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The Nature of the Corporation: Implications for Ethical Governance

Abstract

The nature of the corporation has been a prolonged debate since the 19th century. The question is whether the corporation is a private entity or a public institution by nature. This paper argues that the corporation is not a purely private body, nor a purely public institution. It is a unique entity with some combined features of both private and public institutions. The corporation as a quasi-public business entity by nature has significant implications for corporate ethical governance. If nobody is actually responsible for corporate failures under the current institutional arrangements for governance, how do we ensure that the corporation is accountable, responsible and sustainable? Should the public gain some control over the corporation? The paper will discuss about public engagement in corporate governance to answer the above questions.

Introduction

The nature of the corporation has been a major puzzle and also a prolonged debate in the academic circle since the modern corporate systems have been established in the 19th century. The question is whether the corporation is a private entity or a public institution by nature. For many, this does not seem to be a question, as the corporation is popularly perceived as a private entity, which is often taken for granted. However, some influential experts have argued in the opposite way by emphasizing the corporation as a distinct public institution for the grounds that its status and powers are granted by the state and it has huge impacts on society and everybody's life (e.g., Dewey, 1926; Dodd, 1932; Allen, 1992). Some others have moved a step further to put aside the public-private divide and add a third category for the corporate identify (e.g., Johnson, 2012; Ciepliey, 2013).

This paper argues that the corporation is not a purely private body, nor a purely public institution. It is a unique entity with some combined features of both private and public institutions. The corporation is a quasi-public business entity by nature, which does not need to be categorized independently. This conclusion has significant and important implications for corporate governance, particularly ethical governance.

This is a conceptual paper and is in the developmental process and will be completed soon.

Corporate Vacuum: The Puzzle of Corporate Ownership

In a private business, the owner is responsible for his/her own business. If the business fails, the owner assumes all consequences from the failure. But things become complicated in the case of a joint-stock corporation with limited liability. Who owns the corporation? Today the common answer in business and economics is that shareholders are the owners. Yet, the early debates in corporate law showed a completely different answer and indicated that the nature of individual share ownership is not the same as corporate ownership.

The ownership matter is much related to the nature of the corporation. In corporate law, the corporation has a dual status. First, a corporation is an association of its shareholders and shareholders are members of a corporation. In this sense alone, all the shareholders of a corporation could be regarded as owners of the corporation. However, the corporation has another more important status—a legal person. No matter it is a natural person or artificial person as debated early in Europe in the 19th century, the meaning of corporate personality is significant and revolutionary. As a legal person, once established, the corporation itself becomes an independent and permanent entity. It is independent of anyone, including its members, i.e. shareholders. Just like a natural person, the corporation has its own mind, and rights and obligations. It has its own capability to act. It can sue and be sued. It becomes clear in corporate law that the corporation is owned by the corporation itself. As shareholders are separate from the corporation, shareholders do not own the corporation and they only own their invested shares in the corporation.

The difference of share ownership and corporate ownership is further confirmed by the rule of limited liability legally established in England since the mid-19th century. Shareholders' liability to the corporation is only limited to the specific amount they have invested in the corporation. They do not bear any further asset liability of the corporation and are thus not responsible for the whole corporation if it fails and owes significant debts and other liabilities.

As a legal person, however, the corporation has to rely on natural persons to act for it. Those persons in charge belong to different organs of the corporation, such as shareholder general meeting, the board of directors and management. The same as shareholders, all the directors and managers do not own the corporation. They are only servants of the corporation: directors appointed as trustees and managers hired as agents.

There comes out a big dilemma in the modern corporate system design: while there are no any natural persons owning the corporation, who actually cares about the corporation like an owner? Shareholders? In theory, shareholders may care about corporate performances because of their direct investment in it. But first of all, shareholders' care is limited because each shareholder's interest and liability are limited. Second, while shareholders are dispersed and any single shareholder's shares are constrained to a very small proportion, shareholders' care is reduced to the minimum or nil because of the "free rider" problem. Furthermore, shareholders can exit from a corporation in stock markets and choose other corporations to invest, and thus they do not need to spend lots of time and energy to care about a particular corporation. Institutional shareholders usually have a portfolio strategy and do not put all eggs in a basket.

Then, could we expect directors and managers to care about a corporation like their own? In a society built with self-interest and individualistic cultures, the agency problem must always prevail, as Adam Smith pointed out long ago in the 18th century. The current major problem in corporate governance is managerial dominance and abuse of power.

In relation to the ownership problem, a further key question is how the corporation could take responsibility when it fails with significant negative consequences (such as huge losses, a large amount of debts, and damages to the society and environments in many ways), and who as natural persons would ultimately take the responsibility. The fact is that the corporate entity itself cannot be sent to prison. No any natural persons in the corporation, neither shareholders nor directors and managers, are liable for corporate failures. Legal penalties for directors or managers only occur if they have wrongdoings (crime or fraud) and breach their legal duties, which is a different case of charges.

In conclusion, while the corporation is a legal person and owned by itself, the corporation looks 'hollow' or empty in reality and becomes ownerless in practice. Nobody would really care about it and take any responsibility if it fails. 'The ownerless corporation floats out there in a vacuum unaccountable to anybody' (Lord Myners, the UK Treasury Minister, 1 August 2009). While natural persons have consciousness and motivations for morality, the corporate person has no capacity and ability to do so. It has 'no soul to be damned, and no body to be kicked' (Lord Chancellor Thurlow 1731–1806, quoted in Bainbridge 2008). This is a 'black hole' in corporate governance, derived from the modern corporate system design.

Corporation as a Quasi-Public Institution

A private enterprise in a traditional sense must have a private owner or owners. The owner and the enterprise are inseparable. When the corporation is separate from its members and not owned by any natural persons, the corporate entity is not the same as a private enterprise. Rather, the corporation is akin to a public entity and subject to public scrutiny. The existing systems of corporate registration with the state, open information and disclosure to the public, public inquiry and public opinion monitoring on it, all point to the nature of the corporation as a public-like institution.

A corporation is called a public company in Britain and the Commonwealth countries, in the sense that its shares and debentures are open to the public for subscriptions. In theory, a corporation may have potentially unlimited numbers of shareholders and any ordinary people could become a shareholder. In practice, a large corporation often has tens of thousands of shareholders. Thus, while a corporation is publically held with transferable shares changing hands every day in open markets and is always open to the public for share subscriptions, purchasing and selling, it is no longer a private business in the conventional sense. It has some public nature, for a large base of shareholders in a society represent the public in part.

Furthermore, the rules of limited liability and bankruptcy allow corporations to shift their financial, social and environmental liabilities to their stakeholders and the public, which further justifies the pro-public nature of the corporation. Limited liability and bankruptcy mean that while shareholders only assume a small part of the corporate liabilities, the stakeholders and the public will bear all the other part, often the most part, of the whole corporate liabilities (note 1). Who would suffer from the consequences of corporate failures? The victims may include: (1) Creditors, who provide financial resources to the corporation, but may lose their debt rights from the corporation; (2) Employees, who invest their specific human capital in the corporation for a long time and will lose their jobs and may find it difficult to transfer their firm-specific knowledge and skills to other employers (Blair, 1995); (3) Suppliers, who will lose their supply chain relationship with the corporation and may fail their own business if they totally rely on the corporation; (4) Consumers, if they rely on the corporate products or services for their consumptions; (5) The public at large, if the government has to use the tax-payer money to bail-out the corporation, or if the pubic have to assume other negative economic, social and environmental consequences from corporate failures.

Moreover, corporations may transfer more risks to the public through 'securitisation'. Securities backed by financial assets (like subprime mortgages) can be issued and sold in the financial markets through special purpose vehicles (SPVs). Under such a shadow banking system, all the investors would become victims from the corporate failures or market failures. The 2008 financial crisis was just caused by such risk transfer methods. When only a handful companies and managers gained in the risk transfer process, most of people, including shareholders, stakeholders and the public, suffered from the financial crisis.

However, the corporation is not a purely public institution, as a public body is characterised by three key elements: it is owned or funded by the public or the state, it is established to serve a public good, and it is controlled by the public or the state. The corporation only has some public features in nature as discussed above: (1) It is an independent legal person, separate from any private individuals including shareholders, (2) Its legal status and power is created and granted by the state, not by private contracts, (3) Its privilege of limited liability and bankruptcy granted by the state is in return associated with some public interests to serve (e.g., economic functions) and with societal responsibility, (4) It is subject to public scrutiny (public registration, public disclosure, public inquiry, etc.), and (5) It is involved in public functions (regulations, public goods) with huge societal impacts.

In sum, the incorporating process of a business enterprise has caused the fundamental legal status transformation of the enterprise from a private business entity to a quasi-public business institution. The nature of corporate ownership, the public registration and open information system, the public subscriptions to the shares and debentures, and the public risk bearing rules, all demonstrate the pro-public nature of the corporation.

Public Engagement and Democracy

Now we are facing crucial questions in corporate governance: If the corporation is a quasi-public institution, should the public gain some control over the corporation? If nobody is actually responsible for corporate failures under the current governance system, how do we ensure that the corporation is accountable, responsible and sustainable? The current corporate system actually allows and encourages corporate social irresponsibility rather than corporate social responsibility, because there is no public involvement in the governing processes. For the last two decades there have been vigorous calls for stakeholder engagement in corporate governance. Despite a little progress achieved in some legislations in the USA and the UK, the whole corporate governance framework remain untapped—the public are still excluded in the corporate governance system.

For corporate governance reforms, it is not to suggest that we must dismantle the entire corporate system which has shown its tremendous efficiency for economic prosperity and technological innovations. Rather, we need to consider how we may improve the corporate system while retaining its core features such as corporate ownership, limited liability and bankruptcy. The key issue is to consider what approaches we should use to improve it more effectively. For example, is a free market approach to corporate governance any good for CSR? An overreliance on self-regulation and market governance would drive companies to follow the 'the law of the jungle': eat or be eaten, survival of the strongest. A moral hazard ensues here.

Public engagement in corporate governance to ensure corporate social and environmental responsibility and enhance the practical workability of business ethics could be achieved by introducing a form of direct public authority into the corporate self-regulatory framework. This is a 'regulated self-regulation' model, which is an alternative approach to the two polar extremes of regulation on business and economy, namely, the state command-and-control regulation model and the self-regulation (and market governance) model. Regulated self-regulation, also known as co-regulation or audited self-regulation, refers to a situation where self-regulation is supported, guided or intervened by state regulatory instruments. For example, the state may build a legal framework to enable self-regulation, or intervene if the objectives are not met by the self-regulation, or if there are undesirable side effects from the self-regulation (Jakubowicz, 2011, c/f. Palzer, 2003).

The core of a regulated self-regulation model for ethically informed corporate decision-makings is the involvement of the public in the governing process where the public are legally empowered to monitor and control corporate powers that affect public interests. Public direct involvement in corporate ethical governance is a kind of direct democracy, including political and economic democracy. Current democratic governance in the public sphere is only in the legislative domain through elected representatives. Public representation does not exist in the public administrative and corporate domains, yet most decisions involving public responsibilities are made by corporations because of their political role in regulation and public goods and their influence over governmental institutions (Deetz, 1992; Scherer and Palazzo, 2007). The lack of public democracy in corporate governance for social responsibility is both a 'democracy deficit' and 'governance deficit' (Scherer and Palazzo, 2007).

The development of democracy has seen a major shift from liberal representative democracy to public deliberative democracy since the beginning of the 21st Century, as the conventional separation between citizens and government in decision-making is inadequate for solving public problems. In business and economy, the separation between society and economy, between the public and the corporation, and more broadly, between ethics and business, create a condition for businesses to pursue self-interests at the expenses of all others, the whole society and natural environments. Public deliberative democracy, by re-embedding business and economy in society and bridging business and ethics, appears to be the best way of rendering corporations under appropriate control and making them morally and socially responsible.

The idea of public deliberative democracy has long been promoted by many great thinkers like Aristotle, Jürgen Habermas and John Rawls. Habermas deserves much of the credit for making the match between deliberation and democracy, with an expansive definition of inclusive process of deliberation (Gutmann and Thompson, 2004). For Habermas, the collective judgment of the people is the fundamental source of legitimacy. The legitimacy of collective decisions 'is to be found not in the expression of an unmediated popular will, but in a disciplined set of practices defined by the deliberative ideal' (Gutmann and Thompson, 2004). According to Gutmann and Thompson, deliberative democracy is a form of governance in which citizens and their representatives justify decisions in dealing with moral disagreement by providing mutually acceptable and generally accessible reasons.

Public deliberative democracy may take many different forms to act, but the most common practice has been the recent emergence of 'minipublics' like Deliberative Polls, Citizens Parliament, Citizens' Juries, Consensus Conferences, and Planning Cells. However, those 'minipublics' groups and meetings are organised on a small scale with the participation of a small number of randomly selected citizens for addressing particular public policy issues. Thus, their benefits cannot be achieved widely in politics and there is also a lack of the implementation mechanisms for their policy proposals. For effective ethical governance, it is needed to build up a system of public deliberative democracy with a formal structure of deliberations and implementations, including ethical approval, ethical monitoring and ethical enforcement.

Note

1. Limited liability and bankruptcy without any charges were fiercely debated in the 19th century when they were becoming legal rules. Limited liability was once banned in England in the 18th century due to its irresponsible nature and the potential for abuse. Before the late 19th century, any bankrupt must be sent to prison if he could not pay the debts. History shows that those two rules were initially objected in the parliament and by the public, and the two legislations took a substantially long period to complete.

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