Corporations

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Introduction

A corporation is a large company, or a conglomeration of companies, that are legally authorised to act as one entity under the law. Because they are fairly cumbersome things, there is a lot of legal and business cruft surrounding them such as what responsibilities do they hold? How are they governed? What types of corporation exist?

1 Corporate Governance

1.1 What types of corporation/business exist?

First, we need to look at the simplest types. The simplest possible type of business or corporation that can exist is the *sole trader* - this is one person working on their own, for themselves. In this case, the personal and business affairs of the individual are not distinguished. This is often called being *self-employed*, but that term can also cover business partnerships - which is where two or more people (but not too many) work together to make a profit - generally, a partnership is more informal and less "corporate" than a company. For both of these, there is no actual company entity set up - any debts incurred are the full responsibility of the trader(s).

A *limited company* is a type of company set up, such that the maximum debt that the owner(s) are responsible for is capped by the investment put in to the company. For example if x amount of capital is invested into the limited company, then the owners are only legally responsible for up to x amount of debt, should it be incurred. A limited company is created in accordance with the Companies Act (1985 or 2006) and is monitored by the Registrar of Companies. There are two sub-types of limited companies - a *private* limited company (denoted by the "limited" or "ltd." suffix) cannot publicly float shares in the company, whereas a *public* limited company (denoted by the "plc." suffix) may do so. Generally, it's quite easy for a private limited company to become a public limited company, whereas the opposite transition is much more difficult (it's easier to provide shares than to withdraw them).

Hence, the important distinctions are:

Sole proprietor/trader or partnership

- Business is the same entity as the owner
- No distinction between the wealth/assets of the owner and those of the business
- Unlimited liability for business-accrued debts, unless formally noted as a *limited liability partnership* or LLP
- Owner is also the manager of the business and all of its proceedings
- Financial accounts kept only for filing taxes/personal records

Limited company

- Separate legal entity from the owners and employees
- Liability of the shareholders is limited to the amount they invest into the company
- Management and ownership can be separate (but not necessarily)
- Accounts used by many people both inside and outside the company, leading to a regulatory framework for organising accounting records - meaning semi-rigorous accounting standards are needed (for example, for the use by external auditors)

These distinctions also entail differences in the stages of the lifetimes of the company/partnership.

	Company	**Partnership**
Formation	The company doesn't exist at all until the registration procedures detailed in the Companies Act are carried out. The legal document that sets out the formation of the company is called the **Memorandum of Association** and sets out how the company is run, governed and owned, and is signed by all of the initial shareholders.	While some form of written agreement is commonplace in a partnership, it is not necessary - the mere conduct of operations maintains the partnership.
Workforce	Any number of people from one, to an arbitrary number of, employees is permitted for a company.	By definition, at least two people are required for a partnership, but the maximum number of people is only limited by practicality (despite historically there being a regulatory limit of 20 people in a partnership - but not since 2001).
Legal Personality	A registered company is a legally distinct personality which is wholly distinct from its employees. As a side effect, this means that the company itself can by liable for some criminal acts under Tort and Contract law.	The partnership is not a legally distinct entity, meaning anything conducted under the partnership is the liability of the partners alone. Additionally, all partners are liable for illegal acts committed by one partner relating to the business.
Tax	Companies are subject to paying corporation tax.	Partnerships are not subject to corporation tax, as the co-operation is simply a concept rather than a physical or legal entity.
Publicity	Companies are monitored by the Companies Registrar through its annual return, and company accounts and reports are available to inspect by the public (and larger companies are subject to audits) - the Department of Trade and Industry manages investigative powers relating to companies.	A partnership is not externally supervised in any way (except, of course, by the limits of the law). Accounts within a partnership are confidential, unless registered as an LLP (as mentioned before) the public has no right to inspect the inner workings of the partnership.
Termination	Companies exist perpetually until the legal winding-up process, also dictated by the Companies Act, is complete.	A partnership is an informal conceptual object, meaning that the completion of the goal/project, a disagreement or disbanding, a court order (eg. due to illegality) or the death/bankruptcy of a partner can all potentially cause the termination of a partnership.

Additionally, the distinction between public and private companies brings some advantages and disadvantages to both sides. A public company can be listed on the stock exchange, meaning that capital is more readily available - shares can be transferred to members of the public, and the majority shareholders are generally the ones who appoint the managing directors of the company. They are subject to not only the rules of the Companies Act, but also the rules of the stock exchange.

However, to be classed as a public company, a business must meet 4 criteria:

- The Memorandum of Association must be written (or amended) to include the fact that it is a Public Company.
- The company name must be suffixed with *plc*.
- The amount of share capital authorised on the public market must be at least £50,000 - and 25% of that must be paid up in full.

- Per the definition, owners must have limited liability for the debts incurred by the company.

If a company fails to meet these criteria, it is still a limited company, but a private limited company. Shareholders are generally limited to direct participants in the business and, in general, shareholders are directly involved with the management of the business. Being private has some perks; for example, shareholders can also enjoy limited liability (not just the owners). Additionally, if a company chooses so (ie. by a unanimous decision) it can opt out of some of the directives of the Companies Act - for example, one stating that a company must hold an Annual General Meeting. This might be done if the business chooses to have some other mode of keeping shareholders informed. However, being private also means that the capital raising prospects of a company are limited to the ones that the company is directly capable of doing itself - because it isn't listed publicly, external shareholders cannot raise capital for the company.

1.2 The Stock Exchange

The price of shares on the stock exchange are constantly fluctuating and under review, such that the price of a share reflects its value - this helps to maintain and promote investor confidence. The stock exchange serves two primary purposes:

Primary market The stock exchange is where a company that has just became a PLC (either through formation, or transition from a private company) to *float* their shares - that is, to offer shares to the public for the first time, directly from the company. Such a share is known as an IPO, or a, *Initial Public Offering*.

Secondary market Additionally, a shareholder will generally not hold a given share forever. Part of the benefit of a stock market is that shares can be freely traded among investors, and hence the stock market acts as a secondary source for shares in a company, enabling the easy trade of shares (and loan notes) by investors.

Additionally, the *Alternate Investment Market* is a sub-market of the main stock exchange, aimed at smaller, start-up growing businesses (such as family businesses), with a market value between £1 to £250 million. The requirements for listing a company on the AIM are less stringent than the primary market, but the companies are generally perceived as more volatile (due to their small, perhaps transient nature).

However, having listings for a company isn't all sunshine and rainbows. There is the initial expense of having a listing, which over the lifetime of a listing might account for up to 15% of the cost. Additionally there is the ongoing expense of ensuring that your company and the stock complies with the regulations put in place with the Stock Exchange's listing rules, as well as the scrutiny from both the press and financial analysts that is integral to any publicly-listed stock.

Additionally, having listed stock has the potential to warp the management of a company into thinking more about short term financial decisions in order to impress shareholders, which might engender risky or rash investments and decisions. Additionally, if such decisions fail to impress the stock market, confidence in the company is liable to fall and thus make the company liable to be taken over.

1.3 Formation of a Company

A company is set up by its *promoter* through the Registrar of Companies; the main documents required are the Memorandum and the application for registration. The company is then owned by the owners and shareholders, who have limited liability for the company and to its creditors. However, a company is free to exist with only a promoter - only one person is required to set up a company, as mentioned before. The rights of the shareholders are initially laid out in the Memorandum of Association. From this point on, the company is then an artificial person with "perpetual life" - meaning that the company does not cease to exist when its owners do. Rather, the company only ceases to exist when it is either liquidated by its members/owners, or by a court order.

The promoters of a company are the individuals who initially set it up and who solicit money to be invested. They are the ones primarily involved with the formalities and registration procedures, as well as finding the initial directors of the company. Promoters are liable for any contracts entered before this registration process is complete, unless the contract itself states that liability ceases once the registration of the company is complete.

1.3.1 Memorandum of Association

The main purpose of this document is to document the intentions of the people forming the company and becoming members of it - if these members are defined by the shares they hold, the Memorandum must state that they should each hold at least one share. Historically this was an actual part of the company's constitution, but since the 2006 revision of the Companies Act, is now a purely historical piece of documentation, detailing who set the company up.

The application for registration of a company includes the name of the company (including any relevant suffixes), the place of residence (ie. England, Wales, NI, etc.), the address of the registered office and the articles of association. Details what sort of trade the business intends to partake in, the responsibilities of the directors, and how much control the shareholders have over the directors.

The application also dictates whether the company is limited or not - and, if so, whether the company is limited by shares (including how the shares are initially divided), or by guarantee (including the terms of the guarantee). Finally, the application also includes the proposed directors of the company.

Articles of Association

1.4 Liquidation

When the company is liquidated (either voluntarily or by the courts) the assets of the company must be realised to pay off any outstanding debts which are likely to exist. A *liquidator* is brought in to do this, so that the creditors can be paid off. As mentioned in previous notes, this is done in the following order:

- HMRC for any outstanding tax (such as corporation tax)
- Employees for any wages/salary not yet paid
- Creditors; first secured, then unsecured
- Shareholders; first preference, then ordinary

2 Who is in the corporation?

2.1 Directors

Directors are either appointed in the application for registration of the company (the initial directors), or appointed in a general meeting of the company (such as the AGM, if they are held) by a majority vote. All types of directors have one objective: to maximise shareholder wealth. There are a few different classes of director:

Executive Executive, or managing, directors are the day-to-day management. They are full time workers, and they have the relevant expertise and have experience in running the company.

Alternative Alternative directors are ready to fill in for the primary directors, and vote on their behalf, if they are unable to do so (eg. illness).

Shadow Shadow directors have influence on the board. Generally, these are the majority shareholders in the company, and aren't proper directors as such.

Non-directors These aren't day-to-day employees and generally serve to provide advice to the actual executives to limit any bias they may have in their decisions.

Executives generally have the power to borrow money on behalf of the company, and to issue shares. However, once they become executives, they are bound by the terms of the Companies Act and the objects clause of the company. Directors have a duty to the company they work for, shareholders and creditors of the company, and the employees of the company. Before the 2006 revision of the Companies Act, common laws require a directors to act with "reasonable care and skill" when acting on behalf of the business.

The 2006 revision of the Companies Act revises this to flesh it out and make it more formal. The requirements of a director are as follows:

- Act only within the powers exercised upon the director

- Act for, and promote, the success of the company
- Exercise independent judgement
- Act with reasonably expectable skill, care and diligence
- Avoid malicious conflict of interest
- Refuse third-party benefits
- Declare interest in a proposed, or existing, arrangement within the company

2.2 Company Secretary

The secretary is the principal administrator of the company - crucial for any medium- or lerge-sized company. They run the registered office of the company (noted on the Application for Registration) and isn't involved in management. They act as the agent for the company and make sure that the company complies with the Companies Act.

2.3 Auditors

Companies have a duty to appoint an auditor for accounting. For a private company, this must be done within 28 days of the company's accounts being issued. For a public company, this must be done in the first account meeting. They serve to genuinely check and verify the accounts of the company (both for the benefit of HMRC and the company iself). While they have the power to acquire the information they need to produce an honest audit, however they are still liable for contract- and tort-related law (even if the acts are through negligence).

2.4 Shareholders

If you consider ownership as the individuals who have the greatest direction over the business than the "owners" are the shareholders. Shareholders part with their hard-earned capital in order to be used by the managers, with the intention of getting some form of return - even with the acknowledgement of the risk. Their end goal is to make a profit from selling on their shares and dividends.

As an example of this, imagine a firm's shares trade at a value of £3.12 each. Shareholders are paid a 30p dividend on each share for the year. Last year, the shares traded for £2.95 each. What is the return over the past year? The price of the share has increased by 17p, and there is a 30p dividend per share. This amounts to 47p up in total, per share, or a $\frac{47}{295} = 16\%$ return. Hence, the capital growth (the growth in the base value of the shares) is $\frac{312-295}{295} = 6\%$ and the dividend is therefore $\frac{342-312}{295} = 10\%$.

One major factor affecting shareholder wealth is the net present value of the corporation. This affects the price of the shares which in turn affects the wealth of the shareholders.

2.5 Agency Problem

The agency problem describes the situation when the motives of the *agents* (ie. the directors), which are generally self-interested, conflict with those of the *principals* (ie. the owners), which are generally interested in the good of the company. This arises when the control of the company diverges from its ownership - ie. the managers disagree with the shareholders as to the direction of the company. The agency problem arises when shareholders try to determine how to make directors manage the company in their interests. Central to solving this is **goal congruence**. This asks how directors can be directed to see the same rewards as shareholders in the same places.

2.6 Corporate Governance

Corporate Governance is the practice of promoting transparency, fairness and accountability in the direction of the company. It is an attempt to resolve the agency problem, and in the UK is generally self-administered by the corporation. It governs the activities, size and composition of the board of directors, and negotiates the disclosure of activities by the directors.

Managers are driven to follow their own objectives within a corporation, including acquiring power and reputation, job security, and - most importantly - being paid and rewarded. Shareholders, however, aim to maximise their own wealth, by closely monitoring the company (eg. through audits and direct control over the company), selling and buying shares at convenient times, and appointing directors they find congruent with their own goals at GMs.

Agency costs cover the costs associated with poorly performing assets (and, by extension, poor return for shareholders) - ie. the loss of wealth due to suboptimal choices and behaviour by the agent. The ways of preventing this (and the associated costs) include monitoring of what managers are up to (Management Monitoring), or introducing performance-related bonus schemes and other incentives for congruent behaviour (Incentive-based Optimization).

The rewards payable to an executive director usually consists of the basic salary, any performance-related bonuses, non-cash benefits (such as a company car or health insurance), a beneficial pension scheme and bonuses linked to the value of the shares of the corporation - which can backfire if the value of the company has fell. If these bonuses are based on short-term performance measures, then this might promote not only myopic management directives, but also risk-averse behaviour and stagnation. Shareholders generally want some degree of risk, as risk is proportional to reward.

Under-utilisation of the assets of a company might lead to take-over bids by other corporations, which runs the risk of making management and other employees redundant. Additionally, if the cost of directives is in the distant future then share-based payouts might be over-generous; share price is influenced by more than just the action of the managers, meaning that the payouts might be unfairly stingy or generous.

2.7 Overall goals

Corporate Governance should seek to benefit not only the shareholders or the owners, but the employees, creditors, customers, and the community as a whole, which attempts to ethically settle the dispute of how decisions should be made to benefit *everyone* involved in the company. To summarise, effective financial management will recognise and work with risk, identify an appropriate dividend and governance policy, identify investment opportunities that will maximise both shareholder wealth and the development of the corporation.

It should seek to strike a balance between debt and equity, to minimise the overall cost of capital. As the profits retained by the company are one of the primary sources of internal finance, the dividend policy can impact of future financing and investment decisions.

The overall goal of corporations is to make money and profit for the shareholders. However, is wealth a means (to further invest and develop the economy) or an end (exploiting the growth of the economy for personal gain)? Is profitability an end in itself, or a restraint on the company?

3 Corporate Social Responsibility

While corporations might attempt to give the impression that they are large, majestic, precise entities that the public can trust and believe in, many believe they are simply trying to devour as much profit as possible at the expense of whatever stands in the way; the "corporate agenda". But what is a *corporation*?

It's a group of individual working together primarily to sustain legally obtained profits that continue to grow in a sustained manner. Originally, corporations were far more formalised (eg. early USA) and the contract of a corporation had a lot more limits and stipulations.

Corporations re-interpreted civil rights laws regarding "people" to concern corporations instead, by classifying corporations as individuals, meaning they could not be constrained by existing laws put into place.

3.1 A Legal "Person" - Limited Liability Corporations (LLCs)

Once an institution is incorporated, it can buy/sell shares, sue/be sued, loan/lend money, and is a legal individual in its own right. These are called *corporate citizens*. One issue is the obvious fact that they cannot be tried in the same way - they have no physical body to incarcerate. These corporate citizens are required, by law, to place the economic interests of their shareholders above all else, including public interest. This means they value short-term gains above all else, which may obviously be dangerous.

The company attempts to externalise (move elsewhere) as many costs as its consumers will allow; this often leads to substandard production to the point of deprecation purely for the gain of short-term profit, which then has effects on those further up the production chain, often resulting in gross disparities between the profit the company makes, and the salary of the original (manual) workers who are often the baseline for any production for the company at all.

Other effects include exploitation of the environment, animals and the health of the public for the sake of saving a little bit of expenditure. The other glaring fault is the environmental catastrophe resulting from corner cutting and making "effective business decisions". Additionally, companies are generally willing to conveniently break the law, ass long as the resulting profit is greater than the resulting fine.

Objectively, if the corporate individual is treated as a general individual, they tick many of the required boxes for psychopathy.

3.2 Corporate Responsibility

Shareholder primacy is the idea that, in most companies, shareholders are considered above all other factors in the company. How long can capitalism survive for when, rather than attempting to maintain sustainable growth, instead aims for maximised short-term goals at the expense of whatever is in the way. Many times, the only thing that can bring the discussion and awareness of corporate irresponsibility to the forefront is a crisis actually occurring.

Corporations wield a large amount of power over people to the point of danger. One corporation can exercise power over an entire society with very little to stop it, as they are controlled by a different set of laws in different ways, meaning the company is less exposed to the moral and physical consequences of its actions - as it is a decentralised institution.

As corporations have become the driving force of the economy, they are integral to society despite their destructive nature. Should shareholder primacy, and its destructive tendencies, be moved away from? CSR (corporate social responsibility) could act as a framework, rather than a mere artefact, to limit the externalisation of destructive practices from the company. CSR could act as a governor to minimise externality of negative consequences, ensure the positive externalisations aren't lost - meaning the profitability is not compromised.

Modern capitalism is inherently unsustainable and needs to be replaced if we value our current ways of life. Modern-style, globalised capitalism is not compatible with sustainable living. Extremely large corporations have gained an extreme amount of money, and are often richer than many countries joined together. Recent economic crises and the accompanying collapse of many large companies has caused further abuse of the power still held by current managers in large companies. However, many economies depend on these companies for key support, so they're integral to society - despite the fact that society probably benefits from them least.

3.3 Stakeholder Theory

This is a framework for managing corporate responsibility - stakeholders are the group of people to whom the company owes a different kind of responsibility. It prefers a shift to stakeholder primacy, rather than shareholder primacy, and generally states that companies should balance all of their obligations between everyone who has some form of stake in the firm - including the end consumers and the initial workers, as well as the shareholders and the staff. Just as attention should be paid to the activities of dictators and rulers of countries around the world, the world should pay attention to the governance of corporations and the resulting actions.

Note that CSR is not philanthropy and neither is stakeholder theory. It is deeper than that - it's still doing things the company isn't legally obliged to do, but rather than "patching up" the issue, it ais to ensure that the issues never occur in the first place.

CSR is not determined by the *activity* but rather by the *motive*. If it is still profit-driven then it's just standard shareholder primacy at play. If it is aimed at legitimately improving the local environment or community then it's CSR - which itself might be profitable in the future indirectly.