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Corporate Virtue and the Joint-Stock Company

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This article traces the historical evolution of the notion of the "virtuous corporation," from its origins as a public-spirited fellowship to the modern joint-stock company kept in check by the market for corporate control. We suggest that this change in the legal personality of the firm has resulted in a minimalist and extrinsic view of corporate virtue. A more intrinsic and intentional virtue can come from within the enterprise. Employing the language of principal-agent analysis, we argue that "agents" who reflect theologically on the corporation can help create a renewed vision of the virtuous enterprise.

Introduction

In the eyes of scholars and the community at large, the corporate sector should be intentional and collegial about virtue, for "great moral responsibility is inherent in the existence of corporations."[1] For more than a century, this has been a recurring theme of business legislation and analysis: for instance, in 1928, an early corporate finance text described the enterprise as an arm of society, a form of representative government, and, in the 1960s, good corporate character was still seen to reflect the healthy functioning of the corporate polity.[2] The ideal that firms should self-consciously pursue a vision of the good is still very much alive today, with issues pertaining to corporate virtue—and vice—featured regularly in the media.

The legal personality of the business corporation has evolved however, from its origins as an organic business partnership run by its owners to the modern-day impersonal organizations characterized by a transfer of control from owners to engineer managers. The resulting ownership structure is the joint-stock company, in which stockholding is diffuse and the owners of the firm are separate from those who control the enterprise, an observation made famous by Berle and Means.[3] In turn, this creates a problem of identifying exactly where the moral center of the firm resides.

Logically it is the stockholders, as the owners of the equity of the firm and the residual claimants, who are the final custodians of the corporation's sense of public virtue. Paradoxically, however, the problem facing owners is that a joint-stock company by its very nature involves collective action. This gives rise to the principal-agent problem: the possibility that others acting on their behalf may not always act according to the wishes of the owners. This in turn has led to reliance on the market to discipline unethical behavior.

In what follows, we place this modern notion of corporate virtue in historical perspective and then ask whether a richer view of the virtuous corporation can be nurtured with consequential benefits for the public good.

Origins: The Corporation as a Fellowship

The early form of the corporation was a concept that the British had borrowed from the Romans who in the ninth and tenth centuries formed organizations known as *societas maris* (maritime firms) that were ventures to provide capital for maritime voyages.[4] This organizational structure was characterized by a *socius stans*, a partner on land and a *socius tractor*, the individual on the ship—an early origin of the division between capital and labor. This legal construction spread throughout Europe, particularly France and England.[5] In England during the fifteenth century, the church and boroughs were granted royal charters,[6] which in accordance with the "concession theory" were a privilege from the Crown whereby the group could opt out of certain feudal obligations.[7] This carried a certain degree of independence from the Crown, including the right of perpetual succession, to own property, and limited forms of self-governance.[8] In the sixteenth century, this legal tool of royal charter was utilized in a business context to facilitate the raising of capital for mercantile trade, and later turnpikes, canals, and railroads.[9]

Williston (1909) notes that the "most striking peculiarity" of the early history of the corporation was the lack of distinction between public and private, which at that time was couched in terms of lay and ecclesiastical.[10] This can be observed by examining the ancient boroughs and guilds that negotiated a degree of autonomy with the Crown. The Crown before the 1688 revolution and the Parliament thereafter through royal charter, granted the public the power to make bylaws with respect to trade and commerce.[11] Crucially, thinkers at the time classified these associations as a fellowship that was born of voluntary association where the members participated and behaved as if their members believed they could decide and act as collective unities.[12] The concept of a fellowship with "real personality" was central to the legitimacy of corporations, and this had consequences for the regulation of such associations: "If associations have no real being, then they must be mere creatures of the state, and the state is then justified in deciding … according to its own lights when and to which groups associational freedom and corporate status should be permitted, and in revoking such status at will."[13]

The active participation of a corporation's members would impart moral rectitude to the company from which legitimacy flowed and justify an independence from the state. Through consultation and participation, the actions of the group would be communally regulated in accordance with public virtue and, hence, did not require the same level of intervention from the state. In terms of ownership and management, this ideology held that when owners manage their own organization, there is little need for the state to intervene in its internal governance. The philosophy embodied the concept of fellowship by granting self-governing powers.[14] In short, business corporations were not seen as wholly distinct from moral and political concerns, but rather these were all bound up together, one reason being that the fields of business (especially roads, canals, and railroads) were essentially public goods.

The Separation of Ownership and Control

The seventeenth and eighteenth centuries brought a shift in approach. The period experienced a financial revolution that saw a rapid growth in joint-stock companies, banking, insurance, and the first active stock market in Amsterdam.[15] The advent of the stock market was significant as it represented anonymous buyers and sellers who rarely participated directly in corporate governance. The speculative trading of shares soon followed (prompting the Bubble Act of 1720), and the concessional theory that incorporation as a privilege was now effectively being superseded.[16] The new reality was that ownership and control in the corporation had been separated and the corporate entity had moved beyond the notion of a fellowship of personal acquaintances to that of an impersonal collective.[17] This form developed the notions of the corporation as a distinct legal entity, or "persona ficta," separate from its members.[18] This concept of the firm as legal fiction has since been adopted by economists who perceive the firm as a nexus of contracts.[19] Jensen and Meckling state that

> The personalization of the firm is seriously misleading. The firm is not an individual. It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals are brought into equilibrium within a framework of contractual relations. In this sense the behavior of the firm is the behavior of a market, the outcome of a complex equilibrium process.[20]

As time progressed, the business enterprise adapted to the privileges afforded by a separate legal entity such as limited liability, perpetual succession, and the ability to contract on its own behalf.[21] Inevitably, the moral center of the firm grew more nebulous with time.

Matters were further complicated by the rise of the specialist managerial class. The corporation as a purely economic (*vis-à-vis* sociomoral) vehicle proved extremely successful as the wealth held by corporations grew exponentially in the twentieth century. This growth in size meant the business enterprise was no longer limited to family or partnership structures whereby owners managed, controlled, and were liable for their business.[22] Professional managers were the new captains of industry who effectively controlled wealth previously only known to royalty. The rise of managerialism marked a profound transition, one that Chandler later dubbed the "managerial revolution."[23] The class of professional managers possessed greater technical expertise than the stockholders of the firm and consequently began to wield huge influence over the social priorities and ethical stance of the business sector. The corporation's origins as a unified fellowship with an inherent moral unity were deeply affected by the crevice that now existed between management and ownership.

The Principal-Agent Problem

A problem that flowed from the above was ensuring that managers act on the wishes—whether commercial or ethical—of stockholders, a problem known to economists and legal scholars as the principal-agent problem. This problem arises due to the separation of ownership and control whereby the owners of a corporation (shareholders) employ agents (managers) to administer corporate resources on their behalf. To the extent that corporations were operated by nonowners who might behave according to self-interest rather than in the public interest, the solution was seen to lie in an outside force that would act as a restraint. One possibility was regulation by the state, and the other was regulation by the market. Over time, the prevailing philosophy to emerge was that sanctions on the corporation should predominantly lie with the marketplace, with the state playing a supporting role.

Arguably the foremost mechanism that serves to keep the principal-agent problem in check and foster good corporate citizenship for the public good is the market for corporate control.

Extrinsic Virtue: The Market for Corporate Control

As theorized by Manne,[24] the market for corporate control is predicated upon the share market as an objective criterion for guiding managerial performance. In the event an agent neglects its duty to act on the wishes of the principal, corporate performance will wane, causing the stock price to fall. This presents a profit opportunity for third parties to respond by launching a bid for an underperforming company to gain control and install a new managerial team, all with the aim of enhancing corporate performance. In this manner, the market for corporate control ensures diligence and virtue amongst corporate managers, and the threat of takeover has a disciplinary effect on management. Corporate governance would follow the "Wall Street Rule" that if an investor does not agree with the fashion in which a corporation is being governed, the investor can sell the stock.

Manne perceived the market for corporate control as a mechanism by which market forces would promote the responsive corporation. Manne's theory is that if corporate managers pursue their own ends instead of the social good, the stock price will fall.

As an existing company is poorly managed, the market price of shares declines relative to the shares of other companies or relative to the market as a whole. This theory is predicated upon the public share market providing an effective check on managerial performance. The role of the market can thus be seen as serving the public interest:

> [Corporations law] should serve in the future—as it has in the past two generations—to provide a free, fair and informed market that allows [an] investor to exit from the corporation when he believes it is to his interest to make an exit. The share market thus operates as the external adjunct of the corporation's internal governance structure.[25]

In respect to promoting virtue or vice, the theory relies on the market for corporate control to reduce the need for governmental monitoring and provide management with sufficient incentive to behave properly. A corollary of this theory is that public regulation should serve to facilitate the effective functioning of the market, as market forces will lead to the most efficient outcome, therefore serving investors'—and society's—best economic and social interests.

Intrinsic Virtue: Renewing the Firm from Within

Does Manne's ubiquitous market constitute a satisfactory vision for the virtuous corporation? We can be justified in feeling uneasy about the notion that the corporation of the twenty-first century is to have no conscience other than that implied by the impersonal marketplace. One reason is empirical: The track record shows that despite the disciplinary effect of the market, serious breaches still occur. A series of episodes have continued to raise the community's eyebrows about the (lack of) public-spiritedness of the corporate sector, from highly geared entrepreneurs and junk bonds through to high-profile ethical breaches such as Enron, WorldCom, and the Barings Bank collapse. The East Asian currency crisis highlighted the issue of corporate responsibility in emerging markets.[26]

Another equally important reason for unease is theological. The market for corporate control, while useful as a negative discipline on bad behavior, has a major shortcoming: it does not encourage any particular positive vision for the public good. It does not push the virtuous corporation to be all that it has the potential to be, nor does it encourage social entrepreneurship. It imparts a minimum view of corporate responsibility, for which we can be grateful, but does not imagine a maximum moral vision, or mandate the contribution that the joint-stock company as an organic "fellowship" might make, or envision a view of the firm sustained by faith principles.

Such a vision for the virtuous joint-stock company must come from within the organization. As we saw in the historical survey, the idea that the business enterprise can see *itself* as a motivated moral entity has traditional roots in the origins of the corporation itself. If we recover the view of the enterprise not as a mere machine or as a fiction but as the sum of persons, then the concept of a fellowship with "real personality" can again inform the self-understanding of the joint-stock enterprise. As in days of old, active participation by a firm's members can once again impart moral rectitude to the company, and from this can flow renewed moral legitimacy. This will justify a continuing and even stronger independence from government because through consultation and participation the actions of the corporation would be communally regulated in accordance with public concerns.

The Strategic Role of the Reflective "Agent"

How can a vision of the corporation as a virtuous fellowship be regained? The individual agent, in our view, is strategically placed. Novak asked whether a Christian can work for a corporation; perhaps the question does not go far enough.[27] Our response to Novak's excellent question is not just yes, but there is profound value in persons of faith and character populating our corporations. Recent years have witnessed how just one or two people can make an adverse difference to an organization (Enron, WorldCom, and others), but the same applies in reverse: one person acting as "salt and light" (Matt. 5:13–16) can make a significant positive difference for good.

The full practical outworking of this program is a big subject. Here, we can but begin to sketch some of the practical areas where thoughtful insiders might have a salt-and-light effect by way of three examples: the board of directors, fiduciary duties, and executive compensation.

Consider first the board of directors. Shareholders vote to elect representatives who are delegated the power and duty to monitor management and the affairs of the corporation, the theory being that the corporation is run in accordance with the vision of shareholders. Boards are composed of executive directors (EDs) and nonexecutive directors (NEDs) who carry out the task of guiding the company. There is an inherent trade-off with executive directors: on the one hand, they possess specialized and firm-specific skills but, on the other, face potential conflicts of interest because they are charged with the responsibility of monitoring themselves. There has been a recent push (particularly in the United Kingdom)[28] to increase the number of independent, or nonexecutive directors on boards. While the reforms resulted in larger boards and a higher percentage of NEDs,[29] the empirical evidence suggests that the level of board independence and the firm's decision-making are not linked.[30] One explanation for this is that the CEO typically appoints and replaces NEDs, which are well-paid positions and are perceived as a position of privilege and esteem. NEDs thus have an incentive to retain these positions, a consequence of such is to not oppose or contradict the CEO.[31] In turn, this situation can blunt the board's ability to promote the path of virtue and combat corporate excess. A theology of corporate virtue can address such conflicts of interest.

Next, consider the efficacy of fiduciary duties. These are equitable duties that arise in a relationship where one party acts for the benefit of another, and fiduciary duty is the highest legal standard of obligation that the law imports. Such duties are imposed upon directors as general-law duties complemented by statutory duties, which generally include the duty of care, skill, and diligence; the duty to act in good faith and for a proper purpose; the duty to not improperly use their position for personal advantage; and the duty not to improperly use information obtained as a director. These laws manage the balance inherent in directors being charged with the responsibility of other people's money, whilst leaving scope for risk taking, a balance reflected in the "business judgment rule" that essentially says a business discussion will not be found to be in breach of the duty of care if it is found to be made in good faith, on an informed basis, in the best interests of the company. While the rule itself is not objectionable, the application has in practice set a low threshold for directors to evade liability.[32] Arguably, the law in various countries has not placed a high enough level of care, skill, and diligence onto company directors, thereby mitigating the threat of prosecution from stockholder actions against directors and in turn shackling the ability of the law to provide a disincentive for directors to shirk their responsibilities.

In this context, reflective insiders with a vision for the company as a self-aware virtuous fellowship can make a difference.

Another mechanism is executive compensation packages. These seek to overcome the agency problem by aligning managerial incentives with stockholder's interests. These packages exist within what is known as the executive labor market. Empirical studies of management compensation focus upon the sensitivity of pay to performance. In the 1990s, a consensus began to form that compensation was not linked clearly enough to performance, that good performance was not rewarded, and that poor performance was not penalized.[33] More recent studies have confirmed this somewhat depressing picture by finding no significant relationship between executive compensation and corporate performance.[34] The rejection of the hypothesis that performance-based executive remuneration improves corporate performance suggests that the managerial labor market is not functioning effectively.[35] In turn, this casts doubt on the responsiveness of managers to not only fulfill the economic expectations of owners but also fulfill their moral standards.

As the above brief discussion serves to demonstrate, significant opportunities surround the internal mechanisms within the firm for reflective individuals to guide the corporation to a clearer ethical vision for the broader public good.

Conclusion

This article has contrasted two understandings of corporate virtue: extrinsic and intrinsic. It has documented the ambiguity that has arisen over time as to the moral center of the modern joint-stock company, and it has pointed toward the need for a reconceptualization of the virtuous corporation that rediscovers this center. We have argued that the virtuous behavior of business decision-makers is a subject worthy of theological reflection. We have particularly emphasized the desirability that corporations have an effective internal moral compass, and the role that reflective insiders can play in fostering this. A few individuals with courage and faith can spread their influence and permeate the whole entity with a sense of public purpose.

Such persons can be sustained by recovering a view of the corporation as a fellowship whose legitimacy rests on its sense of civic vocation. Such understanding will not be content to delegate truth and meaning to an impersonal market mechanism but will value the notion that true virtue is personal, intrinsic, and endogenous. A richer theology of the corporation will help create a renewed vision of the joint-stock enterprise sustained by higher principles.

Notes

1. M. Novak, *Toward a Theology of the Corporation*, Studies in Religion, Philosophy, and Public Policy (Washington, D.C.: American Enterprise Institute, 1981), 52.

2. E. S. Meade, *Corporation Finance*, 6th ed. (New York: Appleton, 1928); R. S. F. Eels, *The Meaning of Modern Business: An Introduction to the Philosophy of Large Corporate Enterprise* (New York: Columbia University Press, 1960).

3. A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).

4. For discussion, see F. Braudel, *The Wheels of Commerce: Civilization and Capitalism, Fifteenth–Eighteenth Century*, vol. 2 (London: Collins, 1982).

5. J. Angell and S. Ames, *A Treatise on the Law of Private Corporations Aggregate* (London: Hillard, Gray, Little, and Wilkins, 1832) trace this process.

6. F. Pollock and F. Maitland, *The History of English Law*, 2d ed. (London: Collins, 1968) provide a more detailed description.

7. J. Williams, “The Invention of the Municipal Corporation: A Case Study in Legal Change,” *Auckland University Law Review* 34 (1985): 369.

8. More detail is provided by L. Webb, *Legal Personality and Legal Pluralism* (Oxford: Oxford University Press, 1958).

9. P. Dickson, *The Financial Revolution in England* (London: Macmillan, 1967) is a useful source for this history.

10. S. Williston, "The History of the Law of Business Corporations Before 1800," in *Select Essays in Anglo-American Legal History*, vol. 3, ed. Association of American Law Schools (Boston, Little, Brown, and Company, 1909).

11. For more discussion, see G. Frug, "The City as a Legal Concept," *Harvard Law Review* 93 (1980): 1059–71.

12. A. Black, "Editor's Introduction," in *Community in Historical Perspective* (Cambridge: Cambridge University Press, 1990) examines this aspect.

13. Ibid.

14. For instance, the charter of the East India Company in 1600 reflected this, granting the "power to judge (criminal and civil) all persons belonging to the said Governor" and "to send ships to war" (S. Clough and D. Moodie,"Charter of the East India Company," in *European Economic History*, ed. W. Davisson and J. Harper [New York: Appleton-Century-Crofts, 1965]).

15. V. Barbour, *Capitalism in Amsterdam in the Seventeenth Century* (Ann Arbor: University of Michigan Press, 1963) provides discussion.

16. See A. Du Bois, *The English Business Company After the Bubble Act* (New York: Octagon Press, 1971) for general discussion.

17. This suggestion is put forward by H. Butler, "General Incorporation in Nineteenth Century England: Interaction of Common Law and Legislative Process," *International Review of Law and Economics* 6 (1986): 169–88.

18. W. S. Holdsworth, *A History of English Law*, vol. 3 (London: Methuen, 1908). The move from a fellowship to a legal fiction is confirmed in *Salomon v Salomon* (1897, AC 22) where the British House of Lords clearly regarded the legal form as a legal fiction, a fiction that did meet the strict letter of the law. In overruling the Court of Appeal, the House of Lords cemented the corporation's status as one of a mere creature of legislation.

19. A view along these lines can be found in A. Alchain and H. Demsetz, "Production, Information Costs and Economic Organization," *American Economic Review* 62, no. 4 (1972): 444–95 and R. Coase, "The Nature of the Firm," *Econometrica* 4 (1937): 386–405.

20. M. C. Jensen and R. S. Meckling, "Theory of the Firm: Management Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3 (1976): 305–60.

21. See the description by P. Ireland, "The Triumph of the Company Legal Form, 1856–1914," in *Essays for Clive Schmittoff*, ed. J. Adams (Nashville: Abingdon, 1983).

22. This point was well articulated in the early twentieth century by commentators such as W. Lippman, *Drift and Mastery: An Attempt to Diagnose the Current Unrest* (New York: Holt & Co., 1914), T. Veblen, *Absentee Ownership and Business Enterprise in Recent Times: The Case of America* (New York: B. W. Huebsch, 1923), T. N. Carver, *The Present Economic Revolution in the United States* (Boston: Little Brown and Company, 1925), W. Z. Ripley, *Main Street and Wall Street* (Boston: Little Brown and Company, 1927), and I. M. Worsman, *Frankenstein Incorporated* (New York: McGraw-Hill, 1931).

23. A. Chandler, *The Visible Hand: The Managerial Revolution in American Business* (Cambridge: Harvard University Press, 1977) provides a general discussion.

24. H. Manne, "Mergers and Market for Corporate Control," *Journal of Political Economy* 73 (1965): 110–20.

25. W. Werner, "Corporation Law in Search of Its Future," *Columbia Law Review* 81 (1981): 1611. In a similar vein F. Easterbrook and D. Fishel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991) view the stock market as overcoming the agency problem through an organized and public capital market, stating that the market for corporate control "provides some assurance of competitive efficiency among corporate managers" thereby affording a check on self-interest.

26. M. Becht, P. Bolton, and A. Roell, "Corporate Governance and Control," in *Handbook of the Economics of Finance*, ed. G. Constantinedes, M. Harris, and R. Slutz (Amsterdam: Elsevier, 2003).

27. Novak, *Toward a Theology of the Corporation*, 1.

28. See A. Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee & Co., 1992) and D. Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (London: Department of Trade and Industry, 2003).

29. J. Dahya, J. McConnoli, and N. Travalos, "The Cadbury Committee, Corporate Performance, and Top Management Turnover," *Journal of Finance* 57, no. 1 (2002): 461–83; M. Ezzamel and R. Watson, "Pay Comparability Across and Within UK Boards: An Empirical Analysis of the Cash Pay Awards to CEOs and Other Board Members," *Journal of Management Studies* 39, no. 2 (2002): 207–32.

30. S. Bhagat and B. S. Black, "The Uncertain Relationship Between Board Composition and Firm Performance," *Business Lawyer* 54 (1999): 921–63.

31. M. Mace, *Directors: Myth and Reality* (Boston: Harvard Business School Press, 1971); R. Vancil, *Passing the Baton: Managing the Process of CEO Succession* (Boston: Harvard Business School Press, 1987).

32. For example, in the Australian case of *Smith v van Gorkom* (488 A 2d 858 Del 1985), it was held that the requisite level of being informed to make a decision was merely to be above the level of "grossly negligent," which M. Blair and L. South, "Trust, Trustworthiness, and the Behavioral Foundation of Corporate Law," *University of Pennsylvania Law Review* 14 (2001): 17–35 describe as a situation whereby a director who is marginally above the level of being grossly negligent will evade the liability that is imposed by the fiduciary duty.

33. M. D. Jensen and K. J. Murphy, "Performance Pay and Top-Management Incentives," *Journal of Political Economy* 98 (1990): 225–64.

34. J. Core, W. Guay, and D. Larcker, "Executive Equity Compensation and Incentives: A Survey," *Federal Reserve Bank of New York Policy Review* 8, no. 1 (2003): 27–50; L. A. Bebchuck, J. M. Fried, and D. I. Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation," *University of Chicago Law Review* 69 et al. (2002): 751–846; M. A. Habib and A. P. Ljungqvist, "Firm Value and Managerial Incentives," in *Mimeo* (New York: New York University and London Business School, 2002); J. M. Abowd and D. S. Kaplan, "Executive Compensation: Six Questions That Need Answering," *Journal of Economic Perspectives* 13, no. 4 (1999): 145–68; and K. Murphy, "Executive Compensation," in *Handbook of Labor Economics*, vol. 3, ed., O. C. Ashenfelter and D. Card (Amsterdam: Elsevier, 1999).

35. One explanation may be that the asymmetry of information between corporate managers and the board presents an opportunity for management to exploit. D. Yermack, "Good Timing: CEO Stock Option Awards and Company News Announcements," *Journal of Finance* 52 (1997): 449–76 shows that management manipulate the timing of stock option grants, while D. Aboody and R. Kasznik, "CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures," *Journal of Accounting and Economics* 29, no. 1 (2000): 73–100 find evidence that management times the flow of good and bad news.

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