The Evolution of the Ethical Corporate Structure

By **TAN CHENG HAN**

Businesses evolved from the exchange of goods and services, and the need to protect the rights of trading parties. In this age of globalisation, the transformation of economic processes has irrevocably reshaped how business transactions are conducted and how companies are structured. What happens when ethics is added to the mix?

The modern corporate structure – in particular, the incorporated form – has evolved over the centuries as the complexity of conducting business transactions has increased.

Its primary function is to manifest the partnership of the capitalist with the entrepreneur. In this context, the term "company" implies association. In fact, the precursor of the modern company was the unincorporated joint stock company which was really a partnership that provided for the division of the undertaking into shares transferable by the original partners.

In partnership law, however, each of the investors was liable for the joint stock company's debts, and entitled to its gains. So if the joint stock company wanted to sue a debtor, all investors had in theory to be joined as plaintiffs. The converse was also true if the joint stock company was to be sued; all investors had to be joined as defendants.

The deed of settlement company, by vesting the company's property in trustees, and providing that the trustees could sue or be sued on behalf of the undertaking, was an attempt to get around this particular difficulty. This did not, however, remove the potential for personal liability on the part of investors. After much agitation, legislation was passed to allow the incorporated form and soon after, limited liability.

Here, it is important to note the role played by social amelioration. According to this idea, the concept of limited liability would open up more opportunities to the middle and working classes to become entrepreneurs/investors, so that they would not be excluded from fair competition through the fear of personal bankruptcy. The idea of fairness is one of the first dimensions of ethics forming part of the modern corporate structure. Many aspects of corporate law have aspects of fairness embedded within it.

As game-changing as this new creature was, however, notes of ambivalence were sounded early. The economist Adam Smith expressed reservations about the potential conflict of interest for the managers of companies. In his view, they, as custodians of the money of others, could not be expected to exercise the same degree of vigilance as partners would over their own funds.

The agency problem

This concern is today broadly referred to as the "agency problem", that is, the risk that managers may act in their own interests rather than the interests of the shareholders of the company.

A solution was found by treating these managers, or the modern-day directors and senior executives, as fiduciaries. Indeed, the concept of stewardship is one of the pillars upon which ethical standards apply to directors. A steward is someone who looks after the affairs or property of another and acts to further their interests and not his own.

In this way, the law sent out a strong signal of what was unacceptable conduct, a position that endures to the modern era: unless there is fully informed consent, a director is prohibited absolutely from profiting from his position as steward. He should not be tempted to put his interests over those of the company. Such an action would indicate that the relationship of trust has been broken. Here, we see the ethical dimension not merely as an aspiration but one with great practical benefit.

What next?

While not a fail-proof concept, the modern corporate form has survived the changes brought about by technological disruption, and even sometimes mind-boggling corporate fraud.

For better or for worse, such a form is likely to remain with us for the forseeable future, if for no other reason than the fact that no viable alternative has emerged.

Without a corporate structure, it is difficult to see how shareholders in an unincorporated association can avoid potential personal liability for civil wrongs. A more subtle point is that, ultimately, the ability to incorporate was created by legislatures because, whatever their faults, companies bring net utility to society that is not easily substitutable (or, at least, that is their raison d'être). This is the "public" social aspect of incorporation that must be balanced against its "private", more dispassionate contract-based nature.

Thus, incorporators, owners and managers of companies must ask themselves if their companies are benefiting society. A focus on profit alone is, from an ethical perspective, neither enough nor appropriate.

Other broader ethical dimensions, such as sustainability, the environment and fair labour practices, must also be considered. Facilitating human endeavour and enterprise is worthwhile only if there are net benefits to society.

This is the basis for the law to intervene in what is otherwise a strictly private matter between commercial entities: to ensure that the parties behave optimally for the benefit and greater good of society. This broader vision must therefore always be kept in mind. If not, the very reason for the existence of the corporate form becomes questionable.

To adapt a well-known aphorism: "With great privilege comes great responsibility." ■

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