously.

[2] Donaldson and Dunfee carefully maneuver themselves around this fallacy by emphasizing "that the specification of a definitive listing of hypernorms is not necessary to the understanding and application of ISCT" (1999: 54).

[3] Economists commonly speak of multiple (coordination) equilibria, and tend to define the substantiation problem in contractualist ethics as a problem of equilibrium selection (see Binmore, 2003).

[4] Note the connection with a virtue ethical approach to business ethics here (Solomon, 1992, 2003).

[5] Buchanan & Tullock (1962) make the more realistic assumption that people have limited anticipatory capacities, which in their view constitutes a "veil of uncertainty". We make a similar assumption below.

[6] As was pointed out to one of the authors by Tom Donaldson, an internal morality of contracting can also be conceived of as a result of Kantian *transcendental* exercise (compare Bowie, 1999). Because a naturalist position that relies on the commitments we implicitly or explicitly make in everyday life (cf. Winch, 1958) appears to fit better with the empirical mode of inquiry that currently dominates the study of management and organization, we conceive of the internal morality of contracting as immanent to the relevant contracting practices.

[7] The first condition, which pertains to individual contractors, describes the well-known Nash equilibrium. The second, pertaining to groups of contractors, refers to the more demanding concept of an "evolutionary stable strategy" (Sugden, 1990).

[8] Screening may of course be associated with negative societal consequences (such as racial or gender discrimination), but, if applied appropriately, it may also produce desirable social outcomes. As Stigler (1962: 104) has pointed out: "In a regime of ignorance [in which there is no room for screening], Enrico Fermi would have been a gardener, Von Neumann a checkout clerk at a drugstore."