A New Concept of Corporations: A Contractual and Private Property Model

Robert Hessen
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By Robert Hessen*

Introduction: The Concession Theory and Views of Corporate Legitimacy

The Concession Theory

In 1906 the Supreme Court declared, "[T]he corporation is a creature of the State. It is presumed to be incorporated for the benefit of the public."1 Known as the "concession theory," this view holds that incorporation requires governmental permission or authorization, and that through its charter a corporation receives various special privileges that only a government can create and confer, such as limited liability. These "special privileges" allegedly give a corporation an advantage in competition with noncorporate businesses, such as partnerships; hence, corporations are more likely to survive, grow, and reap profits. In exchange, however, the corporation is expected to display a sense of "social responsibility," that is, to place public service ahead of private profit.

This viewpoint is reflected in Professor Willard F. Mueller's comment, "Most Americans seem to have forgotten . . . that business corporations are created and survive only as a special privilege of the state . . . ."2 and in Professor Robert Dahl's observation:

[It] is absurd to regard the corporation simply as an enterprise established for the sole purpose of allowing profit-making. One has simply to ask: Why should citizens, through their government, grant special rights, powers, privileges, and protections to any firm except on the understanding that its activities are to fulfill their purposes?

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Corporations exist because we allow them to do so.\textsuperscript{3}

The importance of the concession theory can hardly be overstated. It is a tenet of orthodox legal theory, accepted as a self-evident truth by people of all political persuasions. Those who are hostile to corporations, however, put it to special use. When critics demand, for example, that Congress compel corporations to adopt a new system of internal decision-making, the obvious question is: Why do the critics believe that government has any legal or moral right to dictate the internal structure of a private business? The reason they offer is that a corporation, unlike any other form of organization or association, is a "creature of the state." From this basic premise, they conclude that corporations must submit to whatever constraints or demands government may choose to impose on them.

The concession theory contains an important corollary—the idea that corporations are "fictitious legal persons" or "artificial legal entities" distinct from their owners and officers. At first glance, this idea may seem innocuous, with no political or policy implications. The contrary, however, is true because critics of corporations use this "entity" idea in asserting that corporations have no rights. Rights, after all, apply to individuals or groups of individuals (such as partnerships) but not to imaginary "entities." Hence, many people are puzzled and others protest that an "entity" or "fictitious legal person" is accorded the same substantive and procedural safeguards that apply to individuals under the fourteenth amendment. The concession theory and its corollary, the entity idea, are applied to all corporations regardless of their size or whether the shares are privately held or publicly traded.

The Illegitimacy of Corporations

There is a second major premise in the contemporary view of corporations—one that applies only to giant corporations whose shares are publicly traded, namely, that they are illegitimate. This claim is made not only by socialists but also by defenders of capitalism. For example, Professor Irving Kristol declares that "the trouble with the large corporation today is that it does not possess a clear theoretical—i.e. ideological—legitimacy" within the framework of capitalism. He believes that neither the founding fathers nor Adam Smith would understand or approve of the giant corporations that exist today: "[T]hey would have asked themselves the same questions we have been asking ourselves for

almost a century now: Who 'owns' this new leviathan? Who governs it—and by what right, and according to what principles?"\(^4\)

Kristol's viewpoint derives from *The Modern Corporation and Private Property*, written in 1932 by Adolf A. Berle, Jr. and Gardiner C. Means. It is the single most influential book ever written about corporations and one whose central thesis continues to dominate contemporary discussion. Berle and Means contended that during the twentieth century the increase in the number of shareholders, each owning only a few shares, enabled officers to usurp control in corporations whose shares are publicly traded. The shareholders lose or surrender control over their wealth, and the officers gain control of wealth that they personally do not own. This separation of ownership and control allegedly means that giant corporations are not private property and, hence, do not deserve to be treated or protected by government as private property.

According to Berle and Means,

\[\text{[T]he owners of passive property [i.e., shares], by surrendering control and responsibility over the active property [i.e., assets], have surrendered the right that the corporation should be operated in their sole interest, they have released the community from the obligation to protect them to the full extent implied in the doctrine of strict property rights.}\(^5\)

Berle and Means did not recommend that the officers run the corporation on their own behalf; instead, “[t]he control groups have . . . cleared the way for the claims of a group far wider than either the owners or the control. They have placed the community in a position to demand that the modern corporation serve not alone the owners or the control but all society.”\(^6\) Although they did not coin the phrase “social responsibility,” Berle and Means certainly supported and lent justification to the idea that the primary obligation of a giant corporation is to serve society rather than to make profits for its owners and officers.

**A Contractual and Private Property Model**

The concession theory and the Berle thesis are the two major premises held by those who now advocate “social responsibility” and who urge or seek to justify greater federal and state control over giant corporations. If these premises stand unchallenged, they endanger

\(^4\) Kristol, *On Corporate Capitalism in America*, PUB. INT. No. 41, 124, 125, 137 (1975).

\(^5\) A. Berle & G. Means, *The Modern Corporation and Private Property* 355 (1932) [hereinafter cited as *Berle & Means*].

\(^6\) *Id.* at 355-56.
whatever degree of autonomy today's giant corporations still possess. The purpose of this Article, therefore, is to analyze these tenets and to offer an alternative: a contractual and private property model of the giant publicly traded corporation.

The contract model holds that a corporation is simply and literally a voluntary association of individuals, united by a network of contracts, who are entitled to exactly the same rights and legal protections as all other individuals and organizations. It holds that corporations are not the recipients of special privileges, that they do not require governmental permission to exist, and that their "charters" do not contain any promise (express or implied) to place public service ahead of private profit.

In answer to the questions, "Who 'owns' this leviathan? Who governs it—and by what right, and according to what principles?" the property and contract model holds that the shareholders own it, the officers make major decisions without consulting the owners, and yet this relationship is perfectly unobjectionable because it rests upon the principles of choice, consent, and contractual authorization.

Now we must examine each of these issues in detail.

**Examining the Concession Theory**

Creating Corporate Features by Contract

How would one make a case to support the idea that corporations receive "special privileges" from government and, thus, are "creatures of the state"? This idea is allegedly supported by showing that corporations possess features that other types of business organizations (such as partnerships) do not possess and that these features cannot be created by contractual agreement. The three corporate features invariably cited are entity status, perpetual duration, and limited liability. But are they, in fact, state-created privileges?

First, consider entity status. A corporation can sue and be sued in its own name, but a partnership cannot; unless authorized by law, a partnership can sue only in the name of its individual owners. The reason for this difference is that a partnership, in Anglo-American legal theory, is considered to be an aggregate, an association of individuals acting together to pursue a common goal. By contrast, a corporation is held to be something entirely different: an entity, a fictitious legal person, an artificial legal being, existing independently of its individual owners. The ability of a corporation to sue in its own name is an immense convenience that results from the fact that the law views a cor-
orporation as a distinct entity. Presumably, this point supports the belief that entity status is a state-created privilege.

Second, consider perpetual life. A partnership automatically dissolves whenever one of the general partners dies, goes bankrupt, becomes insane, is expelled, or wishes to withdraw. Terms like “transient,” “ephemeral,” and “short-lived” are often used to describe partnerships. By contrast, a corporation is called “immortal” or “eternal” because, as a distinct entity, it continues to exist despite changes in the ranks of its owners, and because the law permits the founders of a corporation to specify “perpetual duration” in the articles of incorporation. Thus, “immortality” also seems to be a privilege conferred by the state.

Third, consider limited liability. Partners (like sole proprietors) incur unlimited personal liability for the business’ debts. In contrast, if a corporation cannot meet its debt obligations to outside creditors, the shareholders cannot be assessed to make up the deficit. What accounts for this important difference? By law, a corporation is an entity distinct from the shareholders, so it contracts debts in its own name. Hence, “they” (the owners) are not responsible for “its” (the corporation’s) debts.

A Contractual Explanation

These three fundamental differences between partnerships and corporations seem to prove that a corporation receives special privileges from government. However, another way to explain entity status, perpetual duration, and limited liability is as features created by contract.

Entity status means that a corporation can sue and be sued as a unit, instead of having to specify the name of every shareholder. It also means that a corporation can hold legal title to property despite changes in the ranks of its shareholders. If a privilege means a favor or immunity bestowed by law upon one party at the expense of another, then entity status cannot be classified as a privilege. As Professor Berle noted, “More accurately, the associates are granted a legal convenience, in that they may use the courts without writing the name of every shareholder into their papers.”7 If this convenience is considered a privilege, then it is neutralized, for, as Berle noted, “The reverse process—that of liability to be sued under a single name, is manifestly not advantageous to them, but is rather a measure of fairness to their

7. Id. at 128 n.2.
Moreover, entity status is an optional feature for all unincorporated businesses, including partnerships, limited partnerships, and trusts. The owners can designate trustees to represent them in lawsuits and to accept or convey title to property on their behalf. Possessing entity status, then, is clearly not unique to corporations, nor a one-sided advantage, nor a state-created privilege.

Likewise, it is inaccurate to call perpetual duration a special privilege conferred by government. It simply means that the articles of incorporation need not be renewed, unless the founders originally specified that the enterprise was to exist only for a fixed period of time. The “privilege” of perpetuity certainly does not guarantee that a corporation will continue in business forever—witness the fact that more than half of all corporate ventures fail and go out of existence within five years of their inception. On the other hand, while partnerships are not automatically “immortal,” many firms—of attorneys, accountants, architects, and stockbrokers, to mention a few—have been in existence continuously for a century or more.

If they choose to do so, partners can make their enterprise “immortal” by providing in a continuity agreement that the firm will not be liquidated when one of the general partners dies or withdraws. After outlining a variety of means by which partners can assure the continuity of their enterprise, Professor Alan R. Bromberg writes, “By skillful use of agreements, partnerships can be given virtually any desired degree of continuity.” So much for the illusion that government confers immortality upon corporations, while partnerships cannot achieve a permanent, unlimited existence.

Finally, we must analyze limited liability, the most controversial and least understood corporate feature. How can it be explained except as a state-created privilege? Limited liability actually derives from an implied contract between the corporate owners and their creditors. As Professor Berle observed, “A clause could be put in every contract by which the apposite party [i.e., the creditor] limited his right of recovery to the common fund: the incorporation act may fairly be construed as legislating into all corporate contracts an implied clause to that effect.”

Contrary to popular belief, limited liability does not discriminate

8. Id.
9. A. BROMBERG, CRANE & BROMBERG ON PARTNERSHIP 516 (1968) [hereinafter cited as BROMBERG].
10. BERLE & MEANS, supra note 5, at 128 n.2.
against creditors for the benefit of shareholders. Outsiders cannot be compelled to extend credit to a corporation on a limited liability basis. They can, and often do, insist that one or several of the shareholders become personal guarantors or sureties for the debt. This fact explains why limited liability is often an illusory feature for a new or unstable corporate enterprise. When creditors do accept limited liability, they do so, as Professor Berle noted, by means of an implied contract. Because creditors have a choice in the matter, limited liability cannot be viewed as a state-created privilege that benefits the corporation at the expense of the creditor.

**Limited Liability for Torts**

How, if at all, can limited liability for torts be integrated into a *contractual* theory of corporations, as tort victims do not agree to limit their claims to the assets of the corporation? The answer is it can't—and it needn't be. The question poses the false dilemma that limited liability for torts either is a state-created privilege or is contractual (which it obviously is not). In fact, there is a third possibility.

We must first examine how the rules of tort liability originated. Many centuries ago in England the courts laid down the doctrine of *respondeat superior*—let the master be answerable for the acts of the servant. This principle of vicarious liability is based on the premise that the servant commits the tort while engaged in some activity on behalf of the master (for example, injuring a pedestrian while driving the master's carriage), and that the servant is personally hired, instructed, and supervised by the master. By holding masters fully liable for the torts committed by their servants, the courts gave the tort victim someone solvent (a "deep pocket") to sue for damages. Equally important, however, the courts gave notice to masters that they must carefully choose and closely supervise their servants, or else bear the financial consequences of their failure to do so.

Subsequently, the principle of vicarious liability was extended to sole proprietors and to general partners on the assumption that they personally select and monitor their employees and agents. While this extension was reasonable, it does not automatically follow that the same principle should be extended to corporate shareholders. Vicarious liability should apply only to shareholders who play an active role.

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in managing the enterprise or in selecting and supervising its employees and agents. The tort liability of inactive shareholders ought to be the same as that of limited partners, that is, limited to the amount invested. The same rationale applies to both because inactive shareholders and limited partners contribute capital but do not participate actively in management and control.

Applying the principle of vicarious liability, the proper rule would impose personal liability for the torts of agents and employees on whoever controls a business, regardless of its legal form. Thus, in partnerships vicarious liability would fall upon the general partners only, while in corporations the officers would be liable (whether or not they also happen to be owner-investors or are only hired managers). General partners and corporate officers may protect themselves through careful selection and close supervision of personnel and the purchase of liability insurance.

The argument presented here, that a corporation's limited liability for torts is not a state-created privilege, should not be construed as an attempt to lessen corporations' tort liabilities, nor as advocacy of preferential treatment for corporations. Corporations should not be relieved of any of the responsibilities or liabilities that apply to individuals or to other organizations, either business or nonbusiness. Instead, corporations should be held to exactly the same rules of liability and the same standards of conduct and accountability that apply to everyone else, nothing less and nothing more.\(^{13}\)

**The Entity Idea**

Thus far this Article has argued that three corporate features usually regarded as state-created privileges—the capacity to sue and be sued as a separate entity, perpetual duration, and limited liability for debts—are actually created by contract. As such, it is unnecessary to view a corporation as an imaginary entity. Further, the entity idea is not needed to account for limited liability for torts, because the rule of vicarious liability should not apply to inactive investors, whether they be limited partners or corporate shareholders. These conclusions raise another question: Does the entity idea serve any valid purpose, or can it be discarded? Before answering, it is worth examining how the entity concept gained prominence.\(^{14}\)

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14. For an analysis of the medieval concept of the corporate entity, see id.
In America, the source of the idea that a corporation is a distinct entity was Chief Justice John Marshall's 1819 dictum that "[a] corporation is an artificial being, invisible, intangible, and existing only in contemplation of law." His statement still serves as a leading definition of a corporation and is widely quoted in judicial opinions and legal treatises. Nonetheless, Marshall's definition is defective because it fails to indicate how corporations differ from partnerships or other forms of business organization. It also is confusing because it is metaphorical, not literal; it makes a corporation sound like a hallucination, a legal pink elephant.

Many writers have attempted to reformulate Marshall's definition in nonmetaphorical language. One recent attempt states, "A corporation . . . is a fictitious legal person. . . . In the eyes of the law, therefore, the group has an existence which is independent of that of its individual members." Another scholar, after surveying numerous attempts to revise Marshall's definition, reports that they all are "perverted by the notion of a 'body' or an 'entity' or an 'artificial legal creation,' the continuance of which does not depend on that of the component persons, and the being or existence of which is owed to an act of state."

Despite the fact that a partnership is considered to be an aggregate, an association of individuals, while a corporation is viewed as an entity apart from its individual members, this distinction is not a valid one. Every organization, regardless of its legal form or features, consists only of individuals. A group or association is only a concept, a mental construct, used to classify different types of relationships between individuals. Whether the relationship is a marriage, a partnership, a team, a crowd, a choir, a corps de ballet, or a corporation, one fact remains constant: the concept denotes the relationship between individuals and has no referent apart from it. In a marriage, for example, there are two individuals whose relationship is designated by the concepts of husband and wife. There is no need to posit or invent an artificial entity to represent "the marriage" or to account for the fact that, in the eyes of the law, the husband and wife are regarded as a unit for some purposes (community property, for example). If a census-taker was to enumerate three individuals—two real (husband and wife) and

one "fictitious legal entity" ("the couple" or "the marriage")—the error would be obvious. This kind of error, however, goes unrecognized when the subject is corporations.

The term "corporation" actually means a group of individuals who engage in a particular type of contractual relationship with each other. To designate their relationship as a "corporation" is, as Frederic W. Maitland noted in 1900, "a mere labour-saving device, like stenography or the mathematician's symbols." Instead of describing the intricate details of their relationship, which would be tedious and time consuming, a shorthand symbol, a concept, is substituted. The use of the corporate symbol, however, should not be allowed to obscure the fact that when rights are imputed to a corporation, the referents are actually the rights of its individual members.

Describing corporations as "entities" obscures the fact that they actually are associations of human beings. As Professor Wesley Newcomb Hohfeld observed:

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\text{[T}r\text{ansacting business under the forms, methods and procedure pertaining to so-called corporations is simply another mode by which individuals or natural persons can enjoy their property and engage in business. Just as several individuals may transact business collectively as partners, so they may as members of a corporation—the corporation being nothing more than an association of such individuals.}
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The Corporate Charter

State Creation: An Invalid Theory

There seem to be two weapons left in the concession theorist's arsenal: that a corporation requires governmental permission to exist, and that a corporation is granted a charter in return for an implied promise to place public service ahead of private profit. The strongest statement of this claim was made by Ralph Nader in 1973: "In order to exist it [a corporation] must obtain a charter. A corporate charter is in effect an agreement whereby a government gives the corporate entity existence and that entity, in return, agrees to serve the public interest."20

What Nader calls a charter is actually the articles of incorporation, which have nothing whatever to do with state permission or authoriza-

18. Maitland, Introduction, in O. Gierke, Political Theories of the Middle Age xxiv (1900).


tion or any corporate promise to serve "the public interest." The articles actually contain certain purely factual information: the name of the business; the intended duration (which may be a specified number of years rather than "perpetual"); the purpose of the business; the number of shares to be issued and the voting rights if more than one class of stock is to be created; the amount of capital to be paid in before the business commences; the name of the registered agent; the number and identity of the first group of directors, and the names of the three or more incorporators. Nothing else is required in the articles.

When this information is presented to the secretary of state or commissioner of corporations in the state in which the incorporators choose to establish the legal residence of their enterprise, the state official has no discretionary powers. Such officials cannot demand any additional information; they cannot extract any oath of corporate allegiance to "the public interest"; they cannot, with minor exceptions, even refuse to certify the articles of incorporation. They must sign and date both copies, keeping one on file, and must issue a receipt (called a "certificate of incorporation") that attests that the articles of incorporation have been filed.21

The state does not give life or birth to the corporation. Just as the registrar of deeds records every sale of land, and the county clerk records the birth of every baby, so the commissioner of corporations records the formation of every corporation—nothing more. The function of the state—to record the creation of corporations—is not essential to their existence any more than the registrar of births is essential to the conception or birth of a child.

This mere procedural requirement of filing the articles with a state official is equated with state creation. Procedural requirements, though, are not unique to corporations. On the contrary, procedural requirements apply to virtually all contracts. For example, to be legally valid, a marriage contract must follow specified procedural requirements: it must be performed by someone authorized by the state, it must be witnessed, and a signed certificate must be filed with the state. If these requirements make the state a party to a contract, then every marriage is a ménage à trois: bride, groom, and government. Quite literally, the government plays a smaller role in the creation of a corporation than of a marriage. Yet who, for that reason, would describe marriage as a creature of the state or claim that a marriage certificate contains a promise to serve the public interest? As a legal scholar re-

cently noted, “In the literal sense, no ‘charter’ is now issued to a business corporation under the general incorporation laws.”

The Origin of Corporate Charters

The idea that a corporation receives a charter and that it contains a promise to serve the state is a carry-over from the sixteenth and seventeenth centuries, when the Tudors and Stuarts reigned in England. Englishmen who wanted to travel or trade overseas had to obtain a charter—a royal permit—which the king would grant only if he stood to reap some gain. Freedom of commerce, freedom to join with others to engage in overseas trade, was viewed as a privilege or concession that the king could grant or withhold at will. So when persons sought the king's permission, their petitions contained glowing promises to serve the king, to bring wealth and glory to his realm.

If Englishmen had tried to act without obtaining a royal charter, they were subject to prosecution for usurping the sovereign's prerogative, a crime that carried the penalty of imprisonment and forfeiture of property. In an age when the divine right of kings was the prevailing political doctrine, individuals wisely avoided provoking the king's wrath. As a British legal historian observed:

[I]f they wanted to trade overseas, to depart from the Realm, to take out ships and men, goods and bullion, it was as well to have the royal permission in writing. . . .

. . . Not only would a royal charter be a mark of royal favour and protection, but it would sanction something which the Crown would otherwise regard with jealousy and suspicion.

In other words, individuals found it expedient to justify their request for charters in terms of benefit to the king so that he would not take offense at their exercise of commercial freedom. Any other course of action was inconceivable, because the Tudors and Stuarts did not recognize the principle of individual rights or freedom of association.

The Glorious Revolution of 1688, which ousted King James II, repudiated the divine right of kings, and the American Revolution of 1776 sealed its doom. Nonetheless, the concession theory survived, as did the medieval concept of a charter, by taking on a new meaning. In the late eighteenth century, after the American Revolution, concessions and charters signified an exclusive grant to profit by such activities as building and operating a canal, bridge, wharf, or harbor, or operating a

bank or a water, fire, or street-improvement company. The rationale for these grants was not to enrich royal favorites but, rather, to encourage the investment of private funds to supply quasi-governmental services.

Businessmen, who otherwise would have formed a partnership, incurred the expense of obtaining a corporate charter from a state legislature. The charter gave them privileges and benefits that were granted only to corporations. These included a legally enforced monopoly, exemption from taxation, release of employees from militia and jury duty, power to exercise eminent domain, and authorization to hold lotteries as a means of raising capital. Corporations in that era, as Professor Stuart Bruchey has observed, "were accorded certain exclusive privileges in order to encourage the devotion of scarce private capital to public ends."

These concessions and charters, however, were denounced as oppressive and exploitative. The fiercest critics were the "Jacksonian reformers" like William Leggett, Theodore Sedgwick, John Vethake, and William Gouge. They called for the abolition of all legally protected monopolies and special privileges, and their viewpoint eventually triumphed. Until that time, however, a corporation required a charter from the state legislature and, thus, actually was a "creature of the state."

The Era of General Incorporation Laws

A new era began in 1837 when Connecticut passed the first all-purpose, general incorporation statute. The Act of 1837 established a standardized, simplified procedure for creating a corporation that other states copied in later decades. Instead of obtaining a special charter from the state legislature, the promoters of a corporation only had to file certain information with an official of the state government. In response to decades of anticorporate criticism, the opportunity to incorporate was thrown open to nearly every group of would-be business associates.


26. Similar laws, such as that enacted by New York in 1811, had applied only to companies in specific industries.

The state legislators really had no other choice. Once public opinion made it impossible for legislatures to continue awarding special privileges and monopolies, there was no reason for businessmen to seek state charters of incorporation. The legislators came to realize what businessmen already knew: corporate features could be acquired without incorporation. In fact, this was a discovery that British businessmen had made in the late seventeenth century. By contract, and without obtaining governmental permission, British businessmen created joint stock associations that offered investors the attraction of freely transferable shares. They did this merely by copying the structure of the joint stock companies that held royal or parliamentary charters of incorporation. In 1720, however, Parliament passed the Bubble Act at the urging of the South Sea Company, a chartered corporation that resented competition for investor's capital. The Act forbade companies without charters to issue transferable shares or otherwise to imitate corporate features.

The measure backfired, however, and businessmen and barristers soon devised a second way to acquire corporate features without obtaining a charter from Parliament or the crown. They did so by combining two common-law forms: a partnership and a trust. By designating a few of the potentially numerous partners to be trustees for all the others, with exclusive authority to make contracts with outside parties, they concentrated managerial power in a few hands. Consequently, all the other investors could be offered freely transferable partnership interests virtually identical to corporate shares. The success of these unincorporated associations forced Parliament to relent, and in 1844 a permissive enabling act was passed.28

The process was identical in America. Although the Bubble Act was extended to the American Colonies in 1741, it had no impact. Like their British counterparts, American businessmen were able to create corporate features without incorporating. This ability enabled them to attract millions of dollars from investors for large-scale, long-term enterprises, such as textile factories and land-development companies.29

The commonly held view that today's corporations are descendants of the chartered corporations is challenged by Professor Shaw Livermore:


It seems to be little realized that unincorporated private business associations of the eighteenth century, although barred from the legal status of corporations, approximated the business status and character of the modern corporation, both in England and in this country. . . . These business units, and not the old chartered bodies of the sixteenth and seventeenth centuries, are thus the direct progenitors of the business corporation of today, which is formed as they were by private initiative and possesses a purely perfunctory and automatic legal approval.  

For nearly a century, legal scholars have recognized the fundamental change from government chartering of corporations to private contractual creation. They have noted that the concession theory is now an anachronism, as is the idea that a corporation is awarded a charter in exchange for a promise to serve the state. In 1900, for example, Frederic W. Maitland wrote:

> It has become difficult to maintain that the State makes corporations in any other sense than that in which the State makes marriages when it declares that people who want to marry can do so by going, and cannot do so without going, to church or registry. The age of corporations created by way of "privilege" is passing away.

Similarly, in 1908, a leading American lawyer, Arthur W. Machen, Jr., noted:

> Always should the fact be recognized that nowadays when the right to organize a corporation is almost as free as the right to execute a deed of real estate, corporations are very different things from what they were when that right was confined to a few favorites of king or parliament.

In 1930, Professor Berle observed how much the concept of incorporation had changed but how little the change had been integrated into legal theory:

> So large a part of the legal history of corporations was bound up with actual cases in which the state had granted something—a charter plus a privilege, as monopolies to trade, the right to run a ferry, the right to mine gold, etc.,—that the legal concepts are still filled with survivals of the idea.

A decisive change had occurred, Berle noted, "from a time when a corporation really did represent a bargain between a group of people and the state to the time when the state merely granted permission to a group of people to make an agreement between themselves." In 1948,
Professor Berle began another of his books by stressing the total obsolescence of the idea that a charter is a grant of special privileges:

Though the theory has not been seriously overhauled, the hundred years of corporate development from the middle of the 19th to the 20th Century has revolutionized the nature and content of corporate creation.

... The economic fact is that a corporate charter is an agreement under which associates can invest their money and act as a group in an enterprise and along lines which they themselves or their predecessors devised and accepted.  

It is ironic, indeed, that Professor Berle, whose writings provide so much evidence to support a contractual theory of corporations, was the person who propounded and popularized the idea that giant corporations are illegitimate because of the separation of ownership and control. If, as argued here, a corporation is created by private contract, then it is not clear why some corporations, those giants whose shares are publicly traded, are expected or exhorted to place public service ahead of private profit. What justification does Berle offer for the doctrine of "social responsibility?"

Examining the Legitimacy of Corporations

Separation of Ownership and Control

In The Modern Corporation and Private Property, Berle and Means, like many subsequent writers, invoked the authority of Adam Smith to prove that giant corporations are not private property nor are they compatible with capitalism. Adam Smith’s defense of private property and capitalism was based on three assumptions about the typical business firm: that it would be small-scale, that the individual owner or small group of owners would invest personal savings in their business venture, and that they would manage it directly, reaping profits or suffering losses, depending on their own personal managerial abilities.

Those who see Adam Smith as a critic of corporations do no more than create and demolish a straw man. There is no justification for equating capitalism with a particular configuration of small firms run by their owners, and Adam Smith’s preferences are not binding upon persons who prefer to create some other arrangement. The essence of capitalism is the inviolability of individual rights, including the right to use or invest wealth as one chooses and the right to associate with

36. BERLE & MEANS, supra note 5, at 345-51.
others for any purpose and under any mutually acceptable terms of association.

A Comparison of Corporations and Partnerships

In order to demonstrate the legitimacy of the giant publicly traded corporation—that is, to show that it is private property and that the officers have not usurped control but are the authorized agents of the shareholders—it is necessary to examine briefly how a corporation differs from a partnership. This difference will explain why the separation of ownership and control is an advantage and attraction of the giant corporation, not an abuse of the corporate form.

Partnership rests upon two assumptions. The first is that the partners collectively will manage the business; therefore, unless otherwise agreed, each partner is entitled to an equal voice and vote in decision-making. The second is that every partner will be a full-time, active participant in the business; therefore, unless otherwise agreed, partners owe each other exclusive allegiance, and no one can simultaneously be a general partner in two firms, regardless of whether they are competitors or not.

From the standpoint of creditors, the distinctive feature of partnership is that every partner is presumed to possess the powers and incur the obligations of a sole proprietor. Every partner is presumed to be an authorized agent of the firm, that is, able to sign contracts that are binding upon all the partners. In addition, each partner is personally liable for the total debt obligations of the firm. The fact that partners are mutual agents creates the need to restrict the transferability of partnership interests. Otherwise, if a partner could sell or give his interest to anyone, the other partners would be exposed to great risk: the new partner would be authorized to sign contracts on behalf of everyone else. Clearly, partnership is a relationship ill-suited to strangers or to persons who harbor doubts about each other's intelligence, integrity, or ability.

The primary difference between corporations and partnerships relates to agency authority. Because partners are mutual agents, restrictions are placed on the transferability of partnership interests. On the other hand, because shareholders are *not* mutual agents, there is no need to restrict the transferability of shares. This means that a corporation's capital can be supplied by hundreds, thousands, or potentially even millions of investors, each of whom may be a stranger to all the others.

It also means that a corporation's long-term capital needs can be
supplied by a steady succession of short-term investors. Although it is fashionable to disparage short-term investors as being speculators whose buying and selling of shares serves no useful or productive function, the exact opposite is true. They provide liquidity for any existing investor who needs or wants to sell out. Free transferability creates instant liquidity. There is no need to obtain the other owners' approval of a prospective buyer, as is necessary to admit a new general partner, and there is no time period to wait before one can sell one's shares, nor any penalty for early withdrawal. Instead, each investor can retain ownership of shares for as long or as little time as desired. It is hard to imagine a more equitable or attractive arrangement.

Ownership without Control by Choice

According to Berle and Means, the increase in the number of corporate shareholders led to a separation of ownership and control. That claim is wrong, however, because it reverses cause and effect. It was the separation of ownership and control—that is, the creation of two distinct functions (investment and management)—that made possible the increased number of shareholders. The corporate form flourished precisely because it split the atom of ownership into two parts. Unlike general partners, corporate shareholders are not mutual agents and do not automatically play an active role in managing the business. Conversely, the officers, executives, and managers need not be owner-investors. It is a beneficial relationship for all concerned.

Critics of giant corporations contend that the shareholders are inactive because they have been denied access to information about corporate activities. There is another explanation, however, for their inactivity: it is a deliberate decision for most shareholders. They are attracted to corporate shares precisely because they will not be required to participate in managerial decision-making. What they seek is a sideline investment, an opportunity to entrust some of their savings to managerial specialists in return for a share of the resulting profits.

The "separation of ownership and control" in giant corporations is frequently denounced, yet it merely represents a widening specialization of function or division of labor. There is no reason why a shareholder must personally manage his own money. If he wants to supply both capital and managerial services, he can become a sole proprietor or a general partner. Why should anyone else protest, however, if he decides to rely upon the managerial expertise of others? Such investment is analogous to what a person does in depositing money in a sav-
ings bank, or becoming a limited partner, or buying shares in a mutual fund, or purchasing corporate bonds.

Just as most investors do not seek to exercise managerial authority, so, too, when a corporation goes public, the founding officers and their successors do not intend to relinquish their decision-making powers. For example, when Walt Disney, Edwin Land, and Thomas J. Watson sold stock in their companies to outsiders, they were seeking capital, not advice on how to produce cartoons, cameras, or computers. New investors were never led to believe that they were acquiring managerial powers equivalent to those of general partners. If the relationship between shareholders and corporate officers is mutually acceptable, if millions of people willingly invest in corporations that they will not personally manage, then critics have no right to interfere.

To denounce the largest corporations because shareholders do not directly control their policies or select the officers—to say that they should, that they must because they are the owners—ignores the fact that owners do not exercise any control in some other leading forms of business organization. Limited partners, for example, are owners, yet they have no voice or vote in setting business policy. Those who purchase certificates in business trusts exercise no control. Like shareholders, trust beneficiaries obtain freely transferable shares with limited liability, but, unlike shareholders, they acquire no voting rights. Investment without control is not an evil if the owners freely consent to that relationship. Rather, it is an example of what has been called "capitalist acts between consenting adults."³⁷

Far from receiving too little information, most shareholders are deliberately inactive and uninvolved because it takes too much time to study the information already available to them. A small-scale investor may have other, more personal and urgent interests to pursue, rather than studying the financial and statistical data sent by each of the corporations whose shares are owned. Time and energy are scarce resources, and, quite rationally, a person will concentrate attention on those areas of life where the effects of a poor decision will be most intensely experienced. Thus, the more widely a person diversifies an investment portfolio, the less incentive there is to closely monitor each situation.

The primary safeguard for shareholders of giant corporations is their ability instantly to sell their shares. The stock market functions as a daily plebiscite, enabling investors to register their individual reac-

tions without needing to be members of a majority voting coalition. Professor Henry G. Manne has shown that if the officers pursue policies that offend or disappoint a substantial number of shareholders, the officers will be undermining their own position. A massive exodus or sell-off by disgruntled shareholders will depress the price of the stock and thus make it attractive for "corporate raiders" to attempt a takeover.38 Professor Burton G. Malkiel concurs:

A company that has been run by a management group whose major objective is not the well-being of the shareholders will become a prime target for a take-over bid. The ever present threat of such a bid is likely to provide a powerful incentive for management to make the maximization of the shareholders' wealth a primary goal of the firm.39

Today a medium-size corporate giant, such as Coca-Cola or Bristol-Myers, has 60,000 shareholders, while General Motors has 1,400,000 and American Telephone and Telegraph has nearly three million. Unlike general partners who are intimate acquaintances, today's shareholders are strangers to each other, residents of all fifty states and more than 100 different nations. If persons today living in Alaska, Arizona, Austria, or Australia buy shares in General Motors or U.S. Steel, they don't expect to be consulted as if they were general partners.

When shares can be easily traded through stock exchanges, it is fairer to all parties if those who disapprove of the policies initiated by the officers simply sell their shares. Given the low cost of selling one's shares and switching one's funds to another corporation or to some other investment opportunity, it is hardly surprising that dissatisfied investors prefer to sell, instead of expending time and energy to form a coalition of shareholders to oust the existing officers and directors. A policy of "love it or leave it" makes perfect sense when there are 14,000 publicly traded corporations (including those traded over the counter) to choose among. Anyone whose professed goal is to give shareholders the widest possible range of choices would be unable to conceive of or to create the stock exchange system that spontaneously evolved over the past century. Far from being the antithesis of free choice and continuous accountability, the publicly traded giant corporation is the highest embodiment and expression of those ideals.

Agency Authority of Corporate Officers

One last issue needs to be clarified. It is possible to agree that most shareholders do not want to participate in managerial decision-making and that they are better off financially if they function as passive investors. Nonetheless, one might argue that the benefit to shareholders does not excuse or justify the usurpation of control by the corporate officers. If the officers are a self-perpetuating oligarchy, if they exercise control without authorization from those whose money they manage, it hardly matters that the shareholders are the beneficiaries of a system of despotism. But is this true? Do the officers operate without authorization from the shareholders?

Ralph Nader contends that officers are not authorized agents. He writes:

In nearly every large American business corporation, there exists a management autocracy. One man—variously titled the President, or the Chairman of the Board, or the Chief Executive Officer—or a small coterie of men rule the corporation. Far from being chosen by the directors to run the corporation, this chief executive or executive clique chooses the board of directors and, with the acquiescence of the board, controls the corporation.\(^4\)

According to Nader, the shareholders want to be in control, to play an active role in determining corporate goals and in designing the strategy to achieve those goals. Because the officers do not want anyone to interfere with their autocratic powers, however, they deliberately withhold information that shareholders need to make intelligent policy decisions. The officers will not relinquish their autocratic powers voluntarily and, under today's system of state incorporation laws, they cannot be forced to do so. The states, says Nader, have been co-conspirators; they have favored the officers at the expense of the shareholders. Instead of enforcing a code that requires officers to carry out only those policies initiated by the shareholders or expressly approved by them, the states have permitted corporate officers to exercise vast discretionary powers.\(^4\)

Moreover, Nader argues that the pattern of corporate democracy is mandatory, not optional:

All modern state corporation statutes describe a common image of corporate governance, an image pyramidal in form. At the base of the pyramid are the shareholders or owners of the corporation. . . . The intermediate level is held by the board of directors, who are re-


\(^{41}\). Id. at 80-102.
quired by a provision common to nearly every state corporation law "to manage the business and affairs of the corporation." . . . Finally, at the apex of the pyramid are the corporate officers. In the
eyes of the law, the officers are the employees of the shareholder
owners. Their authority is limited to those responsibilities which the
directors delegate to them.42

He condemns the states for not enforcing adherence to this pattern: "In
reality, this legal image is virtually a myth."43

Nader's criticism rests upon two false assumptions. First, he as-
sumes that the state incorporation laws are prescriptive, setting forth a
norm that must be adhered to; instead, they are suppletory, setting forth
a norm that applies only if no agreement to modify the norm has been
made. (The laws of partnership and of intestacy serve exactly the same
purpose.) As long as no one is being coerced or defrauded, any pattern
should be permissible.

Second, he assumes that the pattern described in the state incorpo-
ration statutes must be eternal and unalterable. His own summary,
though, indicates that deviations from the statutory norm are possible
by stating that the authority of the officers "is limited to those responsi-
bilities which the directors delegate to them."44 Nothing in that state-
ment implies a static pattern. When a business is first incorporated, the
same small group of individuals is likely to be simultaneously the
shareholders, directors, and officers. The owners of the most shares al-
most certainly will elect themselves to serve as the directors, and then,
acting as directors, they will elect officers from amongst themselves.
Given this close relationship, it is possible—indeed, likely—that the
corporate president will exercise discretionary authority.

The president can acquire discretionary authority in several ways.
One is by an explicit grant from the directors. Another is by making an
unauthorized exercise of authority—for example, by signing a contract
with an outside party, even though the articles of incorporation and by-
laws give no such authority. If the directors subsequently approve the
unauthorized act, however, they have ratified it, giving retroactive au-
thority to the president. If the newly asserted authority becomes a rati-
fied power of the president, it usually automatically passes to successors
in office. Nothing about this procedure is fraudulent or illegal. The
concept of ratification is central in the law of agency, which, in turn, is
a crucial element of the law of property and contracts.

There is a third and far more common way in which corporate

42. Id. at 75.
43. Id.
44. Id.
presidents acquire discretionary authority. The language of the by-laws is usually very general and unrestricted, stating, for example, that the president shall be "chief executive officer." The exact meaning of that phrase is rarely, if ever, fully explained. Instead, the president usually acts according to personal judgment of what is beneficial to the business, and, depending on the degree of confidence of the directors, the president may or may not give them frequent or detailed reports on operating decisions. In companies where the president is the founder or principal shareholder, the directors are well aware that the president is handling certain types of situations without consulting them, and rarely do they either ratify or repudiate such decisions. Situations in which the directors rebuke the president for exercising authority without their approval are so rare as to be noteworthy.45

There is no uniform rule about presidential authority that prevails throughout the business world. Instead, the exercise of discretionary authority varies from industry to industry, and even companies in the same industry do not necessarily abide by the same custom. The exercise of discretionary authority by the president is rarely challenged by a disgruntled shareholder suing to undo the consequences, so there are relatively few judicial decisions on the scope of presidential authority.

When the corporation later "goes public," it is not morally or legally necessary to ask the new shareholders to approve the president's past exercises of discretionary authority. Their share purchases involve a contract of adhesion. They implicitly agree to accept all of the corporation's existing contractual relationships including delegations of authority. The new shareholders have no basis for complaint; they have not been deceived or defrauded. Their shares are private property, and the officers are acting as authorized agents of the owners.

**Conclusion**

The alleged illegitimacy of giant publicly traded corporations is a conclusion that can be reached only by ignoring obvious facts and substituting for them the critic's personal vision of what the shareholders should want. Millions of people have an ownership interest in America's giant corporations, either directly through purchase of shares or indirectly through pension funds, insurance companies, and other financial intermediaries. Critics who claim to be speaking on their behalf have offered no evidence that shareholders want or need the "re-

45. For a famous example of a president being censured by the board for exceeding his authority, see R. Hessen, Steel Titan: The Life of Charles M. Schwab 128 (1975).
forms” that are demanded in their name. The critics certainly have not shown that shareholders endorse “social responsibility,” if that means placing public service ahead of private profit.

If there is any justification for the concept of “social responsibility,” it cannot be found either in the concession theory or in the separation of ownership and control. The giant corporation is private property; it is a voluntary association created and sustained by an exercise of freedom of contract. Its right to function freely on an equal footing with other organizations and associations requires no further justification.46

46. On all of the issues treated briefly in this essay and on many other criticisms of corporations, see the author’s book, R. Hessen, In Defense of the Corporation (1979).