Corporate Governance

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the legal and ethical responsibilities of corporations. Specifically, this lesson will cover:

1. Legal Organization of Corporations

As you learned in a previous lesson, corporations involve **shareholders**, **directors**, and **officers**. Shareholders elect directors, who then hire officers to manage the company.

From this structure, some very basic realities follow. Because the directors of a corporation do not meet that often, it's possible for the officers hired (top management, or the "C-suite") to be selective of what the board knows about, and directors are not always ready and able to provide the oversight that the shareholders would like. Nor does the law require officers to be shareholders, so that officers' motivations may not align with the best interests of the company.

This is the "agency problem" often discussed in corporate governance: how to get officers and other top management to align their own interests with those of the shareholders.

EXAMPLE A CEO might trade insider information to the detriment of the company's shareholders.

Even board members are susceptible to misalignment of interests.

EXAMPLE Board members might resist hostile takeover bids because they would likely lose their **perks** (short for perquisites) as directors, even though the tender offer would benefit shareholders.

Among other attempted realignments, the use of **stock options** was an attempt to make managers more attentive to the value of company **stock**, but the law of unintended consequences was in full force; managers tweaked and managed earnings in the bubble of the 1990s bull market, and "managing by numbers" became an epidemic in corporations organized under U.S. corporate law.

The rights of shareholders can be bolstered by changes in state and federal law, and there have been some attempts to do that since the late 1990s. But as owners, shareholders have the ultimate power to replace nonperforming or underperforming directors, which usually results in changes at the C-suite level as well.

TERMS TO KNOW

Shareholders
The individuals or entities who own shares of stock in a corporation. They have the right to vote to influence actions of the corporation.

Directors

The individuals who make up a corporation's board of directors. They are elected by the shareholders and are legally required to supervise the activities of the corporation as fiduciaries.

Officers

The individuals appointed by a corporation's board of directors to be in charge of a corporation as fiduciaries. Officers have a duty of loyalty to the corporation and the authority to make day to day decisions to manage the corporation and delegate authority.

Perks

Also known as perquisites; the incidental benefits that come with a job, such as travel opportunities, an expense account, a company car, and the like.

Stock

A share of a corporation.

Stock Option

A purchased privilege (but not an obligation) to buy a stock at a certain price within a prescribed period of time.

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2. Duty to Maximize Profits

There are two main views about what the corporation's duties are. The first view - maximizing profits - is the prevailing view among business managers and in business schools. This view largely follows the idea of Milton Friedman that the duty of a manager is to maximize return on investment to the owners.

In essence, managers' legally prescribed duties are those that make their employment possible. In terms of the legal organization of the corporation, the shareholders elect directors who hire managers, who have legally prescribed duties toward both directors and shareholders.

Those legally prescribed duties are a reflection of the fact that managers are managing other people's money and have a moral duty to act as a responsible agent for the owners. In law, this is called the manager's **fiduciary** duty. Directors have the same duties toward shareholders. Friedman emphasized the primacy of this duty in his writings about corporations and social responsibility, as shown in the excerpts below.

"The Social Responsibility of Business Is to Increase Its Profits"
Milton Friedman, *New York Times Magazine*, September 13, 1970

> What does it mean to say that "business" has responsibilities? Only people can have responsibilities. A corporation is an artificial person and, in this sense, may have artificial responsibilities, but "business" as a whole cannot be said to have responsibilities, even in this vague sense....
> Presumably, the individuals who are to be responsible are businessmen, which means individual proprietors or corporate executives.... In a free enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the

society, both those embodied in law and those embodied in ethical custom....

...[T]he manager is that agent of the individuals who own the corporation or establish the eleemosynary institution, and his primary responsibility is to them...

Of course, the corporate executive is also a person in his own right. As a person, he may have other responsibilities that he recognizes or assumes voluntarily—to his family, his conscience, his feeling of charity, his church, his clubs, his city, his country. He may feel impelled by these responsibilities to devote part of his income to causes he regards as worthy, to refuse to work for particular corporations, even to leave his job... But in these respects he is acting as a principal, not an agent; he is spending his own money or time or energy, not the money of his employers or the time or energy he has contracted to devote to their purposes. If these are "social responsibilities," they are the social responsibilities of individuals, not of business.

What does it mean to say that the corporate executive has a "social responsibility" in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he has to act in some way that is not in the interest of his employers. For example, that he is to refrain from increasing the price of the product in order to contribute to the social objective of preventing inflation, even though a price increase would be in the best interests of the corporation. Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment. Or that, at the expense of corporate profits, he is to hire "hardcore" unemployed instead of better qualified available workmen to contribute to the social objective of reducing poverty.

In each of these cases, the corporate executive would be spending someone else's money for a general social interest. Insofar as his actions... reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money.

This process raises political questions on two levels: principle and consequences. On the level of political principle, the imposition of taxes and the expenditure of tax proceeds are governmental functions. We have established elaborate constitutional, parliamentary, and judicial provisions to control these functions, to assure that taxes are imposed so far as possible in accordance with the preferences and desires of the public....

Others have challenged the notion that corporate managers have no real duties except toward the owners (shareholders). By changing two letters in *shareholder*, stakeholder theorists widened the range of people and institutions that a corporation should pay moral consideration to. Thus, they contend that a corporation, through its management, has a set of responsibilities toward non-shareholder interests.

TERM TO KNOW

Fiduciary

An individual who is given a high degree of authority and of whom is demanded a very high level of loyalty and trust. Examples include officers and directors of corporations, bank officers who handle money that is not their own, and trustees of funded organizations.

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3. Stakeholder Theory

Stakeholders (distinct from shareholders who are also called stockholders because they own stock) of a corporation include its employees, suppliers, creditors, contractors, customers, and the community.

Stakeholder is a deliberate play on the word shareholder, to emphasize that corporations have obligations that extend beyond the bottom-line aim of maximizing profits. A stakeholder is anyone who most would agree is significantly affected (positively or negatively) by the decision of another moral agent.

There is one vital fact about corporations: The corporation is a creation of the law. Without law (and government), corporations would not have existence. The key concept for corporations is the legal fact of limited liability. The benefit of limited liability for shareholders of a corporation (meaning shareholders are not liable for corporate wrongdoing) meant that larger pools of capital could be aggregated for larger enterprises; shareholders could only lose their investments should the venture fail in any way, and there would be no personal liability and thus no potential loss of personal assets other than the value of the corporate stock.

Before New Jersey and Delaware competed to make incorporation as easy as possible and beneficial to the incorporators and founders, those who wanted the benefits of incorporation had to go to legislatures - usually among the states - to show a public purpose that the company would serve.

IN CONTEXT

In the late 1800s, New Jersey and Delaware changed their laws to make incorporating relatively easy. These two states allowed incorporation “for any legal purpose,” rather than requiring some public purpose. Thus, it is government (and its laws) that make limited liability happen through the corporate form. That is, only through the consent of the state and armed with the charter granted by the state can a corporation’s shareholders have limited liability.

This is a right granted by the state, a right granted for good and practical reasons for encouraging capital and innovation. But with this right comes a related duty, not clearly stated at law, but assumed when a charter is granted by the state: that the corporate form of doing business is legal because the government feels that it socially useful.

Implicitly, then, there is a social contract between governments and corporations: As long as corporations are considered socially useful, they can exist. But do they have explicit social responsibilities? Milton Friedman’s position suggests that having gone along with legal duties, the corporation can ignore any other social obligations. But there are others (such as advocates of stakeholder theory) who would say that a corporation’s social responsibilities go beyond just staying within the law and go beyond the corporation’s shareholders to include a number of other important stakeholders, those whose lives can be affected by corporate decisions.

According to stakeholder theorists, corporations (and other business organizations) must pay attention not only to the bottom line, but also to their overall effect on the community. Public perception of a company’s unfairness, uncaring, disrespect, or lack of trustworthiness often leads to long-term failure, whatever the short-term successes or profits may be. A socially responsible corporation is likely to consider the impact of its decisions on a wide range of stakeholders, not just shareholders.

As the table below indicates, stakeholders have very different kinds of interests (“stakes”) in the actions of a corporation.

Stake	Description	Stakeholders

Ownership	The value of the organization has a direct impact on the wealth of these stakeholders.	Managers Directors who own stock
Economic dependence	Stakeholders can be economically dependent without having ownership. Each of these stakeholders relies on the corporation in some way for financial well-being.	Salaried managers Creditors Suppliers Employees Local communities
Social interests	These stakeholders are not directly linked to the organization, but have an interest in making sure the organization acts in a socially responsible manner.	Communities Government Media

TERM TO KNOW

Stakeholders

A general term referring to persons or organizations who have an interest in a particular matter. For example, the stakeholders interested in whether or not a bar or liquor store can be located in a particular location would be workers, businesses, the community at large, the owner of the proposed business, and law enforcement.

SUMMARY

In this lesson, you learned that the **legal organization of corporations** consists of shareholders who elect directors, who then hire officers to manage the business. One view of corporate responsibility is the **duty to maximize profits**, which argues that managers have a responsibility to act in the best financial interests of the company. Another view of corporate responsibility is **stakeholder theory,** which argues that both financial gain and a good reputation in the community are company responsibilities.

Best of luck in your learning!

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