

***The Moral Responsibility of
Business Corporations and
Fiduciary Individuals***

by

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For or Against'
at INSEAD Europe Campus
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Themes of the Conference

A perennial question in business ethics concerns the extent to which business firms and organizations themselves can be correctly said to have moral responsibilities and obligations (or not). In philosophical terms, the question is often posed as one of the “moral agency” of organizations. The view that business firms possess moral and ethical qualities of this kind has been strongly advocated by a number of leading scholars in different disciplines. A competing view has argued instead that only individual human beings can be truly said to have moral obligations and responsibilities. To say that a firm or other organization has the capacity for moral behaviour or cognition, on this view, is incorrect. This debate continues among prominent scholars today, and our aim in this conference is to bring together some of the strongest voices on both sides of the debate to update the current state of argument and to develop new and potentially useful approaches to the underlying problem.

Although this debate is primarily a theoretical one, its outcome has great significance for practice. For example, a conclusion that business firms have moral responsibility will have implications for both business practitioners and educators. If a particular business is deemed correctly to be morally compromised, for example, then it would follow that it may deserve a social response such as “shunning” or boycotting its products or services. There are also significant legal consequences, and different societies currently adopt different positions on the issue. In the United States, for example, a corporation can be deemed under appropriate circumstances to be found legally culpable for criminal acts (e.g., SAC Capital). Some scholars have questioned whether this approach is morally justified, and other countries such as Germany have refused to sanction the idea that a business firm can have moral and therefore legal culpability. A result is that laws and their enforcement are focused more directly on the culpability of individuals, that is, the actual human beings involved in various cases of wrongdoing. Subscribing to corporate moral agency might be seen to let these culpable individuals “off the hook.”

We do not anticipate that this conference will finally settle the deep philosophical disagreements about the moral nature of business firms (or not). However, we believe that it will help to resurface this important discussion in business schools and advance mutual understanding of the competing arguments. It will help call attention to the continuing practical importance of this central issue in business ethics, and it is an issue with much wider application as well, not least for the disciplines of economics, finance, law, and management.

Eric W. Orts, Guardsmark Professor, Legal Studies and Business Ethics Department,
The Wharton School, University of Pennsylvania
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1. Do firms have moral responsibility?

NO,

if by firms we mean “classical firms”.

YES,

if by firms we mean “business corporations”.



Theoretical & practical confusions in corporate ethics & governance are mostly due to the failure to distinguish these two forms of firms, though there is a wide gray zone between them.

2. Does subscribing to corporate moral agency let culpable Individuals off the hook?

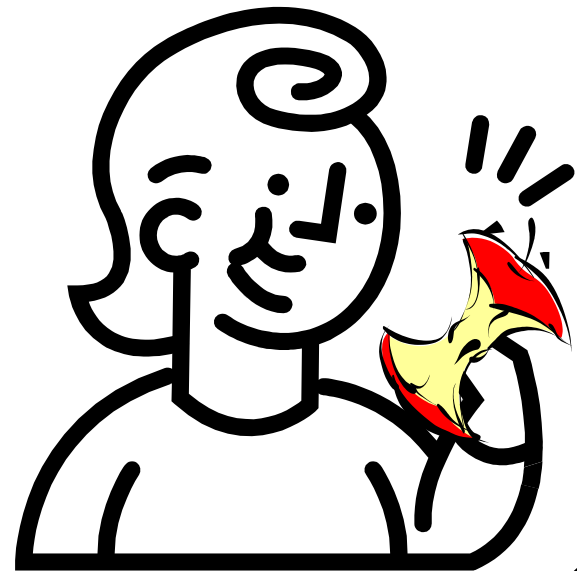
NO,

as long as they play the role of fiduciaries.

Part 1:

<Moral Responsibility of Business Corporations>

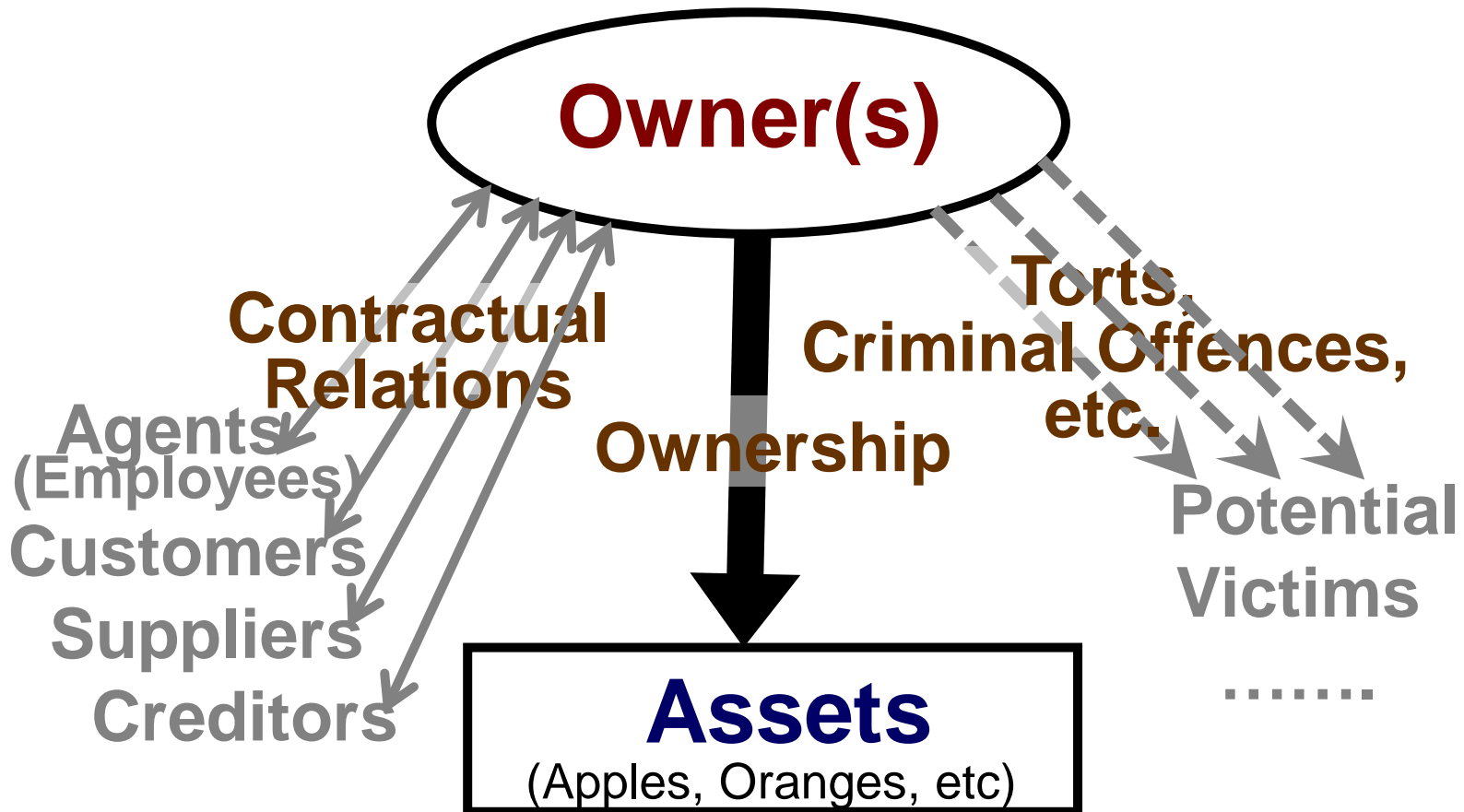
A grocery shop around the corner
||
an “unincorporated firm”
or
a “classical firm.”



Shop owner



The single-story structure of a *classical firm*



(A *classical firm* is “a nexus of contracts” with the **owner(s)** as their node.)

Do *classical firms* have moral responsibility?

↑↑
No.

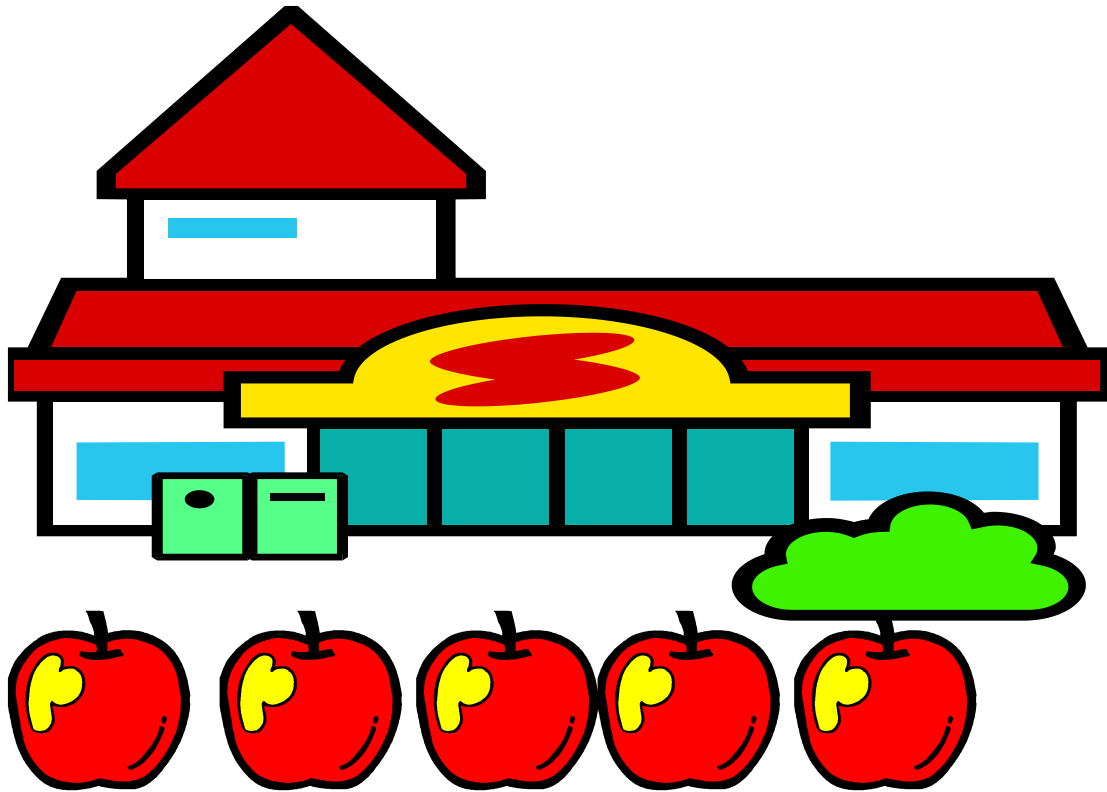
↑↑
It is the **owners** who are
the sole subjects of the *firm*.

↓
The **owners** have all the responsibilities,
legal or ethical, i.e. **moral**, for
any consequence the *firm*'s activity gives rise to.

**Note: Morality *à la* Kant
= Legality + Ethicality (or Virtue).**

**Even agents' acts are subject to vicarious liability,
except torts outside scope of employment.
(and exceptions are a matter of agency law.)** ⁶

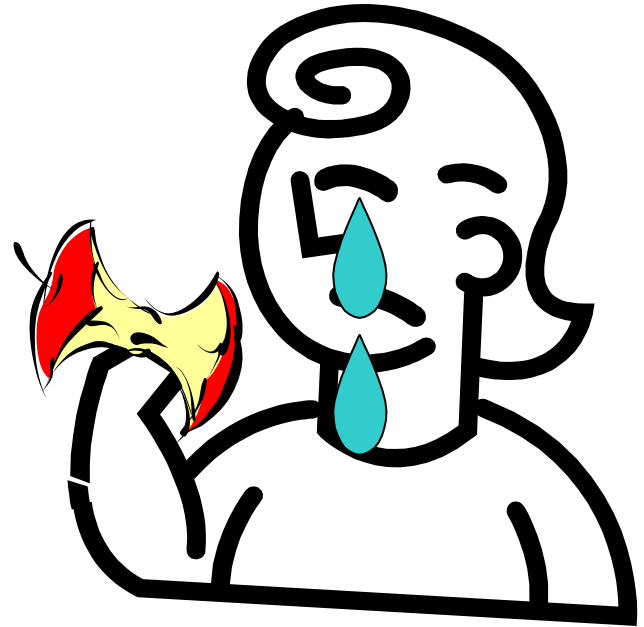
A big super-market chain inc.
||
an “incorporated firm”
or
a “business corporation.”



A shareholder⁷



WHY?



A **shareholder** is **NOT**
the legal owner of **corporate assets**.



The **Corporation** as a **Legal Person**
IS!



(corporate assets = corporation's assets)

A **corporation** is a **thing**.



(= **Not** naturally a **person** - e.g., organization, fund, &c.)

Yet,

“**it**” has the same power as an **individual**
to do things necessary or convenient
to carry out its business and affairs” (*RMBCA*)



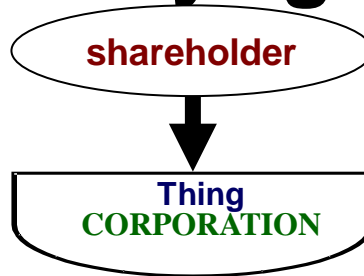
A **Corporation** is
a **Thing** treated Legally as a **Person**.



Corporation as **Person/Thing** Duality!

What, then, is a **corporate shareholder**?

The owner of (a unit of) the **corporation** as a **thing**, distinct from underlying **corporate assets**.



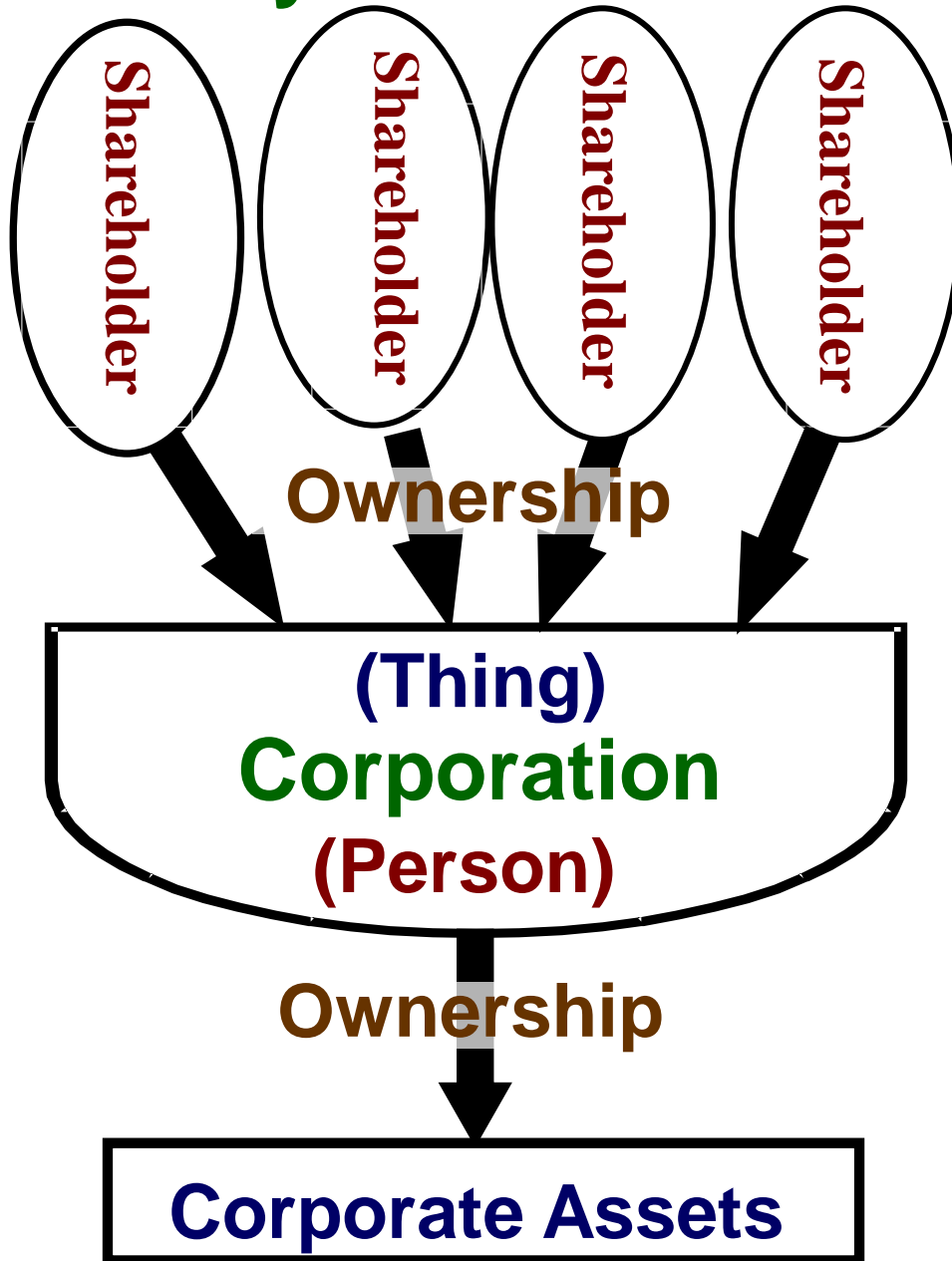
A **corporate share**

A bundle of participatory & financial rights in corporation which can be held as a piece of **property**, separate & distinct from **corporate assets**

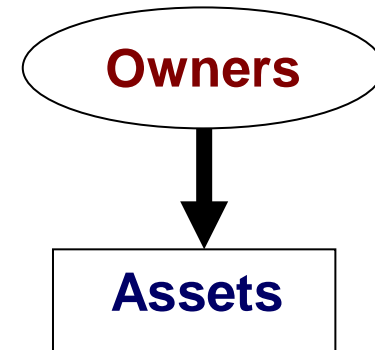
A unit into which **corporation** as a **thing** is divided.



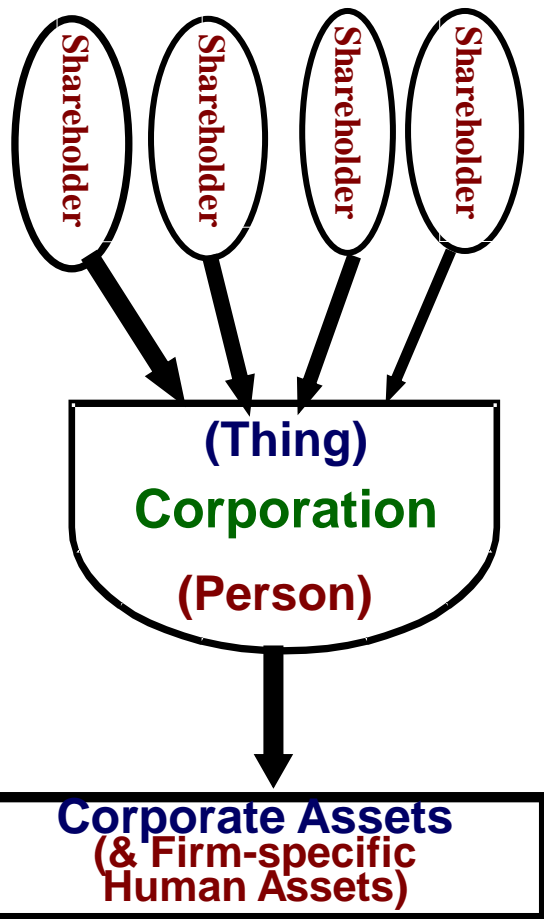
Two-story structure of business corporation



↕
Single-story structure of
classical firm



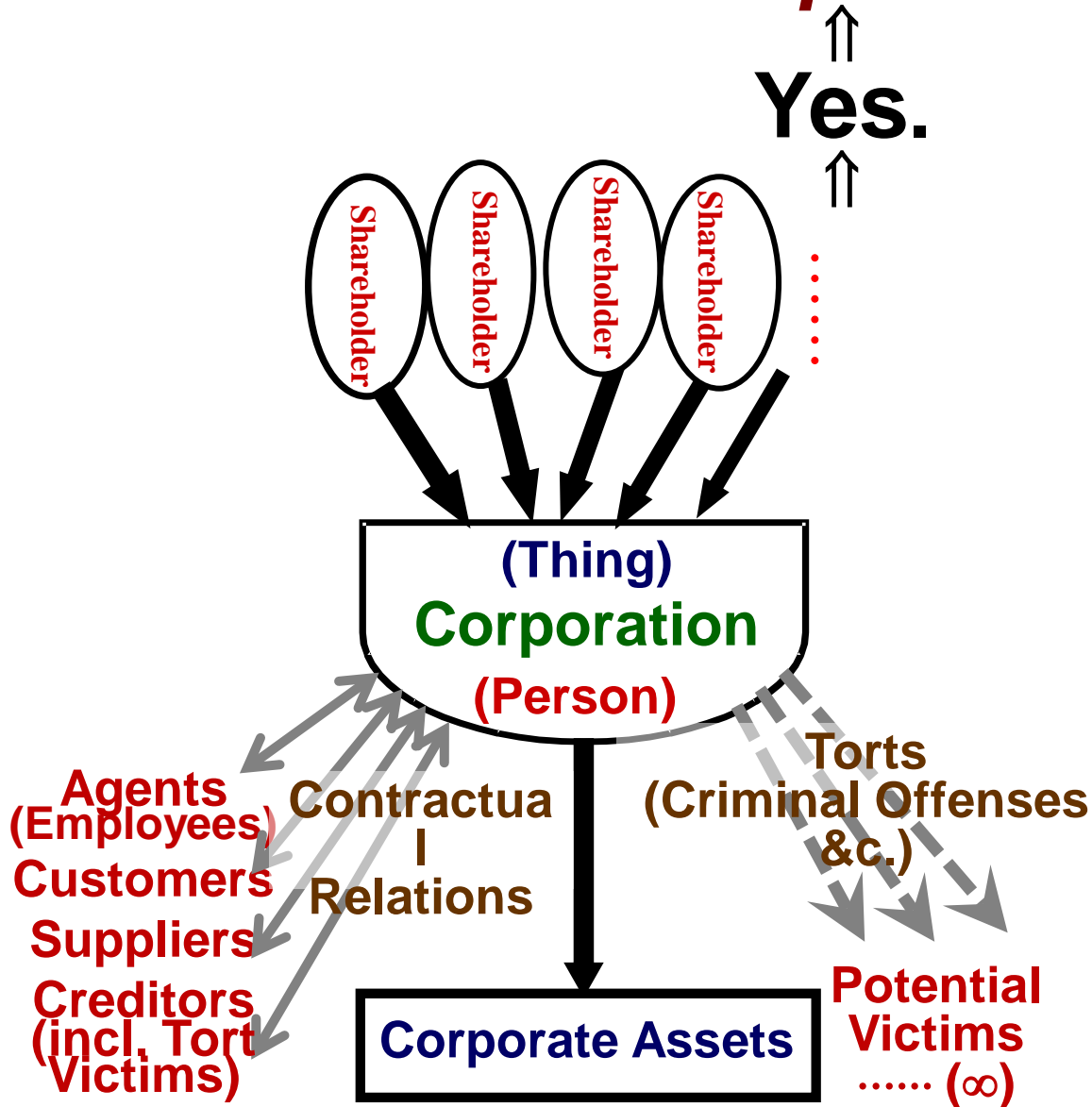
The **person/thing** duality of **corporation** has, by joining two private ownership relations, enabled capitalism (or private-property system) to have a wide variety of organization forms.



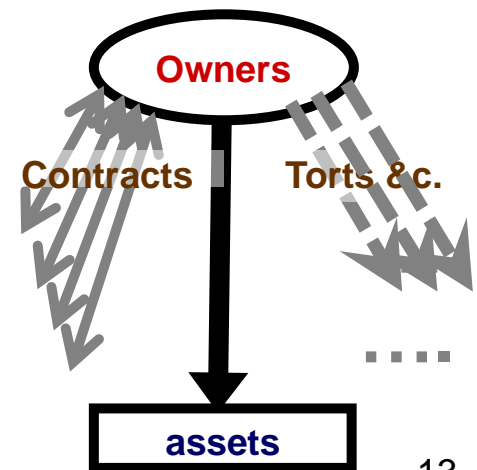
1st digression: *Upstairs Downstairs.*

- Where upstairs is emphasized
 - ≈ **Corporate nominalism**
 - ≈ **Anglo-American corporate system**
 - ⇒ Maximizing shareholders' returns
- Where downstairs is emphasized
 - ≈ **Corporate realism**
 - ≈ **Japanese-German corporate system**
 - ⇒ Growth and sustenance of the corporation as an organization

Do *business corporations* have *moral responsibility*?



Cf. A classical firm



The **corporation** as a **legal person**
is the **sole subject**
not only of the **internal ownership**
but also of all the **external relationships**
(contracts, torts, criminal offenses &c.).



“It” is, at least **legally, liable** to
any consequence, good or bad,
its business activities causes to **others**.



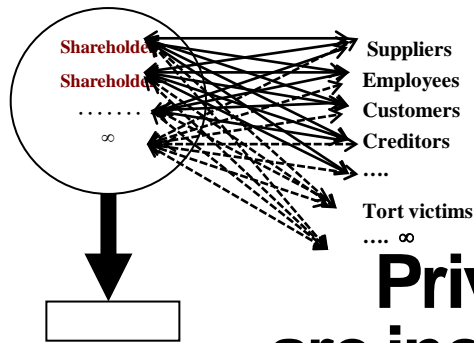
Limited liability of **shareholders**
is a mere corollary of
the **legal personality** of the **corporation**.



It should not be regarded as an incentive system.
(The case of controlling shareholders → later.)⁴

2nd digression:

Fallacy of contractual theory of corporation.



A **corporate** act cannot be reduced to the joint act of **shareholders**.



Private contracts among **shareholders** are incapable of making *prior* contracts with **tort victims** who are by def. **unknown**; hardly capable of keeping contracts even with **known others** if **shareholders** themselves are many & varying.

(Hohfeldian muddle: trying to reduce infinity to multital.)



A **corporation** is **liable to outsiders** only because it is already **recognized by society** (i.e. by tradition or by fiat or by law) as the ultimate holder of rights & duties.



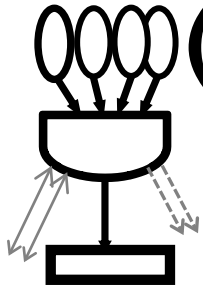
The **corporation** is intrinsically a **social** entity. (Indeed, even a **natural person** is a **social** entity.)

Can **corporations** also be **ethical agents**?

Yes.

Ethics, at least in the sense of Kant, is a set of laws governing **all rational-beings**.

Rationality = the freedom to choose an end, independently of natural human interests (happiness, sentiments, profits, &c.).



Its two-story structure allows **corporation** to choose **ethical ends**, in spite of **shareholders'** natural pursuit of profits.

The **corporation** is a **rational-being** whose acts can be **ethically** imputed to it.

(Can a **corporation** have an absolute worth?
← As a *de facto* owner of firm-specific human assets.)¹⁶

Part 2:

<Moral Responsibility of Fiduciary Individuals>



*Does subscribing to corporate moral agency
let culpable Individuals off the hook?*

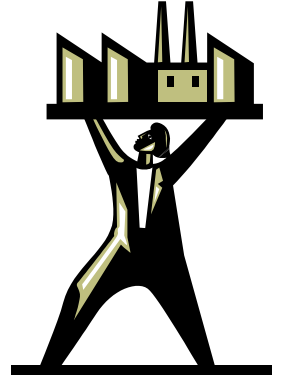


Two ways to look at
the **person**/**thing** duality of the **corporation**.



- 1) A **thing** that is legally a full **person**.
⇒ Part 1.
- 2) A **person** that is actually a mere **thing**.
⇒ Part 2.

Even if the **corporation** is in law a **person**,
it is in reality incapable of performing any act
except through the act of
fresh & blood **natural persons**.



↑
Any **corporation** must have **managers**.
(= a board of **directors**
+ **officers** as their agents).

“All corporate powers shall be exercised by or under authority of,
and the business and affairs of a corporation shall be managed,
under the direction of its board of directors” *RMBCA*.

(↔ **Classical firms can do without managers.**)

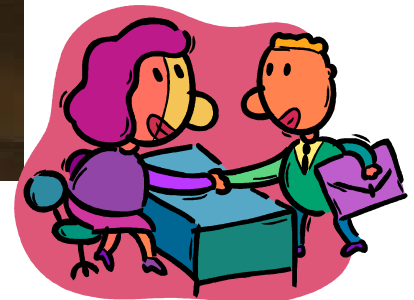
↓
Any act **managers** perform
qua managers
(i.e. in the name of the **corporation**)
legally binds the **corporation** to it
as **its own act**.



Bunraku (Japanese Puppet Theater)

A Play = Puppeteers → Puppets

A Corporate Act = Managers → Corporation
A Fiduciary Act = Fiduciary → Beneficiary



A contract
between two
competent
people

*The relation between **managers** & **corporation***

Contractual relationship \neq (or agency in economics)

Any contract between **managers** & **corporation** would necessarily degenerate, at least in part, into **managers' contract with themselves** or its equivalent – a mere vow (=a self-imposed duty) with no standing at law.

⇓
Fiduciary Relationship!

Managers owe to the **corporation** **the duty of loyalty & the duty of care** (duty to act solely for the benefits of corporation & duty to exercise reasonable care in management)

⇓
These **fiduciary duties** (should) constitute the core of every **corporate governance** system. (+ supplementary governance by stakeholders.)

3rd digression: *What is **Fiduciary Relationship**?*

An absolutely unequal relationship in which one party (**fiduciary**) dominates the other (**beneficiary**) in actual or legal capacity, knowledge, skills &c., so that the former has to be 'entrusted' to serve the latter.

(guardian/ward, trustee/beneficiary, manager/corporation, agent/principal, partner/partner, doctor/patient, attorney/client, fund-manager/investor &c.)



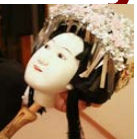
Any contractual arrangement would necessarily degenerate, at least in part, into



the fiduciary's contract with oneself or its equivalent
= a self-imposed ethical duty no contract law can enforce!

Any attempt to control **fiduciaries** by contracts would inevitably lead to **their self-contract** or the like, creating the very problem it is attempting to solve.

Equity places on anyone who undertakes to be a **fiduciary**
the duty of loyalty & the duty of care
& asks courts to enforce them as legal duties.



If **managers**' act (or failure to act) as **managers** causes the **corporation** to harm **third parties**, it violates their **fiduciary duties** to loyally serve the **corporation**'s interests, at least financially (by paying reparations to victims) & even morally (by e.g., demoralizing its employees).



If intentional, a breach of the duty of loyalty.

⇒ Liable to disgorge their unauthorized gains.

If by negligence, a breach of the duty of care.

⇒ Liable to compensate corporation's reparation.



'Control test' for vicarious liability is by def. inapplicable for **fiduciary breaches**.



Managers set **corporate ends** (at least in part) & pursue them in the name of **corporation**.



They are both controlling & controlled agents.

The issue is not:
whether **managers** are liable to **corporate wrongs**.
They are, as **corporation's fiduciaries**.

Indemnification or insurance arrangements with
corporations involve **managerial self-dealing** &
contradict the very *raison d'être* of **fiduciary duties**.

The issue is rather:
how much **they** are liable to **corporate wrongs**.
They owe their liability only to the extent of
their involvement as **fiduciaries** to the **corporation**.

Liability should be limited to incomes & other
benefits **managers** have gained as **managers**.

(Should the **corporation** incur all the remaining liability or
share it with society is an open theoretical issue.)²³

Liability of **Shareholders** & **Creditors**?

If **shareholders** are controlling shareholders, they also become liable to **corporate wrongs**. (In the extreme case → corporate veil piercing.)

&

- If major **creditors** have taken over the control of the **corporation** on the brink of bankruptcy, they also become liable to **corporate wrongs**.

↑↑

However, their liability to the **corporation** is neither as its **shareholders** nor as its **creditors** but as its *de facto* **fiduciaries**.

This presentation is based partly on:

- Katsuhito Iwai, “Persons, Things and Corporations: The Corporate Personality Controversy and Comparative Corporate Governance,” *American Journal of Comparative Law*. 47(4), Fall 1999.
- , “The Nature of the Business Corporation— Its Legal Structure and Economic Functions,” *Japanese Economic Review*, 53 (3), Sept. 2002.
- , *What Will Become of the Corporation?*(in Japanese), (Tokyo: Heibonsha) February 2003.
- , “The Foundation for a Unified Theory of Fiduciary Relationships: ‘One May Not Make a Contract with Oneself’.” *Mimeograph*, Nov. 2013.; <http://www.iwai-k.com/FoundationforUnifiedTheoryofFiduciaryRelationships.pdf>.

Other important references are:

- Immanuel Kant, *The Metaphysics of Morals*, translated by Mary Gregor, Cambridge Univ. Press (1996; 1797)
- F. C. von Savigny, *Jurial Relations: or, the Roman Law of Persons as Subjects of Jurial Relations; The Second Book of System of Modern Roman Law*, translated by W. H. Rattigan, (Wildy & Sons, 1884; 1840-49)
- Robert Clark, *Corporate Law* (Little, Brown and Co., 1986)
- Orts, Eric W. , “Enterprise Liability, Business Participant Liability, and Limited Liability,” Chap. 4 of *Business Persons : A Legal Theory of the Firm*. Oxford Univ. Press (2013), 133-173.