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## Stakeholders, transactional algebras and conflict systems (mapping on why the founding charter compact becomes the mainstay of corporate governance)

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**STAKEHOLDERS, TRANSACTIONAL  
ENVIRONMENTS, AND CONFLICT SYSTEMS  
(MAPPING ON WHY THE FOUNDING CHARTER COMPACT  
BECOMES THE MAINSTAY OF CORPORATE GOVERNANCE)**

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# **UNIVERSIDAD DEL CEMA**

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## **STAKEHOLDERS, TRANSACTIONAL ENVIRONMENTS, AND CONFLICT SYSTEMS**

### **MAPPING ON WHY THE FOUNDING CHARTER COMPACT BECOMES THE MAINSTAY OF CORPORATE GOVERNANCE**

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## **Abstract**

In this paper we put forward an alternative approach to dealing with the Charter of any organization, that essential document which ought to be regarded as the mainstay of governance. In the first place, we show that an organization carries out its tasks by becoming a responsive mechanism to fulfill stakeholders' demands as well as costly restraints stemming from transactional environments. In the second place, organizations behave like conflict-systems within which political issues are of the essence when coping with power, influence, control and authority; on these grounds, we give heed to agenda building and the problem of factions. We argue that such three-tiered structure stands for the preconditions of any Charter. Lastly, we set up the Charter as a compact of regulatory and discretionary governance, comprised not only by the articles and certificate of incorporation, but also internal bylaws of the organization, the Statute of Governance, the Code of Good Practices, and provisions for upgrading, overhauling, and even changing the architecture of governance in its entirety.

**JEL:** G30, G34, G20

**Key Words:** charter, corporate governance, stakeholders, transactional environments, conflict-systems, regulatory governance.

## **Institutional Disclaimer**

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## 1. INTRODUCTION

This paper sets about an innovative framework of analysis from which both theory and practice of Corporate Governance might be elicited on the grounds of context and purpose. It will provide the context within which most governance problems should be addressed and managed, and will stress why those problems become a matter of import within organizations.

There is a first building block that brings to light the players and the playgrounds of governance. Moreover, section 2 is concerned with stakeholders while section 3 does it with transactional environments, giving heed to asymmetric information and regulatory constraints.

Next, we add a second building block consisting of two sections, the first of them on conflicts of interest (section 4), to focus later on agenda building and the problem of factions. Afterwards and in section 5, we expand on the viewpoint that regards any organization both as a conflict-system and a political setting where coalitions are born, coalesce and compete among them.

Lastly, section 6 handles the issue of the extent to which the foregoing building blocks lay the foundations for the Charter Compact to become the mainstay of any governance.

## 2. STAKEHOLDERS

Although the notion of stakeholders seems rooted to that of a claimant, when we deal with organizations and their governance such usage turns out to be rather slippery. Hence, we want to ascertain what the expression “stakeholders” stands for.

To begin with, **claimants** are those who seek as due a right they assess as being legally theirs, or who demand something to which they presume to be entitled. Such broad meaning frequently encompasses making claims on standalone transactions. For instance, how many times did you press claims to the lost baggage office at an airport? Or how often did you stake your claim in a court of law? Seldom, actually, since they are examples of sparse and particular circumstances.

First and foremost, when using the term **stakeholder** we must bear in mind that basically it refers to a claimant. However, we need to narrow down the range of its meaning to the context of organizations and

their governance. Therefore, we are going to attach two further qualifications to make the distinction clear.

- For one thing, we must place emphasis on the relationship between the claimant and the organization. Far from being grounded on a standalone basis, we must regard it like a persistent binding that remains steady along a relevant span of time.
- For another, we have to add a connotation that has recently been introduced, which asserts that in the relationship of claimants with organizations not only the success of the latter but also its failures pertain to the interests of the former. After the wave of corporate scandals that took place at the dawn of our century, awareness about this implicit covenant has grown hard<sup>1</sup>.

After these remarks, next definition<sup>2</sup> will attempt to comprise both qualifications into a functional approach to our subject. **Exhibit 1** displays the network around which stakeholders link themselves to an organization.

### **Definition 1                      Stakeholders**

*By **stakeholders** of certain organization we mean single or collective subjects submitting rightful claims that match two constraints:*

- *they arise out of persistent and enduring relationships;*
- *claimants affect and are affected both by the success or failure of the organization.*

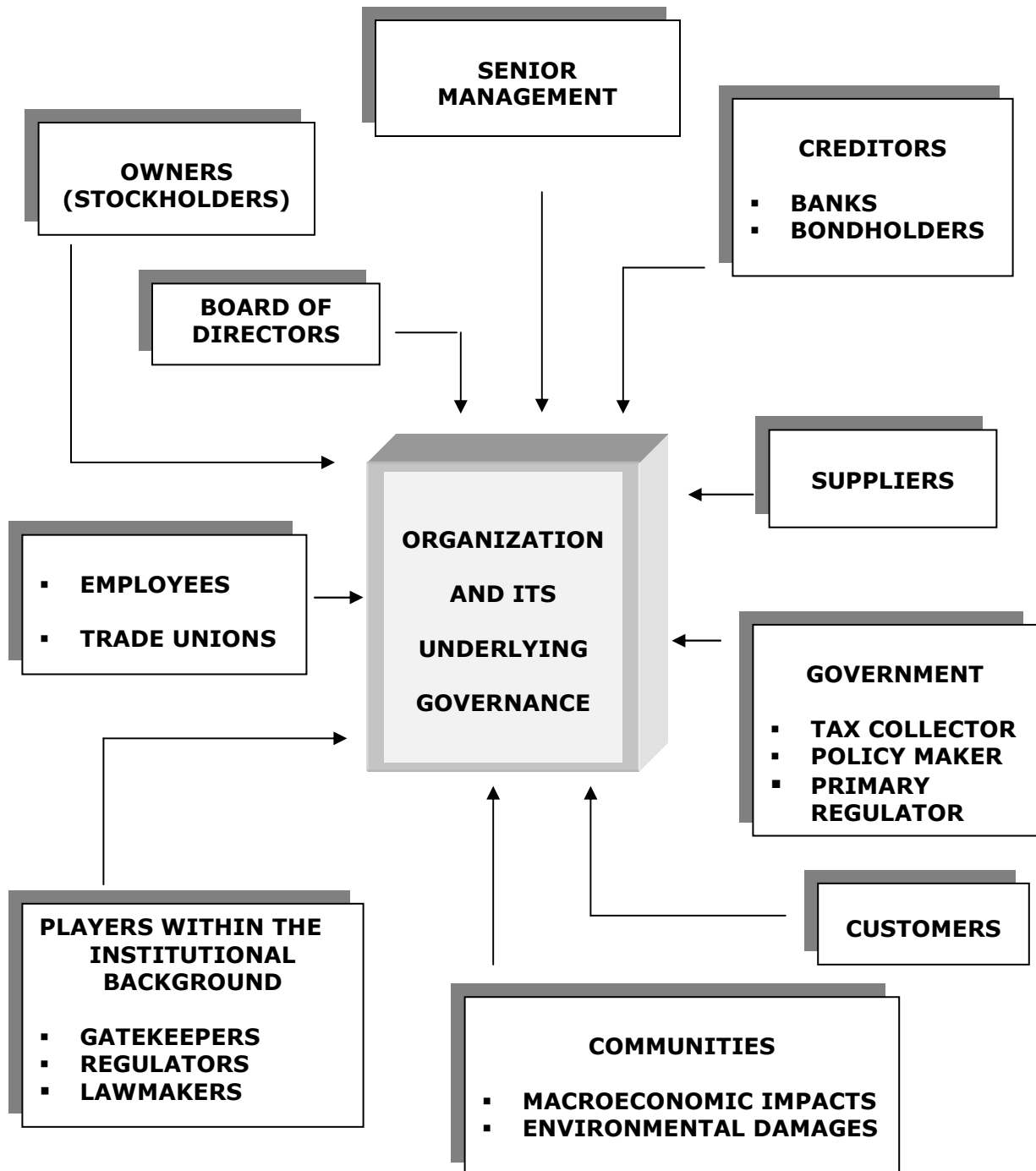
Borderlines between being a claimant or a stakeholder are clearly depicted by the definition. For instance, if we do our shopping in a store near our holiday place, we are transient customers for sure, and likely claimants by right, but not stakeholders in the sense conveyed by our definition. Instead, regular suppliers and customers can be

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<sup>1</sup> On the shameful story of Enron and the lessons we can draw from its demise, see Apreda (2002b).

<sup>2</sup> Definitions, in the context of this paper, intend to give a semantic frame as from which the ensuing argument might evolve consistently. Therefore, they do not seek to render the only meaning attachable to the expressions we wish to define, neither the best one. But they convey what is to be understood when we use them all over the paper.

regarded stakeholders of that store. Moreover, creditors, employees, managers, customers, owners and suppliers profit from the store's success, while they all stand to lose whenever the business fails or suffers financial distress.



**Exhibit 1** Main stakeholders in an organization of the private sector

### 3. TRANSACTIONAL ENVIRONMENTS

Notwithstanding the kind of organizations we have to deal with, all of them can be considered like dynamic systems in which numberless exchanges take place, either within the organization itself, or out of its boundaries. The ultimate units of any exchange, as Williamson (1996) has pointed out, are to be called **transactions**. In his own words:

*[A transaction is] the microanalytical unit of analysis in transaction cost economics. **A transaction occurs when a good or service is transferred across a technologically separable interface.** Transactions are mediated by governance structures (markets, hybrids, [and] hierarchies).*

Therefore, we can deem any organization like a complex hub around which internal and external transactions become distinctive by means of specific and enabling arrangements.

Two criteria will prove helpful to understand the concept of transaction as being the ultimate unit of any trade or exchange between two organizations **A** and **B**.

- a) Whenever an organization **A** successfully carries a transaction through, its accountancy records will register the outgoing of something from **A**'s books, and the incoming of that thing in **B**'s books.

In particular, this is also what happens when **A** and **B** are the same company. In such case transactions are internal, from one division to another within the company, by means of transfer pricing.

- b) If an organization **A** brings a transaction to completion with a different organization **B**, nothing less than property rights are transferred at the end of the day.

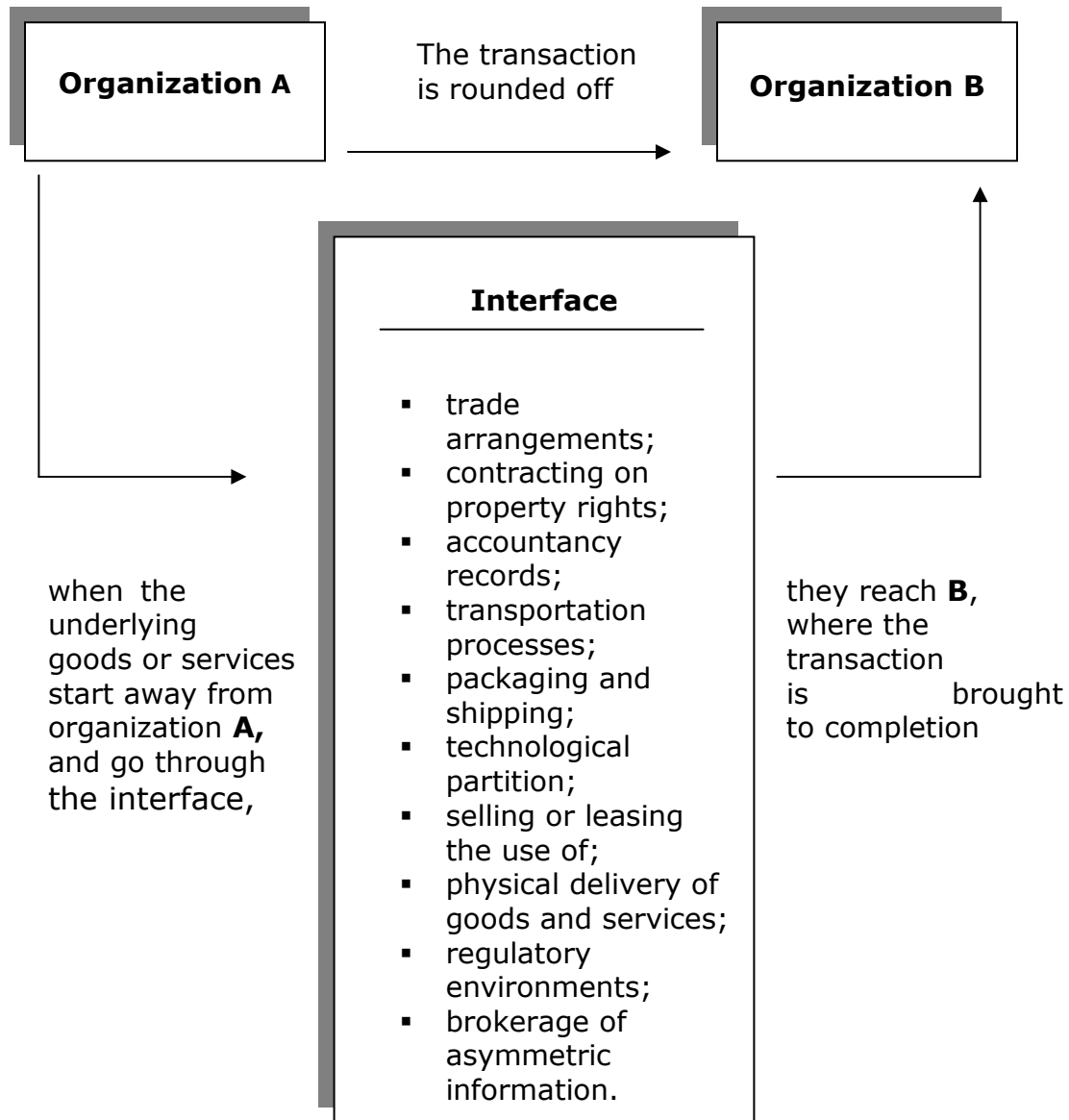
Turning to the first setting, given by (a), we see that "interface" means much more than mechanical procedures related to the physical transfer from one place to the other. In point of fact, the interface turns an asset of **A** into an asset of **B** (see **Exhibit 2**).

Looking at the second setting, (b), we can apprise that what actually takes place in exchanging has to do with contractual features that lend meaning to the transaction. Either if we attached value (internal transactions) or price (market transactions), in both cases **A** would



have to relinquish property rights that should become entitlements to **B**. An interface stands for the medium of exchange and contractual linkages that keep both organizations apart, bridging the gap between them.

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**Exhibit 2    Interfaces and transactions**

We intend to sharpen up the meaning of any transaction with the help of a broader semantics that comprises those environments where transactions actually take place.

## **Definition 2                      Transactional environments**

By **transactional environments** we mean:

- a) *institutional arrangements by which organizations manage their internal and external transactions;*
- b) *a variegated set of interfaces that allow organizations to bring transactions into completion.*

**Current markets** are the first examples that come to mind:

*Merchandises and services markets* (also known as markets of products), where the company trades its own outputs or purchases its own inputs.

*Labor markets*, those settings from which manpower, technicians, professionals, and managerial talent are usually tapped into organizations.

*Financial markets*, where the company seeks out monetary resources to finance its investment decisions, either through capital markets or the banking system.

In all cases, we know that for these transactions to be attained in a lasting way, rules of the game and behavior constraints must be enforced, what amounts to say that exchanges are ultimately shaped by institutional arrangements (see **Exhibit 3**).

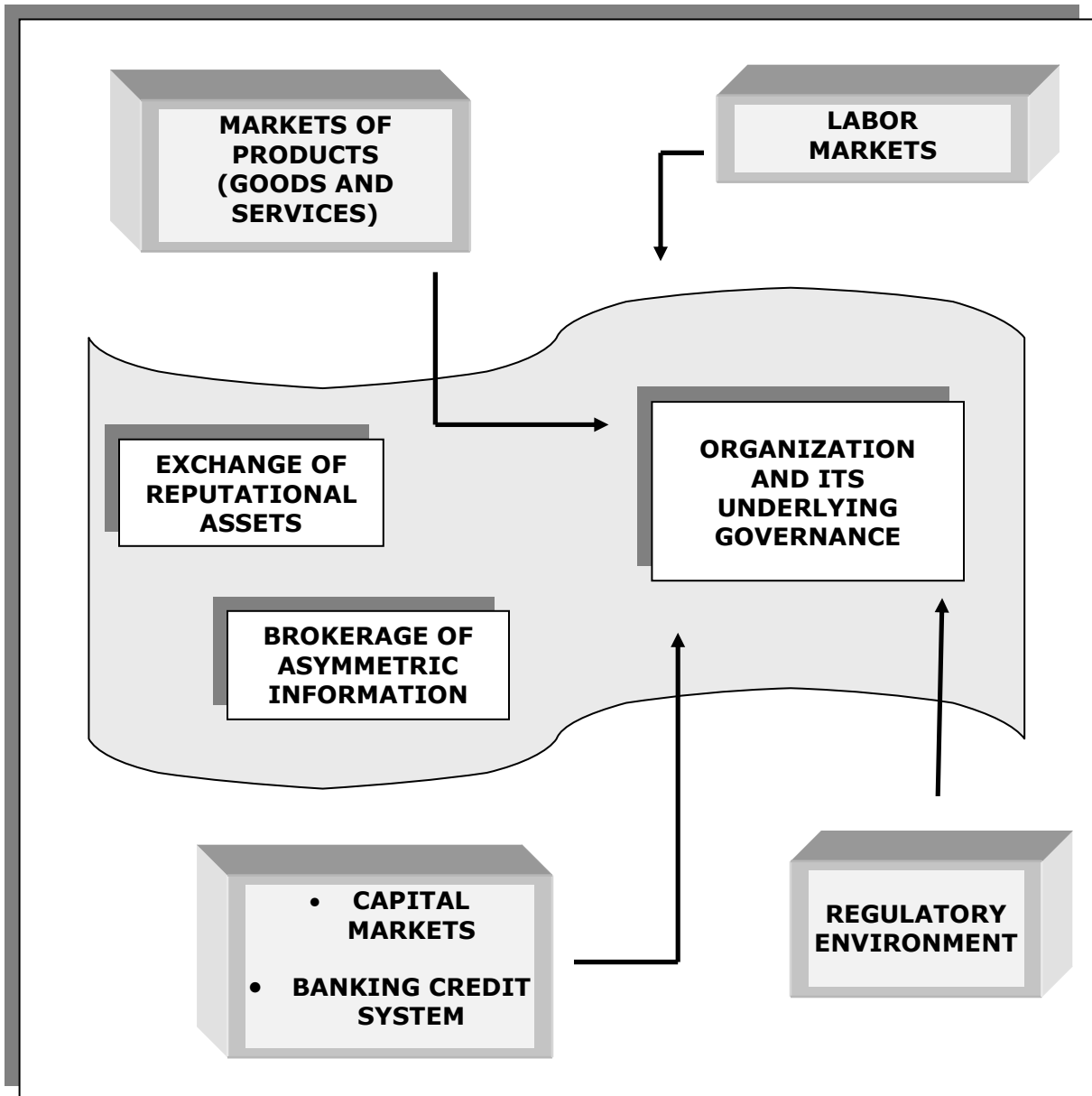
Nevertheless, this picture has undergone major alterations from the 80s in the last century. Two processes have been evolving to an extent that had not been witnessed before, both stemming from innovations in knowledge, data transmission, finance, communication networks and commercial procedures. We are speaking about

- i. the wide-ranging expansion of globalization in markets and ownership rights;
- ii. the building up of a strongly efficient Post-Industrial information-based Economy.

Such unprecedented events gave rise to a couple of distinctive backgrounds needed for many exchanges to take place but whose transactions could not be figured out in the realm of current markets.

In other words, we are referring to **information and regulatory environments**.

It's worth noticing that these new developments allow transactions not only to overlap with those being carried out in single conventional markets, but they are also part and parcel of interface contexts as well (see **Exhibit 2**).



**Exhibit 3** Transactional environments

### 3.1 INFORMATION ENVIRONMENTS

The basic transaction in this scenario consists of information, either as input, throughput or output of organizations. Most significantly, it means that information appears as a sort of commodity<sup>3</sup>; it can be not only exchanged, but priced and bargained as well. The main outgrowth of this innovative process consists in the brokerage of asymmetric information and the trade of reputational assets.

- ***The brokerage of asymmetric information***<sup>4</sup>

Wherever demand for and supply of relevant information persistently meet together, we find brokers that carry on their trade with asymmetric information. Among well-known brokers of asymmetric information, we can display two distinctive groups:

*a) Intermediaries*

This is the pivotal role performed by wholesalers, retailers, brokers and dealers in the broadest sense, investment banks, valuers in the property markets, advertising and management consultants.

Intermediaries are the outgrowth of technological innovation, the division of labor, professional credentials, regulatory constraints and, above all, asymmetric information which has become the most pervasive feature in modern markets, as Scitovsky (1990) argued so forcefully. In his opinion, sellers and intermediaries carry out their jobs in asymmetric markets whose structure is predicated upon competitive monopolies. Therefore, they also engage in non-price competition, mainly through the nurturing of buyers' markets, in which ancillary conveniences and services are bundled and, ultimately, purchased by customers.

*b) Gatekeepers*

They are the watchdogs that keep transactional environments running smoothly. Among the most conspicuous, we can single out the following:

auditing firms; law firms;

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<sup>3</sup> To a certain extent, a sort of commodity, but not a commodity entirely. Information hardly meets the requirement of becoming standardized. Otherwise, asymmetric information would not be raised as an issue.

<sup>4</sup> Apreda (2001) was the first to coin and work out this expression.

risk-rating companies; institutional investors;  
regulators and state agencies with regulatory goals;  
self-regulated exchanges and professional bodies;  
universities and research centers; journalism;  
non-governmental organizations, including churches and unions.

▪ ***Reputational assets***

Organizations become reputation-seekers, partly due to the fact that it is a good thing to compete for in the markets (as it has been the case for centuries), but mainly because they realize that is an asset that places a premium over and above others. The outrageous wave of corporate scandals at the beginning of our present century meant for many people a grievous reminder of what happens when reputation is tarnished or lost eventually.

As long as companies look for reputational assets, two noticeable developments come to light:

- a) they create value and economic rent year after year, which is embedded in the market assessment of how well the company performs in the long run;
- b) commitments to stakeholders are strengthened.

In order to cope with the issue of how to enhance their reputation, companies resort to brokers of asymmetric information, whose job consists in making the company more reliable through its transactional environment, by disclosing relevant and timely information<sup>5</sup> to different stakeholders.

The more transparent the company becomes, the less asymmetric information is kept in the wraps. This is, by the way, the rationale behind the behavior of any company looking for a well-established investment bank and an outstanding risk-rating firm before floating its own stock or bonds.

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<sup>5</sup> Apreda (2007a) delves at length into the functions of Corporate Governance brokers.

### 3.2 REGULATORY ENVIRONMENTS

Looking back to last century, we can't help noticing how deeply governments and their regulatory agencies have become involved with the economy of their countries and the running of their companies. Such commitment arises out of governments concerns, public opinion pressures, political or electoral advantage, and the ultimate fulfillment of their fiduciary role on behalf of the interests and demands of their constituencies. Globalization and the information-based Economy have empowered governments with far-reaching instruments to regulate stakeholders relationships within transactional environments<sup>6</sup>.

Sometimes, regulators redress wrongs, but in other circumstances they dare to curb and downgrade the workings of markets, their scope for innovation, even the mechanisms of price formation.

Let us draw up a list of key issues on which regulators have a last say in Corporate Governance, for the sake of illustration only:

- a) they prescribe how we can set up organizations, through legislation pertaining either for profit or non-profit companies;
- b) they state how many organizational arrangements will be allowed and which will be forbidden;
- c) they establish a pecking order concerning which stakeholders would become more prominent than others;
- d) they design frameworks about the quality, quantity, nature and extent of different financial vehicles intended to undertake investment decisions;
- e) they rule about ownership structure, voting rights, Board composition, control and decision rights;
- f) they make their voice heard about entry or exit of companies in the market, as well as mechanisms through which companies may carry out their job, providing with compulsory environments for conflict mediation or resolution .

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<sup>6</sup> It was Hanna Arendt (1958) who undertook, in her masterful work *The Human Condition*, a deeper analysis that goes beyond the private and public governance borderlines, and expands on the private and public realms of human beings.

As Roe (2003) highlighted, regulators' behavior is contingent upon the institutional arrangements of each country. In France, for instance, when conflicts of interests arise among workers, managers and the owners, most of the time workers claims are favored. If conflicts became awry, even the managers would enter into a political coalition with workers, to the extent of defying both Directors and owners.

Whereas many companies find out that their regulatory constraints convey a cost structure that is more than they could bear, still for many others there is an alternative choice: *they can shift from certain place with stifling regulations towards another place that offers lower operating costs as well as variegated business incentives.*

While we are in the subject, such is the reason why some exchanges thrive while others wither away. On this regard, look at what happens with foreign direct investment when some countries like Ireland or New Zealand built up friendly regulatory environments.

To close this section, **Exhibit 4** uncovers the intuition lying behind the common thread that runs through the notions of stakeholders and transactional environments.

#### **4. CONFLICTS OF INTERESTS**

The study of conflicts of interests and the rewards for economic agents to bring their personal goals into alignment with those of other actors or organizations to which they bind eventually, has brought about a fertile subject matter for the last thirty years<sup>7</sup>.

Take for instance Demsky's paper (2003), where he defined the issue in the following way:

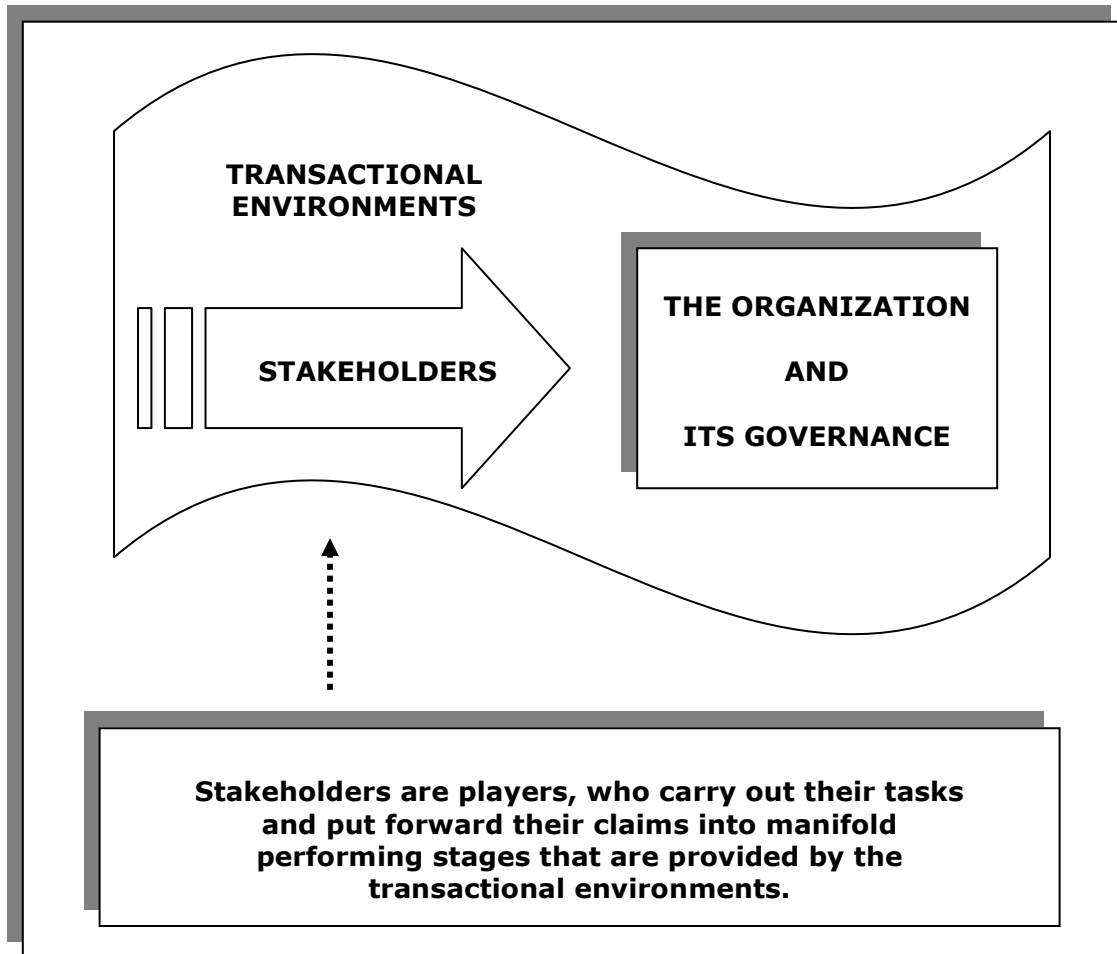
*A conflict of interest arises when an executive, an officeholder or even an organization encounters a situation where official action or influence has the potential to benefit private interest.*

Although agreeing with Demsky, we feel, however, that the notion of conflict of interest should be more encompassing than the one he offered, to the extent of being inclusive of any stakeholder in their

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<sup>7</sup> The groundwork on this subject matter was laid on, among others, by Jensen, Meckling, Smith, Fama and Williamson. The latter provides extensively the founding references in his book *The Mechanisms of Governance* (1996).

relationship with the organization. The one we are going to adopt in this paper was rendered for the first time by Apreda (2002a)<sup>8</sup>.



**Exhibit 4**     *The linkage between stakeholders and transactional environments*

**Definition 3**                      **Conflicts of interests**

We are going to say that economic actors **A** y **B** face or bear a **conflict of interest** when both are related in a context with the following features:

- i. the actor **A**'s interests are not fully compatible with those of actor **B**'s;

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<sup>8</sup> A comprehensive development of this topic so far as corporate governance is concerned, can be found in Apreda (2002a and 2005a).



- ii. *such situation stems, firstly, from the fact that some of their interests, at least, markedly differ;*
- iii. *and, secondly, from the fact that the fulfillment of **A's** interests could not be successfully pursued if **B** attempted his own ones as well;*
- iv. *eventually, **A** will try to achieve his interests in disregard of **B's** purposes.*

The definition stated above conveys a flexible format, to the extent that we can use it even when a single actor suffers a conflict of interest between two activities or personal choices. For example, Mr. X could play a role, R1, in performing like the company's CEO and, at the same time, following another role, R2, in acting as member of the Social Action Group, a non-profit in his town of residence<sup>9</sup>.

As a matter of course, economic or political actors are forward-looking and end-seeker creatures. Pursuing this logic, therefore, both **A** and **B** are likely to clash over their preferences, any time they cannot attain them at the same time or under the same circumstances. If an economic agent makes her decision, she will realize that certain path of action has been chosen and others left out. Whatever the ultimate rule of choice be, we must bear in mind that it is not only grounded on objective preferences but also subjective ones.

Because most among the conflicts of interests taking place in organizations seem unavoidable, we must design, firstly, governance arrangements so as to manage them and, secondly, benchmarks against which to measure the stakeholders' performance<sup>10</sup>.

Broadly speaking, conflicts of interests can be classified as positive or negatives:

By **positive conflicts of interests** we mean those that arise in competitive contexts in which relationships, preferences, tasks, and expectations voluntarily follow enforceable rules of the game.

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<sup>9</sup> This example is a case in point for the current debate on independent directors, after Enron and World Com became paradigms of contempt of law and governance failure.

<sup>10</sup> In section 5.3, we submit a definition of Corporate Governance.

Several examples come out of sports, suppliers' biddings, the working of free-markets, internal discrepancies in the life of organizations, marketing and institutional campaigns, entrance tests to universities, electoral contests in representative democracies, as well artistic or academic competition striving for scholarships, appointments or rewards.

In contradistinction to positive conflicts of interest, we say that conflicts of interest are **negative** when they unfold through a pattern like this one:

- **A** and **B** realize there is a conflict of interest between them;
- there is a growing awareness that chances could be profitable for one of the parties to the detriment of the other;
- the time comes when one of the actors makes up her mind to not follow the rules of the game by the book, and then she pursues her own personal agenda showing disregard of the counterpart's claims, benefits, and entitlements.

How do negative conflicts of interests evolve and become material<sup>11</sup>? The answer rests at the root of many issues arising in Corporate Governance, accounting for the failure to hold up healthy internal political coalitions, the inherent frailty of business relationships with customers or suppliers, or the hazardous trade off between short- and long-term plans for any sustainable process of growth. From the broader perspective these variegated circumstances provide, we see that economic actors reach a conflict when their preferences cannot hold at the same time, or one excludes the other outright.

When **A** and **B** face a conflict of interest between them, the underlying reasons (or the interpretation for such state of affairs) may be tracked down onto some basic disagreements about issues, beliefs or preferences at stake, among which we highlight the following:

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<sup>11</sup> Although "material" is a catchword, there is a meaning that has proved suitable for corporate governance. Following the Black's Law Dictionary, by material is understood *something of such nature that knowledge of the item would affect a person's decision-making process*. This amounts to monetary or reputational losses, in case we are prevented from taking advantage of such knowledge. Furthermore, compliance risks convey material losses whenever they turn into regulatory punishments.

- a) which are the goals;
- b) which is the starting point as from which **A** and **B** can negotiate;
- c) what the affordable means are;
- d) how to carry out the decision-making process;
- e) to what extent either beliefs or preferences are compatible;
- f) who is to decide which are the scarce resources at hand and how each party is entitled to their effective allocation.

At this juncture, we should subscribe to Demsky's warning about the underlying factors that could explain the apparent failure at coping with conflicts of interests kept under wraps<sup>12</sup>:

*Yet I fear we have failed to appreciate, or have forgotten, the delicacy of a well-crafted web of controls for managing conflict of interests. [...] Yet reality is multiple conflicts among multiple players, in the context of an enlarged, interactive, web of controls.*

Bearing this in mind, we move on next to manifold conflicts involving multiple players, as it is the case when we focus on agenda building and the problem of factions.

#### **4.1 AGENDA BUILDING**

Let us imagine that certain economic agent **G<sub>k</sub>** faces a set of alternative courses of action from which a decision-making process will allow him to pick out one of them over the others. Next topics would then become relevant:

- a) Are the feasible courses of action independently assessed, and implemented eventually, by **G<sub>k</sub>**?
- b) Are they contingent upon scarce resources?
- c) Are they contingent upon the prior agenda of another decision-maker?

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<sup>12</sup> See Demsky (2003) in References.



- *they must be held on behalf of the organization;*
- *issues and preferences in the final draft of the agenda are constrained by the Founding Charter and by-laws of the organization.*

It should come as no surprise that, when negotiating among them, stakeholders endorse their **personal agendas**, which consist of accessible options that they keep open, either to choose one among them or to have them in store for later decision-making. However, this would point to a misleading environment unless we laid bare two further features:

- opportunistic behavior;
- transaction costs.

Different endowments of information make some actors more powerful than others, and the problem is compounded by opportunistic behavior from the side of some players. Transaction costs prevent weak actors with fewer resources from contesting and prevailing over stronger ones.

If we focused on agendas that have to be settled for a group of actors, then we could be entangled in a daunting task, because this time we have to cope with an agenda that arises from collective action. Therefore, as regards a **collective agenda-setting problem**, the distinctive question we should raise seems the following:

**What is the extent of influence, for any stakeholder, to decide which are the options that must be included, and which are the ones that should be ruled out?**

The problem of agenda-setting brings to light the quality of the conflicts of interests that pervades any organization, regardless they are positive or negative. Not surprisingly, and from its own nature, agenda setting becomes a political issue within any organization<sup>15</sup>.

For the sake of example, in most open companies with highly dispersed ownership structure, it is for senior management to draw up the agenda. However, we can watch a strikingly different picture in closely held family-owned organizations, where few people own and

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<sup>15</sup> We will explain this in greater detail shortly in section 6.

manage their company. In the latter case, the fact remains that agenda-setting is in the hands of the few.

## **4.2 THE PROBLEM OF FACTIONS**

Which would be the underlying causes that make the process of agenda building to go awry? Well, in the first place, negotiations might have failed. In the second place, a dominant stakeholder might have substituted agenda control for agenda building. In the third place, if such background became persistent as time passes by, it is likely that **factions** might have developed.

Any organization can be viewed like a two-tiered structure: one consisting of the whole set of economic actors that work for the organization, the other as a collection of subgroups of economic actors. The latter tier conveys a natural process in the sense that members of any division or management unit nurture a sense of belonging, and share distinctive values and goals that make each unit different from the others. On the other hand, internal groups arise out of formal requirements or informal pressures and enter into purposive coalitions. From a sociological standpoint, Peter Blau (2005) cutely stressed the countervailing features of this process:

*In brief, differentiation of power in a collective situation evokes contrasting dynamic forces: legitimating processes that foster the organization of individuals and groups in common endeavors; and countervailing forces that deny legitimacy to existing powers and promote opposition and cleavage. Under the influence of these forces, the scope of legitimate organization expands to include ever larger collectivities, but opposition and conflict recurrently redivide these collectivities and stimulate reorganization along different lines.*

In any event, conflicts of interests unceasingly sprout and develop in every organization. Most of them are positive and disclose viewpoints in opposition, with regard to either means or ends. The best test to know whether we should be concerned or not with conflicts of interest consists in answering the question: are the subgroups in conflict but keeping themselves within the common knowledge, values and objectives of the organization? That is to say, are the subgroups' agendas aligned with the company's agenda?

If one subgroup in certain organization played the game in pursuit of its agenda to the extent of damaging the organizations' own agenda, then we would witness how the group's membership becomes

relentlessly contestant. As far as this pattern of behavior turns out to be a long-lasting one, the process of agenda building goes from bad to worse, and factions enter to play a part in the game. Let us frame this notion to conclude the section.

### Definition 5 Factions

We will understand by **factions** any subgroup in an organization that sets up a pattern of behavior whose distinctive features are the following:

- a) *they stick to a persistent and long-lasting bid for power against other subgroups or the whole organization;*
- b) *conflicts of interests become negative, and the challenger builds up an agenda that clashes with the one backed up by their opponents;*
- c) *they substitute contest and power-seeking for cooperation and common goals;*
- d) *their opportunistic behavior with guile issues a threat against the Founding Charter as well as the company's long-term strategies.*

## 5. ORGANIZATIONS FROM THE VIEWPOINT OF CONFLICT SYSTEMS

Let us move on, firstly, to frame the concept of purpose-built systems and, afterwards, to handle the basic features of those systems within which conflicts come to light as a fact of life. For better or worse, conflicts of interests are ingrained in the life of organizations. Lastly, we will delve into the political nature of conflict-systems.

## 5.1 PURPOSE-BUILT SYSTEMS

The mainstream definition of a purposive system states that it consists of a set of components that are linked by explicit relationships in the pursuit of one or more goals.

We are going to narrow down such a broad meaning, by primarily focusing on organizations. Therefore, let us describe a functional structure to this paper.

### *Components*

Economic actors (groups or individuals) make for the elementary components of this construct. Their activities become consequential either at the levels of collective action or those of deviant behavior.

The fabric of this structure lies on patterns of behavior, which arrange themselves through roles to be performed by single actors as well as the workings of groups of stakeholders within any organization.

### *Relationships*

Interactions among components make sense within the context of transactional environments, internal or external to the organization. They furnish social rules of the game by which economic agents carry out their actions eventually, evolving and turning into a network of linkages among stakeholders.

### *Goals*

They stem from purposes, agreements, tasks, that are laid on the Founding Charter, as well as in laws and regulatory environments.

## **5.2 CONFLICT-SYSTEMS**

In an insightful paper published in the early 60s, James March introduced the idea of conflict-systems, which helped him to shape a perspective from which organizations in the private sector could be looked upon as political coalitions. It was not surprising that this work came out in *The Journal of Politics*<sup>16</sup> since the whole approach intended to become consequential for political analysis as well.

On the grounds of March's paper, we intend to engineer a definition of conflict-system that may come in handy to organizations from the viewpoint of purposive systems.

### **Definition 6                      Conflict-Systems**

*By a **conflict-system** it is meant any organization in which*

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<sup>16</sup> James March (1962), *The Business Firm as a Political Coalition*, *The Journal of Politics*, volume 24, number 4, pp. 662-678.



- a) components in the system persistently make choices among alternative states or conditions of the system;*
- b) conflicts arise from the fact that most preferred states of the system are not attainable at the same time and with the mutual understanding of most components;*
- c) assumptions, relationships, goals, and means, are contestable;*
- d) groups of stakeholders may set up coalitions to confront agendas, and ending up as factions ingrained in the organization.*

The first two requirements closely follows those depicted in March's contribution. However, we introduce two additional predicates: on the one side, we give heed to issues that can be contested; on the other, we point out that opportunistic behavior could thrive and spoil, through agenda-settings and factions, the whole governance of organizations.

In general, and according to Jervis (1997), for purposive systems to become suitable to use in the analysis of organizational interactions and structures, we have to focus on the following characteristics:

- Elementary components are so deeply related that changes stemming from a group of them brings about changes in other groups of components within the system.
- The whole arrangement of components, relationships, and goals, conveys some patterns of behavior that are different from the ones we could make out of single components. In other words, the whole cannot be explained by the summation of its building parts.
- Stakeholders do not carry out only one action at the time. On the contrary, they attempt and follow up manifold activities simultaneously.
- Frequently, actions disclose unintended consequences on different actors, even upon the relationships within the system itself.

**Corporate Governance**, therefore, deals with conflict-systems that are complex, purposive and highly dynamic, because they change and evolve as time passes by.

### 5.3 ORGANIZATIONS FROM THE VIEWPOINT OF POLITICAL CONFLICT-SYSTEMS

The main outcome of March's paper stems from the fact of regarding any organization as a **political coalition**, and it brings forth a sensible answer to cope with the problems raised within conflict systems. In that context, the senior management and the Board of Directors perform the role of political brokers. In his own words:

*The composition of the firm is not given; it is negotiated. The goals of the firm are not given; they are bargained.*

From the fact that there is a set of potential participants in any firm who make claims on the system, March regards such demands as a required price set by stakeholders to participate in the coalition.

This subject deserves a further development, since as soon as we look upon an organization like a network of political coalitions, the focus naturally shifts towards the political nature of the organization itself.

Following Dahl (1963), in what has become a standard definition, by a **political system** is meant

*Any persistent pattern of human relationships that involves, to a significant extent, control, influence, power and authority.*

It was Coase (1937, 1988) who, well ahead of his time, hinted that transactions within the firm are ruled by power relationships and not the mechanism of prices.

Following this line of analysis, Rajan and Zingales (2000) have argued that **the problem of power** is a central tenet for the analysis of governance and they pointed up that next features seem worthy of being noticed:

- ownership of physical assets becomes neither the only source of power nor the most effective;
- any individual elicits power from the valuable resources he or she substantially contributes to his organization;
- in those situations not accounted for by contracts (which are incomplete as a fact of life) there are institutional arrangements

that grants any economic agent the allocation of power through the exercise of residual control rights<sup>17</sup>;

- in the case of human capital, we find out that most control rights become residual (that is to say, with no explicit provisions or covenants in contracts); therefore, it is “access” that provides a mechanism to allocate power within organizations. Rajan and Zingales stated the problem of power allocation through **access** this way:

*We define access as the ability to use, or work with, a critical resource. If the critical resource is a machine, access implies the ability to operate the machine; if the resource is an idea, access implies being exposed to the details of the idea; if the resource is a person, access is the ability to work closely with the person.*

Taking advantage of the ongoing argument, we go now to one level higher of abstraction than we have dealt with so far, and frame the notion of governance and, subsequently, the one of corporate governance, drawing from our earlier contribution *The Semantics of Governance* (Apreda, 2003, 2006).

In general, **Governance** turns out to be a field of learning and experience whose main targets are:

- a) the search of principles, rules, procedures and good practices that allow organizations to be efficiently run within the constraints of evolving and changing transactional environments;
- b) the design, implementation and following-up of functional mechanisms to grant representation, countervailing monitoring, voting, accountability and transparency;
- c) the development of blueprints for courses of action to manage conflicts of interests, wield power or authority, as well as enforceable decision-making.

Therefore, political issues are at the root of our viewpoint of governance, from which we can derive matching definitions of Corporate (or private), public, and global governances<sup>18</sup>.

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<sup>17</sup> The groundbreaking reference on this matter is Grossman and Hart (1986).

<sup>18</sup> Background on Public Governance is given in Apreda (2005b) while on Global Governance can be found in Apreda (2005c).

By **Corporate Governance**, then, we mean the governance within corporations and nearly alike organizations (including state-owned firms) that brings to focus the following subjects:

- the company's Founding Charter, bylaws or statutes;
- the ownership structure and voting rights allocation;
- the Board of Directors, its fiduciary duties, and the allocation of control rights;
- managers' decision rights, measures of performance and incentives; mechanisms about how to avoid rent-seeking and soft-budget constraints;
- accountability, transparency and good practices;
- investors' property rights and protective covenants;
- conflicts of interest between managers, directors, creditors, owners and other stakeholders.

## **6. HOW THE FOUNDING CHARTER COMPACT BECOMES THE MAINSTAY OF CORPORATE GOVERNANCE**

In this last section, we are going to seek out how the foregoing line of research provides nothing less than the ex ante predicates (or the preconditions) for any Founding Charter. In point of fact, three layers of analysis stem from our approach, overlapping and giving feedback among them:

- a) the first tier comprises the players to whom the organization will be held accountable, that is to say the stakeholders;
- b) the second describes the playgrounds where internal and external transactions are designed, started, offered, bargained, and brought to completion;
- c) the last one focuses on conflicts of interests, featuring any organization as a political conflict-system within which different stakeholders contest and bid for power, authority, influence and control.

Either when we build an organization up from scratch, or we intend to improve its governance, our aim will be doomed to failure if we disregarded the underpinnings of governance, centered around the three-tiered structure encompassed by stakeholders, transactional environments and conflict-systems.

So far, there has been growing an impressive empirical evidence [see Roe (2003), or Lopez Silanes et al (1999) to take only two ready-made examples], which points to the fact that these three levels of analysis are relevant. However, and up to our knowledge, this paper seems the first one to stress and articulate their theoretical links with the core of any governance.

Whereas the Founding Charter is, by and large, the starting point of governance we feel, however, that the streamlined notion is too narrowly constrained to the articles of incorporation and the certification process; that is to say, it is restricted to a judiciary viewpoint. Be that as it may, a considered treatment of the Charter should take into account the contributions made to our subject through the last two decades, which spring from many quarters like the *Law and Economics* approach, Political Science, and Theory of Organizations.

We are going to split the whole issue around the Charter into two levels:

- i. The first arises out of what has been called **Regulatory Governance**<sup>19</sup>, mainly concerned with the articles of incorporation and the certification.

In general, we find here procedural steps that must be taken to set into motion and run an organization according to Law.

- ii. The second one proceeds from the self-regulation capacity of any organization, a feature which we call **Discretionary Governance** and that plays a core function by means of three binding targets:
  - to establish connections between the organization's bylaws and some contents of the articles of incorporation;
  - to expand further the bylaws by embedding into them two key vehicles of internal governance: the Governance Statute, and the Code of Good Practices;
  - to provide a mechanism by which owners and the Board could amend, overhaul, and upgrade the articles of incorporation, inclusive of bylaws, the Governance Statute and the Code of Good Practices.

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<sup>19</sup> More background on regulatory governance in Apreda (2007b).

So as to develop our program we move on, firstly, to the constitutional metaphor and, next, the shaping of a new Charter's definition as a compact that comprises both regulatory and private governance.

## **6.1 THE CONSTITUTIONAL METAPHOR**

There is a useful metaphor that brings to light essential features around the Founding Charter. It assumes that the whole process involves nothing less than setting up a Constitution for the organization, as it has been done for state-nations all over the world.

In the beginning, there is always a group of founders, the so-called original constituency, who intend to set up an organization. They contract into a sort of Founding Charter by which the basic rights and duties of the constituents are laid down, as well as the declaration of purposes for the organization that comes into existence.

For the new entity to be run following the Charter both efficaciously and efficiently, constituents elect representatives who must live up to founders' expectations and act on behalf of their interests, carrying out a fiduciary role on which the representative could be held accountable at the end of the day.

As soon as the organization starts working, the original scope of the Charter must be enlarged by means of internal commitments, statutes, even decision-making procedures; in other words, **Bylaws**, upon which the organization rules its own governance. Furthermore, it becomes clear that the development and survival of any organization is constrained or fostered within a complex environment of traditions and institutions.

At this point of the story, regulators start to mediate between organizations and transactional environments:

- Firstly, if it is a corporation, there must be a document drawn up that conveys the articles of incorporation and a matching certificate of incorporation. Different legislations also make for either a Memorandum of Association or Statutes for Business Companies (the latter case is frequent in countries following the civil-law tradition).
- Secondly, other organizational arrangements must, in a broad sense, submit to regulators a statement of purpose and primary social arrangement so as to be granted legal status.

Such is the case for cooperatives, foundations, limited or unlimited partnerships, to name but a few examples.

The **articles of incorporation** comprise not only what regulations require so as to achieve the legal status, but also basic statements that give account of which are the goals and the means to achieve them.

The **certificate of incorporation** attests that the organization has fulfilled the requirements of the law to be recognized as such.

Now, it would be useful to bring back the constitutional metaphor, viewing corporations as having enlarged constituencies and representatives with competing, although not necessarily clashing interests: shareholders, directors, managers, and creditors.

- **Shareholders**<sup>20</sup>, who will appoint their representatives, the Managers, to become involved with the day-to-day running of the company. From a certain stage on, they will also appoint representatives to mediate between them and the managers, that is to say the Board of Directors. Shareholders' power lies on the exercise of residual control rights.
- **The Board of Directors**, which carries on the manifold tasks of hiring, monitoring, rewarding and punishing managers. Besides, they audit that the company enhances its value and increase the wealth of shareholders. At last, but not least, they oversee the extent to which the company ultimately meets the Charter statements. The underlying source of the Board's power must be sought in the Fiduciary Role, which basically comprises the duties of loyalty, care, and information, as well as the fulfillment of the business judgement rule<sup>21</sup>.
- **The Managers**, who are the doers in the company. Their role is also fiduciary, in the sense that they must advance the company on behalf of their shareholders, showing in such task as much care and diligence as they should pay to their own private affairs. Managers are directly held accountable to the Board of Directors.

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<sup>20</sup> Instead of shareholders, in other organizational formats we could speak of owners, members, partners.

<sup>21</sup> On this topic, Easterbrook and Fischel (1998) proves to be a handy reference.

- **The Creditors**, who are mainly represented through banks, institutional investors and bondholders. Although creditors turn out to be a most influential stakeholder in any company, they are not truly constituents of the private corporation because, in general, they had neither been signatories of the founding Charter nor been appointed to the Board or as managers. However, the more institutional investors or banks become involved with the financing of the company, the more “voice” they acquire, to the extent of sitting their own representatives in the Board and, in doing so, becoming part of the inside constituency albeit being recruited from the outside<sup>22</sup>.

The earlier bylaws of any company almost always prescribe a procedure whereby some body representing the constituency, for instance the Board of Directors or the Shareholders’ Annual Convention, has final authority over major decisions.

On the other hand, this arrangement of rights and duties call to mind a system of **checks and balances**, like the one found in representative democracies by means of countervailing powers. The cast of actors listed above plays this game of founding, voting, financing, running and overseeing the government of the company.

## 6.2 THE FOUNDING CHARTER COMPACT

When establishing the Founding Charter of any organization, their framers must design provisions so that interactive processes arising from the exercise and management of power could successfully take place. It goes without saying that the Founding Charter is neither static nor definitive. Organizations change, and such ongoing process entails not only the overhauling, updating or revision of the Founding Charter, but also bringing about by-laws amendments.

For this concept to become more fruitful and operational, we should stress its two-sided nature, the one that stems from regulatory governance, and the other that is grounded on the exercise of internal governance choices. That’s why we intend to frame the notion of Charter as a compact<sup>23</sup>.

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<sup>22</sup> Needless to say, this scenario is valid for going concerns. When financial distress arises, creditors eventually may take over both the decision and control rights, although this will be contingent on each country bankruptcy and reorganization laws.

<sup>23</sup> We are going to use, interchangeably, the expressions Founding Charter Compact and Charter Compact.



## **Definition 7                      The Founding Charter Compact**

By the **Founding Charter Compact** is meant a four-tiered structure whose layers are the following:

- a) the articles and the certificate of incorporation;
- b) the bylaws of the organization;
- c) the Governance Statute and the Code of Good Practices;
- d) Provisions dealing with procedures or criteria to amend articles of incorporation, bylaws, the Governance Statute and the Code of Good Practices.

In the foregoing definition, we profit from the two-fold meaning of the word **compact**:

- i) as a broad and enforceable agreement, or covenant, between two or more parties;
- ii) as an arrangement of things that are sorted out together in a close way.

So far, the Governance Statute has seldom been designed by companies. It is our contention that any organization should start this sound practice of listing the principles on which its governance is grounded, as a fiduciary covenant on behalf of the primary stakeholders. Therefore, this statute greatly contributes to shape the Charter as a compact and becomes the blueprint of the organization's governance.

Besides, there is another compelling reason for the Governance Statute: the Code of Good Practices, each of whose prescriptions must show their relationship with a distinctive principle of governance, as we have expanded on elsewhere<sup>24</sup> (Apreda, 2003 and 2007b).

Furthermore, the Founding Charter Compact meets the following key functions:

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<sup>24</sup> Among the best examples of a code which set principles of governance apart from good practices, although the latter are shown as explicitly dependent from the former, is the one advocated by the Sydney Stock Exchange in Australia ([www.asx.com.au/supervision/governance/index.htm](http://www.asx.com.au/supervision/governance/index.htm)).

- to provide with a blueprint that accounts for the architecture of any organization;
- to come in handy not only for corporations, but also when dealing with for profits and non-profits alike.
- to attempt solving the manifold problems that transactional environments give rise to;
- to comply with the regulatory environment;
- it is the place where covenants are laid down to cope with conflicts of interests;
- to become the benchmark through which healthy relationships with stakeholders could become sustainable.

In a nutshell: the accomplishment of these functions makes the Founding Charter Compact the kernel of any governance.

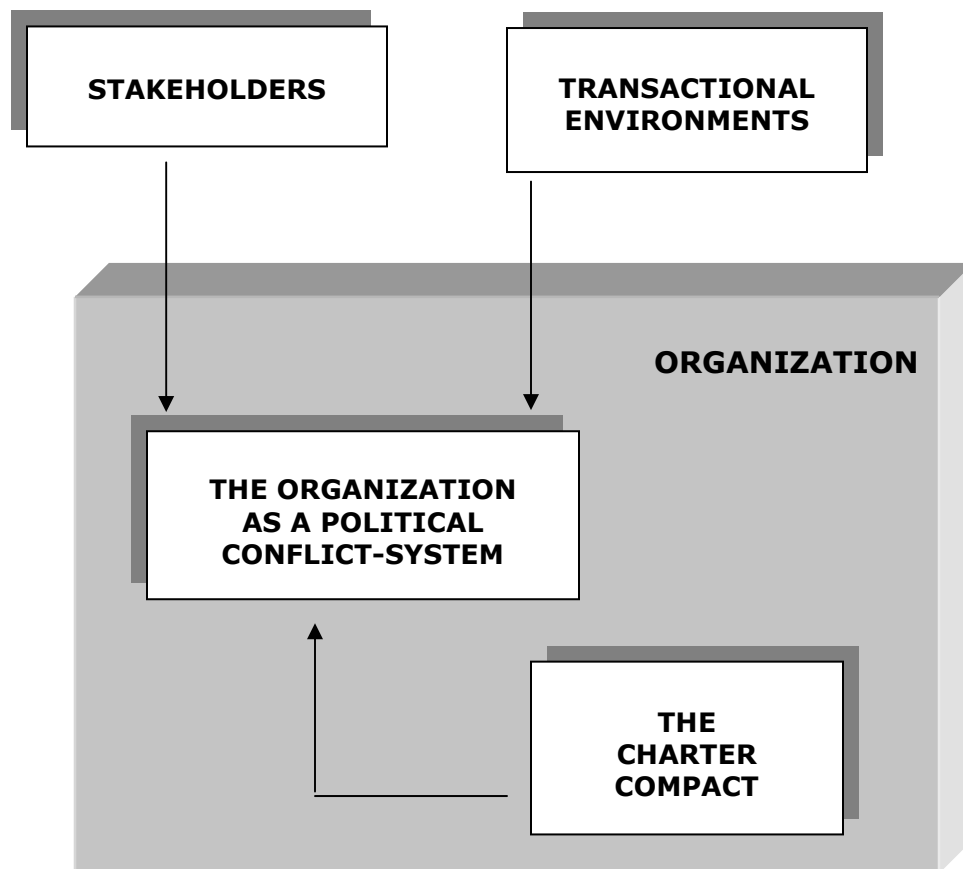
**Exhibit 7** stresses the fact that the Founding Charter Compact must be seen as the scaffolding of an organization, in the first place. But also it is an adaptive mechanism by which the organization adjusts itself to the demands, strictures, and pressures set forth by transactional environments, stakeholders, and the political nature of the underlying conflict-system.

## **CONCLUSIONS**

The Charter Compact stands out among other governance tools for many compelling reasons:

- a) It is the foundation stone of any organization.
- b) As long as the organization thrives and grows, the Charter evolves to not lose its principal role of being the blueprint of governance.
- c) By far, it consists of a primary set of covenants intended to cope with, on an ex ante basis, the most conspicuous conflicts of interests that ensue from stakeholders.

- d) The Charter Compact stands as the sum and substance of how any organization meets variegated constraints that transactional environments put forward relentlessly.
- e) It is through the Statute of Governance and the Code of Good Practices that an organization sets up attainable interfaces for manifold transactions to be brought into completion, on behalf of stakeholders, markets and regulators.



*Exhibit 6 Stakeholders, transactional environments and conflict-systems as inputs for the Founding Charter Compact*

- f) Internal bylaws attempt, firstly, to cope with problems that face the organization as a conflict-system and, secondly, to foster responsiveness, accountability and transparency.

- g) Finally, the compact should be regarded as a variegated composite of safeguards (protective covenants) that keep running sound relationships among owners, directors, managers and creditors.

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