PART ONE

Background

CHAPTER 1

Corporations

After reading this chapter, you will be able to

- Understand what a corporation is
- Understand how corporations are organized
- Understand the concept of capital structure
- Understand the concept of governance
- Understand the competing goals that corporations may have
- Understand why there is a call for corporations to be more ethical

Before moving directly into a discussion of good Corporate Governance, it is important to create a foundation based on the initial concepts of the corporation, its role in society, and its organization.

The corporation, like no other fictional entity, has created an unprecedented volume of debate and discussion. There are those who argue for its existence, its reform, and its abolishment. There are groups that study the corporation in terms of its sociological impact on individuals and those who study the corporation in terms of its impact on itself.

At the core of all meaningful discussions of the corporation is the concept of Corporate Governance.

This chapter discusses corporations in terms of defining what they are and how they are organized. This chapter also introduces the concept of corporate ownership, a theme that is carried throughout each part of this book.

In addition, readers will learn about theories suggesting the possible purposes of the corporate structure and the concept of corporate ethics. Finally, this chapter closes with an introduction into the concept of Corporate Governance as a nonnormative descriptive term used to express the method by which corporations are governed rather than the way in which they should be governed.

Corporate Structure

It is sometimes helpful to think about corporations as imaginary people. In many ways they do have the same rights and powers that the average citizen does; they are able to open bank accounts, file taxes, make purchases, and own property.

Unlike nonincorporated businesses that do these things under their company name, the corporation's assets are not directly owned by the company owner or partners. Specifically, when a nonincorporated business purchases property, the deed is held by the company owner. However, when a corporation does the same, the deed is held by the corporation itself.

Corporate Organization

Corporations are owned by stockholders who purchase shares and therefore own a percentage of the sum of the corporation's assets.

The stockholders elect a board of directors to represent their interests and govern the running of the corporation. The directors then appoint an executive to oversee the operations of the corporation. It is the role of the directors to govern the actions of the executive and ensure that the interests of the shareholders remain forefront in all decisions.

TIPS AND TECHNIQUES

Identifying Noncorporate Structures

In addition to the corporate structure, several other business forms exist. Two of the ones most commonly encountered are proprietorships and partnerships.

- *Proprietorships.* Businesses that are owned and run by one or more individuals.
- *Partnerships.* Businesses that are owned by one or more individuals and run by one or more of the same. This form is different from proprietorships in that not all owners need be involved in the operation of the business.

Corporate Ownership

Shareholders are the legal owners of the corporation. However, this concept of ownership carries roles and rights different from those commonly associated with the concept of private ownership.

In corporations, the roles of ownership and operation are separated. Shareholders may be the legal owners of the company, but they do not have control over its operations. As a result, they have no claim to the assets of the corporation, except in terms of dividend payment and asset division at dissolution. Beneficially speaking, this also means that shareholders are not personally liable for the debts of the corporation except to the extent that their stock value will be lost.

Benefits of Incorporating

Although companies all have unique reasons for seeking incorporation, one of the principal advantages is that assets of the corporation are not linked to the assets of the owners (shareholders).

Because the corporation is its own entity under the law, if it is sued or files for bankruptcy, the corporation is solely liable. This means that the corporation's assets can be redistributed through legal procedures, but the shareholders' personal assets are not assessed.

This is contrary to the situation of a nonincorporated business in which the business owner's personal assets can be seized in situations of civil or criminal litigation and bankruptcy.

In the Real World

There are two types of corporations, C corporations and S corporations. One of the primary distinctions between these two classes of corporations is in terms of taxes.

C corporations are subject to two levels of taxation on income. First, the corporation itself is taxed on its revenue. When that revenue is

IN THE REAL WORLD (CONTINUED)

distributed to shareholders as dividends on their stock, a second level of taxation occurs.

The alternative is to form an S corporation, in which only one tax is applied. S corporations elect to have the corporate profits pass directly to the shareholders, without first being revenue of the corporation itself.

The major benefit of forming an S corporation is that a greater percentage of corporate revenue is passed to the shareholders as dividends because the amount is not first taxed.

Purpose of Corporations

There are many debates about the purpose of the corporation. These debates include questions about whose needs the corporation is designed to fulfill. Some believe that the corporation's sole purpose is to meet the needs of the shareholders, and that in doing so, everyone will be better off. Milton Friedman, author and economist, was one of the most notable proponents of this belief.

Others argue that the corporations should be accountable to not just the shareholders, but also their employees, the market members, and the community as a whole. Those who subscribe to this belief promote the ideology that corporations can create value for several factions that include, but are not limited to, the shareholders.

These two positions do not seem wholly irreconcilable. To meet the needs of the shareholder would mean that the corporation maximizes its share value. This would be done by building the most successful business possible, which could very well entail meeting the needs of other parties.

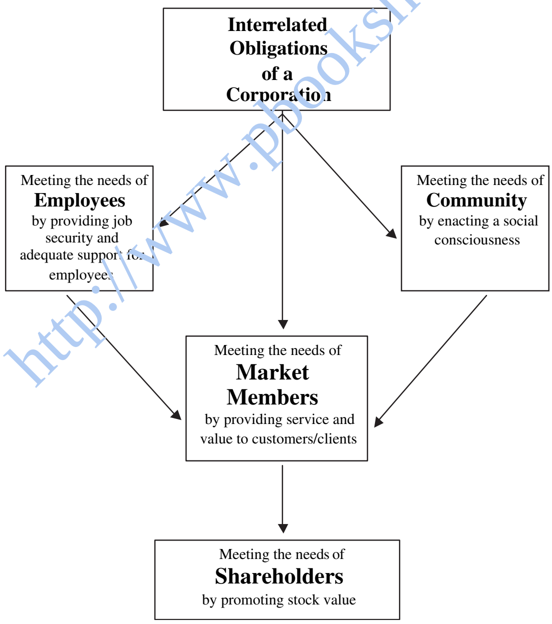
On the whole, there are several groups to which the corporation could be obligated, as shown in Exhibits 1.1 and 1.2. It is arguable that companies have duties to themselves, their shareholders, the economy, employees, and society as a whole.

Some of these duties include:

- *Needs of the corporation.* A duty to itself would entail the corporation's responsibility to sustain its own existence. This duty would include adherence to fiscal responsibility, the establishment of

EXHIBIT 1.1

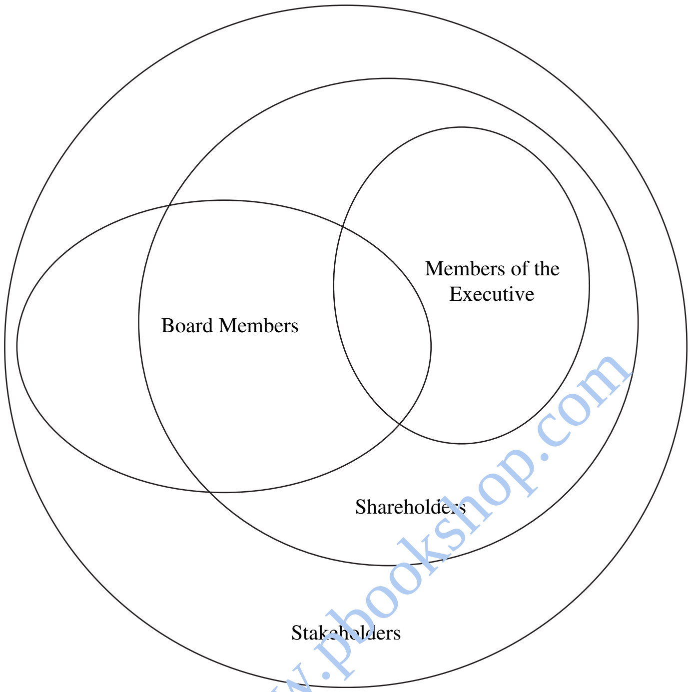
Interrelated Obligations of a Corporation



The corporation serves many roles within society, including meeting the needs of the economy, the corporation itself, the shareholders, the employees, and society.

EXHIBIT 1.2

Corporation's Interested Parties



Within a corporation there are several overlapping groups of interested parties. The largest group, which encompass everyone with interest, are the stakeholders. There are also members of the board of directors who may or may not be shareholders and who may or may not be members of the executive. Similarly, an executive member may or may not serve on the board.

highly functioning boards and executives, and possibly avoidance of takeovers.

- *Needs of the shareholder.* That corporations have a duty to shareholders is not often disputed. Instead, debate arises regarding the extent to which this duty should be fulfilled. Corporations, their boards, and their executives must respect the corporate owners and work in favor of their interests.

- *Needs of the economy.* As embedded members of the economy, corporations may have a responsibility to the economy as a whole and others in its membership. Compliance with regulations that promote market health, such as the Sarbanes-Oxley Act and U.S. Securities and Exchange Commission guidelines, works toward fulfilling this potential duty.
- *Needs of the employees.* Outside of the American corporate structure, there are those corporations that consider the interests of the stakeholders rather than simply the shareholders. Within these corporate frameworks, the corporation has at a least a limited duty to provide for the interests of its employees.
- *Needs of society.* Discussions of corporations and their ethical responsibility all hinge on the question of whether they have a duty to society. Issues that would fall under this duty include considerations of the environment and activities in less regulated, emerging markets.

Irrespective of what a corporation believes that its duties are, or where its allegiances lie, it is clear that the existence of a corporation is inherently dependent on shareholders and their willingness to invest. Regardless of whomever else the corporation is obligated to, it must promote stock sales.

At the same time, corporations are not afforded the freedom to meet that duty by any means possible. It is reasonable to expect that their actions will be limited, certainly by the law and possibly by ethical considerations.

The Government, the Economy, and the Corporation

In this chapter we discuss the possibility that corporations have an obligation to meet the needs of the economy in addition to those of the shareholder. Whether or not corporations agree that they have such a duty, the government, in most instances, insists on it.

Government intervention and regulation of corporate activity is geared toward protecting the interests of the economy and the society while at the same time fostering successful business efforts.

The government's role is to balance the needs of several parties and demands, including:

- The employee, through the sustaining of a successful economy that provides jobs, but also through the establishment of regulations to ensure fair treatment, safe working environments, and minimum pay
- The consumer, through the fostering of a competitive marketplace that provides variety, but also against consumer fraud, hazardous products, and other consumer-related risks
- The environment, through the establishment of laws and policies that regulate hazardous materials, pollution, and other environmentally unsound practices
- The economy, through the establishment of policies that encourage market growth and investment while preventing accounting fraud and other activities that can be economically damaging

Frequently these needs are in direct competition with each other, and often the solution for one impedes the creation of the other.

Corporations and Ethics

That corporations have some level of ethical responsibility is almost universally agreed. Dissent and debate occur when the level of ethical responsibility is discussed, with some factions believing that corporate obligations do not extend past increasing share values and others arguing that as legal entities, fictional or not, corporations have ethical responsibilities.

Those who believe that corporations have ethical responsibilities argue that, because they are embedded within society and are capable of creating social and environmental impacts, they are ethically culpable for the outcomes.[1]

IN THE REAL WORLD

Nike, the Gap, and Public Dissent

There is a great deal of discussion in boardrooms and on the streets as to whether corporations are ethically responsible for their actions and, if so, the degree to which this obligation extends.

Irrespective of what theorists and corporations themselves decide, the public ultimately will determine whether corporations take stronger ethical considerations into account. In the end, the majority of most corporations are motivated by their bottom line. When consumers cease to consume in protest of unethical behavior, the corporate structure will adapt.

Over the past decade, we have seen stronger outcries on the part of consumers in regard to ethical treatment of the environment, workers in emerging markets, and other social issues. Two major poster children for unethical corporate behavior have been the Gap and Nike, both of which have received publicity for mistreatment of workers in developing countries.

Capital Structure

Corporations must have systems in place by which they finance themselves. In most instances these systems include some combination of equity sales, equity options, bonds, and loans. The exact formula used is different for each corporation, and every entity works to discover the optimal combination that provides the greatest stock value and lowest cost.

Governance

This book is dedicated to explaining and illustrating the importance of good Corporate Governance and the concepts that this entails. One of the first distinctions that must be made, however, is the distinction between the value-based definition of Corporate Governance and the practical-based one.

In terms of practicality, all corporations have policies of Corporate Governance; they all have management and boards of directors who govern the corporation's activities. From a practical standpoint, Corporate Governance does not have a value in terms of being right or wrong.

There is also the concept of Corporate Governance that reflects the judgment of what makes for good Corporate Governance and what makes for poor Corporate Governance. It is this definition that we will be using throughout the remainder of the book, but for now we will look at the principles of Corporate Governance as they apply to the basic governing of an organization rather than the proper, or good, governing of the same.

As the concept of the corporate organization has evolved, several models have emerged. Each of these models has been implemented in various markets, at various times, and with various degrees of success. All have their unique benefits and challenges.

- *Traditional model.* The traditional model is the most familiar governance model. This framework includes a board of directors that governs the activities of the executives (or management) who run the organization. The board will divide itself into smaller committees for completing specific tasks.
- *Carver model.* This model is similar to the traditional model; however, within the Carver model, the board of directors does not divide itself into smaller committees.
- *Collective model.* Conforming to the collective model requires that there be little distinction among the board, management, and staff in that all are involved in decisions and service delivery. This model is most frequently found in small organizations.
- *Operational model.* This model for Corporate Governance holds that the board of the company or organization will not only govern the activities but also run them. The operational model is most often found in charity or other not-for-profit associations in which the board runs an operation that is staffed by volunteers.
- *Management model.* This model is a step beyond that of the operational model in that the organization is run by the board, but includes a paid staff.

Conclusion

Corporations are often referred to as "a legal fiction," meaning that they are entities that do not actually exist but have legal significance anyway. This term reflects the fact that corporations are not human beings, but they do have some of the rights and powers that people have.

Many believe that as entities within our communities and the world at large, corporations should be subject to the same ethical and social standards that we apply to other citizens. Instead of being interested solely in the price of shares, corporations should be accountable to the environment, the community, their employees, and the state of the world.

Perhaps one of the simplest ways to think about corporations and their obligations is to consider them as having the obligation of meeting the needs of the shareholders within a framework that, at the very least, does not infringe on the interests of other parties.

Summary

- Corporations have similar abilities and legal responsibilities as human business owners.
- Corporate Governance can be discussed in terms of the model by which a corporation is run or in value-based terms of good versus bad Corporate Governance.
- The assets of a corporation are owned by shareholders and managed by the corporation's executive and board.
- There are two views as to whom the corporation has a responsibility: (1) the shareholders only, or (2) the shareholders as well as the community, employees, and the economy.

Note

1. Susan Ariel Aaronson, "Broadening Corporate Responsibility: Is Maximizing Shareholder Value Alone a Good Enough Long-Term Strategy?" *The International Economy* (2002).