THE LAW OF CORPORATIONS

SUPPLEMENTAL READINGS

Class 06

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Corporation

A **corporation** is an organization, usually a group of people or a company, authorized to act as a single entity (legally a person) and recognized as such in law. Early incorporated entities were established by charter (i.e. by an *ad hoc* act granted by a monarch or passed by a parliament or legislature). Most jurisdictions now allow the creation of new corporations through registration. Corporations enjoy limited liability for their investors, which can lead to losses being externalized from investors to the government or general public, while losses to investors are generally limited to the amount of their investment.[1]

McDonald's Corporation is one of the most recognizable corporations in the world.

Corporations come in many different types but are usually divided by the law of the jurisdiction where they are chartered into two kinds: by whether they can issue stock or not, or by whether they are formed to make a profit or not.[2] Corporations can be divided by the number of owners: corporation aggregate or corporation sole. The subject of this article is a corporation aggregate. A corporation sole is a legal entity consisting of a single ("sole") incorporated office, occupied by a single ("sole") natural person.

Where local law distinguishes corporations by the ability to issue stock, corporations allowed to do so are referred to as "stock corporations", ownership of the corporation is through stock, and owners of stock are referred to as "stockholders" or "shareholders". Corporations not allowed to issue stock are referred to as "non-stock" corporations; those who are considered the owners of a non-stock corporation are persons (or other entities) who have obtained membership in the corporation and are referred to as a "member" of the corporation.

Corporations chartered in regions where they are distinguished by whether they are allowed to be for profit or not are referred to as "for profit" and "not-for-profit" corporations, respectively.

There is some overlap between stock/non-stock and for-profit/not-for-profit in that not-for-profit corporations are always non-stock as well. A for-profit corporation is almost always a stock corporation, but some for-profit corporations may choose to be non-stock. To simplify the explanation, whenever "Stockholder" or "shareholder" is used in the rest of this article to refer to a stock corporation, it is presumed to mean the same as "member" for a non-profit corporation or for a profit, non-stock corporation.

Registered corporations have legal personality and their shares are owned by shareholders[3][4] whose liability is generally limited to their investment. Shareholders do not typically actively manage a corporation; shareholders instead elect or appoint a board of directors to control the corporation in a fiduciary capacity. In most circumstances, a shareholder may also serve as a director or officer of a corporation.

In American English, the word *corporation* is most often used to describe large business corporations.[5] In British English and in the Commonwealth countries, the term *company* is more widely used to describe the same sort of entity while the word *corporation* encompasses all incorporated entities. In American English, the word *company* can include entities such as partnerships that would not be referred to as companies in British English as they are not a separate legal entity.

Late in the 19th century, a new form of company having the limited liability protections of a corporation, and the more favorable tax treatment of either a sole proprietorship or partnership was developed. While not a corporation, this new type of entity became very attractive as an alternative for corporations not needing to issue stock. In Germany, the organization was referred to as *Gesellschaft mit beschränkter Haftung* or *GmbH*. In the last quarter of the 20th Century this new form of non-corporate organization became available in the United States and other countries, and was known as the *limited liability company* or *LLC*. Since the GmbH and LLC forms of organization are technically not corporations (even though they have many of the same features), they will not be discussed in this article.

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History

The word "corporation" derives from *corpus*, the Latin word for body, or a "body of people". By the time of Justinian (reigned 527–565), Roman law recognized a range of corporate entities under the names *universitas*, *corpus* or *collegium*. These included the state itself (the *Populus Romanus*), municipalities, and such private associations as sponsors of a religious cult, burial clubs, political groups, and guilds of craftsmen or traders. Such bodies commonly had the right to own property and make contracts, to receive gifts and legacies, to sue and be sued, and, in general, to perform legal acts through representatives. Private associations were granted designated privileges and liberties by the emperor.[6]

1/8 share of the Stora Kopparberg mine, dated June 16, 1288.

Entities which carried on business and were the subjects of legal rights were found in ancient Rome, and the Maurya Empire in ancient India.[7] In medieval Europe, churches became incorporated, as did local governments, such as the Pope and the City of London Corporation. The point was that the incorporation would survive longer than the lives of any particular member, existing in perpetuity. The alleged oldest commercial corporation in the world, the Stora Kopparberg mining community in Falun, Sweden, obtained a charter from King Magnus Eriksson in 1347.

In medieval times, traders would do business through common law constructs, such as partnerships. Whenever people acted together with a view to profit, the law deemed that a partnership arose. Early guilds and livery companies were also often involved in the regulation of competition between traders.

Mercantilism

The progenitors of the modern corporation were the chartered companies, such as the Dutch East India Company (VOC) and the Hudson's Bay Company, which were created to lead the colonial ventures of European nations in the 17th century. Acting under a charter sanctioned by the Dutch government, the Dutch East India Company defeated Portuguese forces and established itself in the Moluccan Islands in order to profit from the European demand for spices. Investors in the VOC were issued paper certificates as proof of share ownership, and were able to trade their shares on the original Amsterdam Stock Exchange. Shareholders were also explicitly granted limited liability in the company's royal charter.[22]

Replica of an East Indiaman of the Dutch East India Company/United East Indies Company. The Dutch East India Company (VOC)[8] is often considered by many to be the first historical model of the modern corporation.[9][10][11][12][13][14][15][16] The VOC was also the first permanently organized limited-liability joint-stock corporation, with a permanent capital base.[17][18][19][20][21]

In England, the government created corporations under a royal charter or an Act of Parliament with the grant of a monopoly over a specified territory. The best-known example, established in 1600, was the East India Company of London. Queen Elizabeth I granted it the exclusive right to trade with all countries to the east of the Cape of Good Hope. Some corporations at this time would act on the government's behalf, bringing in revenue from its exploits abroad. Subsequently, the Company became increasingly integrated with English and later British military and colonial policy, just as most corporations were essentially dependent on the Royal Navy's ability to control trade routes.

Labeled by both contemporaries and historians as "the grandest society of merchants in the universe", the English East India Company would come to symbolize the dazzlingly rich potential of the corporation, as well as new methods of business that could be both brutal and exploitative.[23] On 31 December 1600, Queen Elizabeth I granted the company a 15-year monopoly on trade to and from the East Indies and Africa.[24] By 1711, shareholders in the East India Company were earning a return on their investment of almost 150 per cent. Subsequent stock offerings demonstrated just how lucrative the Company had become. Its first stock offering in 1713–1716 raised £418,000, its second in 1717–1722 raised £1.6 million.[25]

A similar chartered company, the South Sea Company, was established in 1711 to trade in the Spanish South American colonies, but met with less success. The South Sea Company's monopoly rights were supposedly backed by the Treaty of Utrecht, signed in 1713 as a settlement following the War of the Spanish Succession, which gave Great Britain an *asiento* to trade in the region for thirty years. In fact the Spanish remained hostile and let only one ship a year enter. Unaware of the problems, investors in Britain, enticed by extravagant promises of profit from company promoters bought thousands of shares. By 1717, the South Sea Company was so wealthy (still having done no real business) that it assumed the public debt of the British government. This accelerated the inflation of the share price further, as did the

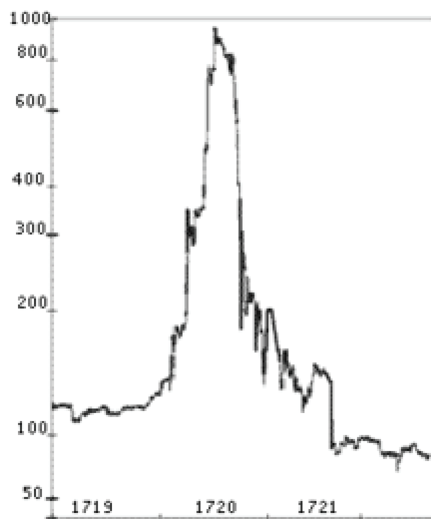
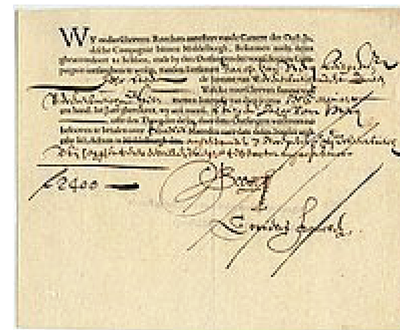


Chart of the South Sea Company's stock prices. The rapid inflation of the stock value in the 1710s led to the Bubble Act 1720, which restricted the establishment of companies without a royal charter.



A bond issued by the Dutch East India Company (VOC), dating from 1623, for the amount of 2,400 florins

Bubble Act 1720, which (possibly with the motive of protecting the South Sea Company from competition) prohibited the establishment of any companies without a Royal Charter. The share price rose so rapidly that people began buying shares merely in order to sell them at a higher price, which in turn led to higher share prices. This was the first speculative bubble the country had seen, but by the end of 1720, the bubble had "burst", and the share price sank from £1000 to under £100. As bankruptcies and recriminations ricocheted through government and high society, the mood against corporations and errant directors was bitter.

In the late 18th century, Stewart Kyd, the author of the first treatise on corporate law in English, defined a corporation as:

> a collection of many individuals united into one body, under a special denomination, having perpetual succession under an artificial form, and vested, by policy of the law, with the capacity of acting, in several respects, as an individual, particularly of taking and granting property, of contracting obligations, and of suing and being sued, of enjoying privileges and immunities in common, and of exercising a variety of political rights, more or less extensive, according to the design of its institution, or the powers conferred upon it, either at the time of its creation, or at any subsequent period of its existence.
>
> — A Treatise on the Law of Corporations, Stewart Kyd (1793–1794)

Development of modern company law

Due to the late 18th century abandonment of mercantilist economic theory and the rise of classical liberalism and laissez-faire economic theory due to a revolution in economics led by Adam Smith and other economists, corporations transitioned from being government or guild affiliated entities to being public and private economic entities free of governmental directions.[26] Smith wrote in his 1776 work *The Wealth of Nations* that mass corporate activity could not match private entrepreneurship, because people in charge of others' money would not exercise as much care as they would with their own.[27]

Deregulation

The British Bubble Act 1720's prohibition on establishing companies remained in force until its repeal in 1825. By this point, the Industrial Revolution had gathered pace, pressing for legal change to facilitate business activity.[28] The repeal was the beginning of a gradual lifting on restrictions, though business ventures (such as those chronicled by Charles Dickens in *Martin Chuzzlewit*) under primitive companies legislation were often scams. Without cohesive regulation, proverbial operations like the "Anglo-Bengalee Disinterested Loan and Life Assurance Company" were

undercapitalised ventures promising no hope of success except for richly paid promoters.[29]

"Jack and the Giant Joint-Stock", a cartoon in *Town Talk* (1858) satirizing the 'monster' joint-stock economy that came into being after the Joint Stock Companies Act 1844.

The process of incorporation was possible only through a royal charter or a private act and was limited, owing to Parliament's jealous protection of the privileges and advantages thereby granted. As a result, many businesses came to be operated as unincorporated associations with possibly thousands of members. Any consequent litigation had to be carried out in the joint names of all the members and was almost impossibly cumbersome. Though Parliament would sometimes grant a private act to allow an individual to represent the whole in legal proceedings, this was a narrow and necessarily costly expedient, allowed only to established companies.

Then, in 1843, William Gladstone became the chairman of a Parliamentary Committee on Joint Stock Companies, which led to the Joint Stock Companies Act 1844, regarded as the first modern piece of company law.[30] The Act created the Registrar of Joint Stock Companies, empowered to register companies by a two-stage process. The first, provisional, stage cost £5 and did not confer corporate status, which arose after completing the second stage for another £5. For the first time in history, it was possible for ordinary people through a simple registration procedure to incorporate.[31] The advantage of establishing a company as a separate legal person was mainly administrative, as a unified entity under which the rights and duties of all investors and managers could be channeled.

Limited liability

However, there was still no limited liability and company members could still be held responsible for unlimited losses by the company.[32] The next, crucial development, then, was the Limited Liability Act 1855, passed at the behest of the then Vice President of the Board of Trade, Mr. Robert Lowe. This allowed investors to limit their liability in the event of business failure to the amount they invested in the company – shareholders were still liable directly to creditors, but just for the unpaid portion of their shares. (The principle that shareholders are liable to the corporation had been introduced in the Joint Stock Companies Act 1844).

The 1855 Act allowed limited liability to companies of more than 25 members (shareholders). Insurance companies were excluded from the act, though it was standard practice for insurance contracts to exclude action against individual members. Limited liability for insurance companies was allowed by the Companies Act 1862.

This prompted the English periodical *The Economist* to write in 1855 that "never, perhaps, was a change so vehemently and generally demanded, of which the importance was so much overrated."[33] The major error of this judgment was recognised by the same magazine more than 70 years later, when it claimed that, "[t]he economic historian of the future... may be inclined to assign to the nameless inventor of the principle of limited liability, as applied to trading corporations, a place of honour with Watt and Stephenson, and other pioneers of the Industrial Revolution. "[34]

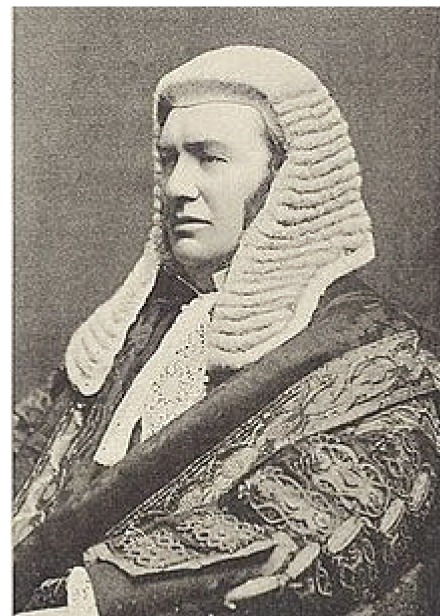
These two features – a simple registration procedure and limited liability – were subsequently codified into the landmark 1856 Joint Stock Companies Act. This was subsequently consolidated with a number of other statutes in the Companies Act 1862, which remained in force for the rest of the century, up to and including the time of the decision in

Salomon v A Salomon & Co Ltd.[35]

The legislation shortly gave way to a railway boom, and from then, the numbers of companies formed soared. In the later nineteenth century, depression took hold, and just as company numbers had boomed, many began to implode and fall into insolvency. Much strong academic, legislative and judicial opinion was opposed to the notion that businessmen could escape accountability for their role in the failing businesses.

Further developments

In 1892, Germany introduced the Gesellschaft mit beschränkter Haftung with a separate legal personality and limited liability even if all the shares of the company were held by only one person. This inspired other countries to introduce corporations of this kind.



Lindley LJ was the leading expert on partnerships and company law in the *Salomon v. Salomon & Co.* case. The landmark case confirmed the distinct corporate identity of the company.

The last significant development in the history of companies was the 1897 decision of the House of Lords in *Salomon v. Salomon & Co.* where the House of Lords confirmed the separate legal personality of the company, and that the liabilities of the company were separate and distinct from those of its owners.

In the United States, forming a corporation usually required an act of legislation until the late 19th century. Many private firms, such as Carnegie's steel company and Rockefeller's Standard Oil, avoided the corporate model for this reason (as a trust). State governments began to adopt more permissive corporate laws from the early 19th century, although these were all restrictive in design, often with the intention of preventing corporations from gaining too much wealth and power.[36]

New Jersey was the first state to adopt an "enabling" corporate law, with the goal of attracting more business to the state,[37] in 1896. In 1899, Delaware followed New Jersey's lead with the enactment of an enabling corporate statute, but Delaware only became the leading corporate state after the enabling provisions of the 1896 New Jersey corporate law were repealed in 1913.[36]

The end of the 19th century saw the emergence of holding companies and corporate mergers creating larger corporations with dispersed shareholders. Countries began enacting anti-trust laws to prevent anti-competitive practices and corporations were granted more legal rights and protections. The 20th century saw a proliferation of laws allowing for the creation of corporations by registration across the world, which helped to drive economic booms in many countries before and after World War I. Another major post World War I shift was toward the development of conglomerates, in which large corporations purchased smaller corporations to expand their industrial base.

Starting in the 1980s, many countries with large state-owned corporations moved toward privatization, the selling of publicly owned (or 'nationalised') services and enterprises to corporations. Deregulation (reducing the regulation of corporate activity) often accompanied privatization as part of a laissez-faire policy.

Ownership and control

A corporation is, at least in theory, owned and controlled by its members. In a joint-stock company the members are known as shareholders and each of their shares in the ownership, control, and profits of the corporation is determined by the portion of shares in the company that they own. Thus a person who owns a quarter of the shares of a joint-stock company owns a quarter of the company, is entitled to a quarter of the profit (or at least a quarter of the profit given to shareholders as dividends) and has a quarter of the votes capable of being cast at general meetings.

In another kind of corporation, the legal document which established the corporation or which contains its current rules will determine who the corporation's members are. Who a member is depends on what kind of corporation is involved. In a worker cooperative, the members are people who work for the cooperative. In a credit union, the members are people who have accounts with the credit union.[38]

The day-to-day activities of a corporation are typically controlled by individuals appointed by the members. In some cases, this will be a single individual but more commonly corporations are controlled by a committee or by committees. Broadly speaking, there are two kinds of committee structure.

- A single committee known as a board of directors is the method favored in most common law countries. Under this model, the board of directors is composed of both executive and non-executive directors, the latter being meant to supervise the former's management of the company.
- A two-tiered committee structure with a supervisory board and a managing board is common in civil law countries.[39]

Formation

Historically, corporations were created by a charter granted by government. Today, corporations are usually registered with the state, province, or national government and regulated by the laws enacted by that government. Registration is the main prerequisite to the corporation's assumption of limited liability. The law sometimes requires the corporation to designate its principal address, as well as a registered agent (a person or company designated to receive legal service of process). It may also be required to designate an agent or other legal representative of the corporation.

Generally, a corporation files articles of incorporation with the government, laying out the general nature of the corporation, the amount of stock it is authorized to issue, and the names and addresses of directors. Once the articles are approved, the corporation's directors meet to create bylaws that govern the internal functions of the corporation, such as meeting procedures and officer positions.

The law of the jurisdiction in which a corporation operates will regulate most of its internal activities, as well as its finances. If a corporation operates outside its home state, it is often required to register with other governments as a foreign corporation, and is almost always subject to laws of its host state pertaining to employment, crimes, contracts, civil actions, and the like.

Naming

Corporations generally have a distinct name. Historically, some corporations were named after their membership: for instance, "The President and Fellows of Harvard College". Nowadays, corporations in most jurisdictions have a distinct name that does not need to make reference to their membership. In Canada, this possibility is taken to its logical extreme: many smaller Canadian corporations have no names at all, merely numbers based on a registration number (for example, "12345678 Ontario Limited"), which is assigned by the provincial or territorial government where the corporation incorporates.

In most countries, corporate names include a term or an abbreviation that denotes the corporate status of the entity (for example, "Incorporated" or "Inc." in the United States) or the limited liability of its members (for example, "Limited" or "Ltd."). These terms vary by jurisdiction and language. In some jurisdictions, they are mandatory, and in others they are not.[40] Their use puts everybody on constructive notice that they are dealing with an entity whose liability is limited: one can only collect from whatever assets the entity still controls when one obtains a judgment against it.

Some jurisdictions do not allow the use of the word "**company**" alone to denote corporate status, since the word "company" may refer to a partnership or some other form of collective ownership (in the United States it can be used by a sole proprietorship but this is not generally the case elsewhere).

Personhood

Despite not being individual human beings, corporations, as far as US law is concerned, are legal persons, and have many of the same rights and responsibilities as natural persons do. For example, a corporation can own property, and can sue or be sued. Corporations can exercise human rights against real individuals and the state,[41][42] and they can themselves be responsible for human rights violations.[43] Corporations can be "dissolved" either by statutory operation, order of court, or voluntary action on the part of shareholders. Insolvency may result in a form of corporate failure, when creditors force the liquidation and dissolution of the corporation under court order,[44] but it most often results in a restructuring of corporate holdings. Corporations can even be convicted of criminal offenses, such as fraud and manslaughter. However, corporations are not considered living entities in the way that humans are.[45]

See also

Law

- Commercial law
- United States corporate law
- European corporate law
- German company law
- History of company law in the United Kingdom
- United Kingdom company law

Other

- Anti-corporate activism
- Business attire
- Blocker corporation
- Community interest company
- Cooperative
- Corporate crime
- Corporate governance
- Corporate group
- Corporate haven
- Corporate welfare
- Corporation sole
- Corporatism
- Corporatization
- Decentralized autonomous organization
- Evil corporation

- Fascism
- Good standing
- Government-owned corporation
- History of competition law
- Incorporation (business)
- Limited liability company
- Living wage
- Megacorporation
- Multinational corporation
- Nationalization
- Nonprofit corporation
- Organizational culture
- Preferred stock
- Privatization
- Professional corporation (PC or P.C.)
- Public limited company (PLC)
- Shelf corporation
- Small business
- South Sea Company
- Tulip mania
- United States antitrust law
- Unlimited company
- Unlimited liability corporation

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42. e.g. South African Constitution Sect.8, especially Art.(4)
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External links

- US Corporate Law at Wikibooks
- an Audio from a talk about the history of corporations and the English Law by Barrister Daniel Bennett (http://www.brh.org.uk/dwtf2008/kcc.html)

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HARVARD
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HISTORY OF THE LAW OF BUSINESS CORPORATIONS BEFORE 1800.

I.

THE most striking peculiarity found on first examination of the history of the law of business corporations is the fact that different kinds of corporations are treated without distinction, and, with few exceptions, as if the same rules were applicable to all alike. Subdivisions into special kinds are indeed made, but the classification is based on differences of fact rather than on differences in legal treatment. Thus, corporations are divided into sole and aggregate. Again, they are divided into ecclesiastical and lay, and lay corporations are again divided into eleemosynary and civil. But the division having been made, the older authors [1] proceed to treat them all together, now and then recording some minor peculiarity of a corporation sole or of an ecclesiastical corporation with one member capable.

Municipal and business corporations, so unlike according to modern ideas, are classed together as civil corporations, and treated together along with the rest. Yet the East India Company was chartered in 1600, and other trading companies had been chartered even earlier, and between 1600 and 1800 numer-

[1] *E. g.*, Coke, in Sutton's Hospital Case, 10 Rep. 1, The Law of Corporations, 1 Blacks. Com. ch. xviii., Kyd on Corporations.

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ous corporations were chartered, having for their objects, trade, fishing, mining, insurance, and other business purposes. To understand how it was that the law of business corporations was so connected with that of other corporations, and how it gradually became distinguished, it is necessary to understand how such corporations grew up, and in what way they were regarded when first they came into existence.

The general idea of a corporation, a fictitious legal person, distinct from the actual persons who compose it, is very old. Blackstone ascribes to Numa Pompilius the honor of originating the idea.[1] Angell and Ames are of the opinion that it was known to the Greeks, and that the Romans borrowed it from them.[2] Sir Henry Maine, however, shows that primitive society was regarded by its members as made up of corporate bodies, that the units "were not individuals but groups of men united by the reality or the fiction of blood relationship," and that the family, clan, tribe, were recognized as distinct entities of society before individuals were.[3] It is not surprising, therefore, to find in the Roman law the conception of corporate unity early developed. Savigny, in whose treatise[4] may be found the best connected account of corporations in the Roman law, states that villages, towns, and colonies were the earliest. "But once established definitely for dependent towns, the institution of the legal person was extended little by little to cases for which one would hardly have thought of introducing it. Thus, it was applied to the old brotherhoods of priests and of artisans; then, by way of abstraction, to the State, which, under the name of *fiscus*, was treated as a person and placed within the jurisdiction of the court. Finally, to subjects of a purely ideal nature, such as gods and temples." Savigny then enumerates the different kinds of corporations among the Romans. The present subject is concerned with but one of these, — the business associations. "To this class belong the old corporations of artisans who always continued to exist, and of whom some, the blacksmiths, for example, had particular privileges; also new corporations, such as the bakers of Rome, and the boatmen at Rome and in the provinces. Their interests were of the

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[1] 1 Blacks. Com. 468.
[2] Angell and Ames on Corp. (1st ed.).
[3] Ancient Law (4th ed.), 183.
[4] System des Heutigen Römischen Rechts, vol. ii. § 86 *et seq.*

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same nature, and this served as the basis of their association, but each one worked, as to-day, on his own account."

"There were also business enterprises carried on in common and under the form of legal persons. They were ordinarily called *societates*. Their nature was, in general, purely contractual; they incurred obligations, and they were dissolved by the will as well as by the death of a single member. Some of them obtained the right of being a corporation, keeping always, however, the name of *societates*. Such were the associations for working mines, salt-works, and for collecting taxes."[1]

This latter kind of corporation seems never to have become sufficiently numerous or important to exert a definite influence on the law. Perhaps the Romans were not a sufficiently commercial people to develop the uses of business corporations. In common with other associations the authorization of the supreme power of the State was needed to constitute them legal persons, though this might be given by tacit recognition;[2] and the assent of the sovereign was equally necessary for dissolution. Three members were requisite for the formation of a corporation, though not for its continued existence. The rights and duties of the fictitious person corresponded closely to those of an actual person, so far as the nature of the case admitted. It could hold and deal with property, enjoy *usufructus*, incur obligations, and compel its members to contribute to the payment of its debts, inherit by succession either testamentary or by patronage, and take a legacy. Whether it could commit a tort was a disputed question.

After the introduction of Christianity the church found numerous applications in its own organization for the doctrines which had been developed in regard to corporations, and through the church and its officials these doctrines strongly influenced the law of England, where they were applied to the existing associations.

The earliest corporate associations in England seem to have

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[1] Savigny, System etc., § 88.

[2] Blackstone is, therefore, in error in saying (1 Com. 472) that by the civil law the voluntary association of the members was sufficient unless contrary to law — an error probably caused by the fact that penalties were imposed on certain forbidden associations in the nature of clubs for acting without the authorization of the State, and only on these.

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been peace-guilds, the members of which were pledged to stand by each other for mutual protection.[1] Such brotherhoods would naturally be formed by neighbors or by those exercising similar occupations. From the tendency to associate on account of proximity of residence were developed municipal corporations; from the tendency to associate on account of similarity of occupation the craft guilds grew. These two classes of corporations were the earliest regularly chartered lay corporations in England. Both of them had their counterparts in the Roman law.[2] At first sight they do not seem to have much in common, but the ancient municipal corporation differed from its modern descendant. It was a real association, and membership could not be acquired simply by residing within the town limits. It exercised a minute supervision over the inhabitants, — among other things regulating trades. The guilds or companies did the same thing, only on a more restricted scale. They made by-laws governing their respective trades, which were not simply such regulations as a modern trade-union might make, since any one carrying on a trade, though not a member of the guild of that trade, was bound by its by-laws, so long as they were not opposed to the law of the land or to public policy as it was then conceived.[3] In short, the guilds exercised a power similar to that exercised by the municipal corporations, and, indeed, so late as the time of Henry VI. guildated and incorporated were synonymous terms.[4] Instead of having for its field all inhabitants of a district and local legislation of every character, the guild was confined to such inhabitants of the district as carried on a certain trade and to regulations suitable for that trade. So far as that trade was concerned the right of government belonged to the guild.

The first trades to become organized in this way were naturally the manual employments necessary to provide the community with the most fundamental necessities of civilized life. The weavers were the earliest. They received a charter from Henry II., "with all the freedom they had in the time of Henry I." The goldsmiths were chartered in 1327, the mercers in 1373, the

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[1] See History of Guilds, Luigi Brentano.

[2] For an account of guilds at Rome see "Les Sociétés Ouvrières à Rome," 96 Rev. des Deux Mondes, 626, by Gaston Boissier.

[3] Butchers' Company *v.* Morey, 1 H. Bl. 370; Kirk *v.* Nowill, 1 T. R. 118.

[4] Madox, Firma Burgi, 29.

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haberdashers in 1407, the fishmongers in 1433, the vintners in 1437, the merchant tailors in 1466.[1]

During the sixteenth century the growth of the commercial spirit, fostered by the recent discovery of the New World, the more thorough exploration of the Southern Atlantic and Indian Oceans, and the search for a North-west passage, led to the establishment and incorporation of companies of foreign adventurers, similar in all respects to the earlier guilds, except that their members were foreign instead of domestic traders. Among the earliest of these were the African Company, the Russia Company, and the Turkey Company.[2] The last two were called "regulated companies"; that is, the members had a monopoly of the trade to Russia and to Turkey, but each member traded on his own account.

A more famous company was chartered by Queen Elizabeth in 1600, under the name of the Company of Merchants of London, trading to the East Indies.[3] It had been found that the expense incident to fitting out ships for voyages, often taking several years for their completion, was too great to be borne easily by individual merchants, and it was one of the claims to favorable consideration which the East India Company put forward, that "noblemen, gentlemen, shopkeepers, widows, orphans, and all other subjects may be traders, and employ their capital in a joint stock."[4]

Sums of various amounts were subscribed, and the profits were to be distributed in the same proportions. This joint-stock adventure was not, however, identical with the corporation. Members of the corporation were not necessarily subscribers to the joint stock, and any member could, if he liked, carry on private trade with the Indies, — a privilege belonging exclusively to members. By the charter, apprentices and sons of members were to be admitted to membership in the same way as was customary in the guilds.

The East India Company was, therefore, in its early days, like the other trading companies, — an association of a class of merchants to which was given the monopoly of carrying on a particular trade, and

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[1] 1 And. Hist. of Commerce, 250. [2] Knight's Hist. of England, vol. v. 39.

[3] What follows in regard to the East India Company is based on "The History of European Commerce with India," by David Macpherson, London, 1812, and documents therein quoted.

[4] From the defence of the Company in the Privy Council, 2 And. Hist. Com. 173.

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the right to make regulations in regard to it. Till 1614 the joint stock was subscribed for each voyage separately, and at the end of the voyage was redivided. After that, for many years, the joint stock was subscribed for a longer or shorter term of years, and at the end of each term the old stock was usually taken at a valuation by the new subscribers. Membership in the corporation, however, soon became merely a formal matter, — useless, except to those interested in the joint stock, especially as regulations were passed forbidding other members from engaging in private trading ventures to India. After 1692 no private trading of any kind was allowed except to the captains and seamen of the Company's ships. The form, however, was still retained, and every purchaser of stock who was not a member of the Company was obliged to pay a fee of £5 for membership.

At this time (1692) there were but two other joint-stock companies of any importance in England, — the Royal African Company and the recently chartered[1] Hudson's Bay Company. The outline given above will serve to indicate their general nature and also to show how something like the modern joint-stock corporation grew out of the union of the ideas of association for the government of a particular trade by those who carried it on, and of combination of capital and mutual coöperation, suggested and made necessary by the great expense incident to carrying on trade with distant countries. But the corporation was far from being regarded as simply an organization for the more convenient prosecution of business. It was looked on as a public agency, to which had been confided the due regulation of foreign trade, just as the domestic trades were subject to the government of the guilds. In a little book, entitled "The Law of Corporations," published anonymously in 1702,[2] it is said: "The general intent and end of all civil incorporations is for better government, either general or special. The corporations for general government are those of cities and towns, mayor and citizens, mayor and burgesses, mayor and commonalty, etc. Special government is so called because it is remitted to the managers of particular things, as trade, charity, and the like, for government, whereof several companies and corporations for trade were erected, and several hospitals and houses for charity."[3]

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[1] 1670. [2] This is the first English book wholly devoted to the subject of corporations.
[3] Law of Corporations, p. 2.

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This idea that the object of a business corporation is the public one of managing and ordering the trade in which it is engaged, as well as the private one of profit for its members, may also be noticed in the charters granted to new corporations, especially in the recitals, and in the provisions usually found that the newly chartered company shall have the exclusive control of the trade intrusted to it.

At the end of the seventeenth century the advantages of corporate enterprises seem to have been realized, and acts of Parliament, authorizing the king to grant charters to various business associations, were more frequent. In 1692 the Company of Merchants of London trading to Greenland was incorporated;[1] the act reciting the great importance of the Greenland trade, how it had fallen into the hands of other nations, and could only be regained by a greater undertaking than would be possible for a private individual, and the consequent necessity of a joint-stock company. In 1694 the Bank of England received its first charter.[2] The act authorizing it was essentially a scheme to raise money for the government. Those who advanced money to the government were to receive a corresponding interest in the bank, the capital of which was to consist of the debt of the government. No other association of more than six persons was allowed to carry on a similar business.[3] Charters were also granted about this time to the National Land Bank,[4] the Royal Lustring Company,[5] the Company of Mine Adventurers,[6] the famous South Sea Company,[7] the Royal Exchange and the London (Marine) Assurance Companies.[8] In these charters also the public interest in having the undertaking prosecuted and the great expense incident thereto are mentioned. The capital of the South Sea Company, like that of the Bank, consisted of a debt due from the government on account of money loaned by private individuals.

The extravagant commercial speculations in joint-stock companies and the stock-jobbing in their shares which characterized the early part of the eighteenth century are well known. Anderson, in his "History of Commerce,"[9] enumerates upwards of

[1] 4 and 5 Wm. III., c. 17.
[2] 5 and 6 Wm. III., c. 20.
[3] By Stat. 6 Anne, c. 22. § 9.
[4] 7 and 8 Wm. III., c. 31.
[5] 9 and 10 Wm. III., c. 43.
[6] See 9 Anne, c. 24.
[7] 9 Anne, c. 21.
[8] 6 Geo. I., c. 18.
[9] Vol. i. (1st ed.) 291 *et seq.*

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two hundred companies formed about the year 1720, for the prosecution of every kind of enterprise, including one for the "Insurance and Improvement of Children's Fortunes," and another for "Making Salt Water Fresh." With very few exceptions, these companies were not incorporated and in 1720 writs of *scire facias* were issued,[1] directing an inquiry as to their right to carry on business, in usurpation of corporate powers. This put a sudden end to many of these unfortunate ventures, and the consequent collapse of the enormously inflated public credit carried down others, so that only four of the long list were still in existence when Anderson wrote, — the York Buildings Company, the two Assurance Companies mentioned above, and the English Copper Company. The speculation in shares had been too great and the expectations of profit too extravagant not to cause a correspondingly great distrust in corporate enterprises when the bubble burst, and the profits realized were found to be small and extremely variable. Adam Smith, writing in 1776, was of opinion,[2] that "the only trades which it seems possible for a joint-stock company to carry on successfully without an exclusive privilege, are those of which all the operations are capable of being reduced to what is called routine, or to such a uniformity of method as admits of little or no variation. Of this kind is, *first*, the banking trade; *secondly*, the trade of insurance from fire, and from sea risk and capture in time of war; *thirdly*, the trade of making and maintaining a navigable cut or canal; and, *fourthly*, the similar trade of bringing water for the supply of a great city." To render the establishment of a joint stock reasonable, however, the author says, two other circumstances should concur: first, "that the undertaking is of greater and more general utility than the greater part of common trades; and, secondly, that it requires a greater capital than can easily be collected into a private copartnery."

But during the latter part of the eighteenth century corporations were gradually increasing in number and importance. The need for them was felt in establishing canals, water-works, and, to some extent, in conducting the growing manufactures of the kingdom. The progress was indeed slow, and was destined to be so until the introduction of gas-lighting into all the larger cities and

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1 And. Hist. Com., Vol. ii. 296.

2 Wealth of Nations, book v. ch. 1. art. 5.

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towns early in the present century, and later the laying of railways, created a wide-spread necessity for united capital.

The outline sketch just given of the growth of business corporations shows that they are not a spontaneous product, but are rather the result of a gradual development of earlier institutions, running back farther than can be traced. It would be strange if signs of this development were not found in the history of the law relating to them. The natural expectation would be, and such is in fact the case, that as to the points which modern business corporations have in common with the early guilds and municipalities, the law relating to them dates back farther than almost any other branch of the law, while as to the points which belong exclusively to the conception of the business corporation, the law has been formed very largely since 1800. And not only had a body of new law to be thus formed, but old doctrines laid down by early judges as true of all corporations, though in reality suited only to the kinds of corporations then existing, had to be discarded or adapted to changed conditions.

In the first place, then, the endeavor will be to examine the points which belong essentially to every kind of corporation, and afterwards to consider what was settled before the present century in regard to the peculiar relations arising from the nature of a business corporation.

In the case of Sutton's Hospital,[1] decided in 1612, the general law of corporations was considered at some length, and the following things were said to be "of the essence of a corporation:[2] 1st, Lawful authority of incorporation, and that may be by four means, viz., by the common law, as the king himself, etc.; by authority of Parliament; by the king's charter; and by prescription. The 2d, which is of the essence of the incorporation, are persons to be incorporated, and that in two manners; viz., persons natural, or bodies incorporate and political. 3d, A name by which they are incorporated. 4th, Of a place, for without a place no incorporation can be made. 5th, By words sufficient in law, but not restrained to any certain, legal, and prescript form of words."

This, then, was the mould in which every corporation had to be cast, regardless of what might be its nature or its purpose.

The first requirement, due authorization, existed in the Roman

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[1] 10 Rep. 22 b. [2] 10 Rep. 29 b.

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law as well as in English.[1] But, since corporate bodies were recognized as facts from the earliest dawn of history, when the rule became recognized that the authority of the supreme power of the State was necessary for their formation, a theory had to be found to support the old associations, which had not been formed in accordance with the rule. This was done both in Roman and in English law by recognizing that a corporation could come into existence by prescription. It is safe to say, however, that prescriptive and common-law corporations, were of the older forms only, and that for the formation of business corporations, from the first, a charter from the king directly or by authority of Parliament was necessary.

Originally the power was exercised exclusively by the king; but his power to grant charters allowing exemptions or monopolies was gradually restricted, like many of his other powers, as little by little the House of Commons assumed the entire effective control of the government. The regulated Russia Company received its charter from the crown in 1555 without the consent of Parliament; so did the East India Company in 1600, the Canary Company in 1665, the Hudson's Bay Company in 1670. All of these companies were given monopolies. The rights of the Russia Company and of the East India Company were afterwards regulated by statute; and the patent of the Canary Company was soon withdrawn, though not before giving rise to a test case[2] on the validity of the monopoly, in which the court decided against it. The Hudson's Bay Company continued to enjoy its charter without interference, but its right to a monopoly held good so long only as nobody cared to dispute it. After the Revolution, no doubt, it was tacitly admitted that for the validity of a charter conferring a monopoly or other special privilege an act of Parliament was necessary, though for granting the simple franchise of acting as a corporation the patent of the king was sufficient.

The last of the requisites enumerated by Coke may be regarded as included within the first. "Lawful authority of incorporation" must necessarily be given "by words sufficient in law." The necessity for persons to compose the corporation results from the nature of things rather than from any rule of law. Perhaps the same may be said of the importance of a name. As an actual

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[1] See *supra*, p. 107.

[2] Horne *v.* Ivy, 1 Ventr. 47.

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person could hardly transact business or sue and be sued in the courts without a name, so the fictitious person of a corporation rests under a similar necessity. Possibly Coke meant something more, regarding a corporation as an abstraction which would have no existence without a name. "For a corporation aggregate of many is invisible, immortal, and rests only in intendment and consideration of the law."[1] But if such was his view, it was not shared by his successors, when the tinge of scholasticism which colored all the law of the period faded away. In the case of the Dutch West India Company *v.* Van Moses,[2] decided in 1724, it was held that the action was well brought, though no certain name had been given the company by the Dutch States, the name being that by which it was usually called; and there are numerous cases to the effect that a technical misnomer of a corporation had even less effect than the misnomer of an individual.[3]

When Coke wrote, it seems to have been necessary that a corporation should be named as of a certain place.[4] This requirement, apparently so fanciful, is explained by the fact that the early corporations were almost all formed for local or special government of some kind, and it was consequently necessary to designate the place where the jurisdiction was to be exercised. The requisite must very early have become merely formal in case of certain classes of corporations, and might be fictitious. Thus, such names may be found as, "The Hospital of St. Lazarus of Jerusalem in England" and "The Prior and Brothers of St. Mary of Mt. Carmel in England."[5] As the purpose for which corporations were instituted became more varied, and the modes of thought of lawyers became more reasonable, less stress was laid on the formality under consideration. It is hardly mentioned in "The Law of Corporations" or in Blackstone's chapter.[6] Kyd merely says, "It is generally denominated of some place;[7] and it may be assumed as true of business corporations, as well as of most others, that before the beginning of the present century there was no

[1] Sutton's Hospital Case, 10 Rep. 32.

[2] 1 Stra. 612; and see the Law of Corporations, 13. Also, if the name of a corporation be changed, it retains its possessions, debts, etc. Bishop of Rochester's Case, Owen, 73; s. c. 2 And. 107; Luttrel's Case, 4 Rep. 87 b; Mayor of S. *v.* Butler, 3 Lev. 237; Haddock's Case, 1 Ventr. 355.

[3] Kyd, 236 *et seq.*

[4] Button *v.* Wrightman, Cro. Eliz. 338.

[5] Rol. 512.

[6] Blacks. Com. ch. xviii.

[7] 1 Kyd, 228.

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force in Coke's fifth essential for the existence of a corporation other than as a matter of convenience.[1]

Grant, now, that a corporation was legally called into being, what abilities and disabilities was it considered to have? Coke says:[2] "When a corporation is duly created all other incidents are tacitly annexed — . . . and therefore divers clauses subsequent in the charters are not of necessity, but only declaratory and might well be left out; as —

"1st. By the same to have authority, ability, and capacity to purchase, but no clause is added that they may alien, etc., and it need not, for it is an incident.

"2d. To sue and be sued, implead and be impleaded.

"3d. To have a seal; that is also declaratory, for when they are incorporated they may make or use what seal they will.

"4th. To restrain them from aliening or devising but in certain form; that is an ordinance testifying the king's desire, but it is but a precept and does not bind in law.

"5th. That the survivors shall be a corporation; that is a good clause to oust doubts and questions which might arise, the number being certain.

"6th. If the revenues increase, that they shall be used to increase the number of the poor, etc.; that is also explanatory.

"8th. To make ordinances; that is requisite for the good order and government of the poor, etc., but not to the essence of the incorporation.

"10th. The license to purchase in mortmain is necessary for the maintenance and support of the poor, for without revenues they cannot live, and without a license in mortmain they cannot lawfully purchase revenues, and yet that is not of the essence of the corporation, for the corporation is perfect without it."

This list of attributes laid down by Coke as necessarily belonging to all corporations is quoted with approval in "The Law of Corporations."[3] It is given by Blackstone in substance, though altered to the following form:[4]

The incidents which are tacitly annexed to every corporation as soon as it is duly erected are —

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[1] See Mayor of Stafford *v.* Bolton, 1 B. & P. 40.

[2] Sutton's Hospital Case, 10 Rep. 30, citing as authority 22 Edw. IV., Grants, 30.

[3] p. 16.

[4] 1 Blackst. Com. 475; also in Wood's Inst. of the Laws of Eng., bk. i. ch. viii.

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"1st. To have perpetual succession. This is the very end of its incorporation, for there cannot be a succession forever without an incorporation, and therefore all aggregate corporations have a power necessarily implied of electing members in the room of such as go off.

"2d. To sue or be sued, implead or be impleaded, grant or receive, by its corporate name, and do all other acts as natural persons may.

"3d. To purchase lands and hold them for the benefit of themselves and their successors, which two are consequential of the former.

"4th. To have a common seal. . . .

"5th. To make by-laws or private statutes for the better government of the corporation, which are binding on themselves, unless contrary to the law of the realm, and then they are void."

The enumeration of Blackstone is given without substantial alteration by Kyd,[1] though he adds that the last two powers are unnecessary for a corporation sole, and that the right to make by-laws is not inseparably incident to all kinds of corporations aggregate, for there are some to which rules may be prescribed; and, further, that the list is not exhaustive. The first three capacities are reducible to this, that the fictitious person of the corporation shall have, in general, the capacity of acting as an actual person, so far as the nature of the case admits. Such must have been the recognized law ever since corporations, as we understand the word, existed; for the conception of a corporation as a legal person, a conception going back farther than can be definitely traced, involves necessarily the consequence that before the law the corporation shall be treated like any other person. To this consequence there is a necessary exception in regard to such rights and duties as require an actual person for their subject.

The right and the necessity of having a corporate seal was probably in its origin simply the result of treating a corporation in the same way as an individual. The great antiquity of the custom of using seals is well known. It prevailed among the Jews and Persians,[2] as well as among the Romans. It was spread over all the countries whose systems of law were borrowed from the Romans, and it was introduced into England by the Normans.[3]

[1] Vol. i. p. 69.

[2] 2 Blackst. Com. 305; Genesis, xxxviii. 18; Esther, viii. 8; Jeremiah, xxxii. 10.

[3] 2 Blackst. Com. 306.

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In England, owing to the generally prevailing illiteracy, the use of the seal became the ordinary way of indicating the maker of a charter. The practice, apparently, was not the result of a desire for peculiar solemnity, but merely for indentification. The use and object of a corporate seal may be assumed to have been the same as of an individual seal. It is true that Blackstone[1] finds a reason for its use in the fact that "a corporation, being an invisible body, cannot manifest its intentions by any personal act or oral discourse; it therefore acts and speaks only by its common seal." But this reason, besides bearing on its face indications of having been invented after the fact, goes altogether too far. A corporation has no hand with which to affix its seal, and if it may perform that act by an agent, there is no reason in the nature of things why it should not do anything else by the same instrumentality.[2] And in the Roman law the use of a common seal was only a possible, not a necessary, way for a corporation to act.

When writing became a general accomplishment, the use of a seal for private documents was reserved for instruments of a peculiarly formal or solemn character. That a similar transition did not take place in the use of the seal of a corporation may be ascribed to the natural conservatism of a number of men acting in a body, and to the fact that from the character of early corporations the inconvenience of sealing all corporate contracts was not likely to be felt. However this may be, it was a rule of law well settled before business corporations came into existence that a corporation could only act by deed under its common seal. To the rule some slight exceptions were allowed, but only in few cases. Such a restriction could not fail to be extremely embarrassing to corporations, when they afterwards sprang up, the object of which was to carry on trade; and the development of the law on this point in regard to such corporations shows not so much a growth of legal doctrine, as an endeavor to do away with the inconvenient restraint imposed on all aggregate corporations, which had its origin when guilds and municipal and ecclesiastical associations were the only corporate bodies, — an endeavor that met with but indifferent success.[3]

The general rule seems to have been well settled in the fifteenth

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[1] 1 Com. 475.

[2] 1 Blackst. Com. (Sharswood's ed.) 475, n. 7.

[3] Taylor on Evidence (8th ed.), § 976 *et seq.*

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century, and it also appears that there were some slight exceptions to it.[1] Just what these were, was by no means definitely marked out. In Y. B. 4 Hy. VII. 17 b, one of the judges, Townsend, said: "A body corporate cannot make a feoffment or lease or anything relating to their inheritance without deed, but of offices and things which pertain to servants they can. For they can appoint plowmen and servants of husbandry without deed, and butlers and cooks and things of that kind, and can depute their servants to do anything without deed. They can do this because it is not in disinheritance of the corporation, but only by way of service, and it is the common course to justify by command of the body corporate, and not show anything from it." Brian, however, was of a contrary opinion, saying, "A body corporate can do none of those things without deed." Townsend's opinion undoubtedly made more sweeping exceptions than were afterwards allowed, but his statement that a corporation could appoint a cook or butler without a deed was for centuries cited as indicating the extent of the power of acting without using the corporate seal.[2] In Y. B. 7 Hy. VII. 9, it was held that the defendant in an action of trespass could not justify as acting for a corporation without showing authority by deed. Wood adds: "But of little things the law is otherwise, for it would be infinite if each little act was by deed, as, a command to their servants, to light a candle in church, or to make a fire, or such things." With this the court with one exception agreed. This statement of the law is based on a principle which continued to be decisive in the eighteenth as in the sixteenth century. In transactions which from their nature could be done under seal only with great inconvenience, the formality of sealing was dispensed with. The inconvenience might arise from the pettiness of the act, or from its being of every-day occurrence and necessity, or from the importance of immediate action. The exception was wrested by common sense from the scope of the rule.

Accordingly, when business corporations arose, it must have been tacitly admitted that the daily business need not all be transacted under seal. For instance, the bills of the Bank and of the East India Company were never sealed. The right to make

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[1] Y. Bks. 9 Edw. IV. 39, 4 Hy. VII. 17 b, 7 Hy. VII. 9.

[2] Horne *v.* Ivy, 1 Vent. 47; Dunston *v.* Imp. Gas Co., 3 B. & Ad. 125, 129; Tilson *v.* Warwick Gas Co., 4 B. & C. 962, 964.

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such bills was afterward defended and explained as necessarily implied in the powers given them by Parliament. These corporations "could not carry on their business without the making of such instruments, and they would cease to be bills or notes if under seal. It is clear, however, that this indulgence is not allowed by law to be extended beyond cases of absolute necessity."[1]

A more difficult point was raised in 1717, in the case of Rex *v.* Bigg,[2] the leading case before the present century on the extent to which a business corporation could act without the use of its seal. Bigg was charged with felony in altering a bank-note signed by one Adams, an officer of the bank. It was objected that Adams did not have authority under the seal of the bank to affix his name, and that consequently the altered instrument was not a valid obligation, and the prisoner was not guilty of forgery. The argument of Peere Williams for the prisoner is fully given, and the cases which he cites seem to bear him out in his contention that such an agent could not be appointed without deed; but a majority of the court held the prisoner guilty of felony. No opinion is given. It must be admitted that the decision involved some extension of the old rule that a cook or butler or servant for some petty purpose could be retained without a sealed instrument, but after this the law was settled that the regular servants and agents of a business corporation were to be regarded in a similar way.[3]

But, granting this, how far could an agent of such a corporation act in its behalf without a deed? As mentioned above, a corporation, the charter of which authorized it to carry on a business that required for its proper exercise the issue of bills and notes, did not need to affix the common seal to such obligations. Undoubtedly, also, a large amount of routine business was transacted entirely by parol, and there is no case reported where a transaction executed on both sides was set aside because the corporation did not act by deed. But, for the rest, it may at least be said that till after the first quarter of the present century had passed, no unsealed executory contract was binding on either party;[4] and it is probable, also, that in a partially executed transaction no special

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[1] East London Waterworks Co. *v.* Bailey, 12 Moore, 532; S. C. 4 Bing. 283; and see Edie *v.* E. I. Co., 2 Burr. 1216 where assumpsit was brought against the Company on a bill of exchange, without objection.

[2] 3 P. Wms. 419.

[3] Bac. Abr., tit. Corporation (E) 3; 1 Kyd on Corp. 26.

[4] East London Waterworks *v.* Bailey, 12 Moore, 532; S. C. 4 Bing. 283.

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agreement was valid without seal. On the other hand, if the transaction was such as of itself gave rise to an obligation, it could be enforced; forfeitures and tolls could be recovered in assumpsit;[1] if land were demised without deed, and the lessee occupied the premises, he was liable for rent in an action for use and occupation; and similarly, no doubt, if goods were bought or sold by a corporation and delivery was made, the vendee could have been forced to return or pay for them.[2]

The courts were sometimes able to mitigate the hardships which followed from the necessity of doing everything under seal, by presuming, as a matter of pleading, that when performance by a corporation was averred, performance with all necessary formalities was intended,[3] and partial relief was given in special instances by act of Parliament;[4] but at best it would be hard to find a more striking instance of a rule of law which arose from the customs prevailing in an entirely different state of society still maintaining itself when every reason for its existence had ceased, and its only effect was to produce injustice.

The right to pass by-laws for the regulation of their affairs belonged to corporations in the Roman law[5] from a very early period, and also in the English law. Indeed, the right is a consequence almost necessarily following from the nature of the early corporations. Institutions to which were delegated powers of government, whether ecclesiastical or secular, whether exercised over all within a certain locality or confined to those practising a particular trade, must have been allowed appropriate means of exerting their authority, and the scope of the by-laws must have been proportioned to the jurisdiction. Thus, the by-laws of a corporate town were binding on any one who came within its limits.[6] The by-laws of a guild were binding not on its members only,

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[1] The Barber Surgeons *v.* Pelson, 2 Lev. 252; Mayor of London *v.* Hunt, 3 Lev. 37; and see Parbury *v.* Bank of England, 2 Doug. 524, where, at the suggestion of Lord Mansfield, a special action of assumpsit was brought on account of the bank's refusal to transfer stock on the books.

[2] E. I. Co. *v.* Glover, 1 Stra. 612.

[3] Edgar *v.* Sorell, Cro. Car. 169; Tilson *v.* Warwick Gas Co., 4 B. & C. 962; Rex *v.* Bigg, 3 P. Wms. 419.

[4] *E. g.*, 11 Geo. I. c. 30, § 43, which allowed the two insurance companies recently chartered to make use of the freer pleading in vogue in the action of assumpsit when sued on their policies, which were under seal.

[5] Dig. xlvii. 22, lex 4.

[6] Cuddon *v.* Eastwick, 1 Salk. 193, pl. 5.

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but on such outsiders as exercised the trade which the guild governed and regulated.[1] The power of making by-laws would be useless without means of enforcing them, and the imposition of penalties for failure to comply with its by-laws was within the power of a corporation, from an indefinite time.[2] The farther back the examination is carried the broader seems to have been the power of punishing the refractory, extending by special charter in many cases to imprisonment as well as fine.[3] By Coke's time, however, it was settled that the power of imprisonment could not be given by letters-patent from the king, but required an act of Parliament; [4] and it was further held that similar authority was needed for a by-law affixing as a penalty the forfeiture of goods; [5] but that such by-laws were formally valid may be inferred from the fact that this mode of enforcement was sometimes supported as being in accordance with an immemorial custom.[6] Further limitations on the power of making by-laws, which were more strictly construed as time went on, were that they must not be contrary, nor even cumulative, to the statutes of Parliament,[7] nor in restraint of trade,[8] nor unreasonable.[9] Business corporations, when they arose, were dealt with according to the same principles. As it was well recognized that such by-laws only could be made as were in harmony with the objects for which the corporation was created,[10] and as the purposes for which business corporations were chartered were as a rule definitely marked out, the scope of the right to make by-laws was correspondingly narrowed. A few of the earlier joint-stock companies were intrusted with the regulation of the trade in which they were engaged, and the by-laws of these were binding on all engaged in the trade, precisely as was the case with guilds.[11] But by the change in the conception of a

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[1] Butchers' Co. *v.* Morey, 1 H. Bl. 370; Kirk *v.* Nowill, 1 T. R. 118.

[2] The Law of Corp. 209.

[3] Grant on Corp. 86, especially notes d and f.

[4] Towle's Case, Cro. Car. 582; Chancey's Case, 12 Rep. 83.

[5] 8 Rep. 125 a; Horne *v.* Ivy, 1 Ventr. 47; Clarke *v.* Tuckett, 2 Ventr. 183; Nightingale *v.* Bridges, 1 Show. 135.

[6] Clearywalk *v.* Constable, Cro. Eliz. 110; Sams *v.* Foster, Cro. Eliz. 352; s. c. Dyer, 297 b.

[7] Grant on Corp. 78.

[8] Ibid. 83.

[9] Ibid. 80.

[10] Child *v.* Hudson's Bay Co., 2 P. Wms. 207; 2 Kyd on Corp. 102.

[11] *E.g.*, the East India Company in its early days regulated the right of private trading with the Indies, and soon forbade it altogether. It endeavored to enforce this rule against

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corporation from an institution for special government to a simple instrumentality for carrying on a large business, the right to pass by-laws was restricted to regulations for the management of the corporate business.[1] Such regulations, of course, like the by-laws of municipal corporations and guilds, were void if contrary to statutory or common law, or if unreasonable. Whether a certain by-law was held unreasonable or not depended in some measure on the discretion of the court. The decision might be different when judged by the standards of the eighteenth century from what it would be if judged by modern standards. Thus, a by-law of the Hudson's Bay Company giving itself a lien on its members' stock for any indebtedness due from them to the Company was held valid,[2] the court saying, "All by-laws for the benefit and advantage of trade are good unless such by-laws be unreasonable or unjust; that this, in their opinion, was neither." To-day, in a jurisdiction unfettered by authority, the conclusion would probably be otherwise.[3]

In addition to the doctrines which have just been considered, a few others may be mentioned as applicable to all corporations alike. In general, questions of rights and duties towards the outside world are much the same for all kinds of corporations. The law, it is said, makes no personal distinctions, and it is at least true that wherever considered practicable the fictitious legal person of a corporation, whatever its nature, was treated by the law in the same way as an actual person. On the other hand, the law regulating the relations of the members to each other and to the united body must differ according to the nature and objects of the corporation.

It has often been questioned whether a corporation could commit a tort or crime. The better opinion in the Roman law seems to

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a non-member by forfeiture of his vessel. He petitioned the House of Lords, which ordered the Company to put in its answer. The case finally resulted in a quarrel between the Lords and the Commons as to the right of the former to take jurisdiction. The Lords gave judgment for the plaintiff, but it was never executed. Macpherson, Hist. 127. See, also, Horne *v.* Ivy, 1 Ventr. 47.

Further illustrations of by-laws of business corporations binding on the public may be found in the regulations passed by early canal and railway companies in accordance with 6 Geo. IV. c. 71, and 8 and 9 Vict. c. 20, § 109.

[1] Child *v.* Hudson's Bay Co., 2 P. Wms. 207.

[2] Child *v.* Hudson's Bay Co., 2 P. Wms. 207, re-argued *sub nom.* Gibson *v.* Hudson's Bay Co., 1 Stra. 645; s. c. 7 Vin. Abr. 125.

[3] Lowell, Transfer of Stock, § 166.

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have been that the question should be answered in the negative, at least whenever *dolus* or *culpa* was necessary to make the act under consideration wrongful.[1] In England, however, it was very early held that corporations might be liable in actions on the case or in trespass,[2] and afterwards in trover.[3] But it is not likely that a corporate body would have been held liable for any tort of which actual malice or *dolus* was an essential part. Similarly it was held that a corporation could not be guilty of a true crime,[4] that is, it could not have a criminal intent, but it could be indicted for a nuisance or for breach of a prescriptive or statutory duty, and, in general, where only the remedy was criminal in its nature.[5]

It was generally laid down that a corporation could not hold in trust.[6] It is not very clear exactly on what reasoning the conclusion was based. There is very little to support it, except in very old cases. The view gradually became obsolete, and though there was no decision before the year 1800 definitely deciding the point, it is probable that it was recognized before that time that a corporation might hold in trust.[7]

Samuel Williston.

CAMBRIDGE, May 31, 1888.

(*To be continued.*)

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1 Savigny, System, §§ 94, 95.

2 See Grant on Corp. 277, 278, and notes, in which are cited many cases from the Year Books.

3 Yarborough *v.* Bank of England, 16 East, 6.

4 Anon., 12 Mod. 559; that it cannot commit treason see Vin. Abr., Corpor. Z, pl. 2.

5 Grant on Corp. 283, 284.

6 The authorities are collected in Gilbert on Uses, 5, 170, and Sugden's note.

7 See Atty.-Gen. *v.* Stafford, Barnard. Ch. 33.

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THE GENESIS OF THE CORPORATION.

A FEW years ago the writer became interested in the trust problem, and after some study of the subject reached the conclusion that the corporation furnished the only means by which trusts were able to maintain their existence.[1] This naturally suggested an examination of the contrivance which was sufficiently convenient and effective to accomplish such large results. The process of forming a corporation was of course familiar, but on close inspection the thing itself seemed to merit investigation. Several persons associate themselves and comply with certain forms prescribed by law, and the result is something having an identity and existence entirely independent from these persons, and with rights, powers, and duties of its own. All the familiarity in the world with this process does not render the result other than remarkable. Nor is the phenomenon clearly explained by the well-known statements that this mysterious something is "created by the sovereign power," and that it is "a fictitious or artificial person."[2] Inevitably the inquiry arises whether the corporation represents a natural privilege, or whether it is an arbitrarily constructed species of machinery. This in turn suggests further questions: Where did the corporation come from? Who invented it? On what basic principle does it rest? In the ultimate analysis what is the corporate idea? In considering these questions it is the single endeavor of this paper to arrive at the inherent nature of the corporation. It is proposed first to discuss the matter in the abstract, and then to illustrate that discussion by specific examples.

The germ of the corporate idea lies merely in a mode of thought; in thinking of several as a group, as one. This mental process, familiar as soon as there was any conscious thought, is so nearly elemental in its nature that it has been said to defy analysis.[3] Nevertheless, as individuals are the primary units from the point of

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[1] 16 HARV. L. REV. 791.

[2] Marshall, C. J., in Dartmouth College *v.* Woodward, 4 Wheat. (U. S.) 518; Cal. Civil Code, § 283; Georgia Code, § 1836.

[3] Morawetz, Law of Private Corporations, § 1, note.

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view of logic, if not of history,[1] a thought which embraces several individuals must be susceptible to some extent of explanation. It is the recognition of a fact, namely, that a certain number of persons are seen or heard or in some way appear as a body, as one; they are perceived by some one or more of the senses to manifest a certain cohesion. The underlying cause or motive force which produces this perceptible cohesion is that each of the individuals in question bears precisely the same relation to some aspect or phase of existence; each has an identity of relationship to a common influence or factor. This common factor may be trivial and of momentary effect, or it may be of permanent and vital significance. For example, it may consist in ties of blood or place of residence, or it may be merely the desire to see a passing street parade. In other words, there are groups of all sorts and degrees. The persons gathered to chat on a street corner, the men who row in a college boat, the statesmen who legislate at Washington, a crowd, a crew, a congress, are groups created, it is true, by accident, and evanescent, but different in degree only from such groups as families and tribes, the members of which are considered as one because of a cohesion due to a continued identity of relationship. The mental process which we have tried to analyze, expressed in written or spoken language, results in a word which stands for several but which is itself in the singular number. We suggest therefore, without fear of being accused of confusing cause with effect, that a clear, practical definition of a group is this, namely, such a collection of individuals as may be represented by a word of the singular number. That this is not a wholly accurate test is admitted; that it constitutes a good working rule is shown by the following examples: crowd, crew, team, court, board, class, regiment, army, flock, herd, audience, congregation, party, cabinet. For the persons stopping over night at a hotel, the passengers on a train, the guests at a ball, collections of individuals not manifesting a perceptible cohesion, there is no adequate word of the singular number.[2]

Having seen that the basis of all groups is merely a mode of thought, let us analyze the process by which some groups become

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[1] Sir Henry Maine intimates that the family, clan, and tribe were recognized entities of society before individuals were. Ancient Law 258.

[2] These collections of persons certainly have an identity of relationship to a common factor. It seems to the writer, however, that in the examples cited it does not produce a perceptible cohesion which leads us to think of them as groups.

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more important than others. Because several individuals are perceived to manifest a certain cohesion in respect to a single episode, as in the case of a crowd on a street corner, we think of them and name them as one. Unless something further happens, that is the end of it. Frequently, however, something further does happen, and it is this: instead of being perceived as one in a solitary instance, the same several persons act or appear together on various occasions during a considerable period of time. A simple example is a quartette of musicians. The oftener this happens, the more the oneness of these same several persons is emphasized. It is necessary to think of them as a group, not once, but frequently, perhaps continuously; the group becomes established in the minds of others as something definite and lasting, and finally as something independent of the individuals who compose it. This independence is of vital importance, for it means that the persons composing the group may change and yet the group continue. A regiment of soldiers is an example of this. As the group performs acts, it demands recognition as such, not in the mind merely, but in the conduct of others towards it. The several individuals composing the group are not only thought of and named as one, but of necessity are treated as one also. The oneness, the something produced by the cohesion of several,[1] has become something which must be dealt with in practical affairs and which under certain circumstances must be recognized by the law.

The extent to which a group is treated as one by those dealing with it depends entirely on the demands of practical convenience. Very many groups which maintain a fairly active existence require recognition as such in hardly more than nomenclature, recognition which is accorded to the simplest group. Take, for

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[1] It seems proper to speak of the oneness produced by several as something independent, having an existence of its own. It is proper, however, simply because the demands of convenience are so nearly, if not quite, peremptory that they must be complied with or the joint action of several cease to cut any figure as a practical matter. As far as tangible facts go, nothing is produced from the several in a group. In the last terms of accuracy a group name is merely a short way of describing several persons, their relation to one another, and the effect they have on outsiders. So the word "corporation" is, in strict accuracy, nothing but a short way of describing several persons who have peculiar attributes and definite, though complicated, relations with one another and with outsiders. If, however, every time the persons in a corporation were dealt with we had to think and say several pages of words, it would be impossible for them to become real factors in daily life in their group capacity. The oneness as a practical matter is nearly as real as the several and is but one step beyond them.

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example, a college football team. It is a true group, something different from any or all of its members. During the season the eleven players are thought of as one, in practice and matches are treated as one, and as one may go down to posterity as the best or worst football team ever known. But this is the only recognition this sort of group demands. It does not touch life on its practical side. It is not apt to hold property, nor likely to get into controversies which require it to sue or be sued; it has no use for legal rights, nor need for a definite status in business or law. Some groups which are active in practical affairs are treated by the law merely as so many individuals. A partnership, for example, owns property and performs acts, but in contemplation of the law does so through its members. Facts do not require recognition of the oneness of these groups to be carried to the point of recognition in law. The demands of convenience are satisfied by the law as to co-ownership. Other groups which wage war, negotiate treaties, and make laws, such as nations and states, touch life on vital points, are of necessity treated as groups in many and important affairs; and therefore the oneness of these groups must be established on an approximately exact or at least a well-defined basis. In other words, without artificial aid such as is accorded by arbitrary command of a sovereign power, that is, by a statute, a group receives just the degree of recognition which ordinary every-day circumstances make necessary. The true corporation is nothing but a marked instance of such recognition in a high degree.

It is apparent that the same fertile germ lies behind all joint action and endeavor. The corporation, though representing perhaps the most advanced attainment of the group idea, is only one manifestation of a development which has gone on in every country under the sun having a claim to be called civilized.[1] Obviously, and this cannot be too strongly insisted upon, it was not the invention of any one man or one people. No philosopher, statesman, or lawyer sat down, cogitated, and said, "It would be convenient to give several persons acting together certain attributes and call them a corporation." Nor is the cor-

[1] "Every system of law that has attained a certain degree of maturity seems compelled by the ever-increasing complexity of human affairs to create persons who are not men, or rather (for this may be a truer statement) to recognize that such persons have come or are coming into existence." Pollock and Maitland, Hist. of Eng. Law, 2d ed., i. 486.

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poration in its essentials peculiar to any country or any people, although the contrary view has been advanced by many learned writers. Blackstone, for example, says of corporations: "The honor of inventing these political constitutions entirely belongs to the Romans."[1] A study of the code and digest unquestionably had an influence on the form of the corporation of to-day, but the corporation existed in England long before Roman law-books were known in that country. There as everywhere it was the result, not of imitation, but of evolution, — a natural, though hardly inevitable, manifestation of the group idea.[2]

It is time to test our abstract discussion by the examination of facts. The truth of our inferences could be proved by the history of numberless groups which have become active at various times from the days of the Old Testament to the present. The practical importance of the oneness of groups could be shown specifically by presenting the characteristic development of the group idea manifested by the universities[3] of the middle ages, and by the great livery companies of London.[4] Naturally, however, our happiest illustration, both of the general development of the group idea and of the necessity for establishing it as something definite, lies in the story of the groups which were the immediate predecessors of the corporation.

The course of development may first be briefly indicated in general terms. When certain groups became active factors in daily life, especially in trade matters, when as groups they were accorded legal rights and were owners of property, it became necessary as a matter of practical convenience to put the several persons in their group capacity on a definite basis which could be dealt with in business and in law. The oneness, the indefinite something which is the essence of every group, in these particular groups became so accentuated and so important in respect to the most usual and practical affairs of life that it fairly vociferated for

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[1] Sharswood's Blackstone's Commentaries 468.

[2] All that we have said as to groups might be true and yet never a corporation have come into existence. There may be much associate activity not in the corporate form.

[3] Masters and scholars received privileges as a class or unit. Corporations, their Origin and Development, i. 257 *et seq.*

[4] Members received by grant from the king privileges which they held as a body. See Charter of Edward III. to the Fishmongers; Charter of Richard II. to Skinners; Charter of Richard II. to the Merchant Tailors, which says: "We . . . do for us and our heirs as much as in us is by tenor of these presents grant and confirm all and singular the premises to the aforesaid Taylors and Linen Armourers and their successors forever." And generally Stubbs, Select Charters.

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complete recognition. Not from fanciful considerations, but in response to the stern insistence of actual facts, it became necessary "to give to airy nothings a local habitation and a name."

The corporation in England was the joint result of certain groups in ecclesiastical life and certain other groups active in temporal affairs. For centuries the development of each was wholly independent of the other, and we may briefly consider each in turn.[1]

The starting-point of the corporation in temporal affairs was simply that certain people lived near one another. In at least this aspect of life they had an identity of interest. At first there was nothing but the fact of propinquity. There were no rights or duties except those appertaining to the several persons who lived in the locality as individuals. What they owned they owned as individuals, and what they did they did as individuals. They created towns and villages. Some of these settlements became more densely populated than others, and this was, at first at least, what chiefly distinguished a borough, the group which directly led to the corporation, from the ordinary village. This distinction was familiar at least from the early years of the thirteenth century. All sorts and conditions of people resorted to the larger center. Its population became heterogeneous. Some inhabitants held their land directly from the king, some from nobles; the borough would not become the property of any one person. Nothing intervened between it as a whole and the king as overlord of all the realm.[2]

Along with increased population, partly as cause and partly as effect, went increased trade both among the inhabitants themselves and with others. Life became more active, more complex; there was more contact with the rest of the world. Then, too, in these larger settlements the instinct for local self-government awoke and developed. It amounted to more to be an inhabitant of a large

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[1] The facts which are hardly more than suggested in the following pages are treated at length by Pollock and Maitland in their History of the English Law, 2d ed. in the chapters called "The Borough" and "Corporations and Churches." The writer cannot too highly express his admiration for the breadth of treatment, the keen thought, the wonderful industry indicated by these chapters. See also Stubbs' Constitutional History; Gross, The Gild Merchant; Adler, A Summary of the Law of Corporations; Davis, Corporations, their Origin and Development. It is obvious that this article does not pretend to be a work of original research; the writer nevertheless has verified statements as to facts from primary sources.

[2] Pollock and Maitland, Hist. of Eng. Law, i. 637–638.

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center than a small one. The larger place inevitably felt its strength and importance, and as a consequence reached after what might add to the power and comfort of the persons who were and should become its inhabitants. It wanted and needed special privileges. What was equally important, it was in a position by force of its numbers and wealth to secure them from the king.

The franchises acquired by the borough from the king were principally three, namely, right to hold its own courts, right to its own customs, and freedom from toll.[1] The last was the most important in bringing out the oneness of the borough, and should receive a word of explanation. It was exemption from certain mercantile taxes or imposts which were collected all over England either by the king, through his agents, or by nobles who had acquired the right from the king. The nature of these taxes is sufficiently indicated by their names: duty on buying and selling, toll exacted in markets, passage money on merchants visiting fairs and markets, toll for maintenance of bridges, stallage, or money paid for permission to have a stall in a fair; fee for permission to trade. They constituted a considerable burden on the merchants of a community, especially when their enterprises called them to other parts of the country than their own. As a part of the grant of freedom from toll, the king gave to the inhabitants of the borough, the burgesses, the right to farm their own borough. That is, he substituted for his own toll-gatherer the burgesses, who paid him a fixed annual sum in lieu of toll. He also exempted them from paying toll elsewhere in England. Usually accompanying these privileges was the right to form a merchant gild,[2] for the purpose of better securing the right of freedom from toll. A merchant of the borough traveling to other places and standing boldly on his borough rights needed the support of an active, prudent organization. Besides, the right to take toll from strangers required to be fearlessly exercised and jealously guarded. These were the primary functions of the gild merchant.[3] The possession of free-

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[1] There were many and various franchises granted. See, for privileges granted to boroughs, Charter from King John to Nottingham in 1200; from Henry II. to Lincoln in 1189; from John to Burgesses of Helleston in 1201; from Henry II. to Winchester; and generally Stubbs's Select Charters.

[2] There were other kinds of gilds long before privileges were ever granted by the king to a borough. The festive and religious gild may be traced back to the days of heathenry. Pollock and Maitland, 2d ed., i. 639; Gross, The Gild Merchant i. 174 *et seq.*

[3] A borough had two organizations, gild and governmental; each was closely con-

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dom from toll with the accompanying right to have a merchant gild naturally increased the activity of the borough in degree and in variety.

These franchises came from the king, and they came in the form of a grant.[1] The operative words of a typical charter were as follows:

> "John, by grace of God, King, etc. Be it known that we have granted and by our present charter confirmed to our burgesses of Ipswich our borough of Ipswich with all its appurtenances and all its franchises and freedom from imposts, to hold of us and our heirs, to themselves and their heirs, they paying into our exchequer each year on the feast of St. Michael, in behalf of the aforesaid Ipswich, the just and customary rent." [2]

There was nothing in the grant which expressly brought a legal person into existence, nothing which incorporated the borough. But in the very gift of these privileges there lurked a problem which sooner or later would require solution. Who really owned these franchises? No one asked the question at this time, and probably it was not the subject of much conscious speculation. Without doubt the offhand idea of the king was that the grant was to the individual burgesses living in a particular place; of the burgesses, that they received the privileges as individuals. A second thought on the part of either would hardly have sustained the offhand idea. Clearly the oneness of the burgesses was recognized, at least by implication.

Not only was the possession of these privileges from the first hardly to be accounted for on the theory of co-ownership of many individuals, but little by little this kind of property became subject to incidents wholly irreconcilable with any such theory. The burgesses died, and the privileges continued to be held by the burgesses who came after them.[3] The king, as the punishment for the act of

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nected, but not identical. "The Gild Merchant was a very important, but only a subsidiary part of the municipal administrative machinery, subordinated to the chief borough magistrates, though far more autonomous than any department of the town government of to-day." Gross, The Gild Merchant i. 63.

[1] It was in form and reality a grant, although the analogy of the Magna Charta, which used the words "to all the free men of England and their heirs," might suggest that it was a local law.

[2] King John's Charter to Ipswich. Gross, The Gild Merchant ii. 115.

[3] The preamble to Statute 15 Richard II., c. 5 (1392 A.D.), recites that an extension of the provisions of the Mortmain Statute is necessary, "because mayors, bailiffs, and commons of cities, boroughs and other terms which have a perpetual commonalty, and others which have offices perpetual, be as perpetual as people of religion."

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one or more individuals, took away the franchises he had granted to all.[1] Sometimes the punishment continued after the old inhabitants had given place to new ones. The punishment fell not on persons, but on the community. The burgesses not only profited by their franchises, but had to maintain them. It was necessary to deal with this property in daily affairs, to defend it at law if need be. In 1200 Ipswich got a common seal, and other boroughs followed suit.[2] In 1225 the burgesses of Nottingham demised to the burgesses of Retford the tolls belonging to the former borough and arising within certain geographical limits at an annual rent of twenty marks.[3] In grants from the king the phrase "and their successors, burgesses," began to supplant the phrase "and their heirs."[4] In a word, the king treated the burgesses as a group, and the burgesses in respect to their property acted as a group. The group, and not the individuals, was the property owner.

To sum up: From the temporal development we get, by reason of the association of individuals in the same locality plus an active interest therein, especially in trade matters, a unit interest which demands and receives franchises and privileges which belong to the associated persons in a way not provided for by any of the existing theories of ownership. We get the fact of a oneness which has a place in business and law without the conscious recognition of its existence.[5] The process was vague; it was not marked off by distinct steps. The oneness of the burgesses was there all the time, as it is in every group, but many years had to elapse and many unconsidered acts to be done before it emerged from the mist as something definite and real.

Meanwhile the group idea was developing in ecclesiastical life. For wholly different reasons religious groups were formed. There the association depended, not on accident of locality, but on the voluntary act of individuals. From the first there was a tendency of churchmen to come together. The basic doctrines of the Chris-

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[1] Riley, Chronicles of London 11, 15, 18, 22; P. Q. W. 160. There is record that once in such a case the Londoners prayed that only the guilty might be punished. Riley, Chronicles 84.

[2] Gross, The Gild Merchant ii. 119, 121.

[3] Pollock and Maitland, 2d ed., i. 95.

[4] King John's charter for Waterford: Chartae, Privilegia, et Immunitates, Irish Record Commission 13. Cited in Pollock and Maitland i. 677. This was a step in advance, but the idea of plurality is still suggested.

[5] Pollock and Maitland say the necessity for a new idea existed at least before the end of the thirteenth century. History of English Law, 2d ed., i. 687.

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tian church require coöperation and also continuity of thought and effort. It was inevitable that churchmen should join together to spread their belief, to do works of charity, to study, to honor a favorite saint. Monasteries, convents, and chapters[1] were the result.

These religious groups did not touch life so closely on the practical side as did the borough. At first, at any rate, they were not property owners although they managed property. As a group they were not so likely to deal with others in respect to merely business affairs. Nevertheless the members of the group were closely associated. Joint action was required; meetings were held and votes taken. In particular the oneness of the ecclesiastical groups was from the first recognized as independent; that is, the personnel of the group changed, but the group went on.[2] As the property managed by the religious groups became more valuable, the oneness of these groups became something to be reckoned with in practical affairs.

To sum up: From the ecclesiastical development we get organizations of individuals formed for different purposes and by voluntary association, which have a continuous existence and which are recognized as units.

We have then a unit interest or oneness which, as exemplified by both temporal and ecclesiastical groups, owned or managed property, dealt with outsiders, — in a word, was an active factor in affairs. It was time that the indefinite something produced by the association of several be given a name and its status established.[3] The facts called for a new legal theory. To construct one was not a simple matter. There was much blind groping after the nature of this indefinite something. For a time the idea naturally sug-

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[1] Davis, in "Corporations, their Origin and Development," says that corporations may have their origin by means "of such changes in the supreme organization of society as to leave some of its groups, retaining their old organizations, in an exceptional relation to it." He instances cathedral chapters. This may be true as to corporations. Manifestly it cannot apply to the origin of simple groups.

[2] As to this, Bracton says (f. 374 b): "If an abbot, prior, or other collegiate men demand land or an advowson or the like in the name of their church on the seizin of their predecessors they say 'and whereof such an abbot was seized in his demesne,' etc. They do not in their count trace a descent from abbot to abbot, or prior to prior, nor do they mention the abbots or priors intermediate (between themselves and him on whose seizin they rely), *for in colleges and chapters the same body endures forever, although all may die one after the other and others may be placed in their stead; just as with flocks of sheep, the flock remains the same though the sheep die.*"

[3] "The law is slowly coming to the idea of a corporation by dealing with corporations (if we may call them so) of very different kinds." Pollock and Maitland, 2d ed., i. 494.

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gested by the analogy of the human body was applied to these groups. The chief officer, as mayor or bishop, was the head, and the members were the arms, legs, etc.[1] This was called the anthropomorphic theory, and for a long time obscured the true corporate idea.[2] Finally, however, the oneness of these groups was given a definite recognition, not as a real but as an ideal or legal person.

The conception of an ideal person having legal rights and duties was borrowed directly from the early English theory as to church ownership, a theory attained not without difficulty. In very early times, several centuries at least before the reign of Edward I., there were in England what were vaguely known as church lands.[3] At first the land was given direct to God. Such a dedication came naturally and spontaneously. The Deity was vaguely conceived of as a property holder; the incidents of ownership were not considered. Sometimes the land was given to a saint;[4] such a saint was frequently buried in a particular church and was supposed to protect and guard it. So little by little the saint and the church, the actual building, became merged in each other, and finally the church itself was thought of as a property holder. The institution, the structure of stone and wood, together with its spiritual attributes, was personified. About this time church lawyers, the canonists, discovered the *universitas* in the Roman law books and applied it to the church. The theory of an ideal person was attained.

Although the church was the property owner, the functions of ownership were necessarily performed by human beings, by the clergy. The personified institution could not collect moneys, nor make conveyances, nor bring and defend suits. The group of

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[1] Abbot of Holme *v.* Mayor, etc., of Norwich, Y. B., 21 Edw. IV. f. 69. And see Y. B., 21 Edw. IV. f. 15, f. 68, per Vavisour.

[2] Pollock and Maitland, 2d ed., i. 491, 492, and citations of Year Books there given.

[3] In the earliest Christian times in England when a man built a church on his land it was his church, just as a house or shed built on his land was his. This remained true to some extent at the time of William the Conqueror (Doomsday Book II. 290 b). But the Bishop or other ecclesiastical dignitary in the locality could withhold the spiritual attributes necessary to convert the building into a true church by refusing to consecrate it unless the priest was provided for. Pollock and Maitland, 2d ed., i. 498, 499.

[4] As in charter from King Ethelbert to Rochester Cathedral, 604 A. D. "To thee, Saint Andrew, and to thy church at Rochester where Justus the Bishop presides, do I give a portion of my land." Kemble, Cod. Dipl., i. No. 1; Stubbs and Haddann, iii. 52; Councils and Ecclesiastical Documents relating to Great Britain and Ireland.

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clergy was not the *universitas*, but represented it. As the clergy advanced in practical importance while the institution receded, the theory of the ideal person was unconsciously transferred from the church to them. Being primarily the personification of an institution, the theory naturally was extended to cases where there was only one cleric. Thus was introduced that curious anomaly, not really a corporation at all, namely, the corporation sole.[1] We have shown that the theory was constructed primarily not to represent the oneness produced by the association of several, but, on the contrary, merely as a "feigned substratum for rights." This explains why the ecclesiastical corporation was called not only a person but a fictitious person.

The groups in lay and church life alike represented the genuine development of the corporate idea. In the ecclesiastical groups, however, appeared so many manifestations not germane to the development[2] that it is no wonder centuries elapsed before the two sets of groups, lay and clerical, were brought under one head. In the fourteenth and fifteenth centuries, however, church and state came more closely together. The corporate development of each became common knowledge, and lay and ecclesiastical groups were established on the same basis.

In the foregoing it has been impossible to assign precise dates to the events narrated, or to treat them in the order in which they occurred. Much that has been given in sequence, in reality went on at the same time. The effort has been to select the salient characteristics of the development and present them in a somewhat

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[1] Blackstone says (Commentaries, p. 468): "But our laws have considerably refined and improved upon the invention, according to the usual genius of the English nation, particularly with regard to sole corporations consisting of one person only, of which the Roman lawyers had no notion; their maxim being that *tres faciunt collegium*." Pollock and Maitland, on the other hand, with what seems to the writer wholly adequate reason, call the corporation sole "*that unhappy freak of English law*." Hist. of Eng. Law, 2d ed., i. 488, note 1.

"The idea of a corporation sole has been claimed as peculiar to English law, but the novelty consists only in the name; and it has been justly remarked that, 'as so little of the law of corporations in general applies to corporations sole, it might have been better to have given them some other denomination.'" Dr. Wooddeson, Vinerian Lectures i. 471, 472.

[2] Problems which in themselves were difficult were made yet more difficult by the slow growth of the idea that the head of the monastery, though he is a natural person, is also in a certain sense an immortal, non-natural person, or corporation sole, and is likewise the head of a corporation aggregate. Pollock and Maitland, 2d ed., i. 436. In ecclesiastical affairs "the corporation aggregate was almost resolved into a mere collection of corporations sole." *Ibid.* 507.

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logical order. The facts are not important as facts, but as indicating the inherent nature of the corporation.

To sum up: The unit interest or oneness produced by the association in different ways of several persons became such an active factor in practical affairs that people were forced to recognize it as something independent. The oneness had to be given a place in business and in law as something definite.[1] It happened that the basis of a person[2] was adopted; unfortunately, through the influence of a theory entirely proper where it belonged, namely, in church ownership, this person was called a fictitious person. Unfortunately, because the word "fictitious" or "artificial" says more than is necessary, connotes something far removed from the practical everyday affairs of life; signifies feigning or make believe. A corporation is really a collection of flesh-and-blood individuals who have an identity of interest in certain affairs. Neither the individuals nor the relation they bear to one another is fictitious. The mechanical necessity of the case requires that these individuals in their group capacity be put upon some definite basis, and they are therefore treated as a single person. But there can hardly be said to be anything unreal about the matter. A nation represents merely the relationship of certain human beings to one another, but we should hardly call the United States or England a fiction.[3]

The corporation, then, grew by nature. It was the product of a natural evolution. During all the period with which our discussion has concerned itself there was no rule that the corporation must have some definite and authoritative commencement. There was no rule that the corporation must be erected, set up, made, by act of the sovereign power. By the middle of the fifteenth century, however, it was settled as a matter of positive law that the corporation must be created by the sovereign power.[4] This rule arose simply from considerations of political expediency. It was

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[1] Pollock and Maitland call the personality of a corporation "a blank form of legal thought." History of English Law, 2d ed., i. 486.

[2] "Now the words 'person' and 'personality' seem to be appropriate words, and if they were not at our disposal we should be driven to coin others of a similar import." *Ibid.* 488.

[3] In an article not called to his attention until the present article was ready for the printer the writer is gratified to find certain views which seem to be in accord with those here presented. See "The Personality of the Corporation and the State," by W. Jethro Brown, 21 Law Quarterly Review 365.

[4] Y. B. 14 Henry VIII. f. 3 (Mich. pl. 2), P. Q. W. 18; Gross, The Gild Merchant ii. 34.

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recognized that boroughs, organized communities, might be dangerous. It would not do for the sovereign power to have them exist too freely. This reason also applied to the gilds which were likely to become aggressive. Here too was a good source of revenue. The privilege of being a borough or the right to form gilds would be bought. The rule of law was based, like other rules of law, on public safety and convenience.

We have seen that the oneness of the borough was definitely recognized in practice by the king and by others, by the community long before this rule of law was thought of.[1] And this recognition came by common consent as something required by the necessities of the case. When this rule of law was established, therefore, it really meant: recognition of corporations cannot continue without the king's express consent. The sovereign's act was not creation, but permission. In other words, the king's charter of incorporation performs no magic. Beyond peradventure the group person is not fashioned out of nothing by the sovereign power. If there be magic anywhere, it lies in the mode of thought which considers several persons for certain purposes as one, plus the actual happenings which make the thought important. Nevertheless, from the time when this rule of law became established the permission was given in form as though it were creation.[2] This was without doubt due not to accident, but to the necessity of defining with exactness the powers and duties of the group person permitted to exist. The oneness of several recognized by the community, even though recognized as a person, would be somewhat vague in these respects. Therefore charters of incorporation have universally said in so many words "incorporate"; that is, they have in form expressly set up or created the legal person. This made it necessary to account by some theory for the corporations already existing which had never been expressly incorporated. It was said that such were corporations by prescription.[3]

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[1] "The formal incorporation of boroughs in the fourteenth and fifteenth centuries did not materially alter the town constitution; it was in most cases merely a recognition of existing franchises with a stronger accentuation and a more precise formulation of the right of independent action as a collective personality with a distinctive name, — especially as regards holding real property." Gross, The Gild Merchant ii. 95.

[2] In 1440 the first municipal charter of incorporation was granted by statute of 18 Henry VI. c. 6. By its terms the mayor, burgesses, and their successors, mayors and burgesses of the town of Kingston-upon-Hull, are incorporated so as to form "one perpetual corporate commonalty" by the title of "The Mayor and Burgesses" of the said town.

[3] Jenkins *v.* Harvey, 1 Gale 457.

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The fact that permission of the sovereign was given in the form of creation, however, had another and a far greater effect on corporate law: an effect of capital importance. If permission only were given, the corporation could never be very different from the group person called into existence by common consent, by the recognition of the community. It would be no more than a species of machinery which facts made necessary in order that complex situations might be better handled and civilization advance. The opinion as to what was necessary would change, but the corporation would always depend upon the general opinion of the community. There could never be anything arbitrary in its character. If, however, the corporation were created by the sovereign, its powers and characteristics would depend not on the consent of the community, but on the will of the sovereign. In other words, corporations came to be things made according to the ideas of the sovereign. Even so, it was long before the sovereign went in advance of the general opinion, and corporations were for a long time limited to endeavors strictly for the public.

Gradually, however, the corporation came to be used in private enterprise. It was recognized by business men as a species of machinery having great advantages over an individual, and they proceeded to adapt it for their purposes. The rule of law that the corporation is created allowed persons selfishly interested to have their own ideas recorded by sovereigns that knew little of the subject. Particularly in this country and within the last forty years the corporate idea has been seized and developed with Yankee ingenuity to a point which in the light of the genesis of the corporation is startling.

A corporation which in business affairs can do practically anything and everything that can be done by an individual and can do it anywhere and everywhere [1] is a long distance from the true corporation which was brought into existence by absolute necessity, which was recognized simply because the progress of events demanded its recognition, which was the result of natural growth, of logical evolution. The modern corporation is the product of arbitrary legislation struck off at a given time. It does not represent the natural growth of the corporate idea, but rather is a distorted application of that idea. Serving as a buffer between

[1] See Charter of United States Steel Corporation, and, generally, forms in Dill on New Jersey Corporations.

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questionable acts and their natural consequences, it has been used to bring about a state of affairs in the commercial world which rests on neither a just nor a sound basis.[1] If existing conditions are to be improved, it must be by intelligent amendment of our corporation laws. An exact standard by which to measure proposed legislation is not to be hoped for; but in a clear understanding of what a corporation really is we may find both guidance and authority for action.

Robert L. Raymond.

BOSTON, February, 1906.

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[1] A Statement of the Trust Problem, 16 HARV. L. REV. 79.

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Law and Finance "at the Origin"

Ulrike Malmendier*

December 2008

Abstract

What are the key determinants of financial development and growth? A large literature debates the relative importance of countries' legal and political environment. In this paper, I present evidence from ancient Rome, where an early form of shareholder company, the *societas publicanorum*, developed. I show that the *societas publicanorum* flourished in a legally underdeveloped but politically supportive environment (Roman Republic) and disappeared when Roman law reached its height of legal sophistication but the political environment grew less supportive (Roman Empire). In the Roman case, legal development appears to have mattered little as long as the law as practiced was flexible and adapted to economic needs. The 'law as practiced,' in turn, reflected prevalent political interests. After discussing parallels in more recent history, I provide a brief overview of the literature on law and finance and on politics and finance. The historical evidence suggests that legal systems may be less of a technological constraint for growth than previously thought—at least "at the origin."

1 Introduction

Understanding the causes of financial development and economic growth is central to research agendas in many fields of economics, ranging from macroeconomics and microeconomics to finance. The law and finance literature suggests a causal impact of countries' legal systems.[1] Another strand of the literature emphasizes the role of the political environment and argues that the effectiveness of institutions varies considerably with the political support they receive.[2]

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* I would like to dedicate this article to the late John McMillan, without whose encouragement and interest, I would never have written it. I would also like to thank Daron Acemoglu, Thorsten Beck, Stijn Claessens, Stefano DellaVigna, Peter Howitt, Simon Johnson, Marco Pagano, Enrico Perotti, Paola Sapienza, Walter Scheidel, Andrei Shleifer, Mark Weinstein, Jeff Wurgler, Luigi Zingales as well as the participants at the 2006 Conference on the Formation and Evolution of Institutions at Brown University, UC Berkeley, UCLA, and Yale University for helpful comments and discussions. The article also benefited significantly from the detailed comments of four anonymous referees and Roger Gordon, the editor. Yelena Bakman, Aisling Cleary, Kimberly Fong, Xing Huang, Zhenyu Lai, William Leung, and especially Prasad Krishnamurthy provided excellent research assistance.

[1] La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997) and (1998).

[2] Rajan and Zingales (2003); Acemoglu and Johnson (2005); Pagano and Volpin (2005).

Definitive empirical evidence for either of those approaches is hard to come by. Given the scarcity of perfect natural experiments, careful and detailed analyses of individual cases are a valuable part of the literature, even if they stop short of proving causality. In fact, much of the literature revolves around specific historical examples, mostly taken from the last two centuries.[3]

This paper expands the current body of evidence to a much earlier time period, two thousand years ago in ancient Rome. I focus on a specific cornerstone of financial and economic development: the emergence of the business corporation. I propose that, contrary to widespread belief, the earliest predecessor of the modern business corporation was not the English East India Company nor the medieval *commenda*,[4] but the Roman *societas publicanorum*, i.e. the "society of government leaseholders." While this claim alone may be of independent historical interest, I use the Roman case to shed light on the "law and finance" versus "politics and finance" debate. The Roman evidence illustrates the limitations of the existing law and finance theories. In the case discussed here, legal restrictions (or the lack of legal development) per se appear to matter little as long as the law *as practiced* is flexible and adapts to economic needs. In fact, one of the most important periods of legal development, "classical Roman law," appears to be negatively correlated with financial and economic development. I also show that 'the law as practiced' reflects prevalent political interests.

In addition, the historical evolution of the Roman *societas publicanorum* allows us to better understand the political and economic preconditions for the development of the business corporation in modern history, an organizational format that has been essential for economic development. The Roman case illustrates the balance of power between the political elites and the business elites that determines whether this organizational form can survive and expand.

I first provide a historical introduction to Rome's economy and legal system. This brief overview helps to explain how an ancient economy could arrive at a surprisingly sophisticated level of financial structure. I emphasize the flexibility in the creation and interpretation of legal rules, which allowed new business forms to be invented through modifying preexisting commercial and social institutions (Section 2.1). I then describe the role and business activities of the publicans, from the 5th century BC until their demise under the Roman emperors (Section 2.2). I argue that, at the height of its develop-

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[3] Examples are Engerman and Sokoloff, (1997) and (2002); Berkowitz, Pistor, and Richard (2003); Lamoreaux and Rosenthal (2005); and Haber, Razo and Maurer (2003).

[4] Ekelund and Tollison (1980) and Gower (1969), p. 22. Kindleberger (1984) characterizes, more generally, alterations of the "true" partnership as the earliest forms of business organization but views the medieval *commenda* as the starting point (p. 195). Baskin and Miranti (1997) explicitly assess the development of the business organization under Greco-Roman law as restricted to partnerships.

ment, the *societas publicanorum* resembled the modern shareholder company along several core dimensions: its existence was not affected by the departure of partners (differently from the regular *societas*, i.e. the Roman partnership), and it could issue traded, limited-liability shares (Section 2.3). I then discuss the causes of the corporation's demise under the Roman Empire (Section 2.4). In particular, I point out how a change in political interests triggered its demise at a time when the general legal framework had substantially evolved and was, if anything, better able to support the institutional format of the corporation. That is, I evaluate the demise of the *societas publicanorum* in the light of a drastically changing political environment, the shift from Republic to Empire. In Section 2.5, I summarize the insights from this historical evidence and point to parallels in the later development of the East India Company and other parallel cases from modern history.

I link the historical evidence to the modern debate on the causes of financial development and growth. In Section 3, I first provide a brief overview of the literature on law and finance and on politics and finance. While the law and finance literature emphasizes the importance of a growth-fostering legal environment, the politics and finance literature argues for the predominance of political interests in determining the growth path of an economy. The overview emphasizes research on the role of different business formats (such as the shareholder company) and their characteristics (such as limited liability, agency, and representation), which has found less attention in previous reviews. These historical papers highlight that smooth access to financing requires more than investor and creditor protection. Restrictive business formats impose transaction costs on managers and may impede the funding of promising enterprises.

I discuss the implications of the rise and fall of Roman corporations for the current debate on law versus politics, focusing on two aspects. First, the fundamental assumption underlying the law and finance approach is that the legal environment causally affects economic development. The literature attributes better financial development in common-law than in civil-law countries to the legal flexibility inherent to common-law systems and the lack thereof in civil-law systems, often using Roman legal origin as a proxy for a rigid and growth-hostile legal environment. The historical evidence (from the time period that spawned Roman law) suggests that legal systems may be less of a technological constraint for growth than previously thought—at least "at the origin." Roman law provided a flexible and nurturing legal environment for financial development during the Republic, accommodating fundamental advancements such as a corporate business format. In fact, the case-based evolution of Roman law closely resembles today's common-law systems.

In the same vein, the case of the *societas publicanorum* illustrates that the functioning of an organization may develop independently of formal laws regulating company

formats. Business formats affect firms' access to external financing, stability (or "longevity"), ease of representation by individual managers, and the rights and obligations they can assume. An advanced (corporate) format facilitates its operation. However, analyses focusing on the formal law rather than the 'law as practiced' risk misconstruing the actual state of organizational development and its implications for finance and growth.

Second, if it is the 'law as practiced' that matters, the next question is what affects the practice of law and its responsiveness to economic needs. Here, the historical evidence points to the role of political pressure. The law as practiced appears to serve economic needs if and only if aligned with the dominant political interests. Differently from the view put forward in some of the politics and finance literature (e.g., Perotti and van Thadden, 2006), the Roman case does not provide evidence that the influence of politics acts via its influence on law, i.e., the view that the law matters, but that the choice of the law is endogenous to political forces. What we see in the Roman case is that formal contract and business law develop orthogonally to political changes. Formal law has little influence on economic outcomes because it is trumped by political forces.

While this dominance of politics over law is only a historical observation, based on a specific, non-generalizable case , the Roman case presented here overcomes a basic identification problem faced in the empirical analysis of law, politics, and finance: As law and politics evolve over time, they often develop in the same direction—either fostering or limiting financial development. That makes it difficult to attribute financial development to either source. The *societas publicanorum* provides a rare case in which the evolution of law and politics diverged. During the Roman Republic, when Roman law was still far from a complete body of civil law ("pre-classical" period), political interests demanded stable business organizations that could raise large-scale financing. During the Roman Empire, when Roman legal science peaked ("classical" period) and the law-related transaction costs of economic interaction diminished, political interests reversed and grew less favorable toward the smooth operation of large-scale economic activities. Financial contracting regressed despite the progress in legal framework. My findings suggest that economic development that coincides with government interest requires little formal legal underpinning other than a willingness to sanction experimentation with existing legal forms on a case-by-case basis. Without government support however, it may wither despite an existing legal framework.

These insights do not rule out that law does affect financial development. The Romans might never have arrived at developing an early type of corporation without their advanced legal environment. Nor do we observe the counterfactual history where the formalization of Roman law in the classical period gives explicit sanction to legal forms such as the *societas publicanorum* and codifies their rights. Rather, the historical case il-

lustrates that a failure to account for the political economy and its effect on the legal environment leads to a misreading of the relationship between law, finance, and growth.

2 A Historical Case Study: the Roman Corporation

2.1 Roman Economics and Roman Law

Historical evidence about the publicans and their companies stretches from the beginnings of the Republic into the Empire. The height of their activities falls into the last two centuries BC. I provide a brief overview of the economic and legal development at the time. Table 1 provides a chronological overview.

Economics

A starting point for my analysis is the question of how an early economy could be sophisticated enough to generate a business form as advanced as the *societas publicanorum*. Peter Temin (2001, 2006) uses evidence from grain markets, employment contracts, the manumission of slaves, and loan contracts to argue that Rome's economic institutions during the Early Empire were more market-oriented than even in the medieval economy many centuries later. In this subsection, I provide examples that illustrate the same point and extend the discussion to the period of the Roman Republic.

From the third to the first century BC, Rome grew from a rural community to a power stretching all over Italy and then beyond the Mediterranean, including West and South Europe, Asia Minor, the Near East, Egypt, and North Africa. In the wake of this geographic expansion (see Table 1), large-scale commerce, industries and financial sectors developed, and the volume of trade exploded. This appears to be particularly true for seaborne trade. For example, Hopkins (1980) infers from data on 545 dated ancient shipwrecks, found near the coasts of France, Italy, and Spain, that interregional trade was higher in the period from 200 BC to AD 200 than either before or during any time in the following millennium. Analyses of the number of silver coins minted in Rome during the late Republic (157-50 BC) supports this hypothesis: the circulation of coins increased tenfold over that sample period.

The wide geographical expansion of Rome as a single political entity provided favorable conditions for the establishment of large product markets. Kessler and Temin (2005) argue that there was an integrated grain market stretching over all of the Mediterranean. Analyzing historical data on grain prices in Rome, Northern Italy, Sicily, Spain, Turkey, Palestine, and Egypt, they find a strong linear relationship between prices and distance from the production site, which appears to reflect transportation costs and suggests a functioning market and price mechanism. Similarly, Hopkins (1980) uses the spread of silver coins, minted in Rome, across the different regions of the growing Ro-

man state to illustrate its integration into a single monetary economy. He plots the number of catalogued Roman coins found in Southern Germany, Northern Italy, Britain, France, the Balkans, and Syria, over the years AD 50-200. The positive correlation of time trends across regions suggests a smooth flow of money across the Empire, consistent with the view that Rome had become the monetary center of the known Western world in the first century BC (Cunningham, 1898, p. 164). The coin-flow also corroborates the empire-wide operation of many other product markets (Temin, 2001).

Technical progress supported the growth of the Roman economy. For example, Wilson (2002) argues that the discovery and spread of water-powered devices had a causal impact on economic development in Rome. He shows that the use of water-powered mining technology is strongly correlated with the volume of metal extraction. The estimates of extraction volume are based on analyses of Greenland ice cores, which record the atmospheric pollution from silver, lead, and copper extraction in different periods throughout history. A time-series plot of the concentration of lead between 962 BC and AD 1532 shows a steep increase in the first century BC, a somewhat lower plateau in the first century AD, a further decrease in the second century, and an even lower level up to the fifth century. Similar data of copper pollution reveals peaks from the first century BC to the second century AD and subsequently lower levels – all the way until the Industrial Revolution. The data suggests that advancements in Roman mining technology led to enormous increases in metal extraction. As we will see, the decline in production mirrors the decline of Rome's *societas publicanorum*, though with some time lag.

A broad overview of the archeological evidence of technological innovation and the speed of technological transfer can be found in Greene (2000), especially for the late Republic and early Empire. Examples include the spread of grape- and olive-pressing equipment and water-powered grain-mills throughout the Mediterranean, bone dimensions of cattle that suggest selective breeding, and remains of pumps and water-wheels that allowed mining below the water table in the Northwestern provinces of Gaul and Spain.

The Roman financial system was also fairly developed. Temin (2004a) documents that sophisticated financial intermediaries – bankers (*argentarii*) and brokers (*proxenetae*) – pooled and distributed funds effectively across the Roman economy. Evidence from the early Roman Empire includes the so-called *Muziris* papyrus of a large maritime loan, which appears to be copied from a standardized maritime loan contract; catalogues of loans in Roman Egypt; and numerous literary sources such as Livy's account of the evasion of interest rate regulation via lending to foreigners in his History of Rome (*Ab urbe condita* 35.7). These sources report various lending practices, bank branching, loan transfers, and lending activities of temple endowment and local governments. Related to

the context of my analysis, Temin points out that the publicans functioned as de-facto deposit institutions for the Roman government and provided interest income on revenues they collected for the government.

These details about the ancient Roman economy illustrate the fast-paced economic development during the late Roman Republic and early Empire, in which we have to place the development of a company format as advanced as the *societas publicanorum*.

Law

Our knowledge of Roman law in the period prior to the Punic Wars (middle of the third century BC) is limited to the famous Twelve Tables from 450 BC. The Twelve Tables are generally perceived to be the foundation of Roman law. As far as we can judge from the surviving text fragments,[5] the Twelve Tables were not an exhaustive codification of all legal rules. Rather, they defined various private rights and legal procedures and ensured basic economic and political rights for the plebeians in their power struggle with the patricians.

The jurists of the last two pre-Christian centuries, the pre-classical period, developed a "legal science" with formal legal concepts and systematization. This development has often been attributed to the encounter with Greek philosophy (Kaser, 1980, p. 4). It is also the period in which the activities of the publicans and the formation of *societates publicanorum* achieved their greatest expansion and development.

The "classical" period during the first 250 years AD marks the height of Roman law. The law of this period exerted a large influence on legal development throughout the world and throughout history. The discussion about "Roman-law origin" in the modern law and finance literature is only one example. Among the different fields of law, however, only the private (or civil) law has had this influence, either directly, as the foundation of modern private law, or indirectly, through the modern Civil Codes.[6]

Roman private law did not undergo systematic codification until the beginning of the sixth century AD. During the pre-classical and classical periods, legislated statutes (acts *(leges),* plebeian resolutions *(plebiscita),* or senate resolutions *(senatus consulta)*) played a fairly small role. Rather, the law emanated from the advice of legal experts, the *responsa prudentium*, to the judicature, i.e., to the *praetor* (judge), to the *aediles curules* (senatorial superintendents), and to the governors in the provinces. These magistrates and their jurors, called *tribunales*, usually had no legal training, but appointed jurists into a committee of legal experts, the *consilium*. The appointment as an expert was honorable

[5] See Schöll's *Legis XII tabularum reliquiae* (1866) for a widely cited reconstruction of the Twelve Tables.
[6] Civil-law codifications replaced the direct application of Roman law in many countries, starting at the end of the 18th century (Kaser, 1980, p, 2). Note that even civil code traditions that are not commonly characterized as having Roman legal origin typically borrow directly from Roman law.

and desired among lawyers, who usually belonged to the aristocratic class (patricians) and also advised plaintiffs and defendants. Based on the experts' opinion, the magistrates would grant actions (*actiones*), defenses (*exceptiones*) and other legal remedies. Those expert opinions shaped the legal system, even if they had no formal legal power. Hence, Roman law textbooks often characterize Roman law as "juristic law" (e.g. Schulz, 1951; Buckland and Stein, 1963). Since legal experts did not discuss abstract concepts but concrete cases of current interest, Roman law developed in step with the legal issues of the day. In fact, Roman-law scholars like Duff (1938) and Kaser (1980) liken Roman law to English law today: largely free of abstract concepts and essentially "case law." This gave the Roman law an enormous degree of flexibility, providing the ability to cope with the transformation of Rome from a rural community to a large empire.

Under the Principate, the emperors' decrees (*constitutiones*) started to be recognized as binding legislation. The emperors, however, imposed little constraint on the autonomous, case-driven legal development. The preexisting body of law continued to evolve in a similar fashion as before.

Systematic codification finally took place under the Byzantine emperor Justinian. Justinian aimed at documenting and codifying the full body of Roman law in the so-called *Corpus Iuris Civilis*. In AD 533 and 534, the main parts of the *Corpus* were issued: the *Institutes* (an introductory textbook), the *Digest*, or *Pandects*, (the core piece, which documents various legal debates), and the *Codex* (imperial constitutions from the Principate). Our knowledge of Roman law stems mostly from the *Corpus Iuris Civilis*.

The case-oriented evolution of Roman law helps us to understand how the creation of a quasi-corporation could occur without formal legislative changes and recognition of legal concepts often considered indispensable, such as limited liability, agency and representation.[7] For example, Roman law never recognized limited liability for private businesses – besides removing the right of a creditor to kill or sell into slavery a debtor if he failed to pay (*lex Poetelia Papiria de nexis*) in 326 BC. Instead, Rome accommodated the demand for limited liability by exploiting the *peculium* of slaves. Slaves were legally "things" and, as such, could not own other things. In practice, however, they were allowed to accumulate earnings and other property, denoted as their *peculium* (allowance). They became the legal owner after manumission, i.e., when granted freedom. To remedy the lack of a business format with limited liability, Romans employed "company slaves" (*exercitores servi communes non volentibus dominis* or *servi communes negotiatores*) as managers and funded them with a *peculium* for business transactions. That

[7] For more details see Malmendier (2002), pp. 212-213.

way, they avoided liability for business conducted by the slaves beyond the funds with which they provided them.[8]

Similarly, Rome never instituted the law of agency. Instead, to meet the increasing demand for binding representation in business matters in Rome's growing economy, the Romans employed the *patria potestas*, i.e., the power of a Roman father over his (adult) children, and the ownership of slaves as a form of agency.[9] The Roman *pater familias* and *dominus* could act through children and slaves, in which case he was liable for their offenses.[10] Slaves managed estates and arranged trading and banking transactions on the master's behalf. Even top managers were typically selected from among slaves, which helps to explain the astonishingly common phenomenon of Romans "placing themselves into slavery." Free men sold themselves into slavery in order to attain a high position in the enterprise of a senatorial house,[11] a striking example of how the Romans achieved modern organizational functions without formal legal reform by expanding the interpretation of existing legal institutions.

2.2 Who Were the Publicans?

The *societas publicanorum* owes its creation to Rome's Republican system of government. During its five centuries of existence, the Roman Republic never assembled any sizable bureaucracy. Similar to the ancient democracy in Athens, Rome distrusted the continuity of power embedded in a bureaucratic state machine. Instead, public services were contracted out and public income sources were leased to private entrepreneurs. These private contractors were called "government leaseholders" or publicans (*publicani*). As Ulpian writes in the Digest (*Digesta* 39.4.1.1):

Publicani ... sunt qui publico fruuntur, nam inde nomen habent.	Publicans … are those who deal with public property; that is where their name comes from.

And shortly thereafter (*Digesta* 39.4.12.3 [38 ad ed.]):

Publicani autem dicuntur, qui publica vectigalia habent conducta.	Those are called publicans who conduct the exaction of public taxes.

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[8] Brentano (1929), p. 143; Földi (1996), esp. the summary on p. 211. For a discussion of the exceptions, in which the liability went beyond the *peculium*, see Honsell, Mayer-Maly, and Selb (1987), pp. 378-381.
[9] On the law of agency and its substitutes see Garnsey and Saller (1982), p. 33, and Crook (1967), p. 60. On the same topic in the context of the Roman labor market see Temin (1994b), p. 536.
[10] Taubenschlag (1944), pp. 307 ff., 505 ff.
[11] Ulpian (*Digesta* 28.3.6.5) denotes such slavery as *ad actum gerendum*, i.e., to secure the post of an *actor*, who runs the senatorial household.

Since the Roman senators were not allowed to participate in the government leases, a separate class of entrepreneurs emerged, later often equated with the knights (*equites*).

The business activities of the publicans are described in Badian's classic work titled *Publicans and Sinners* (1983), and in Malmendier (2002).[12] The earliest reports refer to the 5th century BC. Ancient historians such as Dionysius of Halicarnassus and Livy provide accounts of religious and ceremonial services as well as construction jobs contracted out to private entrepreneurs. Another famous example is the feeding of the white geese on the Capitol. The geese received government-sponsored meals since, in 390 BC, their honking had warned the Romans of the attacking Gallic troops.[13] According to Pliny[14], the "geese feeding program" was leased out to the publicans.

Over the course of the Republic, an increasing volume of public works were outsourced, until the publicans were dealing in practically every state department's business (Cunningham, 1898, pp. 157 and 162). The three main areas were:

1. provision of goods and services for the public,
2. utilization of public property, and
3. collection of public revenues.

The key element in the first group of contracts was the provision of supplies to the Roman army.[15] This included the regular supply to fixed and stationary garrisons as well as the less predictable supply demands during wartime. We have evidence of the latter even for the imperial period when the publicans were otherwise in demise. The revenues from these contracts were astonishing; as Badian (1983, p. 29) shows, they were equivalent to the annual pay for 10,000 soldiers (about 1.2m *denarii*) in the case of a supply contract for togas, tunics, and horses in the second century BC (Livy, *Ab urbe condita* 44.16).

The construction, renovation, and maintenance of public facilities were likely the next-largest type of public provision contract. Public buildings included streets, city walls, temples, markets, *porticus*, basilicas, theatres, facilities for the circus games, aqueducts, and public sewers.[16] Private entrepreneurs were also contracted to erect statues.[17]

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[12] The 1997 edition of Badian's work (in German) incorporates some newer sources and offers modified interpretations. Older literature includes Kniep (1896); Deloume (1889); and Ürödgi (1968).

[13] Livy, *Ab urbe condita* 5.47.4.

[14] Pliny, *Naturalis historia* 10.26.51.

[15] See for example Livy, *Ab urbe condita* 23,48,5-49,4; 25,3,10; and 34,6,13 for the year AD 215; 27,10,13 for AD 209; 44,16,4 for AD 169; Valerius Maximus, *Factorum et dictorum memorabilium* 5,6,8. See on the topic Hill (1952), p. 88-89.

[16] Examples can be found in Cicero, *Secunda in Verrem* 1.49.128 (maintenance of temples); Dionysius of Halicarnassus, *Roman Antiquities* 3.67 (maintenance of public sewers); Livy, *Ab urbe condita* 4.22.7 (construction of the *villa publica*); 5.23.7 (construction of the temple for the Mater Matuta at the Forum Boarium for Iuno Regina on the Aventine hill); 6.32.1 (maintenance of city walls); 24.18.10 (maintenance of temples); 29.37.2 (street repairs; also in 41.27.5); 40.51.3-5 (renovation of markets and theatres).

[17] Cf. Milazzo, Realizzazione delle opere pubbliche, p. 147 ff.

Like the army supplies, building contracts required vast financial resources. Badian (1983, p. 67 f.) suggests that the building contract for the Marcian aqueduct in the middle of the second century BC amounted to 45m *denarii*, which was roughly the entire fortune of the (purportedly) richest millionaire in Rome in the first century, M. Crassus.

Another famous, though smaller task was coinage. The government entrusted private entrepreneurs even with the minting of Roman coins.

The second group of contracts, the utilization of public property, includes grazing on the public domain (*ager publicus*), mining, and fishing in public lakes.

The most (in-)famous contracts where those outsourcing tax collection, especially poll or land taxes from the provincials. Taxes and dues initially played a minor role in ancient Rome. Like the Greek *polis*, Rome had no concept of direct taxes. The peoples conquered outside of Italy paid tributes, but direct personal taxation such as an income tax was deemed unworthy of free men. The state's primary source of income was war booty. The only tax burden on the Roman citizen was the *tributum*, a tribute demanded irregularly to finance soldiers' pay.[18] It was levied only when military ventures had exhausted the state treasury. Even then it was perceived as a loan of the citizens to the state, to be repaid later out of war booty.[19] With the expansion of Rome, the tribute disappeared almost completely,[20] at the expense of the provinces. A steadier stream of tax revenues was imposed only during the Principate. At that time, however, an official fiscal administration took over and excluded the publicans from the collection of the taxes.

Instead, the collection of indirect taxes and tributes on goods and services became a core activity of the publicans. These dues were imposed primarily on non-Romans and non-Roman goods, namely traders arriving at ports, city gates, and market places. Cicero mentions the three most important taxes that were contracted out in *De Imperio Cn. Pompei* 6.15: the port tax (*portorium*), the "tenth" of the harvest of agricultural products including grain (*decuma*), and the grazing fee (*scriptura*). The inheritance tax (*vicesima hereditatium*) was also contracted out but played a subsidiary role.[21]

All three types of contracts were awarded via auctions (*sub hasta*), similar to licenses or spectrum rights today. Livy, *Ab urbe condita* 39.44.5-8, mentions public procurement auctions taking place as early as 200 years BC. The auctions appear to have

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[18] Originally, the *tributum* probably replaced the self-provisioning during military service; Laum (1926), p. 229.

[19] Even voluntary contributions were repaid whenever possible. A famous example is the voluntary contributions of Roman citizens during the Second Punic War (in 210 BC). Livy reports (starting in *Ab urbe condita* 23.48.5) that, after the financial situation improved in 204 BC, the contributions were ex post recognized as loans and repaid in three installments. See Briscoe (1989), p. 75.

[20] Cicero describes the *tributum* in *De officiis* 2.21.74 as an overcome means of public financing.

[21] Cicero complains in his *Epistulae ad Atticum* 2.16.2 that the *vicesima* alone generates too little tax income.

been conducted regularly, with a regular and large audience of entrepreneurs specializing in contracts with the state: Livy, *Ab urbe condita* 24.18.10-11, refers to businessmen in 214 BC who "frequently participated in such auctions" (*frequentes qui hastae huius generis adsueverant*). The Roman *censor* (the registrar and "finance minister") awarded utilization or tax-collection rights to the highest bidder, procurement contracts to the lowest bidder. A *societas publicanorum* was represented in the auction by a *manceps*, normally the most illustrious partner (*manceps princeps inter suos* as Cicero formulates in *Pro Plancio* 13.32 and Pseudo–Asconius*, Divinatio in Caecilium* 33). The auctions took place on the central Roman market place, the *Forum Romanum*, with the exception of a few auctions in the provinces. In *De Lege Agraria contra Rullum* 1.3.7, Cicero writes that the censors can grant tax-collection contracts only in front of the Roman people (*censoribus vectigalia locare nisi in conspectu populi Romani non licet*), preventing non-competitive allocations to preferred entrepreneurs.

The customary contract term was five years, likely because the censors were originally in office for the period of five years (*lustrum*).[22] The individual contract terms and conditions were laid down in so-called *leges locationum* (or *lex censoria*), a reservoir of fixed contract clauses that, for the most part, could be used for each new contract grant.[23] The contract specified payment schemes, warranties, and legal rights.

The scale of these three types of business activities expanded vastly with the expansion of Rome. While the types of contracts did not change much throughout the Republic, the economic opportunities grew with the addition of new territories. The decline of the Roman Republic and the onset of the Principate, however, brought an end to the success story of the publicans. As discussed in more detail in Section 2.4, the knights (*equites*), and thus many of the publicans, were subject to proscriptions during the last century BC, resulting from power struggles with the senatorial aristocracy.[24] Legal reforms were passed that restricted the business activities of the publicans. First, they were limited to collecting taxes and dues.[25] Then, Augustus transferred the tax collection contracts in Gaul, Asia, and finally in all imperial provinces to a *procurator Augusti*, who was part of his bureaucracy.[26] The Julio-Claudian emperors (AD 14-68) continued to gradually reduce the contracting with private entrepreneurs and, in the 2nd century AD, Trajan (AD

[22] Mommsen (1877), vol. 2, p. 342 f., speculates that, originally, the franchises were granted *quinto quoque anno*, i.e. every four years, and it was only later that this cycle was extended to five years.
[23] An example is the *Lex Portorii Asiae*, see fn. 29.
[24] According to Appian (*De bello civili* 4.5), 2000 *equestri* were killed; see also the detailed account of the brutality of the proscriptions in Cassius Dio (*Roman History* 47.14). More on this in Üródgi (1968), col. 1201.
[25] Cimma (1981), p. 99 ff.; Hirschfeld (1963), p. 69 ff.; Rostovtzeff (1902), p. 379 ff.
[26] Marquardt (1884), pp. 301-318; Üródgi (1968), col. 1200, 1202. A province was called imperial if the emperor appointed the governor, and senatorial if the senate appointed the governor.

98-117) finally limited it to a few specific taxes such as the inheritance tax. The large-scale operations of the publicans reverted to smaller-sized businesses of so-called *conductores* (contractors), similar to their origins in the early Republic.[27]

Concurrent with the demise of the *societas publicanorum,* economic growth slowed down in several industries. One example is the mining industry, which had formerly seen an explosion in output, likely due to technological improvement and its use by the companies of the publicans. As Wilson (2002) reports, the use of the new water-powered mining techniques and the output from various mines shrank significantly in the first century AD, which is after the emperors took over the mines.

The correlation between output and activities of the publicans in other industries is harder to measure. Tax collection by state officials, for example, might have been easier to enforce, even if less efficiently organized. It was also affected by the drastic changes in tax laws mentioned above. The construction industry remained very active, which is not surprising in light of the territorial expansions and the emperors' demand for villas, temples, and palaces. It would be interesting to know whether the cost of production, e.g. for street repairs or army provisions, increased after the demise of the *societas publicanorum*. Unfortunately, such data is hard to procure.

The demise of the *societas publicanorum* also explains why this business format is not discussed much by economic and legal historians. As mentioned above, most of today's knowledge about Roman law stems from the compilation of Roman law under Justinian, the *Corpus Iuris Civilis*, in AD 533-534. The codex contains legal opinions from the classical and post-classical periods (1st to 6th century AD), but not from the pre-classical period. Since it was compiled after the lease-holding companies had disappeared, the jurists cited in the *Corpus Iuris Civilis* refer to the publicans only in the sense of smaller tax collectors. The lack of easily accessible evidence is likely the reason the *societas publicanorum* is relatively unknown in the history of the corporation.[28]

2.3 The *Societas Publicanorum* as a Business Corporation

To what extent were the large associations of the publicans "corporations"? From the historical literature and inscriptions,[29] we know that Roman law recognized two types of associations, the *collegium* and the *societas*. The *collegium* was the only incorporated form

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[27] See Pliny, *Epistulae* 7.14; *Panegyricus Traiani* 3.7.7; 39.5.

[28] See Malmendier (2002). In addition, most of the scarce evidence about economic activities in ancient Rome comes from the period of the early Empire; see Temin (2006).

[29] I use classical Roman and Greek literature and inscriptions, in particular the *Monumentum Ephesenum,* an inscription discovered in Ephesus in 1976, which turned out to be the translation of a Latin tax law – the *Lex Portorii Asiae* – from AD 62 (Engelmann-Knibbe, 1989). The nucleus of this law, paragraphs 1-36, originates in the late Republic, 75 or 74 BC, and reveals numerous details about the functioning of the lease-holding companies.

of organization besides the public corporations (such as the *populus Romanus,* i.e. the state, or the *aerarium* and *fiscus*, i.e. the state and imperial treasuries). It was, however, available only to organizations with "public purpose" such as religious and political associations, not including government lease-holding.[30] As a result, government leaseholders had to set up their companies as *societates*, the Roman version of partnerships.

The Roman partnership differs from the modern corporation in many ways: Partners (*socii*) could not limit their liability; the partnership could not exist beyond the death or renunciation of a partner nor in case of legal disputes among the partners; and the firm could not assume rights or obligations separately from its members.[31] Hence, the legal format of the *societas* was evidently unsatisfactory for the large-scale and long-term operations of government leaseholders. The Romans resolved this deficiency by reinterpreting and allowing exceptions to the prevailing legal rules, applicable only to lease-holding companies. Four features differentiate the *societas publicanorum* from the simple *societas*:

1. *Representation*: A single person could contractually bind the firm and assume rights in the name of the firm.[32] The representative with whom the *censor* interacted and who bid for contracts in the public auction was called *manceps*, as described above.
2. *Continuity and Stability*: The firm did not cease to exist if a partner died or left the firm. Moreover, legal disputes among the partners did not necessarily affect the existence of the *societas publicanorum*.[33] Even the departure of the key executive, the *manceps*, did not affect the contractual relationship between the company and the Roman government.[34]
3. *External Financing*: Investors could provide capital and acquire shares (*partes*) without becoming a partner and without being liable for the company's obligations. Several ancient authors refer to the shareholders of the *societates publicanorum* as *participes* or *adfines*.[35] We also know that the shares were traded and had fluctuating prices. For instance, Cicero writes about 'shares that had a very high price at that time.'[36] The statement also implies that the shares could be bought either from another shareholder or directly from the company, suggesting secondary offerings. Traders met on the *Forum Romanum*, supposedly near the Temple of Castor.[37]

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[30] Duff (1938), pp. 95 ff.
[31] See, for example, Kaser (1980), pp. 225-227.
[32] *Digesta* 3.4.1.1.
[33] The special legal action was called *actio pro socio manente societate*, see *Digesta* 17.2.65.15.
[34] We can infer this from paragraphs 46 and 54 of the *Lex Portorii Asiae*.
[35] E. g. Cicero, *Pro lege Manila* 2.6, *Pro C. Rabiro Postumo* 2.4; Plautus, *Trinummus* 330-331; Livy, *Ab urbe condita* 43.16.2. The meaning of *adfines* is vaguer; they are never mentioned in Cicero's work.
[36] Cicero, *In P. Vatinium testem interrogatio* 12.29. Badian (1983), p. 102, points out that the high stock prices Cicero mentions are consistent with a price reduction for tax collection rights in the same year.
[37] See Plautus, *Curculio*, 78, and the references in Chancellor (1999), p. 4.

4. *Rights and Obligations*. According to *Digesta* 47.2.31.2 the company of tax collectors could file actions, e.g., against fraud or embezzlement. The company could also own property and inherit items.[38]

The *societas publicanorum* had thus assumed the most important features of the modern corporation. In addition, other sources describe it almost directly as a separate legal entity. For example, Cicero reports about a *societas publicanorum* that "consists of other *societates* [*publicanorum*]",[39] and thus assumes the role of a natural *persona*. Gaius counts the *societas publicanorum* among the organizations with a *corpus* (*Digesta* 3.4.1.1). And *Digesta* 46.1.22 states that the *societas publicanorum* can "act like a person," which is exactly the modern characterization of corporations as legal *personae*.

The modified features of the *societas publicanorum* had a far-reaching effect on its access to capital. Cicero mentions that stock ownership in the *societates publicanorum* was widespread in the Roman population. According to Polybius, "almost every citizen" invested in government leases by the 2nd century BC.[40] A famous statement by Cato indicates that investors aimed for diversified portfolios. Cato advises that, if people wished to obtain money for shipping business, they should form a large association and when the association had 50 members and as many ships, he would take one share in the company.[41] These quotes from Cicero, Polybius and Plutarch illustrate not only the flows and functioning of the Roman capital market, but also that such transactions were a matter of course. Plutarch, for example, quotes Cato with the expectation that his readers in the early Roman Empire would understand his boasting. In other words, educated Romans knew about the possibility of buying shares in the *societates publicanorum*.

In summary, the *societates publicanorum* functioned much like modern corporations in terms of their recognition as legal entities and their access to capital markets. This being said, the *societas publicanorum* does not display every feature of a corporation, at least in the sense of a modern definition of legal *persona*. The concept of the legal *persona* was formed slowly over the centuries. Its modern conceptualization started in the 16th century and was the subject of extensive theoretical debates in the 19th century, most prominently between the "Romanist" legal scholar Friedrich Carl von Savigny and the "Germanist" Otto von Gierke.[42] The modern concept imposes much more structure than existed at the time.[43] The Romans were not concerned with such conceptual debates.

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[38] *Digesta* 3.4.1 (*habere res communes*) and *Digesta* 37.1.3.4 (*bonorum possessio*).
[39] Cicero, *Epistulae ad familiares* 13.9.2 ("*constat ex ceteris societatibus*"). Whether this quote truly indicates corporate pyramiding is debated, see Balsdon (1962) for a discussion, esp. p. 136 (with fn. 22).
[40] Polybius, *Historiae* 6.17.3-4.
[41] Plutarch, *Cato Maior* 21.5-6. I thank an anonymous referee for suggesting this quote.
[42] Von Savigny (1840-49), vol. 2; von Gierke (1887).
[43] A more detailed discussion of appropriate classification criteria for the ancient corporation is in Malmendier (2002). See also Duff (1938), e.g. on p. 48. A similar problem in the modern law and finance lit-

Dealing with the rapid transformation of their small closed agricultural economy into an open system that spanned the entire known world, they managed to accommodate the practical needs of their growing economy without revolutionizing the laws that regulated company formats. From a practical, economic perspective, the historical sources paint a compelling picture of the *societas publicanorum* as the first business corporation.

2.4 Why Did the Publicans Disappear?

Why did the development of the Roman business corporation come to a halt, ultimately being reversed under the Roman emperors? Why did the *societas publicanorum* disappear instead of becoming the direct predecessor of the modern corporation? These questions take us to the debate on the political economy of legal, financial, and economic development. I showed above that the rise of the publicans is closely related to the development and functioning of the Roman Republic and that its demise was triggered by the disappearance of the Republic and the rise of the emperors. But, while it seems clear that the rise and fall of the *societas publicanorum* reflects Rome's changing political environment and that their rise was in the interest of political elite in an expanding Roman Republic, it is less clear what motivated the emperors to suppress the activities of the *publicani* and the related financial and economic developments.

Traditionally, historians have linked the demise of the publicans to their abuse of power. Already in the 16th century, the legal historian Cujaz described the publicans as "unsurpassed in fraud, avarice, immodesty and audacity."[44] Over the last four centuries, this verdict has changed little. Deloume and Ürödgi portray the publicans as revenue-hungry exploiters.[45] Mommsen relates the rise of a class of profit-oriented entrepreneurs, i.e., of the publicans, to the emerging social tensions in the Roman Republic and, later, the disintegration of the Roman Empire.[46] Cunningham lists "avarice," "extortions," and "greed" as their main business motivation.[47] These historians interpret the elimination of the government lease-holding system and its replacement by public administration as an attempt of the emperors to remedy the shortcomings of contracting and outsourcing that

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erature is implicit comparisons relative to the standards in one country. For example, some countries may (formally or informally) recognize firms as separate entities even if they are not registered – which is, instead, a legal prerequisite on most Western countries. As a result, data collected on firms and different types of firms in different countries may be biased. For instance, most Latin American countries have no concept of "partnerships" and only limited-liability companies are included in the "formal" sector (Klapper and Quesada Delgado, 2007).

[44] Cujaz (1595) characterizes the *publicani* in his commentary on *De publicanis et vectigalibus et commissis* (*Digesta* 39,4) as: *"Hi quam fraude, avaritia, immodestia, audacia superent ceteros homines nemo est qui nesciat…*" (p.54).

[45] Deloume (1889), p. 475-476; Ürödgi (1968), col. 1191-1192.

[46] Mommsen (1916), vol. 2, p. 379-380.

[47] Cunningham (1898), pp. 157 and 165.

relied on monetary incentives. Augustus is hailed for organizing an effective public administration that eliminated the abuses of the publicans.

There are, however, two problems with this traditional view. First, it is unclear how severe the abuses of the publicans were. As Badian (1983) points out, the negative image of the publicans is biased. At times when the system of public contracts was working well, there was little reason for ancient writers to report about it. The excesses and abuses of the publicans, instead, stirred the interest of the ancient historians and led then to a partial treatment of the publicans in the historical literature centuries later.

Second, however grave the abuses were, it is unclear whether the governing political class had any interest in protecting the inhabitants of the provinces from the excesses of the publicans. Attempts to restrain the publicans, such as the legislation of Q. Mucius Scaevola as governor of province Asia in the early first century BC, were rare. Politicians had to overcome resistance among their fellow magistrates in order to enact any such legislation, as Cicero reports in his letters to Atticus (*Epistulae ad Atticum* 6.1). Quite to the contrary, the proconsuls displayed similarly abusive behavior in the provinces they were governing.[48] Thus, the traditional explanation for the demise of the publicans, which invokes the "benevolent paternalism" of the imperial Roman government, lacks plausibility.

It is right, however, that the political change from Republic to Empire fundamentally changed the political-economy framework in which the publicans conducted their business. First, the government became less dependent on the publicans for purely organizational reasons. During the Republic, the short tenure of the consuls and other magisterial offices precluded a stable bureaucracy that could have been in charge of public works. In other words, it was a necessary condition for the change from private leaseholding to public ("re-nationalized") administration that the emperors established a permanent bureaucratic apparatus.[49] At the same time, creating a bureaucracy also allowed the emperors to divert public funds more easily. Under the Principate, as the emperors increasingly re-directed public revenues into their (private) pockets and Rome's public treasury, the *aerarium*, lost its importance.[50] Such diversion was likely easier when the emperors' own employees collected public revenues rather than when the task was publicly auctioned off and performed by private entrepreneurs. In fact, as Badian (1983) points out, earlier during the Republic, Gaius Gracchus started to outsource tax collection

[48] See for example, Cary and Scullard (1975), p. 174.
[49] Heuss, 1960, p. 363; Rostovtzeff, 1957, p. 382.
[50] During the Republic, all state finances went through the *aerarium*. It was the role of the two quaestors to manage the *aerarium*, following the decrees of the Senate. During the Principate, the emperors established an additional treasury, the *fiscus*, with whose usage they bypassed Senate. They also started to nominated the quaestors themselves or replaced them with dependent officials. See Cary and Scullard (1975), p. 379.

in the province of Asia to the publicans in order to *prevent* the governors from diverting public revenues. A reverse argument explains why the emperors wanted to discontinue outsourcing.

Second, the switch from private entrepreneurs to bureaucrats coincided with the gradual increase in taxes under the emperors. As discussed above, taxation was generally viewed as intruding on civil liberty and had caused violent resistance all over the empire.[51] Hence, it is conceivable that enforcement was easier for government employees, i.e., representatives of public sovereignty with public enforcement rights, than for private entrepreneurs. Thus, even if the auction-based outsourcing system had revenue-enhancing features, e.g., identified the lowest bidder for the provisions of services and the highest bidder for revenue rights, these advantages might have been outweighed by the better yield from public collection when taxation increased.

A third reason relates to the tensions between the political and business elites in ancient Rome. The emperors may have had concerns about powerful and large business organizations since the power of the publicans posed a threat to their own imperial position, consistent with arguments in the modern political-economy debate (e. g. Rajan and Zingales, 2003). During the Republic (particularly in times of war) the Roman government repeatedly came to realize its dependence on the services of the publicans. The emperors were in the position to avoid such dependence building up their own bureaucracy.

This latter argument is particularly compelling in light of the increasing political role of the publicans. Early during the Republic, the publicans had shown little interest in political involvement. Becoming a senator and running for political offices would have required them to give up their business, as senators were excluded from trade and commerce.[52] The political involvement of the publicans, however, increased significantly with the Gracchan reform movement. After the murder of his elder brother Tiberius Sempronius Gracchus in AD 133, Gaius Sempronius Gracchus continued to strengthen the position of the *equites*, i.e., the knights, who also ran the *societates publicanorum*. He passed a law (*Lex Iudicaria*) granting them control over the courts that dealt with the senatorial extortions in the provinces. These reforms helped to create an *ordo equester*, i.e., a ‘class’ of knights with a distinct identity. C. Gracchus also reinforced the economic power of the publicans by allowing them to collect the “tenth” (*decuma*) in Asia, Rome’s richest province. (Previously the publicans had only collected small taxes in Asia.) The *equites* and, most prominently among them, the publicans started exerting increasing in-

[51] Laum (1926), p. 218; Meincke (1984), pp. 170-1.

[52] Partly, the apparent lack of political ambition might reflect hidden constraints. While *equites* were formally qualified to enter the Senate, being part of the land-owning aristocracy may have been an informal impediment embedded in social prejudice, as for example argued in Badian (1983).

fluence on state politics – an influence that senators (like Drusus and L. Sulla) and, later, the emperors aimed to undermine.

Finally, another possible reason for the demise of the publicans is lack of credible commitment on the side of the emperors. That is, it might have been impossible to sustain the *societas publicanorum* and the system of government leases even if the emperors had wanted the system to persist. How could the emperors convince entrepreneurs that they would respect property rights and honor obligations towards the publicans? The Roman Republic was a system of checks and balances. But the emperors centralized power and could, in principle, bend law and its enforcement in their favor. Eliminating the large companies was that much easier, given that their status was not enshrined in formal law. Similar accounts of kings and other powerful elites imprisoning or killing their bankers are common throughout history, especially if the elites were knee-deep in debt.

These factors point to the importance of politics, in addition to and sometimes in spite of legal development, for the establishment and longevity of corporations in Rome.

2.5 Finance and Growth of Large Firms—With and Without Law

I have shown that the Roman publicans were able to establish large-scale business operations when the governing class supported and, in fact, benefited from those businesses. Laws were reinterpreted to facilitate government lease-holding without fundamental legal reforms. With the transition from a Republican to an imperial government, however, the Roman economic system gradually switched from contracting with private entrepreneurs to large-scale nationalization. Since such financial and economic regression occurred at a time when the legal system reached its height of development, the Roman case allows us to distinguish the influence of political changes from that of legal changes.

The historical case provides one example of corporations functioning without the legal environment we usually presume they need (including legal concepts such as limited liability or private corporation), provided that the government is willing to grant their status and operation. The Roman experience highlights two institutional circumstances that were favorable to the development of the business corporation: First, the state needs to be strong (or rich) enough to generate demand for complex organizational tasks but weak (or frugal) enough that these tasks must be outsourced. Second, the legal system needs to be accommodative enough to extend existing, sanctioned legal forms to solve new organizational problems.

The historical evidence also illustrates that the growth of business organizations in scale and scope tends to generate tensions between the commercial elites who control them and the political elites who control the state. One aspect is that political (and military) needs to centralize may jeopardize the existence of independent business corporations. Another aspect is that the growth of business corporations can result in control over

portions of the economy, leading to significant political influence and control over institutional development – a feedback loop that might result in large and inefficient firms (Morck, Wolfenzon, and Yeung, 2005). One interpretation of the Roman evidence is that the former loop and fear of the latter one explain the demise of the business corporation under the Roman emperors.

Economic historians as well as legal scholars have elaborated on the emergence of financial and economic relationships "even without law" given the right set of institutions (Ellickson, 1991; Greif, 1989). Cull, Davis, Lamoreaux, and Rosenthal (2006), for example, discuss how a wide variety of financial institutions arose across Western Europe and North America to meet the financial needs of small- and medium-size enterprises at times when securities markets and banks focused on financing large enterprises. Temin (2006) points to the growth-promoting qualities of political institutions in Rome, such as granting security to private individuals during the long-lasting *Pax Romana* (27 BC - AD 180). However, the case of the *societas publicanorum* stresses the countervailing force: While it is true that the economic growth of Rome during the late Republic and the early Empire indicates the quality and importance of Roman institutions, it is also true that these institutions persisted only as long as they served the interests of the political elite. They were not stable or resistant enough to protect citizens when political interests reversed.

Interestingly, political and economic interests of the government played a similar role in the later development of the corporation. In the 17th and 18th century, the English East India Company developed from a loose association of merchants, who contributed capital and divided profits one voyage at a time, into a continuous organization.[53] Its incorporation was originally driven by the need to create a body of merchants to which the government could transfer monopolistic trading privileges and which the governmental authority needed to extract economic surplus.[54] As the Company gained in power, it threatened the interests of the British political elite. This conflict led to the centralization of imperial power and expansion of the imperial bureaucracy, the dissolution of the Company, and ultimately the official annexation of the Indian colonies under the crown in the 19th century. By this time, however, the practice of incorporation was established beyond the East India Company and remained in practice in the format of "special incorporation," whereby corporate bodies are created (and dissolved) by explicit acts of the state and provide monopolistic rents to elites in exchange for performing state-like functions. The subsequent rise of democracy in England and the United States led to debates over such elite privileges and the existence of corporations. The function of corporations was

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[53] For a detailed history see, for example, Davis (1973) and Scott (1910-12), vol 2.
[54] Gower (1969), p. 24.

again transformed as a result of political conflict, this time in line with the principles of free entry and competition that inspired the passage of "general incorporation" statutes.

Other examples throughout more recent history provide evidence of the broader point that the state can be critical in fostering economic development, even without systematic changes in legal environment. One example is Mexico's development in the nineteenth century. Historians have related the lack of economic growth in the first half of the nineteenth century to Mexico's political instability and inefficient institutions and the resumption of growth in the second half of the century to the political changes, including of political elite's evolving interest in developing a stable economy, as is evident from the government's active support of railroad construction (Cardenas, 1997) and banking system development in the 1880's (Marichal, 1997).

Even more recent parallels can be found in East Asia, where changes in political interest have affected economic performance without changes in legal framework. One example are the political and social reforms in China during the Great Leap Forward, Mao's attempt to modernize China's agriculture and industries (1958-1960), and the Cultural Revolution, Mao's political campaign to revolutionize Chinese society and eliminate his political rivals (1966-1976). These changes in political interest weakened many central institutions and shifted economic power to local governments.[55] With political support – but without legal reforms – China moved closer to a market economy by decollectivizing agriculture, encouraging private enterprise, and allowing profit sharing in state factories. Later, political elites even pushed for the creation of new forms of business that were exempt from the usual legal restrictions in order to attract foreign investment. On the legal side, however, there were few attempts to establish the type of legal environment that is typically considered central to economic progress, such as secure private-property rights, commercial law (including property and contract law), or an independent court system for adjudication (Montinola, Qian, and Weingast, 1996).

A similar example is Korea. Korea's transformation from depending heavily on foreign aid in 1960 to growing at a rate of over 9 percent between 1965 and 1979 is generally attributed to changes in political economy.[56] Starting in 1962, the Korean government pursued a sequence of aggressive five-year economic development plans, fostering the chemical, steel, and machine industries as well as export-oriented growth. Throughout the 1970s, the scope of governmental intervention expanded, evolving into a government-directed system of economic order.[57] Democratization and the establishment of a free market economy, however, occurred only in the 1980s. The 2008 World Bank business

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[55] Shirk (1993)
[56] Collins (1990)
[57] Cho (1989)

survey of countries' legal environments ranks Korea's investor protection 66th out of 181 countries (China is 84th).[58] This evidence is consistent with the view that political and economic relationships are able to develop despite a dearth in parallel legal developments.[59]

3 Determinants of Financial Development and Growth

The rise and fall of the *societas publicanorum* provides a unique setting in which legal and political influences on financial development and growth can be disentangled. In this section, I discuss how this case informs the current debate about finance, growth, law and politics.

3.1 The Link Between Financial Development and Growth

The underpinning of the debate about legal and political determinants of financial development and growth is the link between finance and growth. While there is little doubt about the positive correlation between finance and growth (see, e.g., Levine and Zervos, 1998), the question is: Does financial development *cause* economic growth? This question is particularly relevant to the "law versus politics" debate since the legal environment has been found to predict various measures of financial outcomes, but less consistently measures of economic growth. The literature uses several methodologies to establish a causal link: simple *post hoc ergo propter hoc* arguments (King and Levine, 1993), the analysis of regulatory changes that affect financial development but not growth (Jayaratne and Strahan, 1996), horse races between alternative explanations (Beck and Levine, 2002), and firm-level analyses (Demirgüç-Kunt and Maximovic, 1998). Each of these approaches is open to obvious endogeneity concerns and alternative explanations so that additional evidence remains valuable.

In the Roman case, financial development and the rise and fall of the Roman shareholder company coincide with the increasing and then decreasing production in some of the *publicani*'s industries. This correlation does not provide evidence of a causal link. We do observe, however, a practical need for advanced contracting and financial development in order to realize the growth opportunities in the expanding Republic: Without a quasi-corporate organizational form such as the *societas publicanorum* and its improved access to external financing (via traded shares) it would have been hard to undertake large-scale projects such as the construction of streets, public buildings, or tax collection. Financial development appears to have been a precondition for growth.

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[58] World Bank Doing Business Survey; CIA World Factbook.
[59] Ginsburg (2000).

The Roman case study also contributes to the debate about the specific channels through which advances in financial contracting can foster productivity. The current literature suggests that financial development leads to growth by channeling financing to growing rather than declining industries (e.g., Wurgler, 2000), to small firms (e.g., Beck, Demirgüç-Kunt and Maksimovic, 2005), and to firms in high need of external financing (see, e.g., Rajan and Zingales, 1998).[60] Here, too, it has been difficult to address endogeneity concerns and to distinguish the proposed channels from correlated determinants.[61] Consider, for example, Rajan and Zingales' (1998) argument for the channel of external financing. They show that sectors in greater need of external finance develop faster in countries with more developed financial markets. "Need of external finance" is calculated as the fraction of capital expenditures not financed internally in the median firm in the corresponding U.S. industry. The analysis is open to the interpretation that sectors with large external financing (in the U.S.) are drivers of economic growth for other reasons; for example, they might be the sectors with the smallest inherent moral hazard problems.

The Roman case study provides an additional piece of evidence for the channel of external financing. The calculations in Section 2.2 indicate the extraordinary magnitude of financing required for the Roman public lease projects. The *societas publicanorum* could issue *partes* (shares) and thus have access to a much larger pool of external financing. Moreover, investors could move their money more easily between different companies, and such investments became wide-spread, as Polybius reports.[62]

3.2 The Determinants of Financial Development

The link between finance and growth raises the question of what, in turn, determines financial development. In my analysis of the *societas publicanorum*, the flexibility of Rome's legal system emerges as one important factor in the development of advanced financial contracting arrangements. A second major influence was the interests of the political elites during the Roman Republic and Empire. Much of the current literature revolves exactly around these two determinants: law and politics.

I briefly review the current debate in the literature, emphasizing questions which the historical Roman evidence speaks to. Excellent surveys of the broader literature are, for example, provided by Levine (2005) and Beck and Levine (2005).

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[60] A relate literature in macroeconomics also identifies access to external finance as a determinant of long-term growth (e.g., Barro, 1997; Aghion, Howitt, and Mayer-Foulkes, 2005; Bencivenga and Smith, 1993).
[61] Koren and Tenreyro (2009) propose technological diversification as an alternative link.
[62] See fn. 40.

3.2.1 Law and Finance

Starting with the seminal papers by La Porta et al. (1997) and (1998), researchers have related financial and economic development to the legal environment of a country. The causal effect of the legal environment, however, is difficult to establish since legal institutions arise endogenously. For example, if a country makes a political choice in favor of banks and then adopts laws that strengthen banks' position as creditors, the resulting correlation between creditor protection and legal environment simply reflects a political choice. La Porta et al. argue that relating financial outcomes to "legal systems" rather than to current laws ameliorates the causality problem. "Legal system" serves as an instrument to isolate the independent effect of legal rules on investor protection since countries have not "chosen" a legal system or, to the extent they have, did not do so on the basis of modern-day investor protection.

La Porta et al. (1998) distinguish four legal systems: British common law, French civil law, German civil law, and Scandinavian civil law.[63] They relate these legal traditions to a core aspect of financial development: investor protection. If the rights of investors are not protected, managers can divert returns into their own pockets, and investors will be unwilling to finance investments in the first place. The authors find higher shareholder protection in common-law than in French civil-law countries. For example, in common-law countries, proxy voting by mail is more common, minority shareholders can more easily challenge major management decisions such as mergers, and lower share capital is required to call an extraordinary meeting. The difference in creditor protection is directionally similar, though not as pronounced.

La Porta et al. (1997) take this evidence one step further and argue that countries with better investor protections have more highly valued and broader capital markets and therefore easier access to external finance. They estimate a 30 percentage point decrease in the ratio of "external capital" (stock market capitalization held by outside shareholders) to GNP associated with a change from common law to any type of civil law, though the effect is insignificant and smaller with some of the control variables used for shareholder protection. The authors also estimate that French civil law is associated with a 12 percentage point lower Debt/GNP ratio than common law. Overall, civil-law systems and French civil law, in particular, emerge as most detrimental to financial development.[64]

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[63] The authors consider only countries with at least five domestic, non-financial, publicly traded firms with no government ownership (no socialist or transition countries): 21 countries with French civil-law tradition, 6 with German civil-law tradition, 4 with Scandinavian civil-law tradition, and 18 common-law countries.

[64] Follow-up research relates investor protection and private property rights to firm valuation (La Porta et al. 2002; Caprio, Laeven, and Levine, 2003), dividends (La Porta et al., 2000), and reinvestment of earnings (Johnson, McMillan, and Woodruff, 2002). Levine (1998, 1999, 2003) and Beck, Levine, and Loayza (2000a, b) link legal-origin induced investor protection to the development of stock markets and financial intermediation.

The Roman evidence presented in this paper cannot contribute to cross-country comparisons of legal systems. But it does speak to the specific channels through which a civil-law system may affect economic outcomes. Two prominent channels, discussed in Beck, Demirgüç-Kunt, and Levine (2003a) and Beck and Levine (2005), are "political structure" and "adaptability." The political-structure argument holds that civil-law countries accord excessive power to the state and constrain property rights. These countries are less likely than common-law countries to maintain politically independent judiciaries, to grant courts jurisdiction in cases involving executive or legislative power, and to extend to courts the power of constitutional review. The adaptability argument holds that the common-law reliance on judicial discretion and case law has allowed it to adapt more easily to changing commercial and financial needs. Judges are better at adapting to new circumstances because they are more objective than legislators and are shielded from political pressure. The adaptability view also points to the common law's eschewal of rigid guidelines for the presentation of evidence and communication between parties that can otherwise hamper the judicial process. By contrast, civil-law systems have evinced, at least from the time of Napoleon, a mistrust of judges and have tied their hands with formalistic statutes and procedures that cannot easily be adapted to changing needs.

On the surface, the Roman evidence may appear to be consistent with the political-structure argument. When the political elites of Republican Rome aimed to foster the entrepreneurship of the *publicani*, legal rules were interpreted in a flexible way so that the *publicani* could access broad financing. Conversely, when the political elites of the Roman Empire aimed to reverse this development, the *publicani* did not benefit from the legal environment any more. But it is not the case that the emperor interfered with judiciaries or the interpretation of law. To the contrary, Roman civil law, especially (and famously) contract law, evolved into a sophisticated and nuanced, yet practically more viable and less formalistic set of rules under the emperors, who did not interfere with the development of legal opinions (Kaser, 1980). Hence, the Roman evidence confirms the role of political influences on economic development, but not via legal development or the lack of politically independent judiciaries.

The Roman case also provides a counter-example to the common-law/adaptability link. It was precisely the adaptability of Roman civil law that allowed the *publicani* to flourish. Legal rules on the Roman partnership (*societas)* were adapted to meet the economic demands of the growing country and its need for larger companies with greater access to external financing. Hence, the adaptability mechanism to which the growth-friendliness of *common*-law systems is attributed was at work also "at the origin" of civil law.

Of course, civil law "at its (Roman) origin" is different from French or German legal origin in its later incarnations. French civil law assumed its more rigid nature with

the codification under Napoleon (Beck, Demirgüç-Kunt, and Levine, 2003a), and one may presume that the same is true for Roman law and the codification under Justinian. That is, one may suspect that, while the Roman law was flexible pre-Justinian, it changed its nature after being codified at the beginning of the sixth century AD. This is, however, not the case. The core piece of the *Corpus Iuris Civilis*, the *Digesta*, presents long discussions of the legal opinions of various jurists, who do not always agree. These discussions typically revolve around case variations that reflect changing commercial circumstances. The discussion of the Roman partnership (*societas*) in the 17th book illustrates precisely this nature of legal evolution. The jurist Pomponius points out that a partnership dissolves if one of the partners dies, with the exception of the *societas vectigalium*, i.e., the type of *societas publicanorum* occupied with tax collection that survived into the Principate.[65] Pomponius then discusses whether this exception applies if the deceased partner founded the business or otherwise played a "core role" in running it.[66] The fact that Pomponius questions the applicability of more relaxed partnership rules in this case illustrates that the adaptation of Roman law was driven by the practical demands of large-scale businesses that were distinct from the involvement of individual "partners." Where this characterization did not apply, as it became more common among the smaller *societates publicanorum* under the Principate, the adapted legal rules did not apply either. This discussion exemplifies how the *Corpus Iuris Civilis* preserved the case-based and adaptable nature of legal rules. Thus, the Roman evidence suggests caution in characterizing civil-law systems as less adaptable to changing circumstances, with or without codification.

This insight resonates with the findings in other historical cases. Comparative historical studies have highlighted that civil-law institutions have better served the organizational needs of an evolving commercial society than common-law institutions at various points in history. Lamoreaux and Rosenthal (2005), for example, argue that French law has historically allowed more flexible forms of liability and ownership than the U.S. common law. Before 1867, businesses in France could not form limited-liability corporations. However, they could form a *société en commandite*, which consisted of general partners, who managed the firm and had unlimited liability for its obligations, and special partners, whose liability was limited to their investments and who had no managerial role. These organizations issued shares as well. The authors argue that the *commandite* provided a sufficient substitute for the corporation. In the mid-19th century, when stock quotations were only available for a few firms in New York and around fifty in Boston, over 200 firms were traded in Paris. No such flexible partnership arrangements were

[65] *Digesta* 17.2.59 *pr*.: *Adeo morte socii solvitur societas … in societate vectigalium nihilo minus manet societas et post mortem alicuius*, …

[66] Later in *Digesta* 17.2.59 pr.: *quid enim, si is mortuus sit, propter cuius operam maxime societas coita sit aut sine quo societas administrari non possit?*

available in the United States. New York's 1822 enable statute for the *commandite* required partners to declare the amount of their individual investments, precluding the trade of shares, and courts often interpreted these arrangements as exposing limited partners to unlimited liability. Unlike American law, French law also allowed ordinary partnerships to alter the terms of partners' liability and managerial authority through contract. The lack of flexibility in American corporate law was particularly onerous to minority shareholders, who could neither force dissolution of the company nor exit easily by selling their shares. Reliable protection for outside investors arrived only with the creation of the Securities and Exchange Commission in the 1930s. The authors conclude that the opposition of a flexible, judge-led common law tradition to an ossified, code-besotted civil law does not stand up to historical scrutiny. While it may characterize the legal environments today, it did not do so at previous points in history, which casts doubt on the perceived fundamental differences between the two legal systems.

The work by Lamoreaux and Rosenthal also emphasizes an aspect of the legal environment that has received less attention in the law and finance literature but is central to our Roman-law analysis: company law and, in particular, the role of "company formats". Does it matter whether firms can incorporate? Does the company format affect access to external finance? External financing is likely to be easier if the liability of investors for company debt can be limited and if the company's existence does not depend on the presence of its members (partners).

To date there is little empirical evidence analyzing the role of legal and organizational formats. Ayyagari, DemirgüçKunt, and Maksimovic (*forthcoming*) provide suggestive evidence from the 1999 World Business Environment Survey that firm-level characteristics, such as legal organization and ownership structure, affect property rights protection as much as institutional factors, such as the legal system. More attention has been paid to the role of limited liability in a number of historical studies. Analyzing the introduction of limited liability in California in 1931, Weinstein (2003) finds little impact on corporations or shareholders. There is no evidence of any surge in the number of firms changing their names to take advantage of limited liability status (as required under the statute) and no dramatic increase in the number of corporations filing income tax returns or in the share values of California's seven NYSE-listed firms after the change.[67]

In contrast, Forbes (1986) argues that the introduction of limited liability in Massachusetts in 1830 had economic benefits. He plots the ratio of incorporations in Massachusetts to those in New York against time (1811-42), where the incorporations in New

[67] In a related paper (Weinstein, 2005), the author also analyzes the position of interest groups (California Bankers Association, California State Bar Committee, San Francisco Association of Credit Men) and is unable to find strong support for or opposition against the change.

York are meant to capture time-variant influences on incorporations in Massachusetts other than the introduction of limited liability. The ratio increases after 1829 (though it plunges after 1839 and shows wide fluctuations before and after). The author estimates a modest $8,290-a-year increase in investment as a result of limited liability. Naturally, the mere time-series identification, based on a single event, leaves ample room for alternative explanations, including other simultaneous legal changes and economic development. Forbes interprets these results as indicating the value of limited liability as a legal innovation. In his conclusions, he speculates why limited liability might have arisen late in England (in 1855), though it was the earliest country to industrialize. The author suggests that large incumbent firms opposed the introduction of limited liability as a means of deterring future entrants, especially in the shipping, cotton, woolens, iron, and steel industries, which were all key sectors in the early part of the Industrial Revolution.[68]

In comparison, the example of the Roman corporation draws a more nuanced picture of the role of limited liability and other legal features. On the one hand, it supports the view that it does not matter whether company laws formally allow for private corporations. Roman businessmen achieved a corporation-type organization in practice, even without the formal legal implementation. On the other hand, it *does* matter whether quasi-corporations were enforced in practice. In the Roman case, large businesses withered when government interests opposed them and prevented their corporate organization.[69]

The Roman evidence also suggests that company features other than limited liability are equally important, such as the ability of the firm to exist independently of specific "partners" or its ability to carry legal right and obligations. Without those it would be hard to issue and trade shares and to involve larger fractions of the population in the financing of these companies. Hansmann, Kraakman, and Squire (2006) emphasize precisely this point. The authors argue that, rather than limited liability, which protects an investor against claims of the company's creditors, protection of the *company* against creditors of the *owners* have been the crucial step in the legal development of the firm.

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[68] An alternative interpretation (e.g. Harris, 2000) is that the delayed arrival of limited liability reflects political tensions between the landed gentry and the rising merchant and manufacturing classes. The aristocratic judges showed little interest in fostering the economic development of the nouveau riche. Thus, the Lord Chancellor in the 1830's held that it was the Crown's prerogative to grant limited liability. Both interpretations agree in their emphasis on the instrumentalization of and opposition against limited liability.

[69] The importance of enforcement is more general. As Easterbrook and Fischel (1991) argue, the explanatory power of legal rules is limited if firms can opt out of the default regulation. From this point of view, it is puzzling that legal rules have *any* significant impact on economic outcomes. Gennaioli (2006), however, points out that "opting out" is a true option only if the alternative private contracts are permitted and enforced by courts. He develops a model illustrating the role of the "contractual channel" via which law can affect economic development.

The above concerns about the adaptability of legal systems and role of legal institutions such as limited liability relates to a broader debate about the classification of legal systems in the law and finance literature. For example, are South Africa and Israel really common-law countries despite the significant civil-law elements in their laws? More broadly, do the four legal systems distinguish significantly different legal environments?

In using this four-part classification scheme, La Porta et al. refer to the classification of commercial legal systems in David and Brierley (1985), a division also utilized by Merryman (1985). However, David and Brierley propose a tripartite division of Western law into Romano-Germanic, common-law, and socialist families, with Romano-Germanic including Latin, Germanic, Scandinavian, Latin American, etc. Merryman classifies French and German law as two of many subclasses of civil law.[70] Similarly, Dawson (1960)'s often cited history of the transformation from lay to professional judges in England, France, and Germany treats these countries as regions with distinct histories and institutions but does not suggest that they are exhaustive typologies of legal systems. Thus, the fourfold typology in the law and finance literature does exist in prior legal literature, but is by no means universally accepted.

The Roman case illustrates one reason why it is hard to identify groups of legal systems with distinct features. Legal systems are in flux and their character changes over time. How can the "origin" cement the character of a modern legal system if the character of the origin itself changed over time from adaptable and case-based to non-adaptable? The case-based evolution of Roman law, in particular, casts doubts on a sharp distinction between Roman and other legal origins. The more rigid character of codified legal systems seems to be the result of later developments, not present at "its origin."

Another, deeper classification concern is that legal origin is not causally relevant for financial development. Omitted variable candidates abound. For example, common law is perfectly correlated with England as the colonizing power and with the Anglican Communion as the dominant Protestant denomination. Beck and Levine (2005) show that the relationship of legal origins to financial development is robust to controlling for many candidate explanations, such as religion, competitiveness of the election process, national openness, and resource endowments. Berkowitz et al. (2003) argue, however, that legal origin matters little in comparison to a country's receptiveness to the legal system at the time it was introduced. They distinguish between "origin countries" like England and France, in which legal systems developed organically over time, "receptive transplants" such as Japan, which selectively borrowed from foreign systems while preserving the

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[70] According to Merryman, French law and German law are rather unrepresentative of the civil-law tradition – in the case of France because of its revolutionary roots, and in the case of Germany because of the large influence German scholars exerted on their jurisprudence.

characteristics of their own systems, and "unreceptive transplants," in which foreign legal codes were adopted wholesale and without the support of domestic constituencies.[71]

The Roman evidence points to one other alternative explanation, political influences, to which I devote the next Subsection.

3.2.2 Politics and Finance

A more recent strand of literature on politics and finance re-evaluates the role of legal relative to political institutions. One part of this literature argues that legal and economic institutions are endogenous to the political environment. According to this view, political elites produce institutional outcomes, including the legal system, which then affect economic outcomes. Another part of the literature takes the role of politics one step further and proposes that politics directly determines long-term growth – with or without law.

The first type of politics and finance literature does not necessarily refute that the legal environment has a causal impact on finance and growth. It merely points out that the finance- and growth-friendliness of a legal system depends on the interest of the political elites. For example, Rajan and Zingales (2003) argue, in the spirit of North (1981), that, if the interests of the elites coincide with financial and economic development, they will implement legal and other institutions that foster development. If their interests and desire to cement their political power demand institutions that are unfavorable to growth, they will implement those. The authors observe that civil-law countries such as Belgium, France, Germany and Sweden had more developed financial systems than common-law countries such as the United States prior to 1913, but when financial development slowed after 1913, the decline was stronger in the civil-law countries. The authors argue that these empirical patterns correlate with the industrial and financial elites opposing open access to financing and, hence, financial liberalization.[72]

Related papers investigate the role of relevant stakeholders and their political weight in the context of investor protection. Roe (1994) details how competing political groups have, through history, cumulatively determined the present form of American corporate governance. Pagano and Volpin (2006), point out that good shareholder protection triggers stock market participation of a broader portion of voters, who then favor even more shareholder protection. Perotti and van Thadden (2006) focus on the identity

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[71] The distinction between origin countries and transplants also helps to address the concern that a time-invariant instrument like legal origin cannot explain the historical evolution of financial systems, i.e., the concern that if legal institutions and legal origin are to be reliable predictors of financial development then they ought to be such a predictor not only today but throughout history. Distinguishing between "origin" and "transplant" and by receptiveness, all of which can vary over time, legal systems are better able to explain economic outcomes (Glaeser and Shleifer, 2002).

[72] Sylla (2006) questions the empirical methodology in Rajan and Zingales (2003). For example, the claim of a "great reversal" of financial development in the US relative to other countries from pre-1913 to post-1913 is based on calculations that do not account for bond markets in the US but do so for other countries.

of the majority shareholder. For example, if the financial participation of the middle class is low, the median voter will choose low investor protection and favor bank or family control. If, instead, middle-class participation is high, the median voter will choose equity control and investor protection. According to Pagano and Volpin (2001), similar dynamics are at play in a variety of policy arenas, including corporate control, public ownership of enterprise, bankruptcy, and securities market regulation. Haber et al. (2003) use the case of Mexico from 1876-1929 to explain how economic systems can remain stable in spite of considerable political instability when governments selectively enforce property rights for those property holders who are integrated into the political system.

The second strand of this literature takes the role of politics one step further. Rather than analyzing the interaction of politics and law, this research asks whether politics determines financial development and long-term growth directly – with or without law. A starting point is the research by Engerman and Sokoloff (1997, 2002). The authors identify the tendency to maintain initial conditions of wealth and political power as a key determinant of cross-country differences in economic growth between North America and other New World economies. They argue that colonies in which initial endowments, climate, and soil conditions favored the farming of crops that were most efficiently produced on large farms (such as sugar, coffee, or tobacco) evolved into an unequal distribution of endowments between a small elite that was rich and politically powerful and a large population of poor workers and slaves without political say. Colonies in which climate and soil favored, instead, mixed farming and provided for little economies of scale evolved into societies with more equality. Acemoglu, Johnson, Robinson (2001) further this argument by using an empirical link between European settler mortality, employed as an instrument for current political inequality in institutions, and economic growth. An even starker example of the direct role of politics is Roe's (2006) analysis of military invasions in the twentieth century. Roe points out that the winners in military conflicts during the past century overwhelmingly had common-law legal systems, but that their financial development may reflect their military success (or lack of war devastation) rather than their legal origin.

Even more directly, Acemoglu and Johnson (2005) question how central legal institutions are to the economic and financial development of a country compared to political institutions. They argue that a weak legal environment (weak protection of contractual rights) can be remedied in private agreements and via reputation, but weak political institutions (weak property protections) cannot. Empirically, they relate various measures of financial and economic development to indices of political and legal institutions. They instrument for political institutions using settler mortality and population density. The basic argument for the first instrument is that, in areas with high initial mortality, colonial

powers established extractive political institutions to expropriate wealth from their colonies, while in areas with low mortality they created settlements with greater property protection.[73] The logic of the second instrument, population density at the time of colonization, is that, in more densely settled societies, colonizers set up institutions to extract resources through slave or bonded labor.[74] The instrument for legal institutions is legal origin, based on the argument in La Porta et al. (1997, 1998) that common-law systems provide more robust contract protections than civil-law systems. The authors argue that this classification is particularly appropriate in the context of colonies since colonized countries neither chose their colonizer nor chose to retain their colonizer's legal system because of its contract law. (A caveat is the potential lack of receptiveness in colonies, as discussed above.) The authors find that, after controlling for political institutions (constraints on the executive, protection against government expropriation, private property protection), none of the proxies for legal institutions (legal formalism, procedural complexity, and the number of procedures necessary to resolve a court case of unpaid commercial debt) predict growth. The coefficient estimate on the political-institutions variable "executive constraint," instead, is significant and large: a one-standard deviation increase in executive constraint doubles GDP. The authors conclude that legal institutions do not have a big impact when they are not backed by political power. And, vice versa, even dysfunctional legal institutions suffice to support economic and financial growth as long as political institutions provide security against expropriation by elites and government.

Beck, Demirgüç-Kunt, and Levine (2003b) undertake a similar horse race between legal and political institutions. They relate cross-country differences in financial systems to law and politics, using French Legal Origin of the colonizer and Setter Mortality as the main independent variables and various measures of financial development as outcome variables, controlling for a wide range of other possible determinants such as

[73] In Acemoglu, Johnson, Robinson (2001), the authors check the validity of settler mortality as an instrument for contemporary institutions. They show the robustness of their results to the inclusion of a large range of proxies for other determinants of contemporary per-capita income that might be correlated with settler mortality in particular geographic and climatic factors (as traditionally suggested, e.g., by Diamond, Sachs, Montesquieu).

[74] Here, some further investigation whether or not the instrument is uncorrelated with determinants of per capita income like disease would be valuable, especially in light of Jared Diamond's (1997) thesis on the link between the early development of populations and the transmission of human disease: hunter-gatherer populations were typically less dense and had less proximity to animals than settled agricultural societies. As a result, they did not develop immunities to human diseases transmitted from domesticated animals—like measles and smallpox—and were virtually exterminated by such diseases after encountering Europeans. Diamond's argument suggests that the transmission of diseases strongly affected the development of different societies. Some of the robustness checks in the related Acemoglu et al. (2002) paper indirectly address this concern (e.g. dropping the Americas, where the arrival of Europeans after prompted a dramatic demographic collapse or excluding populations with extremely low population in 1500).

continent (Latin America and Africa), main religion (Catholicism, Islam, or Other), the percentage of years since 1776 that a country has been independent, and ethnic fractionalization (the probability that two randomly selected individuals in a country will not speak the same language). Similarly to the findings in Acemoglu et al., legal origin typically does not predict private credit or stock market development after including the controls.

Overall, our example of the Roman corporation illustrates precisely the view put forward in this second strand of literature: politics can determine financial and economic outcomes, regardless of the state of the legal development. We observe advanced financial contracting at a time when Roman private law was little developed. And we observe regress at a time when the legal development reaches its height but political interest reverses. Moreover, the Roman case shows that the effect of the political environment does not need to work through changes in the law, i.e., the mechanism suggested in the first strand of the literature. Roman Private Law appears to have followed an independent path of increasing legal sophistication and reduction in transaction costs of legal dealings. A precondition for politics to have a direct impact, irrespective of the formal changes in law, was the flexibility of Roman law discussed above: Roman law as practiced adapted to a changing economic environment without the need for formal legal reform.

4 Conclusions

The ongoing debate about the determinants of finance and growth focuses on two main candidates: law and politics. The evidence about the rise and fall of the Roman shareholder company provides historical support for the view that political institutions can dominate the role of other institutions. The right set of political interests allowed a type of shareholder company, the *societas publicanorum*, to flourish under the Republic, even though the legal environment was not (yet) sophisticated enough to allow for the concept of a private corporation. And, conversely, when the Roman legal system reached its height in the classical period, but government interests changed, the *societas publicanorum* vanished.

At the same time, the evolution of such a sophisticated business format in an ancient economy may never have been possible without Rome's advanced legal environment. And, vice versa, it is possible that the decline in financial contracting and economic scope of markets during the Roman Empire would not have been observed in a different legal environment. A legal environment similar to a modern common-law system might have provided better protection against the State, consistent with the view that civil-law systems are weaker in their protection of property rights. In other words, a horse race between the two determinants is unlikely to be a useful exercise. Today as in ancient Rome, legal determinants cannot be separated from the political environment and the political

developments are preconditioned by the legal framework. The Roman case as well as the recent politics and finance literature *do* clarify, however, that politics cannot be left out of the analysis.

A second insight regards the modern-day empirical proxies for the legal environment. The Roman-law analysis implies that relevant legal determinants are not captured in formally coded law or even the non-codified law that is enforced in the courts. In practice, economic agents may find ways to accommodate their practical needs, such as better access to external financing or limited liability, even if the recognized law appears to stand in the way. Thus, when trying to measure the transaction costs that an institutional environment (including its laws) imposes on economic transactions, it is most sensible to investigate how a specific demand (e.g. for equity financing) is solved in practice – akin in spirit to the law and finance approach of asking lawyers how a legal problem is solved in practice. A number of historical papers on limited liability and corporations point in this direction. It would be desirable to see attempts to quantify such effects today.

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Table 1. Choronology of Rome

Period		BC	Political Events	Economic/Cultural Developments
MONARCHY		700 – 500		Expansion in the western Mediterranean. Growing urban settlements with temples, fortifications, and other communal facilities
		c.625	Foundation of the city of Rome (fictional date: 753)	
		600 – 575		Usage of Greek coinage
EARLY REPUBLIC		500 – 470	Foundation of the Republic: monarchy replaced with time-limited magistracy	
		486		Earliest recorded agrarian laws, regulating the disposition of public land
		c.450	Codificiation of law in the Twelve Tables	
		393		All Roman citizens are alloted 7 iugera (4.38 acres) of land north of the city, leading to the creation of a class of working landowners.
		367 / 366	*Lex Licinia Sextia* restores consulship and appointment of plebeians to consul positions.	*Lex Licinia Sextia* limits the amount of land a citizen can own. Not enforced in practice.
		367 – 287	Class struggle between the two orders, plebeians and patricians; shapes the constitution of the classical Republic and forms a ruling class (*nobilitas*) consisting of both plebeians and patricians.	
		366		First Roman coinage
		347		Century-long legal interest rate of 8 1/3 percent falls by half
		342		Prohibition of interest (*lex Genucia*)
		340 – 290		Earliest centuriations (formal divisions of colonies into square blocks), indicating the appropriation and exploitation of conquered territories.
		300 – 200		Earliest *villas*, indicating large scale slave plantation agriculture.
		287	Resolutions of the plebeian assembly (*plebiscites*) are made binding by the *lex Hortensia*; end of the conflict of the orders.	
		269		Discontiunation of old coinage and implementation of denarial system. Opening of first mint.
		264/3 – 241	First Punic War against Carthage	Beginning of tribute system. Annual tribute to Rome amounts to about one million bushels of wheat.
		264 – 227	Rome expands in the western Mediterranean; establishes first overseas provinces (Sicily and Sardinia) under military governors (praetors).	
		218 – 201	Second Punic War	
		202	Defeat of Hannibal at Zama in North Africa	
		200 – 150		Slaves constitute a significant proportion of the population and an important input to production, especially in *villas*. Wine production and exports begin to flourish
		200		Development of Roman roads and increasing use of mules as packsaddle animals and to pull carts.
		197	Creation of two Roman provinces on the Iberian peninsula	
		194		Revitalization of the harbor of Puteoli; becomes Rome's main sea harbor
		193 – 174		Construction of giant warehouse *Porticus Aemilia* and new marketplaces in Rome.
		167		Direct taxation of Roman citizens abolished. Polybius (historian) arrives in Rome.
		154 – 133	Crisis of Roman control: wars in Spain	Rome's domination in the central and western Mediterranean stimulates exchange and encourages mass production for export.
LATE REPUBLIC		146	Destruction of Carthage and Corinth. Carthaginian North Africa, Macedonia, and parts of Greece become Roman provinces	
		143 – 71	Era of slave rebellions	
	BC 133. Tribunate of Tiberius Gracchus	133 – 129	Creation of the Roman province of Asia	
		131		Census records 318,823 adult males as Roman citizens.
	BC 123. Tribunate of Gaius Gracchus	122		Introduction of subsidized monthly sales of grain in Rome
		91 – 88	Social War. All Italians are granted Roman citizenship	
		88	Sulla's first march on Rome. Militarization of internal conflicts	
		86		Legislation imposes debt forgiveness of 75 percent
		82 / 81	Sulla's dictatorship leads to the reorganization of the state.	
	BC 70. Consulship of Pompey and Crassus	70	Repeal of the main points of the Sullan system.	
	BC 63. Consulship of Cicero	63	Suppression of the Catilinarian conspiracy	Wars cause civil and economic disturbances. Export ban of silver and gold from Italy.
	BC 59. Consulship of Caesar	60	First Triumvirate between Caesar, Crassus, and Pompey	Abolishment of harbor custom dues in all the ports of Italy (but not the provicences) to support Italian industries and resolve dissatisfaction with collection practices. Later reintroduced by Caesar.

Reign / Dynasty	Era	Date	Event	Economy / Society
		49	Caesar crosses the river Rubicon, against Roman law, marking the start of civil war (*alea iacta est* : "the die is cast" [acc. to Sueton]).	Legislation imposes debt forgiveness of 25 percent.
		46 – 44	Caesar's dictatorship; reforms and monarchical reorganization	
		15 Mar 44	Murder of Caesar	
		43	Second Triumvirate between Antony, Lepidus and Octavian	
		Oct / Nov 42	Victory of the triumvirs over the Caesar's murderers Cassius and Brutus at Philippi	
		33 / 32	Break between Antony and Octavian	
		28		Census records 4,063,000 adult males as Roman citizens.
		27 BC – AD 6	Creation of a professional army and provision for veterans	
		27 BC – AD 9	Consolidation of the boundaries of the Roman Empire	Beginning of period of Roman peace, *Pax Romana*
BC 19. Reign of Augustus	PRINCIPATE	19 / 18	Reform legislation of Augustus	
		12	Augustus assumes highest religious position (*pontifex maximus*)	
		AD		
AD 14 - 68. Julio-Claudian Dynasty		43	Claudius conquers Britain.	
		64	Fire in Rome for nine days. Persecution of Christians	
AD 69 - 96. Flavian Dynasty		79	Eruption of Vesuvius. Destruction of Pompeii and Herculaneum	
AD 96 - 192. Age of the Antonines		100 – 110		Tacitus writes *Histories* and *Annals* .
		165		Estimated Population of Roman Empire between 60 and 70 million
		180		End of period of Roman peace, *Pax Romana*
AD 192 - 235. Severan Dynasty		192 – 235	Militarization of the Empire, increasing barbarian pressure at the frontiers, decline of the Roman world.	
		235 – 284	Military anarchy, sequence of nearly twenty Emperors	
		250		Epidemic of plague
		284 – 306	Diocletian re-establishes central power and founds the Tetrarchy (Roman Empire ruled as four separate parts)	
AD 306 - 337. Reign of Constantine the Great	COLLAPSE	312	Constantine wins battle of Milvian Bridge under the sign of the Cross: Christianity declared official state religion	
		395	Division of the Empire between the sons of Theodosius	
AD 378 - 395. Reign of Theodosius the Great		407 – 410	Increasing uprisings and external raids in Britain leads to gradual Roamn withdrawal during Empire's decline.	
		476	End of Roman Empire in the West	
AD 572 - 565. Reign of Justinian, Eastern Emperor	LATE ROME	533		*Digest* of Roman Law is compiled.
		1453	Conquest of Constantinople by the Turks; end of the Eastern Roman Empire	

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[1] Bringmann, Klaus. A History of the Roman Republic. 2007. p. 322-325. ISBN 0-7456-3371-4

[2] Boardman, John; Jasper Griffin and Oswyn Murray. The Oxford Illustrated History of the Roman World. 1986. p. 424-443. ISBN 0-19-285426-4

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[4] Scheidel, Morris and Saller. The Cambridge Economic History of the Greco-Roman World. 2007. ISBN 978-0-521-78053-7

GENERAL CORPORATION LAWS: HISTORY AND ECONOMICS

DAVID MCBRIDE*

> "Where there is no bread, there is no Law; where there is no Law, there is no bread."[1]

> "[T]wo intellectual inventions of the Renaissance, double-entry bookkeeping and the corporation, proved vital to the development of European civilization in the New World . . . ."[2]

I

INTRODUCTION

The symbiosis of law and business is often noted, less often truly appreciated—until either law or economic growth is absent—and much debated. The relationship of corporate law to national economics is real, appreciated, and being hotly debated on this sixtieth anniversary of the Model Business Corporation Act (MBCA). The financial crises, scandals, and economic losses of the first decade of the twenty-first century have caused many to question the efficacy of state corporate laws—like the MBCA and the Delaware General Corporation Law—and advocate fundamental change, deemed to be "reform" of those laws.[3]

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1. BENJAMIN M. FRIEDMAN, THE MORAL CONSEQUENCES OF ECONOMIC GROWTH 325 (2006) (citing RABBI ELEAZAR BEN AZARIAH, CHAPTERS OF THE FATHERS).

2. JOHN STEELE GORDON, AN EMPIRE OF WEALTH: THE EPIC HISTORY OF AMERICAN ECONOMIC POWER 9 (2004).

3. The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act] contains several provisions that treat corporate governance, including most prominently authorization for the SEC to adopt a "proxy access" system, Dodd-Frank Act § 971, and "say on pay" and other executive compensation provisions. Dodd-Frank Act §§ 951–957. For differing views on proxy access, compare Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329 (2010), with Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW. 361 (2010).

There are important and legitimate questions being raised about corporate law and governance.[4] But much of the debate has centered on the appropriate level of government to address the subject—whether the law should be the domain of the states, the federal government, international bodies, or some combination of all of these. This article will leave those arguments aside, for they have been better addressed by others.[5] Rather, this article will briefly address three questions: (1) what are the purposes of the corporate law (or other entity law), as reflected by the history of such organizations and how well have those laws fulfilled those purposes; (2) what economic phenomena have contributed to the success or failure of those laws; and (3) what are the implications of these economic observations for corporate and entity law?

II

THE HISTORY, PURPOSE, AND SUCCESS OF THE CORPORATE FORM

Within the past 150 years, non-governmental corporations have become the principal social institution by which business and economic activity has been conducted—whether for-profit, not-for-profit, or for charitable purposes. It was not always so:

> The word [corporation] refers to any association of individuals bound together into a *corpus*, a body sharing a common purpose in a common name. In the past, that purpose had usually been communal or religious; boroughs, guilds, monasteries, and bishoprics were the earliest European manifestations of the corporate form. They all owed their existence, and the privileges stemming from a corporate charter, to an act of a sovereign authority. It was assumed, as it is still in nonprofit corporations, that the corporate body earned its charter by serving the public good. The same thinking applied in the chartering of joint-stock companies in the age of exploration and colonization.[6]

Before the Civil War in the United States, the corporate charter generally was perceived as a privilege granted only by a special act of the legislature for

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4. *See generally* Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAW. 1 (2009); Frank H. Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 VA. L. REV. 685 (2009); JOSEPH E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY 151–55 (2010); RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 97–99 (2009).

5. *See generally* Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward,* 63 BUS. LAW. 1079 (2008); Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1 (2005); William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003); Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform,* 29 J. CORP. L. 625 (2004); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003); David A. Skeel, Jr., *Icarus and American Corporate Regulation*, 61 BUS. LAW. 155 (2005); Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749 (2006); Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573 (2005).

6. ALAN TRACHTENBERG, THE INCORPORATION OF AMERICA: CULTURE AND SOCIETY IN THE GILDED AGE 5–6 (1982).

purposes deemed to be in the public interest.[7] Incorporation was not yet deemed a right available on application by any private enterprise: "The earliest charters were thus bestowed on insurance companies, commercial banks, canal, dock, and highway companies . . . ."[8] These corporations were not exclusively profit-seeking associations, but were quasi-public agencies of the state, oftentimes "mixed enterprises" in which public funds were invested with private funds for needed internal improvements to transportation facilities, such as highways and canals.[9]

The situation began to change with the economic growth, both in Europe and in the United States, during the nineteenth century, and, in the case of the United States, particularly during the period from the Civil War to the First World War (1860 through 1914). In the eighteenth and early nineteenth centuries, the American economy was characterized by individually and family-owned enterprises.[10] In the entire colonial period, only seven companies were incorporated in the British North American colonies.[11] In just the last four years of the eighteenth century, however, 335 businesses incorporated in the new United States.[12] "Organizations with more than a hundred employees were a rarity. By the time of the Civil War, however, several railroads were employing thousands, and industrial companies were growing as well."[13] In 1811, New York became the first state with a general incorporation statute, but it was available only to corporations manufacturing textiles, glass, metals, and paint. The earliest legislations permitting formation of corporations for any lawful, specified purpose were adopted by Connecticut in 1837 and Iowa in 1846.[14]

The corporate form had numerous advantages over non-corporate forms. The most critical was the doctrine of limited liability. Beginning with the railroads in the mid-1800s and accelerating after the Civil War, it became necessary to raise large sums of capital for growing enterprises. The pooling of small investments by numerous investors became an important means of raising those funds, but investors would not be willing to make small investments in enterprises they would not control, if doing so exposed them to unlimited liability for the debts of the enterprise. The limited liability of stockholders was critical, not only to the development of the corporation, but also to the economic development of Europe and the United States.[15] Other advantages of the corporate form included the ability to utilize "modern" management techniques, which were being developed during the late nineteenth and early

7. *Id.* at 6.
8. *Id.*
9. *Id.*
10. GORDON, *supra* note 2, at 228.
11. *Id.*
12. *Id.* at 228–29.
13. *Id.* at 228.
14. MODEL BUS. CORP. ACT § 3.01 (2008).
15. *See* GORDON, *supra* note 2, at 9–11, 228–29.

twentieth centuries by professional managers who were not owners of the businesses,[16] perpetual existence, and the ability to merge.[17] The corporate form also was utilized as a means to restrain competition and coordinate vertical and horizontal integration in many industries.[18]

The most significant disadvantage of the corporate form is the well-known separation of ownership from operating control of the business.[19] This created the classic problem of management operating the entity for its personal benefit and gave rise to the imposition of fiduciary duties. This problem would pose the most significant threat to the efficacy of the corporate form because trust is so essential to the maintenance of all forms of cooperative human activity. The separation of management from ownership also gave rise to a need for better accounting, as stockholders wanted timely information with which to evaluate management, and management was tempted to use accounting to make its performance appear better.[20] Beginning in the 1880s, "[t]he big Wall Street banks, which were becoming ever more powerful, and the New York Stock Exchange increasingly required companies that . . . wanted to be listed on the exchange to conform to what would come to be called 'generally accepted accounting principles' and to have their books certified by" a newly-created profession—the certified public accountant, first legislatively recognized in New York in 1896.[21]

By the end of the nineteenth century, the laws governing incorporation had evolved to respond to the needs of the economy and the objectives of the business and financial worlds. No longer a privilege, incorporation became a right available to the exuberant businesspersons and financiers of the era. In essence, the corporation had evolved from a specialized entity, created for the particular ends of the "sovereign," to an entity created to facilitate new and ever evolving forms of organization needed by the economy.[22] However, under either structure, the corporation was designed for the purpose of facilitating common action, not restraining or prohibiting it. Not surprisingly, the laws that evolved to facilitate this form increasingly evidenced the characteristic of being "empowering" statutes, not regulatory statutes.[23] The essential caveats to this empowerment were the maintenance of trust, reflected in the fiduciary duties

16. *See* TRACHTENBERG, *supra* note 6, at 83–86.

17. GORDON, *supra* note 2, at 229.

18. TRACHTENBERG, *supra* note 6, at 83–86.

19. *See* GORDON, *supra* note 2, at 229–30.

20. *Id.* at 230.

21. *Id.* at 231–32.

22. By the end of the nineteenth century, the laws treating the corporate form had "converged" in providing five basic features that characterized the corporate form: (1) full legal personality, including the ability to contract; (2) limited liability for owners and managers; (3) shared ownership by investors of capital; (4) delegated management; and (5) transferable shares. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439–40 (2001).

23. *See* MODEL BUS. CORP. ACT § 3.01 (2008).

imposed by the law, and the need for stockholders to be informed about the financial affairs of the corporation.

From this history, it is evident that the legal entity known as the corporation had become the favored form of organization for larger businesses, and that larger businesses were becoming a greater percentage of the economy.[24] This phenomenon leads to several conclusions. First, the essential purpose of a corporation—or any other form of legal entity—is to facilitate collective action by individuals. It allows various persons to make varying contributions to the collective effort. Second, the expansion of the corporate form, from governmental to quasi-governmental to private enterprise, evidences the success of this form of organization and its consequent proliferation. The creation of new types of legal entities has continued this proliferation.[25] Third, while some may question the benefits of growth or the allocation of its benefits among groups within society, it would seem no one could reasonably question the success of the corporate form in promoting growth and economic innovation.[26]

III

FACTORS FOR SUCCESS AND FAILURE

There are a host of reasons for the economic success of corporations, most of which are not directly tied to the law by which corporations are formed, but

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24. By 1904, "about three hundred industrial corporations had won control over more than two fifths of all manufacturing in the country, affecting the operations of about four fifths of the nation's industries." TRACHTENBERG, *supra* note 6, at 4.

25. During the past decade, the limited liability company (LLC) has become the favored form of business organization, except with respect to publicly-traded entities, where the corporation remains the favored legal entity. *See generally* Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 FORDHAM J. CORP. & FIN. L. 459 (2010).

26. *See generally* GORDON, *supra* note 2; FRIEDMAN, *supra* note 1; DANIEL YERGIN & JOSEPH STANISLAW, THE COMMANDING HEIGHTS: THE BATTLE FOR THE WORLD ECONOMY (2002). The rate at which human economic production has grown has skyrocketed in the past 250 years. According to Berkeley economist, J. Bradford Long, per person gross domestic product (GDP) in a hunter-gatherer society of 15,000 years ago was approximately ninety dollars, increasing to $150 in the economy of the ancient Greeks in 1000 B.C. and to $180 in 1750. However, subsequent to 1750, there has been a thirty-seven-fold increase in GDP per person to $6,600, with the wealthiest societies producing well above that level. It took 99.4% of economic history to reach the wealth levels of hunter-gatherers, 0.59% of that history to double that level by 1750, and then just 0.01% of that history for global wealth levels to reach present levels. Over ninety-seven percent of humanity's wealth was created in just the last 0.1% of our history. ERIC BEINHOCKER, THE ORIGIN OF WEALTH: EVOLUTION, COMPLEXITY AND THE RADICAL REMAKING OF ECONOMICS 9–11 (2006). As described by economic historian, David Landes, "the Englishman of 1750 was closer in material things to Caeser's legionnaires than to his own great-grand-children." DAVID S. LANDES, THE UNBOUND PROMETHEUS: TECHNOLOGICAL CHANGE AND INDUSTRIAL DEVELOPMENT IN WESTERN EUROPE FROM 1750 TO THE PRESENT 5 (1969). This period of incredible growth obviously was driven by the industrial revolution and technological advances, but many of those developments were facilitated by and utilized by corporations.

rather, are a product of the strengths and weaknesses of the individuals who participate in or contribute to the enterprise and the social, market, and governmental environment in which they operate. But this article will focus upon several aspects of economic theory that seem important to the success of the corporate form or any form of organization.

To understand how and why the corporate laws may have contributed to the incredible growth of the past 250 years—and to understand how they may continue to do so in the future—an understanding of how and why that growth occurred is helpful. In *The Origin of Wealth: Evolution, Complexity and the Radical Remaking of Economics*, Eric Beinhocker[27] offers a survey and synthesis for the layperson of recent developments in economic theory that provides some explanation for this economic history.[28] He argues that:

> [W]ealth creation is the product of a simple, but profoundly powerful, three-step formula—differentiate, select and amplify—the formula of evolution . . . . Evolution is an *algorithm*; it is an all-purpose formula for innovation, a formula that, through its special brand of trial and error, creates new designs and solves difficult problems.[29]

The biological evolution described by Darwin—which involves differentiation by genetic mutation, natural selection, and amplification by genetic inheritance—is a type of evolution, but DNA is not the only arena in which evolution operates.[30] Biological and economic systems are subclasses of a more general and universal class of evolutionary systems, and researchers

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27. Eric Beinhocker's bio reads as follows:

> Eric Beinhocker is a senior fellow at the McKinsey Global Institute (MGI), McKinsey & Company's economics research arm, where he leads research on economic, management, and public policy issues. He was previously a partner at McKinsey and a leader in its Strategy Practice. His career has bridged both the business and academic worlds. He has been a software CEO, a venture capitalist, and an executive director of the Corporate Executive Board; at McKinsey he has served clients in a broad range of industries, including telecoms, computing, pharmaceuticals, and aerospace. He has also held research appointments at the Harvard Business School and the MIT Sloan School and has been a visiting scholar at the Santa Fe Institute. He is a graduate of Dartmouth College and the MIT Sloan School where he was the Henry Ford II Scholar.

MCKINSEY GLOBAL INST., http://www.mckinsey.com/mgi/perspective/biography/eric.asp (last visited Nov. 8, 2010).

28. BEINHOCKER, *supra* note 26.

29. *Id.* at 11–12. Others have argued that "unguided evolutionary process may, or may not, lead to economic efficiency. Unfortunately, natural selection does not necessarily choose the firms (or institutions) that are the best for the long run. One of the main criticisms of financial markets is that they have become *increasingly* shortsighted." STIGLITZ, *supra* note 4, at 273. Beinhocker, however, does not advocate for an *unguided* evolutionary process. As noted below, Beinhocker believes that the government may play an important role in establishing the environment in which evolutionary processes operate—either by setting goals or by setting constraints.

30. *See* BEINHOCKER, *supra* note 26, at 192. Beinhocker describes an algorithm as "a recipe that takes some set of inputs (for example, flour, eggs, sugar, butter), mechanically works them through some process (for example, stir together well, bake at 350°F or 175°C for fifteen minutes), and, if the instructions are followed, reliably produces some set of outputs (for example, cookies)." Beinhocker defines substrates as "the material or information on which the algorithm acts," and argues that "evolution is an algorithm that is substrate neutral. It takes information about the designs of things and mindlessly grinds that information through a process." *Id.*

believe that there are general laws of evolutionary systems.[31] Beinhocker notes Daniel Dennett's assertion that "evolution [is] a general-purpose algorithm for creating 'design without a designer.'"[32]

Evolution creates or discovers designs through a process of trial and error—a variety of candidate designs are created and tried out in the environment; the successful designs are retained and replicated.[33] An evolutionary process results in the emergence of greater structure and complexity over time, as evolution builds on the successes of the past to create novel designs for the future.[34] As the world changes, so too do the designs change and adapt.[35]

As Beinhocker explains, "[t]he notion that the economy is an evolutionary system is a radical idea, especially because it directly contradicts much of the standard theory in economics developed over the past one hundred years."[36] Since the late nineteenth century, the organizing paradigm of economics has been that the economy is an *equilibrium system*, essentially a system at rest.[37] That economic paradigm was borrowed from another field of science: Newtonian physics.[38] But while physics has moved far beyond the Newtonian universe, economics has not.[39] The new paradigm in physics—as well as other areas of science—is complex systems.[40] Those are systems of many dynamically interacting parts, in which the micro-level interactions of the parts or particles lead to the emergence of macro-level patterns of behavior or emergent characteristics not observed at the micro level.[41] When the parts or particles of the system have the ability to process information and adapt to their environment—Beinhocker refers to such parts or particles as agents—the resulting system is known as a "complex adaptive system."[42] Evolutionary

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31. *Id.* at 12 (citing JOHN H. HOLLAND, ADAPTION IN NATURAL AND ARTIFICIAL SYSTEMS (1992); L.D. WHITLEY, FOUNDATIONS OF GENETIC ALGORITHMS (1993); MELANIE MITCHELL, AN INTRODUCTION TO GENETIC ALGORITHMS (1996); L.F. LANDWEBER & E. WINFREE, EVOLUTION AS COMPUTATION (2002); J.P. CRUTCHFIELD & P. SCHUSTER, EVOLUTIONARY DYNAMICS: EXPLORING THE INTERPLAY OF SELECTION, ACCIDENT, NEUTRALITY, AND FUNCTION (2003)).

32. *Id.* at 13 (citing DANIEL C. DENNETT, DARWIN'S DANGEROUS IDEA 28–34, 48–60 (1995); RICHARD DAWKINS, THE BLIND WATCHMAKER (1986)). Beinhocker's description of evolution borrows heavily from the work of Daniel Dennett, an evolutionary theorist and director of the Center for Cognitive Studies at Tufts University, and from Richard Dawkins, the Oxford evolutionary theorist.

33. *Id.* at 14.

34. *Id.*

35. *Id.*

36. *Id.* at 16. Beinhocker notes that viewing the economy as an evolutionary system is "radical" when compared to traditional economic theory, but it is not new. In fact, Darwin's concept of evolution was sparked by Robert Malthus's economic writings, and, during the late nineteenth and early twentieth centuries, economists Thorstein Veblen, Alfred Marshall, Joseph Schumpter, and Friedrich Hayek examined the relationship between economics and evolutionary theory. *Id.* at 16–17.

37. *Id.* at 17.

38. *See id.*

39. *See id.* at 18.

40. *Id.*

41. *Id.*

42. *Id.*

systems are merely one type of complex adaptive system, and some social scientists have wondered whether economies might be another such system.[43] The study of economic systems as complex adaptive systems or evolutionary systems has created new schools of economic thought, known as "complexity economics" or "evolutionary economics."[44]

The economic evolution described by Beinhocker "is not a single process, but rather the result of three interlinked processes."[45] The first of these linked processes is the evolution of physical technology, such as bronze-making techniques, steam engines, and microchips.[46] The second process is the evolution of social technologies, or "ways of organizing people to do things," such as the rule of law, money, joint-stock companies, and venture capital.[47] The two are equally important, and "coevolve with each other."[48] An example is that the invention of the spinning frame (physical) made it economical to organize cloth-making in large factories (social), which, in turn, promoted development of water power, steam, and electricity (physical).[49] Finally, before the innovations of physical technologies and social technologies have an impact on the world, businesses must be formed to provide the goods and services created by these technologies to a marketplace. "Businesses are themselves a form of design," integrating "strategy, organizational structure, management processes, culture, and a host of other factors."[50]

These three evolutionary processes: physical technology, social technology, and business organization interact and coevolve. What emerges is a complex adaptive system that has three key characteristics: (1) many dynamically interacting parts, (2) the parts have the ability to adapt to changes around them, and (3) micro-level interactions of parts or particles lead to the emergence of macro-level patterns of behavior different from the micro patterns that underlie the system.[51] Perhaps most significantly, this complex adaptive system is not a system designed from the "top-down," but rather emerges from the "bottom-up."[52] The existing global economy is just such a complex adaptive system, "orders of magnitude more complex than any other physical or social structure ever built by humankind."[53]

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43. *Id.* at 18–19.

44. *Id.* at 19. *See also* Ulrich Witt, *Evolutionary Economics*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS (Steven N. Durlauf & Lawrence E. Blume eds., 2008).

45. BEINHOCKER, *supra* note 26, at 15.

46. *Id.*

47. *Id.*

48. *Id.* at 15–16. Beinhocker borrows these concepts from the evolutionary economist Richard Nelson of Columbia University. *See* RICHARD R. NELSON & SIDNEY G. WINTER, AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE (1982); RICHARD R. NELSON, THE SOURCES OF ECONOMIC GROWTH (1996).

49. BEINHOCKER, *supra* note 26, at 16.

50. *Id.*

51. *Id.* at 18.

52. *Id.* at 18–19.

53. *Id.* at 6.

But lest this all sound entirely too mechanistic, there is another aspect of the process, and it involves that greatest of mysteries—human nature. Human nature is an inevitable ingredient in the evolution of these designs; it is a critical factor in their success or failure.[54] These evolutionary processes are all driven—at least in part—by human efforts to seek new and better ways of meeting our needs or desires. Beinhocker asks what spurs these efforts, and here is his answer:

> The answer lies in the magic of non-zero-sum games . . . . [In] zero-sum games . . . one person's gain is another person's loss . . . . [In] non-zero-sum games . . . both people can be made better off by cooperating. Cooperation in non-zero-sum games has a 1+1=3 logic, whereby if you scratch my back, I'll scratch yours, and together we can do something neither can do as well on our own and we both benefit. Non-zero-sum cooperation is one of those Good Tricks of survival that has been widely employed by biological evolution. Dogs hunt in packs, termites collectively build mounds, fish swim in schools, and, like most primates, members of *Homo sapiens* live in groups.[55]

The search for better ways of organizing ourselves—better social technologies—is the search for forms of organization "that enable people to play and capture the benefits of non-zero-sum games."[56] The success of social organizations in accomplishing this result turns on three critical factors. First, the organization must provide the potential for non-zero-sum payoffs or gains.[57] These gains can be produced by a plethora of means including technological improvements, division of labor, exchanging different contributions (labor from some, capital from others), increasing returns to scale, and risk-sharing.[58]

Second, people must share the benefits to be gained from the organization.[59] For people to have an incentive to cooperate, they must receive some share of the spoils, otherwise, cooperation collapses and the non-zero-sum gains evaporate.[60] It is here that the tension between selfish interest and collective interest is most intense, and this is the sphere in which gains that physical

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54. Subsequent to the financial crisis that began in 2007, classical economic theory and "free-market" theories have come under substantial attack. One of the criticisms is that classical economic theory is based upon unrealistic assumptions about human behavior. In particular, classical economics assumes human agents that use complex deductive calculations to assess self-interest, make no cognitive errors and have no cognitive bias, have complete information, and have no need to learn or adapt. *See generally id.* at 115–19. *See also* STIGLITZ, *supra* note 4, at 249–53; POSNER, *supra* note 4, at 79–116.

55. BEINHOCKER, *supra* note 26, at 265–66. (citing SAMUEL BOWLES, MICROECONOMICS: BEHAVIOR, INSTITUTIONS AND EVOLUTION (2004); HERBERT GINTIS, GAME THEORY EVOLVING: A PROBLEM-CENTERED INTRODUCTION TO MODELING STRATEGIC INTERACTION (2000); H. PEYTON YOUNG, INDIVIDUAL STRATEGY AND SOCIAL STRUCTURE: THE EVOLUTIONARY THEORY OF INSTITUTIONS (1998); ROBERT ALEXROD, THE COMPLEXITY OF COOPERATION (1997); BRIAN SKYRMS, EVOLUTION OF THE SOCIAL CONTRACT (1996); ROBERT AXELROD, THE EVOLUTION OF COOPERATION (1984) for the centrality of "game theory" to an understanding of the evolution of social norms and institutions). *See also* R. WRIGHT, NON-ZERO: THE LOGIC OF HUMAN DESTINY (2000).

56. BEINHOCKER, *supra* note 26, at 266.

57. *Id.*

58. *Id.* at 266–67.

59. *Id.* at 267.

60. *Id.*

technologies make possible might be lost. There are two characteristics that promote a sharing of gains in a manner that promotes continuing cooperation: trust and communication.[61] Both are critical because the sharing of gains requires trust in the reciprocal nature of the cooperation and communication about how the gains can be maximized and shared.[62] Trust, especially among strangers, is facilitated by the rule of law. But law cannot replace a lack of trust.[63]

Third, the social organization must have a means of dealing with those who "cheat" by seeking to capture the benefits of cooperation without contributing themselves (the "free rider") or by seeking to capture the benefits without sharing those benefits with others who have contributed.[64] Beinhocker notes that "[t]he incentive to cheat means that cooperation is inherently difficult to achieve and potentially unstable even once attained."[65] Psychological research demonstrates that

> the consistent and deep-rooted nature of human cooperative-reciprocity behavior. Evolution has steered us in a direction whereby we are naturally inclined to be cooperative to capture the riches of non-zero-sum games. Nevertheless, it has also equipped us with a sensitivity to cheating, expectations of fairness, and a willingness to mete out punishment to those we believe have crossed the line.[66]

Human history has evidenced the evolution of increasingly complex and sophisticated social structures for addressing these three prerequisites of non-zero-sum interaction.[67] From the family, to tribes, to agricultural settlements, and to nation-states and modern corporations, the trend has been to ever-larger organizations for cooperative activity encompassing greater numbers and wider geography.[68] Prevailing social technology can be decisive of whether a social organization can realize and perpetuate non-zero-sum gains.[69] One study has demonstrated that the most significant factors in the creation of wealth are *not* natural resources, sophisticated physical technology, or competent government.[70] The most important factors are the rule of law, the existence of property rights, a well-organized banking system, economic transparency, a lack of corruption, and other social factors that promote non-zero-sum gains.[71]

The modern corporation is the largest and most complex non-state institution in the world. It was made possible by technologies that allow for communication across vast space and the ability to process substantial amounts

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61. *Id.* at 274.
62. *See id.* at 267–68.
63. *Id.* at 274.
64. *Id.* at 268–70.
65. *Id.* at 268.
66. *Id.* at 269.
67. *See id.* at 270–75.
68. *Id.*
69. *Id.* at 261.
70. *Id.*
71. *Id.*

of information. It integrates a host of social technologies including money, accounting, and limited liability. Some cognitive scientists even believe that such organizations are capable of having emergent, cognitive capabilities that no individual in the organization has and that are greater than the sum of all the people within the organization.[72] Ironically, Beinhocker states that

> [British Petroleum (BP)], with its 103,000 employees in over a hundred countries around the world, is a marvel of human cooperation. The vast majority of its people have never met and never will meet, but are bound together in a web of social structures, norms, protocols, legal structures, and incentives that enable them to work together for a common purpose. If one extends that web of cooperation beyond BP's immediate employees to include its 1.3 million shareholders and thousands of supplier and other partner companies, then the scale of a social structure such as BP becomes even more remarkable.[73]

Yet, BP's oil spill in the Gulf of Mexico during the Spring and Summer of 2010 evidences the ability of such organizations to create massive harm as well as good.

The foregoing analysis is, of necessity, very generalized and surveys developing areas of study and analysis. Nonetheless, this focus upon evolutionary or complexity economic analysis and upon game theory may contribute to a better understanding of the attributes of corporate and entity law that will facilitate reaching societal or collective goals.

IV

THE IMPLICATIONS FOR CORPORATE LAW

There are three main conclusions from Beinhocker's survey that may have potential implications for corporate and entity law:

> 1. The creation of wealth—and the accomplishment of any human goals—are a function of evolutionary processes that create differing designs or structures, select for the design that is most fit for the environment in which it operates, and allow for the amplification or replication of that design. Organizational structures are one such design.
>
> 2. Economic systems are complex adaptive systems that were not and cannot be created from the top-down, but evolved from the bottom-up. The systems are far too complex to be managed by any singular source or authority because no one can know how all the parts work together. The parts of the system also are capable of evolving and adapting to meet its defined goals or humans needs.
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> 3. Social organizations that evolve successfully will be those that promote the realization of non-zero-sum gains. This requires the

72. *Id.* at 275–76. (citing JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA (2003)).

73. BEINHOCKER, *supra* note 26, at 276.

> intelligence and ingenuity to develop technologies and organizations that create such gains, it requires an allocation of gains in a manner satisfactory to promoting and preserving the cooperation of those needed to realize the gains, and it requires a system to reliably punish those who cheat.

Each of these observations has some significant, if not surprising, implications for the corporate law.

A. Allowing for Evolution

Legal structures that allow for evolutionary processes are important to the success and survival of any social structure. Freedom to experiment is important to fostering this process. The corporate law should allow the flexibility to develop new social technologies and adapt to change, so long as that flexibility does not sacrifice some equally important value. This characteristic has been part of the empowering philosophy of both the MBCA and the Delaware General Corporation Law.[74] With respect to many of the ongoing debates about what form of corporate governance is most advantageous, evolutionary theory suggests that the participants in corporate organizations ought to have the flexibility to experiment with different structures and resolve those issues for themselves. While the general corporation law contains default structures that operate in the absence of a conscious decision to vary them, the ability to vary those provisions is valuable.[75]

For example, stockholders ought to have the ability to experiment with structures that enhance their ability to exercise some control over the organization. The board-centered structure that is part of both the MBCA and the Delaware General Corporate Law ought to be subject to change and experimentation.[76] The empowering philosophy of these statutes ought to not be

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74. Various theorists have argued that free contracting in a competitive system will promote the general welfare. *See generally* FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991). This proposition has been applied to competition among states for incorporations. *See generally* ROBERT ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993). *But see* Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1778–81 (2002). The financial crisis of the past three years has generated substantial criticism of "efficient market" theory as the method for achieving or measuring the common good. Evolutionary or complexity economics may lead to certain conclusions also supported by efficient market theory, but based upon a different economic analysis. Beinhocker questions efficient market theories based upon traditional economic analysis. BEINHOCKER, *supra* note 26, at 21–75. *See also* STIGLITZ, *supra* note 4, at 239–48, 265–71.

75. For example, there are different models for the structure of corporate boards. The same model may not be the best model at all times for all corporations. Easterbrook, *supra* note 4, at 694–95. The point of evolutionary theory is that no one can determine a priori what is the best model, even for most firms, most of the time. Rather, boards operate as part of a complex adaptive system in which the fitness of the model will be determined by an evolutionary process operating from the ground up.

76. There is a considerable debate over the roles of stockholders and directors. For example, there is a plethora of criticism of stockholder activism, contending that stockholders are conflicted in their goals, short-term oriented, and uninformed. *See, e.g.*, Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006); Lynn A. Stout, *The Mythical Benefits of*

limited to empowering boards of directors. It also ought to extend to empowering stockholders, so long as other important values are not sacrificed. Similarly, in the longstanding debate between *stockholder* interest and *stakeholder* interest, the corporate law should be flexible enough to allow for experimentation, allowing other interests to be considered, if desired by the participants. In addition, the law ought to allow flexibility when selecting the purposes for which the corporation is created, recognizing that for-profit activities are not the only ends to be served by the corporate form of organization.[77] In essence, evolution will test the fitness of the various and competing theories advanced with respect to corporate governance.

There are limitations on the principle of flexibility and two are worth noting here. As explained below, the fiduciary duty of loyalty applicable to those who manage the assets and property of others is important to maintaining the type of organization that can create non-zero-sum gains. Experimentation that would jeopardize the existence and enforcement of those duties should be carefully examined. If game theory is correct, forms of social organizations that undermine trust are inherently dysfunctional in the long run. In addition, forms of organization that limit communication between corporate constituencies—especially between stockholders, managers, and directors—operate to hinder the realization of non-zero-sum gains. Experimentation that would jeopardize the ability of stockholders and directors to obtain information about the

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Shareholder Control, 93 VA. L. REV. 789 (2007); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006); Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637 (2006). Others argue that stockholder activism is associated with better long-term performance of the corporation. *See, e.g.*, George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97 (2010) (exhaustively reviewing the literature critical of stockholder activism and the literature demonstrating the benefits of stockholder activism); Easterbrook, *supra* note 4, at 695 (citing Harold Demsetz & Kenneth Lehm, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1161 (1985) (arguing that corporations in which individual investors or small groups of investors own large blocks of stock perform better because the owners are good monitors)).

77. The financial crisis of the past three years—and especially the government assistance provided to publicly-held corporations—has posed a fundamental challenge to the prevailing theories of corporate structure and purpose. Those events have challenged the assumption that the costs of the failure of corporate governance are only borne by the participants in creating, managing, and owning those entities. If corporate governance was a causative factor in the financial crisis—a point that is hotly debated—then that failure imposed tremendous "external costs" on persons other than directors, managers, and stockholders. STIGLITZ, *supra* note 4, at 15–19; POSNER, *supra* note 4, at 106–08, 114–15. In light of those costs and the resulting rescue efforts, it is not surprising that profound questions are being raised about the ultimate purposes to be served by the creation and operation of business entities. Of the six dominant theories of corporate governance, four are premised on long-term profit maximization for stockholders as the primary, if not exclusive, objective of the corporate enterprise, while two of the theories allow for the consideration of the interest of other constituencies or broader societal interests. J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283, 315–26 (2010). One commentator has proposed that "shareholder primacy"—profit maximization for the enterprise and stockholders—be a default setting that would give way in the case of an emergency, such as the financial crisis of 2008. *See generally* Robert J. Rhee, *Fiduciary Exemption for Public Necessity: Shareholder Profit, Public Good, and the Hobson's Choice During a National Crisis*, 17 GEO. MASON L. REV. 661 (2010).

corporation—subject to important confidentiality and trade-secret concerns—should be carefully examined.

Another important caveat about flexibility relates to the phenomenon of "too big to fail." Evolutionary processes necessarily involve change that is adaptive and change that is dysfunctional. The theory is that the process will "select" the successes from the failures. But what if the universe of organizations is so limited that the failure of one organization will result in the failure of that entire segment of the economy—or even of the entire economy? Biological evolution produces species that become extinct as well as those that proliferate. The answer to this paradox is not simple, and this issue poses a significant challenge to the utility of evolutionary economics, which presupposes a diversity of business forms on which selection for fitness operates. Nonetheless, freezing innovation and change by selecting a single form of organization deemed to be the "best" seems both hopeless and ill-advised. Changes in the environment in which corporations operate, including the demands and needs they are attempting to meet to be successful, will never end. Corporations must be able to adapt to those changes, and that adaption will involve experimentation. Nonetheless, experimentation that would produce catastrophic failure is not a prescription for accomplishing any societal goals. The options would seem to be limited to: (1) minimize the size of the institutions so that failure would not be systemic, (2) manage the failure so that the resources of the corporation are re-deployed in new organizations without too great a systemic cost to the economy and without engendering "moral hazard," or (3) allow failure with whatever consequences result. As of yet, it does not appear any satisfactory solution has been found.[78] But a respect for innovation and experimentation cannot ignore the size and concentration of economic—as well as governmental—power and resources. That very concentration may stifle the evolutionary process.

B. The Illusion of Managing a Complex Adaptive System

The global economy undoubtedly is a complex adaptive system. The ability of any lawmakers to control or manage that system is not simply limited by the confines of territorial jurisdiction; it also is limited by the ability to understand the interactions of the multitude of factors affecting its operation. Nonetheless, this conclusion does not mean the system ought to be left to operate in whatever fashion it does. Beinhocker suggests a distinction that may be helpful in this regard:

> Policies that get the government involved in differentiating, selecting, and amplifying [physical or social technologies and business organizations] would be seen as

78. Title II of the Dodd-Frank Act creates a new insolvency process for large, interconnected companies whose failure creates a significant risk to the financial stability of the United States. However, there is serious question whether the process created by Title II is sufficient to avoid the adverse and systemic damage that supposedly was prevented by the Troubled Asset Relief Program (TARP).

> interfering in economic evolution and have all the problems discussed in the critique of socialist economies . . . . In contrast, policies that *shape the fitness environment*, while leaving . . . selection and amplification [of technologies and business organizations] to market mechanisms, are a different matter.[79]

This prescription would leave the structure and form of business organizations to the evolutionary processes allowed by flexible business organization laws, while allowing government regulation to set the parameters within which such evolutionary and market processes would operate. Any evolutionary process operates within an environment that sets the parameters by which fitness is tested. Cold environments produce certain physical traits that promote survival, and hot environments produce other physical traits that will promote survival. What will succeed depends upon the external environment in which the evolutionary process operates and to which that process must adapt. The law may establish the "environment" in which social organizations, including corporations, operate by defining the outcomes being sought and the constraints in which the evolutionary process will operate. Setting such parameters does not necessarily result in losing the benefits of an evolutionary process. The law may define some of the ends, and the means to reach those ends will be created by an evolutionary process. This paradigm also may reconcile the competing, and sometimes conflicting, roles of federal law (or multinational law) and state entity law. The state law allows for the evolutionary process of design creation and selection; federal or multinational law sets the environment in which that process operates, thereby setting the parameters by which "fitness" will be measured.

C. Non-zero-sum Games and Fiduciary Duties

Game theory postulates that social organizations that promote trust and communication between cooperating individuals will better realize the gains possible from non-zero-sum interactions and better sustain such interactions. There are a number of differing groups that must cooperate to produce an effective corporation, but the relationships of most concern to the corporate law are those between (1) officers and directors, (2) stockholders and officers and directors, and (3) among stockholders. A lack of trust and communication between these groups will presumably undermine the ability of the corporation to produce gain.

Game theory also postulates that social organizations must have the ability to identify and discipline cheaters—those who do not reciprocate in sharing benefits or those who "free ride" on the work of others. The precise "bargain" that cooperating parties may strike—and consequently the definition of cheating—may vary from organization to organization. According to John Nash (profiled in the popular book and movie, *A Beautiful Mind*), the bargain struck for dividing the gains from non-zero-sum interactions depends upon how much each of the parties values the benefits of the deal, and what alternatives are

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79. BEINHOCKER, *supra* note 26, at 426 (emphasis in original).

available to each of the parties.[80] The trade is made "at the point at which no one has any incentive to change position, given the actions of the other. This point became known as the Nash equilibrium."[81]

The most critical component of the corporate law for establishing and enforcing trust between directors and officers, on the one hand, and stockholders, on the other, is the fiduciary duty of loyalty. The MBCA codifies that duty in sections 8.31 and 8.42—which obligate directors and officers, respectively, to act "in the manner the director reasonably believes to be in the best interests of the corporation"[82]—and in subchapter F, which deals with directors' conflict-of-interest transactions. The Delaware law imposes similar fiduciary duties on directors and officers, although those duties are developed in the case law and not by statutory codification. In both cases, the corporate law does not allow those fiduciary duties to be modified or eliminated, and in the case of the Delaware General Corporation Law, a director's liability for money damages for breaches of such a duty may not be eliminated.[83] The MBCA is somewhat more permissive in allowing directors to be exculpated from monetary liability for breaches of the duty of loyalty.[84]

Game theory suggests that laws that undermine the obligations of the duty of loyalty could undermine trust and, ultimately, the cooperation necessary to any successful social organization. To a certain extent, the parties may be able to contract as to their expectations of each other, thereby establishing trust through the mechanism of compliance with contractual undertakings.[85] However, such contractual arrangements are more effective if they are the result of real bargaining and are truly reciprocal. Contracts of adhesion that are so one-sided as to destroy any sense of reciprocity are more likely to undermine trust rather than promote it.[86]

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80. *Id.* at 267.

81. *Id.* at 267–68 (emphases omitted).

82. MODEL BUS. CORP. ACT §§ 8.31, 8.42 (2008).

83. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

84. MODEL BUS. CORP. ACT § 2.02(b)(4) (2008).

85. *See generally* Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221 (2009).

86. The proposition that contractual agreements—either real or hypothetical—may be either the best utilitarian outcome or the fairest outcome is hotly debated. *See, e.g.*, J. William Callison & Allan W. Vestal, *Contractarianism and Its Discontents: Reflections on Unincorporated Business Organization Law Reform*, 42 SUFFOLK U. L. REV. 493 (2009). In order to preserve the long-term cooperation essential to creating non-zero-sum gains, the contract should produce a division of gains deemed by the participants in the exchange as minimally fair. As one commentator has noted, "actual contracts carry moral weight insofar as they realize two ideals—autonomy and reciprocity." MICHAEL J. SANDEL, JUSTICE: WHAT'S THE RIGHT THING TO DO? 144 (2009). The autonomy of the contracting parties may be undermined by their unequal bargaining positions, and the reciprocity of the contract may be undermined by a host of factors including the relative knowledge and judgment of the parties. *See id.* at 144–51. The long-term "fitness" of a purely contractual model for legal entities may depend upon how close or far the contract is from the ideals of autonomy and reciprocity. Two factors in evaluating such matters are the size of the enterprise and the role of the parties in setting the terms of the contract.

The need for trust also is critical in the relationship between officers and directors. Directors are largely dependent upon officers to provide the information necessary for decisions, to present the risks and benefits of various options in an even-handed and candid manner, and to alert the directors as to issues that need to be addressed. Officers determined to control the decisions made by the board can attempt to do so by limiting information, biasing the analysis of options, or failing to alert the board to relevant issues. In such an environment, it is difficult for the board process to be meaningful, and, if the board perceives it is operating in such an environment, the board's relationship either with the officers or the stockholders will be undermined. The relationship with officers will be undermined because the board will no longer trust the information or analysis being provided. The relationship with the stockholders will be undermined because the stockholders may perceive the board as not protecting their interest, but merely "rubber-stamping" the proposals made by management.

Finally, the need for trust among stockholders is an increasing issue. The default—and largely mandated—structure of the corporation is built upon the model of stockholder democracy. Each stockholder largely is dependent upon the judgment of a majority of stockholders as to who should be the directors of the corporation, what fundamental transactions (such as a merger) should be undertaken, and what contractual terms should be specified among interested parties with respect to the corporate arrangement (such as what provisions should be in the certificate of incorporation or the bylaws). This model is premised on the idea that all stockholders—either in the long or short run—seek to maximize the value of the corporation. The use of classes of stock with differing terms and powers can create conflicts among stockholders and render stockholders distrustful of each other and corporate governance. Institutional stockholders may have financial interests that may conflict with the interest of others in maximizing the value of the corporation (such as relationships with the corporation in addition to being a mere stockholder, or competing investments). Finally, new derivative instruments may provide opportunities for stockholders to benefit from the failure or lack of success of the corporation, and those interests may be larger and more significant than the stockholders' interest in the stock.

Game theory also postulates that communication is critical to the ability of a social organization to realize the gains of non-zero-sum interactions. The corporate laws and the federal securities law operate to promote communications in certain respects. The corporate law allows stockholders to obtain corporate books and records for certain purposes relevant to their investment, and the securities laws mandate certain disclosures. Laws that restrict a stockholders' ability to obtain information may undermine communication and, in turn, undermine the effectiveness of corporations. On the other hand, more information is not necessarily better information. The volume of information may be so burdensome that it becomes useless. In the final analysis, the information that officers provide to boards and that boards

provide to stockholders may be more effective by focusing boards and stockholders, respectively, on the important issues and decisions, the salient pros and cons, and the value judgments made in collecting and presenting the information. In addition, volumes of information may render the situation more opaque, not more transparent. Once the information is not trusted, the relationship between the parties may become dysfunctional.

V

CONCLUSION

The corporate form was created and succeeded in a much simpler world than the world of today. The increasing size and complexity of corporations and the financial markets has created an increasing number of problems with respect to the most efficient and fair form of organization, maintaining the trust necessary for successfully functioning social organizations and markets, and facilitating the flow of information and communication between interested parties. These challenges may require experimentation with new forms of organization to ascertain by trial and error what forms may best address these issues. If evolutionary economics and game theory are correct, those new forms that best address these issues ought to succeed in the long run. In addition, if evolutionary economics is correct, the law would operate best by allowing experimentation with respect to means, even if the law sets the ends desired and imposes certain constraints. But the law also requires a modesty to acknowledge its own limitations and a realization that the law is an imperfect expression that requires careful and constant reconsideration. The sixtieth anniversary of the MBCA is a perfect occasion for such reconsideration.

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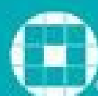

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This book is intended as a general review of a legal subject. It is not intended as a source of advice for the solution of legal matters or problems. For advice on legal matters, the reader should consult an attorney.

CHAPTER 1

INTRODUCTION

I. WHAT IS A CORPORATION

A. Formed by filing with Secretary of State: In every state, one or more people may form a corporation by simply filing a document with the Secretary of State or some similar state official. (The mechanics of this process are described in detail *infra*, p. 21.)

B. Artificial entity: What is this "corporation" that has been so formed? Its key aspect is that it is an ***independent entity***, separate from the identity of its owners (who are, of course, "shareholders"). Even though the corporate entity is artificial, it is treated the ***same as a person*** for many purposes. For instance, it can enter into contracts, own property, and sue or be sued.

C. Key advantages: Why do we need to have corporations at all? Some of the reasons will become clear when we discuss, shortly below, how one should choose between the partnership form and the corporate form in setting up a new business venture. For now, here are the two key advantages that a corporation has over an individual (who if he is operating a business is said to be running a "sole proprietorship") or over a group of individuals (who when they run a business together are said to be operating a "partnership"):

1. **Limited liability:** First and foremost, the corporate form allows for ***limited liability***. Each shareholder is normally liable only for the amounts that he contributes to the corporation; if the corporation runs up large debts, the shareholders are usually not responsible. In contrast, a person operating a sole proprietorship, or a group of individuals operating a partnership, will normally be personally liable for the debts of the enterprise.

2. **Free transferability:** Second, ownership interests in the corporation are ***freely transferable***. Ownership interests in the corporation are represented by shares, and shares can be readily sold. Selling partial stakes in a sole proprietorship or partnership is somewhat more complicated.

II. SOURCES OF CORPORATION LAW

A. **Created by a particular state:** A corporation is always created ***under the laws of a particular state.*** The corporation is then said to be incorporated "in" that state. (There are virtually no "federal" corporations, only corporations created under the laws of a particular state.) The significance of the choice of the state of incorporation is discussed extensively beginning *infra*, p. 19. For now, you should merely understand that the law of the state of incorporation controls nearly all matters of "corporate governance"; thus the powers of stockholders and of the board of directors, the requirements for corporate acquisitions and mergers, the circumstances under which dividends may be paid, indeed virtually all legal principles described in this book (except for certain matters governed by the federal securities laws concerning publicly-held corporations) are determined by the law of the state of incorporation.

B. **Delaware:** The state of ***Delaware*** occupies a disproportionately major role in corporate law. Both for historical reasons and as a matter of the state's own business strategy, a large number of corporations headquartered elsewhere are incorporated in Delaware. (For instance, over half of all the corporations listed on the New York Stock Exchange are incorporated in Delaware. See Hamilton (8th), p. 238.) Delaware has a very finely-developed corporation statute and accompanying body of case law. Therefore, we will be paying far more attention to Delaware corporate law than to the law of any other state.

C. **Other key states:** A few other states have unusual importance in corporate law, not so much because their jurisprudence is so well-developed but simply because these states are the domicile for large

numbers of corporations. New York and California are the principal states, apart from Delaware, that we will be focusing on.

D. MBCA: An important source of guidance about corporation law, especially for students, comes from the ***Model Business Corporations Act*** (MBCA). This is a model act prepared by a committee of the American Bar Association. The MBCA has heavily influenced the corporation statutes of more than half the states. Nutshell, pp. 7-8.

1. Revisions: The present overall version of the MCBA was drafted in 1984. Major revisions of the portions dealing with mergers and acquisitions, and with appraisal rights, were published in 1999.

E. ALI project: The newest major source of guidance on corporate law is the American Law Institute's *Principles of Corporate Governance*. The ALI text is comparable to the Restatements prepared by the ALI in other subjects; the *Principles* form a sort of "Restatement of Corporations." The *Principles* were completed in 1994.

III. CHOOSING BETWEEN CORPORATE AND PARTNERSHIP FORM

A. Choice between partnership and corporation: A lay person who is setting up a business often assumes that the only sensible form of organization for the business is a corporation. However, this is not necessarily true. Often, it will make more sense to set the business up as a ***partnership***. In this Section III, we examine some of the factors that should be considered in choosing between the corporate and partnership forms.

1. Non-corporate non-partnership forms: Before we examine the partnership-vs-corporation decision, let us briefly touch upon two forms of organization that are neither corporations nor partnerships: (1) the ***sole proprietorship***; and (2) the ***limited liability company*** (***LLC***).

a. Sole proprietorship: If there will only be one "owner" of

the business, it may be feasible to set the business up as a ***"sole proprietorship."*** In a sole proprietorship, the owner of the business carries on the business ***as an individual***. This means that he is directly liable for all the debts of the proprietorship, and he reports the gains and losses from the proprietorship directly on his own personal income tax return. In many respects, a sole proprietorship is a "one person partnership" — that is, many of the attributes of partnerships apply to a sole proprietorship. Because of this close resemblance, we will not talk any further about sole proprietorships, and will focus on choosing between the corporate and partnership forms.

b. Limited liability company (LLC): Since the 1990s, every state has recognized a fourth form of organization, the ***"limited liability company,"*** or ***"LLC."*** The two most important attributes of the LLC are that: (1) all those with an economic interest in the business ("members," analogous to partners in a partnership) can ***limit their liability*** to the ***amount invested*** (not so easily done with partnerships); and (2) the entity can elect to be ***taxed either as a corporation or as a partnership***, whichever the members prefer. Also, LLCs offer tremendous flexibility in management, financing, and other operational aspects. LLCs are discussed further *infra*, p. 11.

B. Nature of partnership: In order to assess the pros and cons of partnerships versus corporations, we must first understand a little bit about the nature of partnerships.

1. General partnership: The simple term "partnership" normally refers to a so-called ***"general partnership."*** All partnerships are "general" unless the particular statutory requirements for a limited partnership (see *infra*) are complied with. In all states, general partnerships are governed by statutes patterned on the ***Uniform Partnership Act*** (UPA). The most recent version of the UPA was promulgated in 1997.

a. How created: The UPA defines a partnership as "an

association of two or more persons to carry on as co-owners a business for profit." §6(1). In contrast to a corporation, a general partnership can come into existence by ***operation of law***, without the need to file any formal papers with any state official. Thus if Jones and Smith, without signing any agreement between them and without filing any documents with the state, begin to jointly operate a corner candy store, they will have a general partnership. The most important single fact about general partnerships is that ***each*** partner is liable (vis-a-vis the outside world) for all the ***debts*** of the partnership. (See *infra*, p. 4.)

i. **Creation by "estoppel":** Two people who don't actually intend to be in partnership with each other can even be found to have created a partnership ***"by estoppel,"*** if they ***represent*** to the ***outside world*** that they are in partnership together. Thus §16 of the UPA says that "a person…[who] represents himself, or consents to another representing him to any one, as a partner in an existing partnership … is liable to any such person to whom such representation has been made, who has, on the faith of such representation, ***given credit*** to the actual or apparent partnership."

2. **Limited partnership:** All states also allow the formation of something called a ***"limited"*** partnership. In all states, limited partnerships are governed by either the Uniform Limited Partnership Act (ULPA) or the newer 1976 Revised Uniform Limited Partnership Act (RULPA).

a. **Formation:** Unlike general partnerships (but like corporations), limited partnerships may only be created by filing a formal document with a state official. Also, there must be a ***written agreement*** among the partners. RULPA §201.

b. **Nature:** Limited partnerships have two kinds of partner: (1) one or more "general" partners, who are each liable for ***all*** the debts of the partnership; and (2) one or more ***"limited"*** partners, who are ***not*** liable for the debts of the partnership beyond the amount that they have contributed to the

partnership.

i. **Corporate general partner:** To allow liability to be limited even further, the general partner(s) may be a ***corporation***, and in fact a corporation with few assets. This means that a limited partnership, if carefully constructed, can be put into place without any individual being exposed to the unlimited personal liability that is characteristic of general partnerships.

ii. **Limited partners cannot participate in management:** Why would anyone ever choose to be a general partner in a limited partnership, rather than being a limited partner? The reason is that a limited partner ***may not participate actively in the management of the partnership***; if he does participate, he will lose his limited liability. (But the problem is not as bad as it sounds. The individuals who will be running the partnership probably can create a corporation of which they are the sole stockholders, and can make the corporation be the general partner; the fact that the individuals are running the corporate general partner usually does not cause these individuals to be regarded as "de facto" general partners who have sacrificed their limited liability.

c. **LLP:** Most states now also allow something called a ***"limited liability partnership,"*** or ***LLP***. LLPs are discussed *infra*, p. 5.

C. **List of factors:** In deciding whether to organize a new venture as a corporation or as a partnership, there are six major factors which need to be considered: (1) limited liability; (2) management; (3) continuity of operations; (4) transferability; (5) complexity and expense of forming and operating the enterprise; and (6) federal income tax considerations. We consider each of these factors in turn.

D. **Limited liability:** It is with respect to ***limited liability*** that the difference between corporations and partnerships is clearest.

1. **Corporation:** In the case of a corporation, as noted, the

shareholders' liability is normally ***limited*** to the amount they have invested. If the corporation runs up large debts after the shareholders have made their initial capital contribution, the shareholders are normally not responsible for those debts.

a. **Lenders often require guarantee:** However, this advantage is not quite as significant as it may at first seem to be. The problem is that ***banks*** and ***other lenders*** understand the normal rule of limited shareholder liability just as well as business people do. Therefore, if the corporation is just starting and/or has limited assets, lenders usually simply will not lend money to the corporation without ***personal guarantees*** by some or all shareholders. Therefore, the advantage of limited liability boils down mostly to avoiding liability for (1) debts to ordinary "trade creditors", i.e., suppliers of goods and services to the corporation; and (2) suits by tort claimants (e.g., a person hit by a truck driven by a corporate employee while on corporate business). (But even these two classes of possible creditors may very occasionally be able to recover against the shareholders by "piercing the corporate veil"; see *infra* p. 34.)

2. **Partnership:** The liability of partners, as you might expect, varies depending on whether the partnership is a general or limited one.

a. **General partnership:** In a ***general*** partnership, ***all partners are individually liable for the obligations of the partnership.***

i. **Joint ability to bind partnership:** This joint liability applies even where one partner does not participate in the act that causes the partnership to become liable. For instance, remember Smith and Jones, who are operating the local candy store as a general partnership. Assume that Smith and Jones have signed a partnership agreement that explicitly provides that neither will incur any obligations on behalf of the partnership without the consent of the other. Now, assume that Smith orders a new $50,000 freezer without telling Jones. If the partnership does not pay the

bill, the supplier of the freezer will be able to sue Jones as well as Smith — the Smith-Jones partnership agreement does not save Jones from liability vis-a-vis the world (though he will have a claim over against Smith for breach of the agreement).

ii. **Limited Liability Partnership (LLP):** But the modern (1997) version of the UPA gives partners in what would otherwise be a traditional general partnership a chance to avoid the standard individual liability for partnership debts. The partners can elect to be a ***"limited liability partnership,"*** or ***"LLP."*** UPA §1001. Once the partnership files such a statement of election, ***no partner will be liable for the partnership's obligations*** just by virtue of being a partner. §306(c). (The partnership must indicate that it has LLP status by appending some variant of the word "LLP" after its name [§1002], so that members of the public who do business with the partnership will know that individual partners won't be liable for partnership obligations.)

(1) **Most states now allow:** Most states have now passed statutes, modelled on the UPA provisions, recognizing the LLP.

(2) **Professional service corporations:** The biggest users of LLP status are ***professional service firms***, like ***law firms*** and ***accounting*** firms. The biggest practical benefit of the LLP status to such a service firm is that the individual partners will not be liable for acts of ***malpractice*** committed by other partners.

(3) **Partner can actively participate in management:** The LLP status also has a major advantage over a traditional limited partnership, since a limited partner will lose her freedom from liability by participating in management, but a partner in an LLP will not.

b. **Limited partnership:** In a ***limited*** partnership, as noted, the general partners are personally liable but the limited partners

are liable only to the amount of their capital contributions. But remember that the limited partners will lose this limit on their liability if they participate actively in the management of the partnership. (But as noted above, the *LLP*, or “limited liability partnership,” does not have this problem – in an LLP, as distinguished from a limited partnership, a partner may participate in management to her heart’s content without thereby becoming liable for partnership obligations.)

3. **Summary:** So with respect to limited liability, the corporation is distinctly superior to the general partnership. Also, if individuals want to be able to actively participate in management without losing their limited liability, the corporation is much superior to the limited partnership (but not superior to the LLP).

E. **Management:** Corporations and partnerships differ with respect to how the enterprise will be ***managed*** and controlled.

1. **Corporation:** Corporations follow the principle of ***centralized*** management. The shareholders participate only by electing the board of directors. The board of directors then appoints “officers” (i.e., high-level executives). The corporation is managed under the supervision of the board, with day-to-day control resting with the officers. So if the investors desire to entrust management to non-shareholders, or to some but not all shareholders — which will frequently be the case in a larger corporation — the centralized management structure of the corporation is helpful.

2. **Partnership:** In partnerships, the “standard” mode of management is ***not*** a centralized one.

a. **General partnership:** In a ***general*** partnership, ***all*** partners have an equal voice in managing the enterprise, unless they otherwise agree. But it is important to realize that the partners may indeed “otherwise agree.” For instance, they may decide that the decision-making powers will be limited to one or a few of them rather than all.

i. **Right to deal with the rest of the world:** But remember

that such internal agreements concerning decision-making authority are ***not binding*** on outsiders who are unaware of these agreements. (Remember our example of Smith, Jones and the freezer, *supra*, p. 5.) Thus even if the 26 general partners in ABC Partnership agree that only partner A will have the right to commit the firm, ***any*** partner may nonetheless bind the partnership in a deal with an outsider, if the outsider is not aware of this agreement. See S,S,B&W, p. 164.

b. Limited partnership: Management in a limited partnership is the same as in a general partnership, except that the limited partners may not actively participate in management without losing their limited liability. In other words, each general partner may bind the partnership vis-a-vis the rest of the world.

3. Summary: So if the management of the entity needs to be entrusted to non-owners or to fewer than all of the owners, and it is important to make sure that only certain people can make deals with the rest of the world on behalf of the enterprise, the corporate form is clearly superior.

F. Continuity of existence: Partnership and corporations differ as to their ability to ***continue in existence*** when ownership changes.

1. Corporation: A corporation has ***"perpetual existence."*** In other words, the fact that ownership (i.e., shares) changes hands, whether by sale, inheritance, gift, etc., does not in any way affect the corporation's continuing existence.

2. Partnership: The rules for a partnership are quite different.

a. General: A ***general*** partnership is ***dissolved by the death*** of any general partner. In fact, even the ***withdrawal*** of a general partner will dissolve the partnership unless the partnership agreement otherwise provides. See UPA §§31-32.

i. Provisions for: But this is not as big a problem as it sounds. First, the partnership agreement may provide that the withdrawal of a partner will not cause the partnership to

dissolve. Furthermore, even the mandatory dissolution on account of a partner's death can be made surprisingly painless — the partnership agreement can (and usually does) provide that the dead partner's interest will be "bought out," and that the remaining partners will then carry on the business with a new partnership. S,S,B&W, p. 165.

b. **Limited:** A ***limited*** partnership is not dissolved by the withdrawal or death of a limited partner. *Id*.

3. **Summary:** If it is important to the owners that the business continue with a minimum of fuss even if one owner withdraws or dies, then the corporate form is somewhat superior. But it may be the case (especially in smaller businesses dependent on the skills of a few owners/managers) that an owner/manager will want the bargaining power that comes from an ability to unilaterally dissolve the partnership. In any event, through careful drafting of the partnership or shareholders' agreement, a corporation can be made to look like a partnership, or a partnership like a corporation, with respect to continuity of existence. See the discussion of shareholders' agreements, p. 133.

G. **Transferability of interest:** The two forms of organization differ with respect to how readily ***transferable*** an ownership interest is.

1. **Corporation:** Ownership interests in a ***corporation*** are very readily transferable. Ownership is, of course, embodied in shares of stock. Unless the shareholders otherwise agree (see the discussion of shareholders' agreements *infra*, p. 146), any shareholder may at any time sell or give his shares to anyone else without consent by the other shareholders. This transferability is especially important where: (1) the business wants to attract "venture capital," i.e., equity investments in a young or start-up business; or (2) the business is large and is owned by many different people.

2. **Partnership:** By contrast, a partnership interest is not really transferable to the same extent. Ordinarily, ***all*** partners must consent to the admission of a new partner. See UPA §18(g). A

partner may “assign” his partnership interest, but this does not make the transferee a partner; instead, the transferee merely obtains limited economic rights.

a. **Pros and cons:** Of course, this limited transferability is not necessarily a disadvantage. It will often be very comforting for each partner to know that no new partner may be thrust upon him without his consent. (Since each general partner can bind the entire partnership, this veto power over new partners is absolutely essential. S,S,B&W, p. 166.)

b. **Limited partners:** ***Limited*** partners, similarly, may in a sense transfer their interests, but the transferee does not really become a limited partner — he merely has certain economic rights. The transferability features of limited partnership interests are strong enough that there actually exist “public limited partnerships” whose limited partnership shares are traded on major stock exchanges. One buys and sells “limited partnership interests” in such partnerships much as one would buy or sell stock in a corporation.

3. **Summary:** If free transferability is important, the corporate form is clearly superior to the partnership form. If it is important to the owners that there ***not*** be free transferability, the partnership form may be somewhat preferable (thought the same results can usually be obtained by a corporation through a carefully-drafted shareholders agreement).

H. Complexity of formation and operation: Especially where the business will at the beginning be small and thinly capitalized, the degree of ***complexity*** and ***expense*** involved in forming and operating the business will be important, and will vary as between corporation and partnership.

1. **Corporation:** It is not all that cheap or simple to incorporate. The would-be shareholders must file a moderately complex document with the Secretary of State, and more importantly, must then comply with a small blizzard of regulatory requirements applicable to corporations. There is likely to be a minimum annual tax (often called a “franchise fee”) imposed on

the corporation even if it is unprofitable.

2. **Partnership:** By contrast, a partnership (at least a general partnership) can be created and maintained with somewhat less expense and fuss. As noted, no formal documents need to be filed with the state to create a partnership, and indeed, a partnership can come into existence by operation of law (merely by virtue of the joint operation of a business) even though the partners have not explicitly agreed that they will operate a partnership. There tend to be somewhat fewer regulatory requirements, and some states do not impose a fee on the partnership for the mere privilege of existing. (But remember that both a limited partnership and an LLP are like a corporation in that they *do* have to be formally filed with the state.)

3. **Summary:** So if the enterprise will be a very modest one carried on by just a couple of people, ease and inexpensiveness of creating the enterprise and operating it argue in favor of the partnership rather than corporate form.

I. Federal income tax: The ***federal income tax*** consequences of operating as a corporation rather than as a partnership are enormous. We can only touch very superficially on the differences.

1. **Corporation:** The corporation is taxed as a ***separate entity***. In other words, if the corporation has profits or losses, it files its own tax return, and pays its own taxes independently of the tax position of the stockholders.

   a. **"Double taxation":** One consequence of the corporation's status as a separate taxpayer is that there will often be so-called ***"double taxation."*** The corporation pays a corporate income tax on its profits. If the after-corporate-tax profits are then distributed to the shareholders as ***dividends***, the individual shareholders pay a separate, second, tax on these dividends.

   Example: Suppose that ABC Corp. earns one million dollars after paying all expenses (including salaries). Simplifying in terms of tax rates, ABC will pay a corporate-level tax (at 2002

rates) of 34%, or $340,000. If the remaining $660,000 is paid out to the stockholders as dividends, these stockholders will pay individual income taxes. Assuming that each shareholder has taxable income of, say, $150,000 before these dividends and is married filing jointly, the individual federal marginal tax rate on the total $660,000 dividends will be 30% (or additional taxes of $198,000). So the pre-tax profit will go though a combined tax mill equaling about 54% before ending up in the hands of shareholders. (But if the shareholders are corporations, the dividends they receive will be taxed at a much lower rate, on account of special treatment given to "inter-company dividends.")

i. **Deduction of salaries:** But for closely-held corporations, the double taxation problem is usually not as bad as it seems. If the corporation can pay out most of its pre-tax profits in the form of high ***salaries*** to the owner/managers, the problem just about goes away. The reason is that ***salaries are deductible at the corporate level***; therefore, most of the profits will only be taxed at the individual level (when received by the shareholders as salary), not at the corporate level (since the corporate profit after deducting salaries will be little or nothing).

ii. **Reinvested profits:** Also, keep in mind that the double taxation problem only arises when the corporate profits are actually ***paid out***. If the corporation holds onto the profits to reinvest them in the business, then there is *only* the corporate-level taxation. (There is a possibility that these accumulations might be taxed under a separate provision of the Internal Revenue Code intended to discourage unreasonably large accumulations, but this is usually not a problem.)

b. Subchapter S: The usual principles of corporate taxation can be avoided if the corporation qualifies for status as a "Subchapter S corporation," and elects to be treated that way. See *infra*, p. 10.

c. **Fringe benefits:** Many ***fringe benefits*** given to owner/managers of corporations receive very favorable taxation. For instance, pension and profit-sharing plans, and stock options, are more available to corporations than to partnerships.

2. **Partnership:** Partnerships, unlike corporations, are ***not separately-taxable entities***. Instead, the partnership is viewed as an aggregation of individuals for tax purposes. True, the partnership files a tax return; but this tax return is merely an ***informational*** return, which shows how much the partnership earned and how those earnings are distributed among the partners. The actual tax is ***paid by each individual***, and is therefore a function of his own tax bracket and the other earnings or losses he has.

   a. **Avoids double taxation:** This means that the partnership avoids the "double taxation" problem that can occur in corporations. On our example from p. 8, if ABC operated as a partnership rather than a corporation, the total tax on the $1 million of pre-tax profits would probably be about $300,000, all of which would be reported on the partners' individual tax returns.

   b. **Ability to allocate:** Another tax advantage of partnerships is that the partners may ***allocate*** the gains and losses from the partnership to individual partners pretty much as the partners decide.

   c. **Shelter:** Partnerships offer significant opportunities for ***sheltering*** gains from other activities (though these opportunities were much reduced by the Tax Reform Act of 1986). So long as a partner is ***actively involved*** in management of the partnership, he may offset his share of losses incurred by the partnership against gains from other activities. Thus if Smith and Jones operate their candy store while each holds down a salaried job somewhere else, and the store loses money, each can subtract his share of the losses from his salaried income and pay individual taxes only on the

difference. S,S,B&W, p. 173.

3. **Subchapter S:** If the owner/stockholders of a corporation would like to be taxed approximately as if they were partners in a partnership, they will often be able to do so by having their corporation elect to be treated as a ***Subchapter S*** corporation.

   a. **Tax treatment:** A Subchapter S corporation does not get taxed at the corporate level, unlike a regular (or "Subchapter C") corporation. In a loose sense, stockholders in an S corporation are treated as if they were partners. For instance, if A and B each owned 50% of ABC Corp, an S Corp., and the corporation had pre-tax profits of $100,000, ABC would not pay any tax, and A and B would each report $50,000 of taxable income.

   b. **Shelter:** Like a partnership and unlike a C corporation, an S corporation may furnish the opportunity to ***shelter*** income from other sources. Thus if ABC Corp has a loss of $100,000 instead of a gain, A and B as equal shareholders may each use his $50,000 loss to offset $50,000 from, say, a salary earned at a different job. (However, these losses are limited to each investor's "basis" in his ABC stock, i.e., his investment in the corporation.)

   c. **Requirements:** Not all corporations are eligible for taxation as S corporations. The main requirements are that: (1) there must be no more than 75 shareholders; (2) all shareholders must be individuals, estates or qualified trusts; and (3) there may be only one class of stock outstanding.

4. **LLC:** Similarly, if the members of an ***LLC*** (see *infra,* p. 11) would like to be treated as partners in a partnership, they may so elect.

5. **Summary:** In summary, the investors will probably prefer to be taxed as partners rather than as C corporation stockholders if the business has (after payment of salaries) either losses or large profits. If the partnership form is used, the losses can be offset against other income (at least if the partners are actively involved

in running the business) and the profits will be taxed at a lower rate than if they were corporate profits. Conversely, the corporate form is probably better if, after payment of salaries, the corporation makes a modest profit (say between $15,000 and $75,000). The corporate form is also attractive if fringe benefits like pension and profit sharing plans are an important part of the total economic benefit that will be received by the owners. Lastly, many of the benefits of partnership taxation can be achieved by operating as an S corporation or as an LLC.

J. **Overall summary of corporations vs. partnerships:** Summing up our various factors, we can say the following about the corporation-vs-partnership choice:

1. **Corporations superior:** The corporate form is usually superior: (1) where the owners find it important to limit their liability; (2) where free transferability of interests is important; (3) where centralized management is important, as where there is a large number of owners who cannot all be active in the business; and (4) where continuity of existence, in the face of withdrawal or death of an owner, is significant.

   a. **Large number of owners:** These factors taken together mean that if there will be a large number of owners (say more than several hundred), the corporate form is dramatically superior to the general partnership form. (A ***limited*** partnership may be an adequate alternative in this situation.)

2. **Partnerships superior:** Conversely, the partnership form will be superior where: (1) simplicity and inexpensiveness of creation and operation are very important (as where the enterprise is very small and not very profitable); and (2) where there are either losses or large profits, making the fact that the partnership is taxed only at the level of the individual partners significant. (But remember that these tax advantages will often be largely attainable in the corporate form, by operating as an S corporation.)

IV. THE LIMITED LIABILITY COMPANY (LLC)

A. Limited Liability Companies generally: The fastest growing form of organization since the 1990s has been the ***limited liability company***, or ***LLC***. All 50 states have enacted special statutes recognizing and regulating LLCs. The LLC is neither a corporation nor a partnership, though it has aspects of each. In the opinion of many business lawyers and business operators, LLCs incorporate the best features of both corporations and partnerships.

1. Advantages: Here are the principal ***advantages*** of an LLC over both a corporation and a partnership:

a. Limited liability: Recall that in a standard (general) partnership, ***each partner*** is ***personally liable*** for the debts of the partnership. (*Supra*, p. 5.) Even in a limited partnership, there must be a general partner who has full personal liability for partnership debts. (Furthermore, in a limited partnership, a person who wants to be a limited partner and thus have the protection of limited liability may not be active in the business's operations.)

The LLC suffers from none of these undesirable liability-related problems: ***no "member"*** (analogous to a partner in a partnership or a stockholder in a corporation) ***can be liable for anything other than the amount of his investment in the LLC, regardless of how involved that member is in the daily operations of the business.*** So for liability-limiting purposes, an LLC is every bit as good as a corporation.

b. Taxed as partnership: Yet the LLC members can elect to have the entity treated, for ***federal tax purposes***, as a ***partnership***. Therefore, unlike the standard "C" corporation (*supra*, p. 8), the LLC can operate as a ***"pass-through" entity and avoid double taxation.***

i. Flexibility in allocations: Furthermore, being taxed like a partnership offers great flexibility in the ***allocation of gains and losses***, flexibility that is not present in the one type of corporate structure that is a pass-through, the "S" corporation. For instance, an LLC's two members could agree that *A* (an individual in a high tax bracket) would

receive 99% of all operating losses, and that *B* (a low-tax-bracket person) would receive 99% of all operating profits. They could additionally agree that gains on sale of the business would be split, say, 70% to *A* and 30% to *B*, regardless of what percentage of startup capital each provided. This kind of customized allocation cannot readily be done in an S corporation, where the allocations are essentially dictated by each parties' percentage of stock ownership.

c. Flexibility in operations: Lastly, the LLC provides nearly total flexibility in how ***operations are to be conducted***. For instance, whereas a corporate Board of Directors may generally take action only by a formal meeting (see *infra*, p. 65), an LLC's members may provide that action may be taken without a formal meeting by a vote of a majority of the "managers" (i.e., the people designated to run the company's business operations.) Similarly, the restrictions that exist by statute on a corporation's right to dispose of its financial resources — see, e.g., the restrictions on dividends discussed *infra*, p. 508 — have no counterpart under the LLC statutes. See Hamilton (7th), p. 190.

2. Disadvantages: LLCs, however, do have some ***disadvantages***. Here are a few:

a. Complexity in formation: LLCs are more ***complex to form*** — an LLC requires an ***"operating agreement"*** to specify how it will work (*infra*, pp. 12-14), and the very flexibility that the LLC form allows makes drafting an effective operating agreement more challenging than, say, drafting the more-routine certificate of incorporation and bylaws for a typical corporation. *Id.* at 193.

b. Veil-piercing: It may turn out that it is easier to ***"pierce the veil"*** of an LLC (see *infra*, p. 14) than that of a corporation (see *infra*, p. 34).

c. State taxes: In some states, state income or franchise taxes are applicable to LLCs just as they are to corporations, but are

not applicable to partnerships. In these states, this is therefore an advantage to the partnership form. *Id*. at 194.

3. **ULLCA:** Just as there are Uniform Acts governing other types of business entities (e.g., the Uniform Partnership Act, *supra*, p. 3), so there is now a ***Uniform Limited Liability Company Act (ULLCA)***, created in 1994 and revised in 2006. However, the act has not been very widely adopted: as of the end of 2010, only ten states had enacted either the original or the revised ULLCA. Hamilton (11th), p. 1183.

B. **Operating agreement:** Recall that one of the advantages of LLCs is their extreme flexibility. That flexibility derives from fact that state statutes allowing the formation of LLCs contain far fewer absolute rules about how the entity must conduct its affairs than is the case with, say, corporations. Instead, owners of the LLC (called ***"members"***) must agree among themselves how the business will operate (e.g., what kind of a vote is necessary to sell the LLC's assets or change its principal business?). They typically do so by means of an ***"operating agreement,"*** which is a contract among the members.

1. **May be oral:** The better practice is clearly to have the operating agreement be in writing. But many state statutes allow for an ***oral*** operating agreement. See, e.g., ULLCA §103 ("All members of a limited liability company may enter into an operating agreement, which ***need not be in writing***, to regulate the affairs of the company and the conduct of its business, and to govern relations among the members, managers, and company.")

2. **Company is itself bound:** The parties to an operating agreement are normally the members, and the company itself is not necessarily a member. Therefore, the question sometimes arises, if the LLC itself has not signed the operating agreement, is the LLC nonetheless ***bound*** by the terms of that agreement? In the principal case on the issue, set forth in the next example, the Delaware Supreme Court has answered ***"yes."***

   Example: Two corporations, Elf and Malek, Inc., and an individual, Jaffari (owner of Malek, Inc.) set up an LLC,

Malek LLC, and become its members. The three members sign an operating agreement (the "Agreement") for Malek LLC, but Malek LLC does not itself sign the Agreement. The Agreement contains a clause saying that all disputes must be subjected to arbitration, and that if a dispute is not arbitrable it must be tried in the California courts. The members then have a dispute about how the company is being run, with Elf alleging that Jaffari has withdrawn LLC funds for his personal use and otherwise improperly behaved. Elf brings a "derivative action" (see *infra*, p. 318) against Jaffari and Malek LLC in Delaware. Jaffari asserts that the Agreement's arbitration and forum-selection clauses bar this Delaware litigation. Elf counters that because Malek LLC is not a party to the Agreement, the arbitration and forum-selection clauses are not applicable to Elf's suit against Malek LLC.

Held (by the Delaware Supreme Court), for Jaffari. Even though Malek LLC did not sign the Agreement, all of the LLC's members did, and they are the "real parties in interest" (the LLC is "simply their joint business vehicle.") Therefore, the fact that all members have signed the Agreement is enough to make the arbitration and forum-selection clauses in the Agreement enforceable. Furthermore, "the policy of the [Delaware LLC] Act is to give the maximal effect to the principles of freedom of contract and to the enforceability of LLC agreements[.]" This policy dictates enforcing the parties' decision to change the usual rules under which controversies involving Delaware business entities can be litigated in the Delaware courts. *Elf Atochem North America, Inc. v. Jaffari and Malek LLC*, 727 A.2d 286 (Del. 1999).

3. **Adherence to rights can't be breach of implied covenant of good faith:** An LLC's operating agreement is of course a contract, and you'll remember from first-year Contracts that all contracts contain an ***implied covenant of good faith and fair dealing***. Disgruntled LLC members have frequently argued that another member's conduct, even though expressly allowed by the terms of the operating agreement, ***constitutes a breach*** of this implied covenant. But these arguments have ***not fared well*** in the

courts — where a member exercises a right that is expressly given to her by the operating agreement, courts almost ***never*** hold that that exercise constitutes a breach of the covenant of good faith and fair dealing.

a. **Illustration (*Fisk Ventures v. Segal*):** A Delaware Chancery case, ***Fisk Ventures, LLC v. Segal***, 2008 WL 1961156 (Del. Ch. 2008), illustrates this principle.

   i. **Structure:** In *Fisk Ventures*, P (Segal) was a biochemist who formed Genitrix, LLC ("the LLC"), a biomedical company. The LLC had several classes of membership interests. Segal as founder controlled the Class A interest. D (Fisk Ventures), a venture capital company, together with its head, was the principal investor, and in return received control of the Class B interest. The operating agreement was drafted in such a way that ***no significant action*** could be taken except by ***agreement between the Class A and Class B members.***

   ii. **Fisk's rights:** In return for Fisk's capital, Fisk and the other Class B members received numerous specially-negotiated protections. For instance, the B members received a "Put Right," which allowed them at any time to force the company to re-purchase any or all of the Class B interests at an appraised value; a key feature of the Put Right was that the Class B interests would have a ***liquidation preference*** superior to any claim by anyone who later invested in the company.

   iii. **Company runs short of cash:** The LLC ran short of cash. Segal wanted to bring in new investors, but they would invest only if Fisk would surrender or suspend the Put Right (since the new prospects didn't want to put in fresh money if they would be subordinate to the Class B members). Fisk refused to do this, so the outside investors could not be brought in. Fisk and Segal had various other disagreements, which led to a ***deadlock*** in which the company no longer had any funds, offices, or operations.

Fisk sued to dissolve the company, and Segal asserted various counterclaims.

iv. Segal's counterclaims: Segal's key counterclaim was that when Fisk blocked the various financing opportunities proposed by Segal, Fisk breached the operating agreement's ***implied covenant*** of good faith and fair dealing. Delaware courts had held that this covenant "requires a party in a contractual relationship to refrain from ***arbitrary and unreasonable conduct*** which has the effects of ***preventing the other party to the contract from receiving the fruits of the bargain***." Segal claimed that when Fisk blocked the outside investors, this action had blocked Segal from his bargained-for opportunity to try to continue the company's operations.

v. Court rejects: But the court held against Segal; it decided at the pre-trial motions stage that Segal had not even stated facts showing that he might be entitled to relief. The operating agreement ***expressly granted Fisk the right to block*** any financing of which it disapproved — that right to block was built into the structure that required the Class A and Class B interests to cooperate on any significant company action. The implied covenant of good faith and fair dealing, the court held, is a "gap filler," which can be used only where it is clear from the contract that the parties ***would have agreed to the particular term in question had they thought to negotiate the matter.*** The covenant "cannot be invoked where the contract itself ***expressly covers the subject*** at issue." And every blocking step used by Fisk was expressly authorized in the operating agreement. "The ***mere exercise of one's contractual rights,*** without more, ***cannot constitute*** … a breach … of the implied covenant of good faith and fair dealing[.]"

Note: For discussion of another phase of this case, in which the court granted Fisk's request for a judicial dissolution, on the grounds that it was no longer "reasonably practicable" to operate the business, see *infra*, p. 159.

C. **Piercing the veil of an LLC:** The LLC is, as we've just seen, in theory a limited liability device, under which members are not liable for the debts of the LLC no matter how involved they are in the daily operations of the business. The same is theoretically true of corporations. Yet, as we'll see later (*infra*, p. 34), in the case of a *corporation's* liabilities, courts sometimes ***"pierce the corporate veil"*** and hold some or all of the shareholders ***personally liable*** for the corporation's obligations. May a court similarly ***pierce the veil of an LLC in a suitable case***, so as to hold one or more members personally liable for the LLC's obligations? LLCs are sufficiently new that there is not much of a consensus about the proper answer, but it seems clear that in at least some (maybe most) states, the answer is sometimes ***"yes."***

1. **Some statutes apply similar rules:** Some state LLC ***statutes*** contain express provisions requiring that whatever the jurisdiction's rules are about when a corporate veil may be pierced, similar rules should apply to the piercing of LLCs. Cf. B,W&P (5th), pp. 360-61. So in such a jurisdiction, clearly an LLC's veil may sometimes be pierced.

2. **Where statute is silent:** Where the state statute governing LLCs is ***silent*** about veil-piercing, most courts have held that, as a matter of common law, ***rules similar to those governing veil-piercing in corporations*** should apply. *Id*.

   a. **Criticism:** But there is at least one factor often used in corporate veil-piercing cases— ***failure to follow organizational formalities*** — that perhaps ought ***not*** to be interpreted the same way in an LLC-piercing case. Thus one court considering the matter endorsed the general idea that courts have equitable power to pierce the veil of an LLC, but then cautioned that "the various factors which would justify piercing an LLC veil ***would not be identical*** to the corporate situation for the obvious reason that ***many of the organizational formalities applicable to corporations do not apply to LLCs.***

      The LLC's operation is intended to be much more flexible than a corporation's." *Kaycee Land and Livestock v. Flahive*,

46 P.3d 323 (Wyo. 2002).

Example: For instance, when the stockholders of a corporation fail to formally issue shares, or to hold shareholders' meetings or directors' meetings, this is a factor that sharply raises the risk of a veil-piercing (see *infra*, p. 39); on the other hand, members of an LLC are *not required* to issue member certificates or to hold regular meetings, so their failure to do so would *not* support veil-piercing.

Quiz Yourself on ***INTRODUCTION*** *(CHOOSING A FORM OF ORGANIZATION)*

1. Scrooge and Marley own a catering business, the Roast of Christmas Present, Inc. They each own 50% of the shares. Marley dies in a freak accident when one of the corporation's employees, Bob Cratchit, drops a haunch of venison on him. Since Marley was a 50% owner of the corporation, does the corporation terminate along with him?

____

2. Curly owns part of the Nyuck-Nyuck Wise Guys, a major league baseball team. Curly becomes disgusted with the whole business of baseball when the team makes a $50-million, five-year deal with a free agent, Mr. Potatohead. Without telling the other owners, Curly purports to transfer his interest in the team to Shemp. (Curly is one of several hundred owners.) On the issue of whether Curly's interest is in fact transferable, does it matter whether the team is a partnership or a corporation? ______________________________

3. After their "excellent adventure," Bill and Ted decide to open up a travel agency, Bill & Ted's Excellent Adventures. They decide the business should be operated as a corporation, so they draw up articles of incorporation and put them in the company safe-deposit box. They purport to carry on the business as a corporation, putting an "Inc." after the business name and keeping the company records and finances separate from their own. Is the travel agency a corporation?

____

4. Tarzan and Jane each is a 50% owner of the Me Tarzan, You Jane Charm School, Inc., a standard “C” corporation. Last year, the charm school earned a $10,000 profit, which was spent on new etiquette videos. Do Tarzan and Jane each owe tax personally on their respective (50%) shares of the company’s profit? ____________________________

5. Abe and Barbara want to establish a business entity that will operate a business based on an idea that the two of them have developed. They want to choose a form of business entity that will help them achieve several different objectives: (1) allow each of them to be active in the daily affairs of the business; (2) insulate each of them from liability for claims against the business by third parties to the maximum feasible extent; (3) allow them to put all of the business’s operating profits into their own pocket, without paying more than one level of federal income tax; (4) entitle Abe to 40% and Barbara to 60% of the business’s profits until the first $800,000 of lifetime profits has been distributed, and thereafter entitling the two to split the profits equally; and (5) give each of them a veto over all major business decisions concerning the business. What is the best form of business entity for them to use, and why?

Answers

1. **No.** Corporate existence is perpetual, and doesn’t depend in any way on the continuity of its shareholders. Therefore, the death, withdrawal, or bankruptcy of any shareholder (even a majority or controlling one) doesn’t terminate the corporation. [6]

COMPARE: A *partnership* dissolves when any partner dies, withdraws, or files for bankruptcy, unless the partnership agreement provides otherwise. Uniform Partnership Act §31(1)(a). This means that, when any one of these occurs, the only authority left in the partners, as to the partnership business, is to wind up and liquidate the business. [6]

2. **Yes: if it’s a partnership, Shemp isn’t an owner, and, if it’s a corporation, he probably is.** The rule on transferability of ownership for a corporation is that shares are freely transferable unless they are subject to a written restriction on transfer. [7] (Note that shares in a “close corporation” (see p. 146) usually have restrictions on transfer and are

therefore similar to a partnership in that respect; that's why we specified that there are several hundred owners, so that this wouldn't be considered a close corporation)

For a partnership, unless the partnership contract provides otherwise, a partnership interest is only transferable with the remaining partners' approval; without it, the transferee cannot become a full partner (e.g., he can't vote). [7] (Keep in mind, however, that if the partnership agreement is silent on the subject a partner can assign his *economic interest* in the partnership, such that the assignee gets the partner's profits from the partnership. But the assignee won't have any other involvement with the partnership, such as the power to vote.)

3. **No, it's a partnership.** The principal difference in formation between a partnership and a corporation is filing. Creating a corporation requires that articles of incorporation be filed with the Secretary of State for the state in which the corporation is to be incorporated. A partnership doesn't even require a written document, unless it's a "limited partnership" (in which only the general partners can be liable for the partnership's debts). Since the travel agency's articles of incorporation weren't filed with the state, Bill and Ted have a partnership. (That's because a partnership is merely "an association of two or more persons to carry on as co-owners a business for profit" (UPA §6(1)); thus a partnership will come into existence by operation of law, as soon as the two or more owners conduct business without a corporation's having been validly formed.)

   SIGNIFICANCE: The most important ramification of partnership v. corporation status is that Bill and Ted, as partners in a general partnership, are ***jointly and separately liable*** for the partnership's debts and obligations; if the agency fails, their personal assets could be reached by a partnership creditor. [5] (Here, conceivably the two might get the protection of the "de facto corporation" doctrine, though modern statutes like the MBCA don't recognize this doctrine. [32]) In a corporation, unless the holders have signed explicit guarantees or there are grounds for "piercing the corporate veil," shareholders are only liable for corporate debts and obligations to the extent of their investment in the corporation. [4]

4. **No.** One of the benefits of conducting business as a standard C

corporation is that the corporation is a ***separate taxable entity***, such that unless the corporation's income is distributed to shareholders via a dividend, shareholders don't pay tax on corporate income (and, conversely, can't deduct corporate losses). [8]

EXCEPTION: Small corporations may elect to be treated more-or-less like a partnership for purposes of income and losses, such that income and losses are attributed to the shareholders and must be reported on their personal tax returns regardless of whether income is distributed. This kind of corporation is called a "Subchapter S corporation." [10] (Note that the same result — pass-through taxation as in a partnership— can be created by using a limited liability company (LLC), a newer form of organization that is neither a corporation nor a partnership. [11])

5. **The limited liability company, or LLC.** The LLC outperforms the general partnership and the limited partnership in terms of simultaneously achieving objectives (1) and (2); all partners are personally liable for the debts of a general partnership (thus failing (2)), and in a limited partnership, limited partners are protected against liability, but only if they are passive partners who do not participate in the daily affairs of the business (thus failing (1)). The LLC outperforms an ordinary corporation (a/k/a a "C Corporation"), because the latter will often result in two levels of taxation (corporate-level and individual-level) if the earnings of the business go beyond what can reasonably be paid out as salaries (thus failing (3)). It's true that an "S Corporation" (which is a "pass-through" entity that is essentially taxed only at the individual level) could fulfill objective (3), as well as (1) and (2). But achieving objectives (4) and (5) simultaneously is quite clumsy with an S corporation (or any form of corporation). That's so because the distribution of profits generally has to be done in proportion to each shareholder's holdings of stock, yet it's cumbersome (though doable, through a "shareholders' agreement") to give persons who own unequal amounts of stock equal veto power over all major decisions. The LLC, since it involves the drafting of an operating agreement that can be highly customized with respect to profit-splitting and decision-making, can accomplish all of these five objectives easily. [11-12]

EXAMPLES & EXPLANATIONS

Corporations

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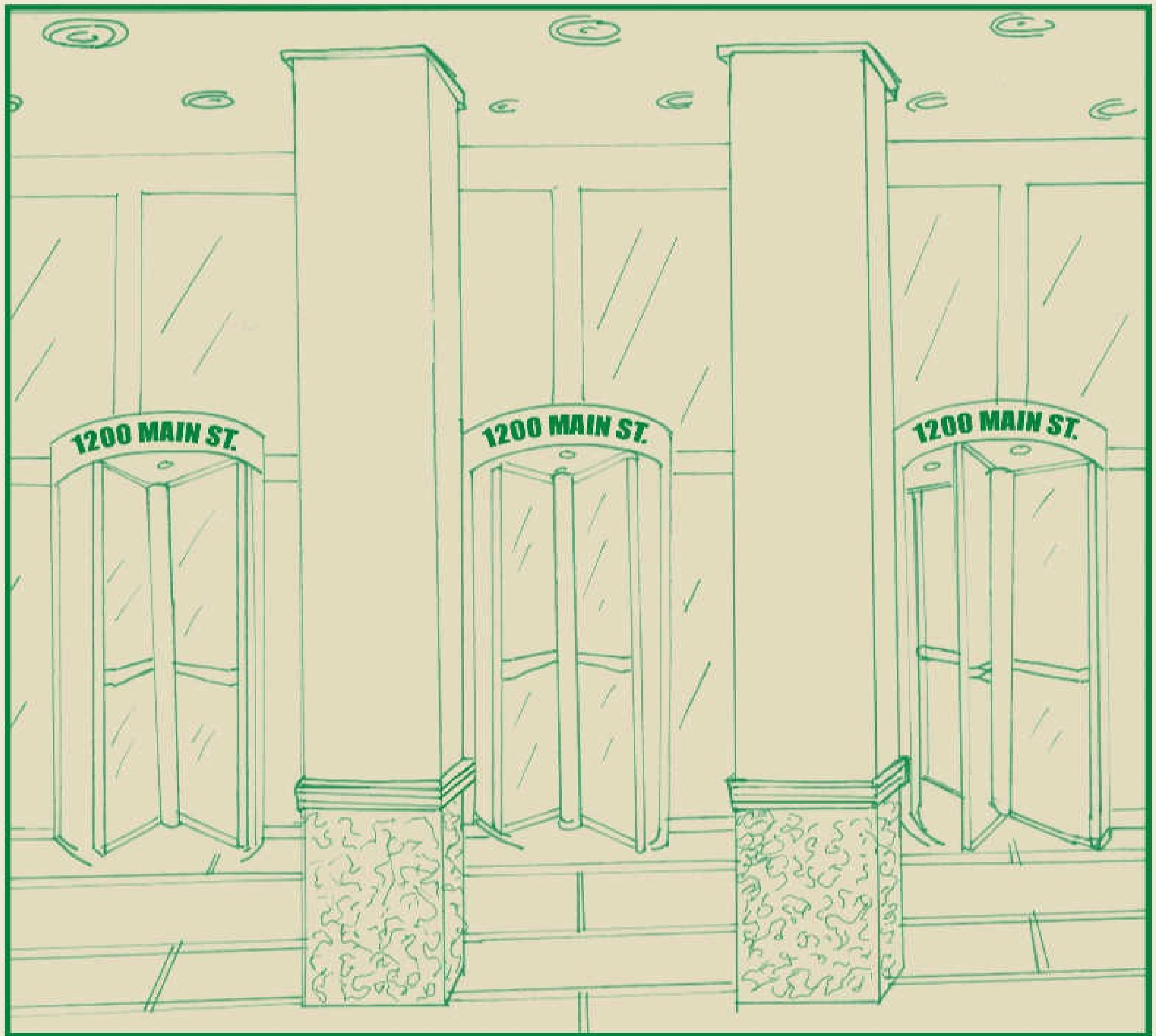
Alan R. Palmiter



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Corporations

Eighth Edition

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PART I

Introduction to Corporate Law

CHAPTER 1

The Corporation — An Overview

What is a “corporation”? It is a framework by which people conduct modern business. It is a convenient legal entity that can enter into contracts, own property, and be a party in court. It comes in assorted sizes, from a publicly held multinational conglomerate to a one-person business.

The corporation is a creature of law—a legal construct. Nobody (not even your law professor) has ever seen one. The corporation’s existence and attributes arise from state-enabling statutes, which give business participants significant freedom to choose their own customized relationships. But the statutory framework is incomplete, and judicial norms fill the many gaps left by the statutes. Other gaps, particularly those involving disclosure to investors, are filled by federal securities law.

Ultimately, the corporation is an investment vehicle for the pooling of money and labor—a grand capitalist tool. *Money capital* comes from shareholders and creditors; *human capital* comes from executives and employees. Both money and labor expect a return on their investment. The corporation defines their legal relationships and mediates their conflicting interests.

This chapter considers the principal attributes of the modern business corporation (§1.1); the history of the U.S. corporation and the sources of U.S. corporate law, including an overview of the Sarbanes-Oxley Act of 2002 (§1.2); and the status of the corporation as a “person” under the U.S. Constitution (§1.3). The corporation is not the only structuring device for modern business. Chapter 2 describes other business organizations, such as

partnerships and LLCs, and compares their attributes. Like a corporation, these other forms resolve the basic issues that arise in every business organization.

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§1.1 CORPORATION BASICS

§1.1.1 Five Basic Attributes

Suppose you are asked to make an investment. What would you ask? The paradigm corporation represents a set of answers to the five basic questions that arise in every investment relationship:

- **How long does the investment last?** The corporation has an independent, perpetual existence. It is an entity distinct from those who contribute capital (shareholders and creditors) and those who manage the business (directors and officers). The persons who constitute the corporation may come and go, but the corporation remains. It owns the business assets and is liable for any business debts.
- **Who manages the investment?** The locus of corporate power is the board of directors, which manages and supervises the business. (The board often delegates its power to officers to act for and bind the corporation.) In exercising their management powers, the directors are subject to fiduciary duties. Shareholders have only a limited governance role. They can vote to elect directors, approve fundamental corporate changes, and initiate limited reforms, but have no power to act on behalf of the corporation.
- **What is the return on the investment?** The corporation establishes a hierarchy to the financial returns generated by the business. Creditors (including bank lenders, bondholders, trade creditors, and employees) are first in line and receive a return based on their contracts. Shareholders are last in line and receive dividends as declared at the discretion of the board. If the business dissolves, creditors' claims have priority, and shareholders are residual claimants.
- **How can investors get out?** Ownership interests (shares) are freely transferable. Shareholders can realize the value of their investment by

selling to other investors interested in acquiring their financial rights. The corporation, however, has no obligation to repurchase these ownership interests. Managers (directors and officers) cannot transfer their positions, but can resign at any time.

- **What are investors' responsibilities to others?** The corporation is liable for its own obligations, but otherwise creates a "nonrecourse" structure. Corporate insiders (directors, officers, shareholders) are not personally liable to outsiders on corporate obligations. Outsiders (such as contract creditors and tort victims) bear the risk of corporate insolvency. Corporate investors and managers risk only their investment.

In effect, the corporation combines five attributes: (1) separate, perpetual legal personality; (2) centralized management under a board structure; (3) shared ownership interests tied to residual earnings and assets; (4) transferability of ownership interests; and (5) limited liability for all participants.

Of course, there are exceptions. For example, shareholders in closely held corporations can agree to manage the business, pay themselves specified dividends, and limit their ability to transfer their shares. In some circumstances courts use equitable principles to hold shareholders personally liable for corporate debts beyond their investment, or lenders may require shareholders to guarantee personally the corporation's obligations. The corporation is mostly a malleable set of *default rules* that specifies the terms of the parties' relationship unless they agree otherwise. This places a premium on the lawyer's role as creative planner.

Note on Corporate Nomenclature

There is some confusion about what is meant by "private corporation" and "public corporation." A "private corporation" generally refers to a nongovernmental, for-profit business that has been incorporated under a state statute. A private corporation can be owned by a few shareholders — referred to as a "closely held corporation" or "close corporation." Or the private corporation can be owned by many shareholders whose shares trade on public trading markets such as the New York Stock

Exchange — referred to as a "publicly held corporation" or "public corporation." See MBCA §1.40 (Definition 18A). Thus, Apple Inc. is a "private corporation" that is also a "public corporation." And Mom & Pop Grocery Corp. is a "private corporation" that is also a "close corporation." To keep things simple, this book avoids the term "private corporation."

Of course, there are some corporations that are governmental, such as the Federal Deposit Insurance Corporation. The FDIC, a government agency established to insure bank deposits, was created by an act of Congress and is governed by a board of governors whose members are appointed by the president. Although some people might call the FDIC a "public corporation," it is clearer to call it a "governmental agency."

Corporate Constituents

Many persons participate in the joint economic activities that constitute the corporation. Shareholders—whether individual investors or institutions that invest for their beneficiaries (pension funds, mutual funds, banks, insurance companies, endowments)—provide money capital. Managers (directors and officers) oversee the business and its employees. Lenders supply additional money capital as secured bank loans, unsecured bonds, short-term notes, and suppliers' trade credit. Suppliers provide inputs for the business under long-term contracts and in market transactions. For some, customers are the reason the business exists. Those injured by the business (whether as employees, customers, or strangers) have claims on the business directly or through governmental enforcement—antitrust, banking, environmental, health, product safety, and workplace safety. As an economic actor in society, the corporation pays federal, state, and local taxes.

Corporate law, however, focuses on the relationship between shareholders and managers—the two constituent groups understood to comprise the "internal" organization of the corporation. "Outside" relationships with creditors, suppliers, customers, employees, and government authorities usually are subject to legal norms that treat the corporation as a person—such as the laws of contract, debtor-creditor, antitrust, labor, and tax.

Note on “Share” Nomenclature

In this book, we use the terms “shares” and “shareholders” to refer to the units of ownership interests in corporations and the persons (including entities) who own these units. See MBCA §1.40 (Definitions 21 and 22). You will notice that others, including the whole state of Delaware, use the terms “stock” and “stockholders.” They’re referring to the same things, but they just sound more regal.

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§1.1.2 Theory of the Firm

In the paradigm corporation, investors delegate control over their investment to managers. By separating the finance and management functions, the corporation creates an investment vehicle for raising large amounts of capital and operating large enterprises. This separation between shareholders and managers, however, makes the corporation a breeding ground for conflicting interests—and opportunism.

Ideally, shareholders and managers should want to maximize business returns, but they will have separate agendas. Once shareholders have invested, managers may become lazy, extract exorbitant perquisites (or worse), or be reluctant to take business risks that threaten their job security. Once managers have committed their human capital, shareholders may demand immediate returns, want managers to take high risks, or seek intrusive control powers. Despite these conflicts, the premise of the corporation is that neither shareholders nor managers can exist without the other—the corporation allows them to coexist.

Corporate law allocates risks between shareholders and managers in an attempt to minimize shareholder-manager conflicts and to maximize the firm’s overall success. It creates a structure for business activities and devices to control conflicts of interest among corporate constituencies. These conflicts are often referred to as “agency problems” since they mimic the conflicts in the principal-agent relationship. In some contexts, corporate law assumes legal intervention is too costly and leaves risk with shareholders. For example, the judicially created business judgment rule gives directors broad discretion to run the business without judicial second-guessing (see §12.2). In other contexts, corporate law regulates conflicts. Shareholders, for example, must approve the board’s decision to merge the corporation into another

corporation (see §35.2.2).

Over the last few decades, some legal theorists have described the corporation as a "nexus of contracts." Contractarians view the corporation as a set of voluntary relationships among corporate constituents bound together by formal contracts, statutory norms, implicit understandings, and market constraints. The corporation serves as an organizing tool for their relationships. Corporate law, a collection of rules and mechanisms for specifying the roles of the corporate constituents, reflects the bargain the parties would have struck had they negotiated.

This vision of the corporation contrasts with the traditional notion of the corporation as a regulatory device. To traditionalists, the corporation creates dangerous opportunities for managers to exploit shareholders and other constituents. Traditionalists maintain that in public corporations active managers exercise "control" at the expense of passive shareholder "owners." In close corporations where no market exists for shareholder interests, the majority can unfairly exploit the minority. Corporate law, particularly corporate fiduciary duties, serves to protect shareholders.

Traditionalists thus place great emphasis on corporate law as a means to control manager opportunism. They urge greater shareholder voting powers, broad disclosure rights, and strong fiduciary protection. On the other hand, contractarians believe that corporate law embodies the terms the parties have chosen. Combined with market forces, these terms are enough to restrain manager opportunism. For example, contractarians argue that if managers act opportunistically, investors can sell their shares; falling market prices of corporate shares will make it harder for managers to raise capital and to compete in product and service markets; and, eventually, any corporation in which managers disregard shareholders will become a takeover target or go bankrupt.

Traditionalists	Contractarians
The corporation is a creature of law; no real bargaining occurs in the modern public corporation.	The corporation (like a contract) is a device, recognized by law, to organize specialized business activity.
Managers can use "control" to exploit shareholders and other constituents.	Managers cannot exploit "control" because market constraints align their interests with shareholders'.
Shareholders can be exploited because they are unsophisticated or uninformed.	Public shareholders act in sophisticated markets; close corporation participants can protect themselves by contract.
Capital (and other) markets are not always efficient; markets act slowly and unevenly to discipline poor managers.	Capital markets operate efficiently so stock prices of public corporations reflect all available public information.
Corporate law should mandate rules to promote fairness and efficiency.	Corporate law should seek to infer the parties' bargain, whether explicit or implicit.
Judges should actively enforce managers' fiduciary duties to shareholders.	Judges should intervene with caution, only to fill gaps in the parties' bargain and protect market constraints.
Managers will abuse incentives, such as by manipulating financials or taking excessive compensation.	Managers can be given incentives, such as stock options, to motivate them to make the business more productive.

§1.2 SOURCES OF CORPORATE LAW

§1.2.1 Historical Sketch of the Corporation

The modern corporation did not happen in one blazing moment of inspiration. Instead, we can trace its current attributes to various earlier times and forms. The idea of an amalgamation of persons forming a separate juridical personality moved from Greece, to Rome, to the Continent, and to England. Originally, perpetual separate existence in England was reserved for ecclesiastical, municipal, and charitable bodies whose existence was conferred by sovereign grant. The idea of common ownership by a body of passive investors originates from joint-stock trading companies, such as the East India Company (a monopoly franchise) in the early 1600s. A combination of continuity of life, centralized management, financial interests in profits, transferability of shares, and limited liability for private business existed in the 1700s in the form of complex deeds of settlement—an

unincorporated association!

These concepts came to the American colonies. At first corporations, like political municipalities, had to receive a special charter from the state legislature. Legislatures granted charters on a case-by-case basis to noncommercial associations (such as churches, universities, and charities) that wanted the convenience of perpetual existence and to commercial associations (such as banks, navigation companies, canals, and turnpikes) with special public purposes and large capital needs. As the needs for capital (and thus incorporation) increased during the early 1800s, states began to enact general incorporation statutes for specified, usually capital-intensive, businesses. From the beginning, many feared the concentrated economic power inherent in the corporate device. Eventually, the U.S. corporation evolved in the mid-1800s into a legal form available to all, though subject to significant statutory restrictions.

During the late 1800s two major trends, leading in opposite directions, shaped modern U.S. corporate law. The first trend led to restraints on business activities. In the 1880s Congress created the Interstate Commerce Commission to regulate the railroad monopolies. In 1890 and 1916 Congress passed antitrust legislation (the Sherman and Clayton Acts) to combat concentrations of corporate economic power. In the early 1900s states enacted "blue sky" laws to deal with fraud in the sale of corporate securities. In the 1930s Congress passed a series of securities laws aimed at abusive management practices in national securities markets.

The other trend led to a liberalization of state corporation statutes. In the late 1800s, to attract incorporation revenues, some states amended their statutes to lift limits on the amount of capital that a corporation could raise, to permit corporate ownership of other corporations, and generally to increase the flexibility available to corporate management. Eventually Delaware won this race of laxity, which some have called a scurrilous "race to the bottom" and others an efficiency-producing "race to the top." Today most large, publicly traded U.S. corporations are incorporated in Delaware.

§1.2.2 Modern State Business Corporation Statutes

The corporation statutes of each state describe the basic corporate attributes. The MBCA is typical in that it details

- how to form a corporation (MBCA Chapters 1, 2, 3, 4, 5)
- the financial rights of shareholders (MBCA Chapter 6)
- the governance roles of shareholders, directors, and officers (MBCA Chapters 7, 8)
- the transferability rights of shareholders (MBCA §6.27)
- limited liability for shareholders (MBCA §6.22)
- structural changes such as charter amendments, mergers, and dissolution (MBCA Chapters 10, 11, 12, 13, 14)

Some of the statutory terms are mandatory, such as the annual election of directors and shareholder voting on dissolution. Others, such as the removal of directors without cause or shareholder action without a meeting, are default terms that apply unless the parties choose different terms. Contractarians often view corporate statutes as providing standardized "off-the-rack" terms that apply unless the parties (usually in the charter) choose different, firm-specific terms. Under the internal affairs doctrine, the law of the state of incorporation governs all shareholder-manager matters in multistate corporations (see §3.2.1).

Although no two state corporation statutes are identical, there has been a trend toward greater uniformity and modernization. In 1950 the American Bar Association's invitation-only committee on corporate laws published the first model business corporation act. This model act, and its many revisions, served as the basis for corporation statutes in most states. In 1984 the American Bar Association (ABA) committee substantially reorganized and rewrote the model act, which follows the enabling structure of Delaware's corporate statute. The model act has since been revised on a number of occasions. The 1984 revisions, first referred to as the Revised Model Business Corporation Act (RMBCA), have become simply the Model Business Corporation Act (MBCA). Significant revisions since 1984 include provisions on directors' conflicting interest transactions (1992), director standards of conduct and liability (1998), and shareholder rights in fundamental transactions (1999). A majority of states (32 as of 2014) have enacted corporate statutes based on the 1984 MBCA.

Not all states, however, have enacted a corporate statute based on the model act. In fact, the most prominent corporate law states—Delaware, California, and New York—have their own idiosyncratic corporation statutes.

Delaware's statute is particularly important in U.S. corporate law because of the leadership of its legislature in being the first to enact corporate law reforms, the sophistication of the state's corporate bar, and the expertise and influence of its judiciary, and because most large, public corporations are incorporated in Delaware.

State corporation statutes generally treat all corporations the same. Corporations with numerous, widely dispersed shareholders (publicly held corporations) generally are subject to the same statutory rules as corporations with a small group of shareholders who do not have a public market for their shares (closely held corporations).

§1.2.3 Role of Judge-Made Law

Corporation statutes are not all-encompassing; court decisions clarify and fill in the gaps of the statutes and the corporation's constitutive documents. The most important judicial gap-filling involves the fiduciary duties of directors, officers, and controlling shareholders. Common-law fiduciary principles that regulate abuse by those who control the corporation's decision-making machinery lie at the heart of corporate law. See Chapter 11 (introduction to fiduciary duties). Lately, many fiduciary rules have turned on the disinterestedness and independence of outside (nonmanagement) directors in making corporate decisions.

§1.2.4 ALI Principles of Corporate Governance

In 1977 the American Law Institute (ALI) embarked on a long-term project to describe and unify the basic standards of corporate governance and structure, particularly in those areas not addressed by state corporation statutes. The project was controversial, often pitting contractarians against traditionalists. In 1993, after more than 15 years, the project came to a conclusion when the ALI approved a final version of the Principles of Corporate Governance. The ALI Principles have not received the same reception as other ALI documents, such as the ALI restatements. Although some courts have embraced portions of the ALI Principles as useful statements of corporate law, other courts have given them little attention, and some have openly rejected them.

§1.2.5 Federal Law

There is no federal corporation statute, despite regular calls for a uniform national law applicable to some or all aspects of publicly traded corporations. Despite the absence of a federal law of corporations, federal statutes add a significant layer of corporate regulation. The Securities Act of 1933 regulates the disclosure when corporations raise capital in public markets, whether by selling stock or taking on debt (see Chapter 5). The Securities Exchange Act of 1934 imposes periodic reporting requirements (see §21.2) and proxy disclosure rules on corporations whose stock is publicly traded (see Chapter 9). In addition, the Exchange Act regulates the trading of securities in public and private markets, including insider trading—that is, the use of material, nonpublic corporate information to buy or sell stock (see Chapters 22 and 23).

Nonetheless, the landscape of corporate governance (the relationship between corporate managers and shareholders) has been significantly altered by two important pieces of federal legislation. In 2002, responding to a spate of corporate and accounting scandals, Congress passed the Sarbanes-Oxley Act—sweeping legislation that federalizes specific aspects of corporate law for public corporations. Among the Act's reforms are limits on corporations hiring their audit firms to do nonaudit work for the corporation, rules governing the composition and functions of the board's audit committee, provisions requiring forfeiture of executive pay when companies correct their financials, bars on individuals from holding corporate office if they have committed securities fraud, prohibitions on companies making personal loans to their executives, mandates for companies to institute and disclose systems of internal controls, and SEC rules governing professional conduct of corporate and securities lawyers. Sarbanes-Oxley is described more fully in §11.5.1.

In 2010, responding to the financial crisis of September 2008 and perceived gaps in financial regulation, Congress passed the Dodd-Frank Act—massive legislation principally concerned with banking reform and securities regulation, but also having major implications for public corporations. Among other things, the Act mandates that compensation committees be composed entirely of independent directors, requires that shareholders have a "say on executive pay," requires corporations to adopt "clawback" policies when executives profit on false financial disclosures,

mandates a new SEC program for employees who report securities violations to receive "whistleblower" bounties, and authorizes the SEC to pass rules giving shareholders the ability (at corporate expense) to nominate directors to the board. Dodd-Frank is described more fully in §11.5.2.

Note on Securities Regulation

In keeping with the traditional demarcation of corporate law and securities regulation in the United States, this book considers the aspects of Sarbanes-Oxley and Dodd-Frank that deal primarily with corporate governance. Those reforms that address disclosure to investors—securities regulation—are left to other sources. See Alan R. Palmiter, *Securities Regulation: Examples & Explanations* (6th ed., Wolters Kluwer Law & Business 2014).

§1.3 CORPORATION AS A CONSTITUTIONAL PERSON

The corporation as "person" is a powerful metaphor. Corporate personality facilitates the aggregation of capital and labor with the attributes of a single entity capable of contracting, owning property, and being a party in court—just like a natural person. For commercial purposes, state and federal law largely respect the corporation-as-person metaphor. Most commercial statutes either specifically define corporations to be persons under the statute or have been so interpreted.

But there are many noncommercial contexts in which the law does not treat the corporation as a natural person, such as laws on intestacy, adoption, and political voting. This makes perfect sense. It would be ludicrous if a corporation could be an adoptive parent (except in the movies) or if the political rule were "one corporation, one vote." When does the corporation have rights under the U.S. Constitution that are normally associated with natural persons?

§1.3.1 Broad Commercial Rights

According to the Supreme Court, the constitutional status of the corporation varies depending on the constitutional right at issue. The Supreme Court has had no trouble treating the corporation as a constitutional "person" when constitutional provisions can be seen as protecting *commercial interests* of the business.

Corporations are protected against state restrictions that burden interstate commerce. *Allenberg Cotton Co., Inc. v. Pittman,* 419 U.S. 20 (1974). Corporate property is protected against governmental deprivation under the Due Process Clauses of the Fifth and Fourteenth Amendments. *Oklahoma Press Publishing Co. v. Walling,* 327 U.S. 186 (1946). Corporations are "persons" entitled to equal protection under the Fourteenth Amendment, thus protecting them from state regulation aimed only at corporations. *Santa Clara County v. Southern Pac. Ry.,* 118 U.S. 394 (1886).

Corporations have First Amendment rights to express themselves as to commercial matters—such as advertising their products. *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council,* 425 U.S. 748 (1976). And corporations have a First Amendment right to *not* be associated with certain speech, thus permitting them to refuse to distribute state-mandated information to customers. *Pacific Gas & Electric Co. v. Public Utilities Commission*, 475 U.S. 1 (1986).

The one (and largely superseded) exception to the commercial-interest analysis was the Supreme Court's refusal to treat corporations as "citizens" protected by the Privileges and Immunities Clause of Article IV. *Paul v. Virginia,* 75 U.S. (8 Wall.) 168 (1868). In theory, this allows states to regulate "foreign" corporations (those incorporated in another state) doing in-state business differently from their own "domestic" corporations, though in practice the differences in regulation have been minor and the equal protection afforded corporations under the Fourteenth Amendment essentially ensures nondiscrimination.

§1.3.2 Limited Noncommercial Rights

As to the corporation's *noncommercial interests,* the Supreme Court has been less willing to extend constitutional protection. For example, corporations cannot claim a Fifth Amendment privilege against self-incrimination. *Bellis v. United States,* 417 U.S. 85 (1974). Yet when the corporation's interests are closely linked to an individual's interests—such as in a one-person

corporation—some lower courts have suggested that the individual's privilege against self-incrimination may extend to the corporation. And corporations have only a limited Fourth Amendment right to be free from unreasonable searches and seizures, on the theory that business privacy is less compelling than personal privacy. *G.M. Leasing Corp. v. United States,* 429 U.S. 338 (1977).

Nonetheless, a corporation has significant free-speech protection under the First Amendment—even as to noncommercial political matters. For example, a state cannot forbid a corporation from expressing its views on a state referendum involving individual tax rates, even when the referendum did not materially affect the corporation's business. *First National Bank of Boston v. Bellotti*, 435 U.S. 765 (1978). Corporations can communicate with the legislative and executive branches by lobbying and commenting on proposed laws and rulemakings and can seek to sway the legislative branch in *amicus* briefs. Corporations can also set up their own political action committees (PACs) funded by voluntary contributions from their shareholders, managers, and employees—thus to speak on political issues and to contribute (subject to limits) to candidates and political parties.

More recently, the Supreme Court has held in a controversial 5-4 decision that a corporation cannot be prohibited from spending its own money to support or oppose a candidate for political office. *Citizens United v. Federal Election Comm'n*. 558 U.S.310(2010). Central to its analysis, the Court in *Citizens United* overruled an earlier 1990 decision that held a state could prohibit corporations from making campaign contributions to state candidates. *Austin v. Michigan Chamber of Commerce*, 494 U.S. 652 (1990). The Court in *Citizens United* rejected that there were compelling justifications to ban political expenditures by corporations that had amassed resources in the marketplace because wealthy individuals could not be banned from spending their money to speak out for or against candidates. Thus, although corporations (like individuals) can be limited with respect to their direct *contributions* to political candidates, corporations (like individuals) cannot be limited with respect to *expenditures*—on their own or through independent PACs—for speech that supports or opposes political candidates.

Note on Conception of "Corporation"

As you can see, the Supreme Court's conception of the corporation has different faces. The Court has variously viewed the corporation (1) as a creature of state law (a "concession" theory), (2) as a distinct legal entity separate from the incorporating state and its shareholders (a "natural rights" theory), and (3) as a set of voluntary relationships among its participants (an "aggregation" theory).

The "concession" theory is reflected in an early decision by the Supreme Court that disallowed states from unilaterally changing the corporate charter, viewing the corporation as a binding contract between two parties—the state and corporation. *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819). The "natural rights" theory, under which corporations are viewed as constitutional persons, was in vogue during the late 1800s when the Court protected corporate persons (and their economic interests) from discriminatory and burdensome state regulation under the Equal Protection and Due Process Clauses. The "aggregate" theory has been used by the Court—most recently in *Citizens United*—to extend to the corporation the rights that individuals (and thus groups of individuals) have against government overreaching. In the end, though, the Court has never really articulated why the corporation is a "person" or the kind of "person" it is.

Examples

1. Alexa and George want to open a bank. They study the Uniform Partnership Act (UPA) and conclude that a partnership structure presents problems for them. According to the UPA, a partnership dissolves whenever any partner dies or withdraws (UPA §31(4)); each partner must contribute new capital (as needed) equally with other partners (UPA §18(a)); each partner is jointly liable for any business debts (UPA §15(b)); every partner votes on partnership matters (§18(e)); new partners can be added only by unanimous vote (UPA §18(g)). How does a corporation solve these problems?
2. Alexa and George incorporate their bank as First Bank of New Columbia, Inc. (FBNC). New Columbia has adopted a statute modeled on the MBCA. Alexa and George each become a director and officer of the corporation; to get the bank started, they raise money from a dispersed group of shareholders.

a. First Bank accepts cash deposits from depositors, the principal source of capital for its lending business. The New Columbia statute mandates that holders of voting shares elect the board of directors annually. See MBCA §8.03(d). Can depositors, instead, elect the corporation's directors?
b. New Columbia's corporate statute says directors must exercise their functions in good faith, in the best interests of the corporation, and with reasonable care. See MBCA §8.30. First Bank loses money because the directors approve construction loans in reliance on overly optimistic projections about the real estate market. Are the directors liable to the shareholders?
c. After a series of New Columbia court decisions exonerating careless directors, New Columbia adopts a corporation statute that specifies that directors are liable to the corporation if they fail to inform themselves in making decisions. Which standard applies—the MBCA standard, the judicial standard, or the revised statutory standard?

3. The Federal Election Campaign Act (FECA) prohibits corporations from using general corporate funds to make any expenditure or contribution in connection with any election to federal office. 2 U.S.C. §441b. Comparable limits do not apply to individuals, who may spend their own money without limit for or against a federal candidate and may make campaign contributions to federal candidates subject to certain contribution caps.

   a. First Bank is faltering, and its managers contribute corporate funds to Save the Banks—a political action committee that contributes to federal candidates who support a bailout of frail financial institutions. Such a bailout would benefit First Bank's shareholders. Is FECA, which prohibits these contributions, constitutional under the First Amendment?
   b. New Columbia is in the middle of a heated federal senatorial race. One of the candidates, an outspoken critic of the banking industry, has proposed increasing criminal sanctions for bank managers who engage in "willful mismanagement." Alexa and George are aghast. They have First Bank fund a newspaper ad campaign to discredit

this candidacy. Is FECA, as applied to First Bank's political advertising, constitutional under the First Amendment?

c. Many of First Bank's shareholders actually prefer stronger bank regulation and support the pro-regulation candidate in the New Columbia race. How might they discipline the First Bank managers and prevent them from continuing to spend corporate funds opposing their preferred candidate?

Explanations

1. The corporation creates an immortal juridical entity that exists beyond the lives of its participants. Unlike a classic partnership, a corporation can have managers who need not contribute capital (directors and officers), and capital providers who have no direct role in the bank's management (shareholders). Shareholders expect financial returns based on bank earnings and can transfer their shares without first obtaining the approval of other participants—both greatly increase the liquidity of their investment (the ease with which their shares can be sold). None of the participants is liable for business debts except to the extent of their financial investment. Is a corporation necessary to accomplish these purposes? If banking law permitted banks to operate in partnership form, modern partnerships could be designed to have many of the attributes of a corporation. Most of the provisions of partnership law are not mandatory, but instead specify default rules as to which the parties can "agree otherwise." (See Chapter 2.) Thus, a partnership agreement could provide for

   - *continuation* of the partnership after any partner's death or withdrawal
   - *centralized management* in which some partners vote on how the business is run and others have only limited voting rights
   - *partnership withdrawals* at specified intervals based on firm profitability
   - *free transferability* of nonmanaging partners' interests

The one principal difficulty is that partners are jointly liable to third parties—a mandatory partnership rule of *personal liability*. Yet it may be possible to contract for a structure that resembles *limited liability*. Voluntary creditors—such as banks, customers, and suppliers—can be required to agree to indemnify partners (whether acting as managers or capital providers) and

look only to partnership assets to satisfy their claims against the business. Liability to involuntary creditors—tort victims—can be minimized through insurance, as well as internal liability allocation (indemnification and contribution) among the partners.

But achieving all of this through the partnership form requires "custom tailoring." The advantage of a corporation is that all these attributes are "off the rack."

2. a. The depositors don't vote unless they own shares. As is true under most corporation statutes, the MBCA reserves voting power to shareholders. The theory is that depositors, and other contract providers of capital to the corporation, have rights fixed by their contract (to be paid interest, to make withdrawals, and to receive account information). Their contractual rights are senior to (come before) the shareholders' financial rights to dividends and payments on liquidation. Shareholders generally cannot withdraw their investment or receive specified periodic payments —their rights are residual. To protect their precarious position, shareholders receive voting rights.

   b. In general, corporate law and the famous "business judgment rule" say no. First Bank's losses can be seen as resulting from two kinds of risks: external risks beyond the control of the firm's managers (real estate market) and internal risks within their control (monitoring, evaluation, and reaction by management to external risks). Corporate law assumes that shareholders are more efficient bearers of risk. Efficient enterprise organization will be advanced if dispersed investors, each with a small stake in the firm, bear the risk of firm losses. Shareholders are better able than managers to diversify their investment, thus dampening the impact of a particular firm's loss, whether arising from external or internal risk. Rarely will a small group of managers, even if individually wealthy, be able to risk sufficient resources to provide the necessary capital for a large, modern business. Moreover, by having shareholders bear internal risks, corporate law facilitates management specialization and rational risk taking. If manager-specialists were required to bear the loss of their poor decisions, they might be reluctant to become managers in the first place (choosing a career in law instead) or they might become overly cautious (shunning positive net-value, high-risk projects).

   But this does not mean that shareholders should (or do) bear all

internal risks. There are some internal risks—such as embezzlement by managers—that if borne by shareholders would hardly encourage investment. But as to internal risks that turn on the honest and informed judgment of corporate managers, the business judgment rule places the burden of loss on shareholders.

c. The statutory standard applies. The MBCA is merely a model statute that a group of lawyers and law professors—members of an ABA committee—have recommended for adoption by state legislatures. No legislature has adopted a version of the model act wholesale without modifications. Corporate judge-made law, like all other state common law, is subject to statutory revision. New Columbia courts, after the statutory revision, will be bound by the statute, though they may use judge-made doctrines to interpret the statute's open-ended meaning.

3. a. *Citizens United* did not address the constitutionality of FECA's ban on corporate *contributions* to political campaigns or to nonindependent PACs that make such contributions. See *Buckley v. Valeo*, 424 U.S. 1 (1976) (permitting limitations on *contributions* to candidates to prevent the appearance of corruption, but not independent *expenditures* in support or opposition of candidates). The FECA ban on corporate campaign contributions may well depend on how we view the corporation. Is the corporation (1) a creature of state law—a "concession" theory? (2) an entity with rights arising by virtue of its existence—a "natural entity" theory? (3) a set of contractual relationships—a "nexus of contracts" theory?

If we regard the corporation as a "creature of law," regulation of corporate campaign contributions can be seen as an inherent consequence of the governmental concession. That is, "the state giveth and the state taketh away." This way of seeing the corporation, first articulated in the early 1800s, was at the heart of the Supreme Court's decision upholding a Michigan campaign finance law that prohibited corporations from using general funds to support specific candidates to state office. *Austin v. Michigan Chamber of Commerce* (see §1.3.2). The *Austin* Court found compelling the state's interest in preventing "the unique state-conferred corporate structure that facilitates the amassing of large treasuries" to obtain an "unfair advantage in the political marketplace." But this view was rejected by the majority in *Citizens United*, which concluded that banning the corporation from spending its

own money to support or oppose a political candidate constituted an unconstitutional condition on the corporate form.

But if we regard the corporation as a natural entity whose rights extend beyond those conceded by the state, corporate rights (exercised by management) may approximate those of individuals. The Supreme Court adopted this viewpoint in *First National Bank of Boston v. Bellotti* (see §1.3.2) when it held Massachusetts could not interfere with corporate free-speech rights in a state referendum, absent a compelling interest. In a similar vein, the Court has viewed the corporation from management's perspective in cases that invalidate state regulation of management-written inserts accompanying monthly utility bills. *Consolidated Edison v. Public Service Commission of New York,* 447 U.S. 530 (1980) (state ban of such inserts); *Pacific Gas & Electric Co. v. Public Utilities Commission of California,* 475 U.S. 1 (1986) (plurality) (state requirement that management include messages by consumer group). Under this perspective, FECA's ban on direct contributions to candidates and their PACs—while such contributions are permitted for individuals, subject to caps—unconstitutionally infringes on the right of First Bank (really, management) to speak.

But if we regard the corporation as a "nexus of contracts," the rights of each constituent group that forms the nexus are relevant. The Supreme Court seemed to adopt this viewpoint when it invalidated FECA's application to a nonprofit corporation formed solely to promote political ideas. *FEC v. Massachusetts Citizens for Life, Inc. (MCFL),* 479 U.S. 238 (1986). The Court held that the nonbusiness organization had "features more akin to a voluntary political association," and the First Amendment prohibited the burden imposed by the regulatory requirement that political expenditures come only from earmarked, segregated funds. Under this view, which the Court seemed to embrace in *Citizens United*, if First Bank's shareholders and other corporate constituents support management's contributions to Save the Banks, FECA interferes with the corporate constituents' collective First Amendment rights and cannot be justified as protecting them from becoming "captive political speakers."

b. This question would seem to be more difficult because the interests of shareholders and managers are not necessarily aligned, as they seemed to be in the previous question. The First Bank shareholders may not

favor the use of corporate funds to oppose the Senate candidate or may support the candidate for other reasons.

Nonetheless, the Supreme Court in *Citizens United* made clear that a corporation (really, management) could not be prohibited from spending the corporation's own money to speak on a political issue, including to support or oppose a political candidate. The Court rejected the "creature of law" analysis in *Austin* and the notion that the accumulation of capital permitted by the corporate form justifies government regulation of corporate speech.

The *Citizens United* majority did not fully embrace a "natural entity" theory in finding FECA's ban on corporate political expenditures to be unconstitutional, given the majority's acceptance of a "compelling justifications" analysis for determining whether corporate expenditures could be banned. Thus, although the FECA ban singled out corporations for regulation not imposed on individuals, this alone was not enough to justify the heavier corporate regulation. Implicitly, the Court concluded the corporation was not fully a "person" under the First Amendment.

The *Citizens United* majority, however, seemed to accept a "nexus of contracts" approach that shareholders had delegated to managers the decision how to best advance corporate interests. Although the Court in *MCFL* (see §1.3.2) had suggested the First Amendment would not protect corporate speech that does not accurately reflect shareholders' political views, the Court in *Citizens United* chose to not raise this potential conflict to constitutional importance. Thus, even though First Bank shareholders might not agree with their managers' expenditure of corporate funds, the remedy—according to the Court majority—would come through "the procedures of corporate democracy," not a congressional ban infirm under the First Amendment.

c. Shareholders in public corporations have little control over corporate decision-making on political spending for and against candidates. The shareholders of First Bank have limited options to protect themselves against management's political activism.

First, corporate political spending need not be separately disclosed under state corporate or federal securities law (see Chapter 21), and corporate donors to super-PACs can mask their identity by contributing

to intermediaries. Lacking information, shareholders can't make investment choices based on such spending. Second, even if shareholders can identify the political spending of their corporation, the business judgment rule (see §12.2) precludes shareholders from challenging in court the spending choices of management (including political spending) if it is arguably beneficial to the corporation's business. Third, shareholders lack effective voting remedies. Although shareholders can pass resolutions condemning management's political spending, the resolutions are not binding but only advisory (see §9.4). And although shareholders can elect directors to the board who share their views on political spending, the significant costs of proposing an insurgent slate must be borne by the nominating shareholder (see §8.1.2).

Thus, the suggestion in *Citizens United* that any "abuses [in corporate political spending] could be corrected by shareholders through the procedures of corporate democracy" rings hollow. Although the Supreme Court held that corporations, like individuals and PACs, could be required to disclose their identities when communicating for or against a candidate, it is unclear whether current disclosure and shareholder input are enough. A recent study, for example, found that political spending by corporations in industries that are neither government dependent nor heavily regulated is correlated with poor corporate financial performance as well as lower shareholder rights and greater managerial abuse in the form of the use of corporate executive jets. The study further finds that corporate political lobbying and contributions to PACs increased after *Citizens United*, with the more politically active corporations experiencing greater losses in shareholder value. In short, the study suggests corporate political activity may not serve shareholder interests. See John C. Coates IV, *Corporate Politics, Governance and Value Before and After* Citizens United, SSRN Paper 1973771 (2011) (based on data of corporate contributions to PACs and voluntary disclosures).

CHAPTER 2

Choice of Organizational Form

Given the advantages of incorporation, it is strange that corporate lawyers often advise their clients, "When in doubt, do not incorporate." There is a common lay perception that no business can be successful without the "corporation" mystique. But choosing what organizational form best suits the needs of the business and its participants is more complicated.

This chapter introduces the various investment vehicles—or business organizations—available for pooling money and labor (§2.1). We describe the basic attributes of the organizational choices (§2.2) and consider the tax implications of the choice (§2.3). The chart on page 46 describes the different organizational forms and how they differ from each other.

Note on Agency Law

The most basic business organization is the principal-agent relationship. Agency is the fiduciary relationship created when a "principal" manifests consent to another person (the "agent") to act on his behalf and under his general control, and the agent consents to this relationship. It is irrelevant whether the parties characterized their relationship as principal-agent. (The employer-employee relationship is a specialized principal-agent relationship, where the employer has the right to control the physical conduct of the employee's services.)

The principal-agent relationship creates mutual duties. The agent must put the principal's interests ahead of her own; the principal must honor all obligations that arise between the agent and third parties in contract or tort.

The agent is bound by a duty of loyalty to her principal. She cannot compete directly with her principal on her own or as an agent of a rival company. She cannot misappropriate her principal's profits, property, or business opportunities. She cannot breach her principal's confidences. An agent who fails to act solely for the benefit of her principal is liable for the profits she earned in violation of her duties. No actual injury to the principal need be shown.

The agent may act on behalf of her principal with actual or apparent authority. *Actual authority* includes both express delegations of authority (the principal states to the agent that he wants something done) and implied delegations (past practice implies ongoing authority; general directions include implied authority to do all things proper, usual, and necessary). *Apparent authority* arises when the principal acts so as to lead a reasonably prudent third party to suppose the agent had authority, such as when an employee does those things usual and proper to the conduct of the employer's business. This depends on the employee's position, the reasonableness of the offered terms, and the employer's communications to the third party through the employee.

One important distinction is whether the principal is *disclosed* or *undisclosed*. An agent acting for a disclosed principal is normally not liable for obligations entered into on behalf of the principal; only the principal is liable. But an agent for an undisclosed principal is liable on such obligations, as is the principal who authorized the agent to act on his behalf.

Authority may also be created retroactively through *ratification*. This happens when the principal agrees (explicitly or implicitly) to be bound by the prior act of his agent, which was otherwise unauthorized. The principal then becomes bound as though he had authorized the act from the beginning.

An employer may become liable vicariously for tortious acts committed by its employees "acting within the scope of their employment." But a principal is generally not liable for the acts of a nonagent general contractor, unless the principal is negligent in hiring

the contractor.

An agency relationship may generally be terminated by either party at any time for any reason.

§2.1 BUSINESS ORGANIZATION CHOICES

Suppose Bud and Rudy plan to open a flower shop. Bud will run the shop; Rudy will put in money. The organizational forms they can use to structure their for-profit business exist along a continuum. Each form can be manipulated to approximate the characteristics of the others. Keep in mind that whatever structure Rudy and Bud choose, it will not significantly affect how they conduct the business of selling flowers. The organizational form determines their legal relationship, their financial rights, their responsibilities for business debts, and their tax liability.

Today, the organizational choices are mind-boggling.

Sole Proprietorship

A single individual, Rudy, owns the business assets and is liable for any business debts; Bud would be her employee. (Or Bud could be the proprietor and Rudy could lend him money.) Proprietorships usually are small, with modest capital needs that can be met from the owner's resources and from lenders.

General Partnership

Bud and Rudy arrange to carry on the business while agreeing to share control and profits, thus automatically creating a partnership. As partners, they are each individually liable for partnership obligations. The general partnership (GP) is prevalent in service industries—such as law, accounting, and medicine—where trust must exist among the participants and capital needs are not great.

All states, except Louisiana, have adopted a version of the Uniform Partnership Act (UPA 1914) or the more recent Revised Uniform Partnership Act (RUPA 1997). In the last couple of decades, nearly all states have also added "limited liability partnership" (LLP) provisions to their partnership statutes.

Limited Partnership

Bud or Rudy organizes a limited partnership (LP) in which so-called limited partners provide capital and are liable only to the extent of their investment. General partners run the business and are fully liable for partnership debts. Since limited partners need not be general partners, Bud could be the general partner and both of them limited partners. LPs combine tax advantages and limited liability.

Nearly all states have adopted the Uniform Limited Partnership Act (ULPA 1916) or the Revised Uniform Limited Partnership Act (RULPA 1985, revised in 2001). Many states have also added "limited liability limited partnership" (LLLP) provisions to their LP statutes.

Limited Liability Company

Bud and Rudy form a limited liability company (LLC)—a hybrid entity between a corporation and partnership. Like a GP, the members of the LLC provide capital and manage the business according to their agreement; their interests generally are not freely transferable. Like a corporation, members are not personally liable for debts of the LLC entity.

In 1977, Wyoming was the first state to adopt an LLC statute. Today all states have LLC statutes. The Uniform Limited Liability Company Act (ULLCA) was approved in 1996 and revised in 2006, but states have been slow in enacting the uniform acts.

Corporation

Bud and Rudy form a legal entity called a corporation. Shareholders provide capital, and directors and officers manage the business. Corporate participants are not personally liable for corporate debts; only the corporation is liable. Corporations are the principal means of organizing businesses with complex organizational structures and large capital needs. The corporate form, however, works for any size business, including a one-person "incorporated proprietorship."

All states have corporation statutes, most based on the Model Business Corporation Act (1984); but some important states, notably Delaware, have their own idiosyncratic statutes.

Other Choices

If this were not enough, there are other variants. A *joint venture* is basically a general partnership with a defined, limited-term objective. Examples include two law professors writing a casebook or three corporations developing a new chemical process. A *business trust* (or *Massachusetts trust*) involves the transfer of investors' property to a trustee who manages and controls the property for their benefit. The investors' beneficial interests are freely transferable, and the beneficiaries generally are not liable for trust debts. A *professional corporation* (as well as a *professional LLC* or *professional LLP*) allows specified professionals—doctors, lawyers, and accountants—to limit their vicarious liability without running afoul of ethical rules that prohibit professionals from practicing in the traditional corporate form.

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§2.2 CHOOSING BETWEEN AN UNINCORPORATED AND INCORPORATED FIRM

If Bud and Rudy want to share in the control and profits of the flower shop, they would likely choose between an unincorporated firm (GP, LP, or LLC) and a corporation. Although a business planner can adapt each form to suit particular needs, some characteristics are relatively immutable—formation, liability, and tax treatment. Others involve default terms and require planning —duration, financial rights, management, and transferability of ownership interests.

Every business organization serves as an investment vehicle for the pooling of money and labor. Each organizational form must resolve five basic issues (see §1.1.1):

1. When does the investment begin and end?
2. What is the return on the investment?
3. Who manages the investment?
4. How can investors get out?
5. What are investors' responsibilities to others?

§2.2.1 Life Span—Formation and Duration

General Partnership

A GP is created when two or more persons associate to carry on a business as co-owners to share profits and control; it does not require legal documentation. UPA §6; RUPA §202(a). A profit-sharing arrangement creates a presumption of a GP even if the parties do not specifically intend to be partners—that is, a general partnership can be formed inadvertently. UPA §7; RUPA §202(c)(3). However, this presumption can be overcome by showing evidence of the parties' intent not to share in control and profits. See *Martin v. Peyton*, 158 N.E. 77 (N.Y. 1927) (finding no partnership where parties merely created lending arrangement with some control for lender); *Smith v. Kelley*, 465 S.W.2d 39 (Ky. Ct. App. 1971) (finding no partnership by estoppel because intent of parties was not to have partnership, even though one of parties held out to public as partner).

A GP without a definite term (an at-will partnership) dissolves upon the withdrawal of any partner. UPA §31; RUPA §801(a). Absent an agreement, the withdrawing partner may demand that the business be liquidated and the net proceeds be distributed to the partners in cash. UPA §38(1); RUPA §807. Under RUPA, when a partner dies, the surviving partners may choose to continue the GP and buy out the deceased partner's interest, without a liquidation. RUPA §701 (buyout price is set at greater of liquidating or going concern value, taking into account discounts for lack of marketability or loss of key partner, but not for minority status).

A GP can obtain limited liability by filing a statement of qualification or registration with state officials as a limited liability partnership (LLP) and adopt a name that identifies its LLP status. RUPA §1001. The LLP statutes protect the personal assets of partners from the risk of negligence or malpractice by others in the firm. But LLP status does not protect partners from claims by co-partners that they have violated their partnership agreement. See *Ederer v. Gursky*, 881 N.E.2d 204 (N.Y. 2007) (holding partners liable for paying withdrawing partner's share, as specified in their agreement).

Limited Partnership

An LP arises when a certificate is filed with a state official. RULPA §201. An LP lasts as long as the parties agree or, absent agreement, until a general partner withdraws. RULPA §801. The rights and duties of partners in an LP

are defined by their *partnership agreement*, which is non-public and tailored to the parties' specific needs. This agreement generally overrides any default provisions in the state's LP statute.

Limited Liability Company

An LLC arises with the filing of *articles of organization* with a state official. ULLCA §202. (Some states refer to this filing as a certificate of organization or formation.) The LLC members then enter into an *operating agreement* that sets forth their rights and duties. ULLCA §110. Some older LLC statutes required there be at least two members, though one-member LLCs are now widely possible. In addition, most recent statutes do not limit the duration of LLCs. ULLCA §203.

Corporation

A corporation arises when *articles of incorporation* are filed with a state official. MBCA §2.03. Corporate existence is perpetual, regardless of what happens to shareholders, directors, or officers. MBCA §3.02. In some ways the corporation is the polar opposite of a GP. In a GP, partners have unlimited personal liability and an equal say in the management of the business. Compare that to a corporation, where management is centralized in a board of directors, and liability is substantially limited for all corporate participants.

§2.2.2 Financial Rights—Claims on Income Stream and Firm Assets

General Partnership

Partners share equally in profits and losses, unless agreed otherwise. UPA §18(a); RUPA §401(b). A partner may enforce the right to profits in an action for an accounting. UPA §22; RUPA §405(b). Partners have no right to compensation for their services, unless provided by agreement. UPA §18(f); RUPA §401(h). On dissolution, after discharging partnership obligations, profits and losses are divided among the partners. UPA §40; RUPA §807.

Limited Partnership

Limited and general partners share profits, losses, and distributions according to their capital contributions, absent a contrary written agreement. RULPA §§503, 504. (Limited partners, however, are generally not liable to third parties for LP obligations. RULPA §303.) Pre-dissolution distributions are by agreement, as is compensation of the general partner. RULPA §601. Generally, partners in an LP have no default right to demand distributions during the normal operation of the business, though default distributions are available to partners upon withdrawal. RULPA §604.

Limited Liability Company

Most LLC statutes allocate financial rights according to member contributions, though some provide for equal shares. ULLCA §405(a) (equal shares). Under many statutes, members can take share certificates to reflect their relative financial interests. Distributions must be approved by all the members. ULLCA §404(c). Absent agreement, members generally have no right to remuneration. ULLCA §403(d).

Corporation

Financial rights are allocated according to shares. MBCA §6.01. Distributions, from surplus or earnings, must be approved by the board of directors. MBCA §6.40. Directors and officers have no right to remuneration, except as fixed by contract.

§2.2.3 Firm Governance—Authority to Bind and Control the Firm

General Partnership

Each partner is an agent of all other partners and can bind the GP, either by transacting business as agreed by the partners (actual authority) or by appearing in the eyes of third parties to carry on partnership business (apparent authority). UPA §9; RUPA §301. Unless otherwise agreed, a majority vote of the partners decides ordinary partnership matters, but anything that is extraordinary or contravenes the agreement requires unanimity. UPA §18(h); RUPA §401(j).

With broad powers come duties. Partners have fiduciary duties to each other to act in good faith with due care and undivided loyalty. RUPA §404.

Among other things, partners must inform co-partners of material information affecting the GP and share in any benefits from transactions connected to the GP. UPA §20, 21; RUPA §404(b). See *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928) (managing co-venturer breached duty of loyalty, "the punctilio of an honor the most sensitive," to capitalist co-venturer by failing to disclose opportunity of expanded project after expiration of their venture, which failure prevented capitalist from competing for project).

Partners can bring an action to enforce their fiduciary rights against co-partners. UPA §22 (accounting); RUPA §405(b) (legal or equitable relief, with or without an accounting). In keeping with its philosophy of promoting party autonomy, RUPA does not automatically prohibit partners from furthering their own interests so long as they do not violate their duty of loyalty. RUPA §404(e).

Limited Partnership

General partners have authority to bind the LP as to ordinary matters. RULPA §403. Limited partners have voting authority over specified matters, but cannot bind the LP. RULPA §302.

General partners have fiduciary duties akin to those of partners in a GP. RULPA §403 (liability to partnership and other partners). Limited partners may bring a derivative action to enforce fiduciary duties owed to the LP. RULPA §1001 (if general partners have refused to bring action or effort to cause them to bring action "not likely to succeed").

Limited Liability Company

LLCs can be member-managed or manager-managed. ULLCA §203 (manager-managed must be specified). Under most statutes, members in a member-managed LLC have broad authority to bind the LLC in much the same way as partners. ULLCA §301(a). Members have no authority to bind the LLC in a manager-managed LLC. Generally, voting in a member-managed LLC is in proportion to the members' capital contributions, though some statutes specify equal management rights. ULLCA §404.

Members and managers of LLCs have fiduciary duties of care and loyalty, which vary depending on whether the LLC is member-managed or manager-managed. ULLCA §409. In a member-managed LLC, fiduciary duties parallel those in a GP. In a manager-managed LLC, only managers have fiduciary duties; a member who is not a manager is said not to owe

fiduciary duties as a member.

Members may bring direct actions against the LLC and other members to enforce their rights as members under the operating agreement and the LLC statute. RULLCA §410 (legal or equitable relief, with or without an accounting). Members may also bring a derivative action on behalf of the LLC to enforce rights of the LLC, if the members or managers who could authorize such an action have refused to sue or an effort to cause them to sue is "not likely to succeed." RULLCA §1101.

Corporation

The corporation has a centralized management structure. Its business and affairs are under the management and supervision of the board of directors. MBCA §8.01. Officers carry out the policies formulated by the board. MBCA §8.41. Shareholders elect the board, MBCA §8.03, and decide specified fundamental matters; they cannot bind the corporation.

Corporate directors and officers owe fiduciary duties of care and loyalty to the corporation and, in some circumstances, to shareholders. These duties are the bedrock of corporate law. See Chapter 11. Controlling shareholders also have more limited fiduciary duties, principally in exercising their control when the corporation's business is sold. See Chapter 17.

Fiduciary duties may be enforced by the corporation or, more often, by shareholders suing on behalf of the corporation in a derivative suit. In many jurisdictions, shareholders must first demand that the board initiate a suit before the shareholder may sue on behalf of the corporation. See Chapter 18.

§2.2.4 Liquidity—Ownership Transferability and Withdrawal

General Partnership

A partner cannot transfer her interest in the GP unless all the remaining partners consent or the partnership agreement permits it. UPA §18(g); RUPA §401(i). A partner may transfer her financial interest in profits and distributions, entitling the transferee (such as a creditor of the partner) to a charging order. UPA §28; RUPA §502. For example, if a partner wanted to obtain a mortgage loan, he could pledge his financial interest in the GP to the bank.

A partner may withdraw from the GP at any time. UPA §31 (dissolution of at-will partnership occurs upon “express will of any partner”); RUPA §601 (disassociation occurs upon “notice of partner’s express will to withdraw”). If the withdrawal is not wrongful, the business is liquidated and the partner is entitled to payment in cash of his proportional share. UPA §38(1) (at-will partnership wound up and any surplus paid in cash to partners pro rata); RUPA §§801, 807 (same). Even if the partner’s withdrawal is wrongful, the partner is entitled to a cash payment for his share, less any damages his withdrawal caused. See UPA §38 (without goodwill); RUPA §701 (including “going concern” value).

Easy withdrawal in a GP creates risks of partner opportunism. Consider, for example, a two-partner tech startup that consists of a business type and a tech type. If the tech partner leverages her crucial skills and threatens to withdraw from the GP to get concessions from the business partner, litigation (costly and uncertain) might not be enough protection. For this reason, many partnership agreements include provisions on what constitutes wrongful dissolution.

Notice that dissolution of a partnership (the same as for other business organizations) does not necessarily mean the business comes to an end. Instead, partnership dissolution merely terminates the legal relationship among the partners, with the withdrawing partner paid his share of the partnership’s value and (typically) the business continuing as a new partnership of the non-withdrawing partners.

Limited Partnership

A general partner cannot transfer his interest unless all the other general and limited partners agree or the partnership agreement permits it. RULPA §401. Limited partner interests are freely assignable. RULPA §702. Limited and general partners can assign their rights to profits and distributions. RULPA §703. Limited partner interests can be assigned if such assignment is pursuant to authority in the partnership agreement or all the partners consent. RULPA §704. General partners, however, may generally transfer or assign their interest only after written notice and then then unanimous vote by all the other partners. See *Star Cellular Telephone Co. v. Baton Rouge CGSA, Inc.*, 1993 WL 294847 (Del. Ch. 1993).

Limited Liability Company

Most LLC statutes provide that members cannot transfer their LLC ownership interests unless all the members consent or transfer rights are established by agreement. ULLCA §503. Some LLC statutes permit the articles of organization to provide standing consent for new members.

Members, however, can transfer their *financial interest* in the LLC to personal creditors, who can obtain a charging order against the member's interest. ULLCA §504. In addition, some states give withdrawing or "disassociating" members the right to have the LLC buy the member's interest for fair value. See RULLCA §§601, 701.

LLCs may be combined by adopting a merger plan, approved by all members, followed by filing appropriate documentation with the state. In a merger, one LLC survives as the "new" company, while the other ceases to exist.

Corporation

Corporate shares are freely transferable unless there are specific written restrictions. MBCA §6.27. In a corporation, a minority shareholder cannot dissolve the corporation. Instead, dissolution requires board action and majority shareholder approval. See MBCA §14.02. Only if the minority shareholder obtained dissolution rights in a shareholders' agreement can he or she liquidate his or her investment using this route.

Corporations can be combined through a merger, where the assets and liabilities of the merging corporations are automatically combined in the surviving corporation. MBCA §11.06. Shareholders in the non-surviving corporation receive consideration, whether cash, shares in the surviving corporation, or another financial instrument. MBCA §11.02. The terms and logistics of the merger are set out in a merger plan, which must be adopted by both corporations' boards of directors and approved by the shareholders affected by the merger. MBCA §11.04. Once the merger plan is approved, articles of merger must be filed with the corresponding state. MBCA §11.06.

§2.2.5 Liability to Outsiders

General Partnership

General partners have unlimited personal liability for partnership obligations. Their personal assets are at risk for partnership obligations, whether

contractual or from misconduct (torts) of the partners or partnership employees and agents. UPA §15; RUPA §306. Generally, partner liability is joint and several; but under some statutes, liability on partnership contracts is only joint so that partnership assets must first be exhausted before partners become individually liable. UPA §15(a) (joint for contract obligations); cf. RUPA §306(a) (joint and several liability).

Limited liability partnership (LLP) statutes graft limited liability onto the GP statutes. LLP partners thus avoid personal liability for partnership obligations, unless the partner's own conduct makes him personally liable or under some statutes the partner "supervised" the wrongful conduct of another partner or associate. See RUPA §306(c) (official comment states "partners remain personally liable for their personal misconduct").

Limited Partnership

At least one partner must be a general partner, with unlimited liability. Limited partners are liable only to the extent of their investment so long as they do not "participate in the control" of the business. RULPA §303. Older statutes did not define "participation," and courts construed the term broadly to cover limited partners who shared in operational decisions and retained control of financial matters. See *Holzman v. de Escamilla*, 195 P.2d 833 (Cal. App. 1948). Modern statutes clarify that some activities do not constitute participation in control. Limited partners do not lose their limited liability merely by being officers, directors, or shareholders of a corporate general partner, voting on major business matters, or advising the general partner. RULPA §303.

Limited liability limited partnership (LLLP) statutes limit the liability of the general partner—creating an LP with the essential attributes of a manager-managed LLC.

Limited Liability Company

LLC members, both in their capacity as capital contributors and managers, are not liable for LLC obligations. ULLCA §303. This ability to fully participate in the company and still receive limited liability is one reason why LLCs are preferable to LPs. Nonetheless, courts have held that members can become individually liable to creditors if equity or justice so requires—so-called veil piercing. See *Kaycee Land & Livestock v. Flahive*, 46 P.3d 323 (Wyo. 2002), holding that LLCs are subject to same piercing principles as

corporations. In addition, members can be liable to creditors for unpaid contributions to the LLC. See ULLCA §402(b).

Corporation

Shareholders have limited liability for corporate obligations. MBCA §6.22. This is also true for directors and officers acting on behalf of the corporation. Corporate participants can lose only what they invested unless there is fraud or an inequity that justifies "piercing the corporate veil." Often, large creditors of small corporations will demand that corporate participants personally guarantee the corporation's obligations, thus reducing the significance of corporate limited liability.

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§2.3 TAXATION—CRITICAL ELEMENT IN THE CHOICE

Bud and Rudy are in business to make money, and their reasons for choosing an organizational form will be largely financial. Tax considerations will loom large. We provide a cursory introduction to this complex area, which is treated more fully in advanced tax courses.

§2.3.1 Tax Implications of Organizational Choice

Under current federal income tax law, a "corporation" is a separate tax-paying entity—but a "partnership" is disregarded and treated as a simple aggregate of individuals. Consider three scenarios:

Scenario	Partnership	Corporation
(1) Business makes money and distributes it.	The partnership acts as a tax conduit — a pipe that directs income. Its income flows through to its partners, who must pay tax — thus tax is paid only once. The partnership files an informational tax return disclosing relevant financial information	The corporation is taxed on its income when earned. If the corporation pays dividends to its shareholders, the shareholders must pay tax on the dividends — a double tax.
(2) Business makes money, but retains it.	The partnership's income flows through to the partners even if retained in the business. But it is taxed only once.	The corporation is taxed when it earns income. The tax on shareholders is deferred until the income is distributed or when they sell their shares after appreciation. Double tax is unavoidable.
(3) Business loses money.	The partnership's losses flow through to the partners, who can deduct them from other personal income (or "shelter" their income). (There are some limitations when the losses arise for a partner who is not active in the business — "passive" losses.)	The corporation can deduct ordinary business losses only against income the business generates. Sometimes, if there is insufficient income in a year, the losses can be carried forward or back to other tax years. Shareholders can deduct losses from personal income only by selling their shares at a loss and deducting capital losses.

As you can see, unless the firm plans on retaining earnings, taxation as a partnership has distinct advantages.

Flow-Through versus Entity Tax Treatment

To illustrate the basic structure of federal income taxation of business organizations, consider the following two cases. (We have used the tax rates for tax year 2014, disregarding the effect of exemptions and other deductions, as well as special tax rules for eligible dividends. As you will notice, individual and corporate tax rates are graduated based on taxable income. That is, taxpayers pay taxes at progressively higher rates as their taxable income increases.)

Case 1 (Low Income)

Bud and Rudy's flower shop generates $150,000 in revenues and $110,000 in tax-deductible expenses during the first year — generating $40,000 in taxable income. They share equally in after-tax earnings, they each are subject to tax rates for married individuals filing jointly, and they have no other income.

	Flow-Through Entity	Corporation
Taxable income	$40,000	$40,000
Entity tax	None	
entity rate		15% of taxable income
entity tax		$6,000
amount for distribution	$40,000	$34,000
Individual tax	Flow-through	Tax on dividends
distribution to each owner	$20,000	$17,000
individual rate	$1,815 + 15% of taxable income > $18,150	10% of taxable income
individual tax	$2,093	$1,700
after-tax income	$17,908	$15,300
Total tax (entity + individual)	$4,185	$9,400
Overall tax rates		
effective rate	10.5%	23.6%
marginal rate	15.0%	27.8%

Case 2 (High Income)

The same as Case 1, except the flower shop generates $1,300,000 in revenues and $900,000 in tax-deductible expenses — generating taxable income of $400,000.

	Flow-Through Entity	Corporation
Taxable income	$400,000	$400,000
Entity tax	None	
entity rate		$113,900 + 34% of taxable income > $335,000
entity tax		$136,650
amount for distribution	$400,000	$263,350
Individual tax	Flow-through	Tax on dividends
distribution to each owner	$200,000	$131,675
individual rate	$28,925 + 28% of taxable income > $148,850	$10,162.50 + 25% of taxable income > $73,800
individual tax	$43,247	$24,631
after-tax income	$156,753	$107,044
Total tax (entity + individual)	$86,494	$185,913
Overall tax rates		
effective rate	21.6%	46.5%
marginal rate	28.0%	50.5%

As these tables show, the impact of double taxation is substantial. There is a significant advantage in achieving "partnership" flow-through tax treatment and avoiding "corporation" status. In both cases a corporation generates greater tax costs compared to a flow-through entity, such as a

partnership, LLC, or S corporation.

- Compare the *effective rates*—that is, the total tax bite stated as a percentage of taxable income. Whether taxable income is $40,000 or $400,000, the IRS takes about twice as much in taxes when the business is a corporation that distributes its dividends to shareholders as when there is flow-through tax treatment.
- Compare the *marginal rates*—that is, the tax bite on each additional $1 of taxable income. What happens if Bud and Rudy go to the trouble of earning another taxable dollar? In Case 2, only 28 percent of that dollar would be taxed if their business were a partnership, and 52.5 percent would be taxed if it were a corporation. Knowing the marginal rates helps them decide whether the trouble of earning an extra dollar is worth it.

§2.3.2 Characterizing the Firm: Corporation or Partnership?

For many years, the distinction between a taxable "corporation" (commonly referred to as a "C Corporation" after IRC Subchapter C) and a flow-through "partnership" turned on a multi-factor test promulgated by the Internal Revenue Service, commonly known as the "Kintner regulations." Treas. Reg. §301.7701-2. The IRS looked at whether the firm exhibited three of four classic "corporate" characteristics—namely (1) continuity of life, (2) centralized management, (3) liability for business debts limited to corporate assets, and (4) free transferability of interests.

As the popularity of LLCs grew, the Kintner regulations proved to be a thorn in the side of this new hybrid entity. To avoid tax as a corporation, statutory drafters and business planners had to eliminate at least two corporate attributes—such as by providing for dissolution upon member withdrawal (no continuity), restricting transferability of member interests (no free transferability), or establishing member-managed structures (no centralized management). As a result, the tax laws became the tail that wagged the dog, forcing LLC members to accept organizational relationships they would not otherwise have chosen.

All of this changed dramatically in 1996 when the IRS promulgated a bold "check the box" rule that allows any closely held domestic unincorporated firm to be taxed as a partnership, unless the parties elect corporate tax treatment by, literally, checking a box. Treas. Reg. §301.7701-1. Unincorporated firms (GPs, LPs, LLCs) can choose whatever organizational attributes best suit the participants' needs, and flow-through tax status is assured.

§2.3.3 Avoiding Double Taxation

Before "check the box," business planners used various techniques to avoid double-tax without giving up limited liability. Some are still relevant for firms that prefer the corporate form.

Subchapter S Corporation

The Internal Revenue Code allows certain corporations to elect flow-through tax treatment. See I.R.C. §§1361—1378 (Subchapter S). An S corporation is one incorporated under state law and thus retains all its corporate attributes—including limited liability and centralized management. But it is not subject to an entity tax, and all corporate income, losses, deductions, and credits flow through to the shareholders. To be eligible, the S corporation

- must be a domestic corporation or LLC that has chosen to be taxed as a corporation
- can have only one class of stock (though there can be shares with different voting rights provided they are otherwise alike)
- can have no more than 100 individual shareholders, though certain tax-exempt entities can be shareholders (such as employee stock ownership plans, pension plans, charities)
- can only have shareholders who are U.S. citizens or residents (thus precluding ownership by nonresident aliens or business entities)

When heavy losses are anticipated, the Subchapter S form may not be as desirable as an LLC or partnership. S corporation shareholders can only write off losses up to the amount of capital they invested (though the loss can be carried forward and recognized in future years).

Zeroing Out Shareholder Payments

Corporate tax in a small, closely held C corporation can be zeroed out by paying shareholders deductible compensation or interest. The effect is that tax is paid only at the shareholder level. For example:

- Shareholder-employees are paid salaries, bonuses, and contributions to profit-sharing plans. "Reasonable compensation" is deductible by the corporation from gross income in computing taxable income, while dividends are not. But there can be too much of a good thing. If compensation is not reasonable—that is, not related to the value of the services—the IRS can treat excess compensation as "constructive dividends," and the corporation loses its deduction.
- Shareholder-lenders are paid deductible interest, rather than nondeductible dividends. Again, there can be too much of a good thing. The IRS will recharacterize debt as equity if it appears the contributions were at "the risk of the business" (see §4.3.2).

Examples

1. Brigg has operated a landscaping business, Good Earth Landscaping, as a sole proprietorship. He has done most of the work himself and financed the business out of his own pocket. Brigg wants to expand by taking on regular employees and purchasing new equipment. His sister Pearl is willing to put up some money, but she wants to be sure she won't be at risk for more than what she invests.
    a. Pearl invests on the understanding that she will share in the profits, will help Brigg run the business, and will not be liable beyond her investment. Are her understandings valid?
    b. What forms of business organization might accommodate Pearl's multiple wishes?
    c. Is Pearl assured of limited liability if she is a limited partner? An LLC member? A corporate shareholder?
    d. For Pearl, what is the difference between being a partner in an LLP, a limited partner in an LP, a member in an LLC, or a shareholder in a corporation?

e. Pearl will contribute cash, while Brigg will manage the business. If the business suffers losses, will Brigg have to bear them?

f. Pearl is concerned about being able to withdraw from the business and receive a return on her investment. Which business form will make it easiest for her to withdraw and receive payment for her investment?

2. Brigg's friend Gravely is willing to invest in Good Earth Landscaping, but wants to help run the business. Gravely, naturally, is worried about personal liability for business obligations. In addition, Brigg and Gravely agree that they would prefer flow-through tax treatment given that the business is likely to have losses at the beginning.
    a. Will a corporation accomplish the parties' purposes?
    b. Brigg believes other wealthy investors (including his uncle in Germany) would be willing to invest. Given the favorable gift and estate tax rules for LP interests, will an LP accomplish the parties' purposes?
    c. Assuming that LLC interests also receive favorable gift and estate tax treatment, will an LLC have advantages over a corporation or LP?
3. Brigg, Pearl, and Gravely decide to form Good Earth Landscaping, LLC. They enter into an operating agreement that gives them equal rights in managing the business. They divide financial rights as follows: Brigg 50 percent interest, Pearl 25 percent, and Gravely 25 percent.
    a. Is this arrangement—in which the three members have equal management rights, but different financial rights—possible in an LLC?
    b. Brigg wants Good Earth to expand beyond residential landscaping into the commercial market, but Pearl disagrees. How will this matter be decided?
    c. Brigg orders another new tractor for the business from Massey Tractors, a leading manufacturer. Without asking Pearl or Gravely, he signs the order form on behalf of Good Earth. Is Good Earth bound on the order?
    d. Good Earth is a business success, and Gravely wants the profits to be distributed, while Brigg and Pearl want to reinvest in the business.

How will this dispute be resolved?

e. Pearl wants to buy a home. To help secure a favorable rate on a loan, she plans to put up her ownership stake in Good Earth as collateral. Can she?

f. Gravely learns that a friend is starting a similar landscaping company as Good Earth in the same city. Gravely sends his friend a list of Good Earth's customers, and the friend sends Gravely a "thank you" check. Has Gravely breached any duty to Green Earth?

g. Brigg supervises a large landscaping job with massive stonework and waterfalls. After the job is done, one of the stones falls on the customer—killing him. The evidence is clear that the stonework was installed negligently by the company's workers. Who is liable?

Explanations

1. a. No. When Brigg and Pearl agreed to "carry on as co-owners of a business for profit" they formed a general partnership (GP)—whether they intended to or not. UPA §6; RUPA §202(a); cf. *Martin v. Peyton*, 246 N.Y. 213 1927) (finding creditor who shared in profits, but did not assume day-to-day control of business, was not partner for purposes of liability to third party). As a partner, Pearl is liable for the business's contractual debts, even if they exceed the amount of her investment. UPA §15; RUPA §306(a).

   b. Pearl wants limited liability. She can be

   - a partner in an LLP
   - a limited partner in an LP (or even a general partner in an LLLP)
   - a member in an LLC
   - a shareholder in a corporation

   In each case, she will be shielded against personal liability if business debts exceed business assets. She will be "liable" only to the extent that the business suffers losses, in which case she may lose her investment. All limited-liability forms require a filing with state officials.

   c. No. These organizational forms provide some, but not complete, assurance that participants can limit their losses to the amount they invested.

   As a limited partner in an LP, Pearl would not be liable for business

debts and obligations beyond her investment unless she "participates" in the management of the business. Although ULPA §7 provides little guidance as to when a limited partner participates in control, RULPA §303 offers a safe-harbor list of permissible activities. Pearl would risk becoming personally liable if she helps Brigg run the day-to-day business.

As an LLP partner, an LLC member, or a corporate shareholder, Pearl would not be liable for business debts or obligations beyond her investment unless the entity/corporate veil is "pierced." Some LLC statutes suggest that LLC members may become personally liable "by reason of their own acts," a formulation similar to that found in corporate statutes. See MBCA §6.22(b). When and whether courts disregard corporate limited liability is an important (and vexing) question of corporate law and is dealt with in Chapter 32. Normally, Pearl would not become liable for corporate obligations merely by being active in the management of the business. Piercing typically happens only when a corporate participant defrauds or confuses creditors about limited liability or engages in activities that frustrate creditors' expectations to be paid ahead of shareholders.

d. As the previous answer illustrates, limited liability is somewhat similar in an LLP, LP (for limited partners), LLC, and corporation. But the tax implications can be markedly different.

Under a corporate structure, there may be double taxation that will reduce the amount of profits available to distribute to Pearl—the return on her investment. Unless the corporate participants can elect "Subchapter S" status, corporate earnings are taxed first at the corporate level and then a second time at the shareholder level when distributed as dividends.

Unless the parties have chosen to be taxed as a corporation, business earnings in a partnership (whether a GP, LLP, LP, or LLLP) or an LLC are taxed only once at the partner or member level, whether or not the earnings are distributed. This flow-through tax treatment leaves available more earnings to distribute to Pearl—a better return on her investment.

e. If they organize a limited liability entity (LLP, LP, LLLP, LLC, or corporation), neither participant will be liable for business losses. But if

their agreement constitutes a GP, there is some question whether the capital partner and labor partner share losses equally. The plain text of the UPA assumes all partners, absent an agreement otherwise, share losses equally (including the capital partner's loss of capital). Yet some cases, recognizing the value of labor, suggest the labor partner loses only his labor and the capital partner his capital. *Kovacik v. Reed*, 315 P.2d 314 (1957).

f. A GP is the business form with easy withdrawal rights. Absent agreement otherwise, GPs are at-will and continue until a partner withdraws from the partnership. Under the UPA, the withdrawal of a partner from an at-will partnership results in "dissolution" (the legal termination of the partnership). Therefore, if Pearl withdraws, the partnership would dissolve and the business would be liquidated—that is, all assets would be sold for cash and all creditors paid. The net proceeds would then be distributed to the partners according to their share of profits.

In an LP, limited partners may sell their interests to other investors, but there is no assurance that anyone would be willing to buy Pearl's interest. And in an LP she cannot compel the LP to buy her interest.

In an LLC, members may not sell their interests to other investors (without the consent of the other members), though some states give withdrawing members a right to have the LLC purchase their interest. The statutory trend, however, is for withdrawing members not to be able to compel a buyback of their interest—thus, to protect the continuity of the business.

In a corporation, shareholders may sell their shares, but in this closely held corporation there is no market into which Pearl could sell her shares. Moreover, absent a decision by the corporation's board of directors or a provision in the corporate documents, the corporation has no duty to repurchase her shares.

2. a. Yes. A corporation can accomplish their purposes. Although a C corporation would be subject to double taxation, Brigg and Gravely can elect to have the corporation treated as an S corporation. This election affects only the corporation's tax treatment, not its nontax attributes. In this way Brigg and Gravely can obtain the limited liability afforded by the corporate form while enjoying the benefits of flow-through tax

treatment. The corporation easily can be made to qualify: It must be incorporated in the United States, it must have fewer than 100 individual shareholders (none may be a nonresident of the United States), and it must have only one class of stock.

b. Perhaps. Although an LP's flow-through tax status is not affected by the number of investors or their nationality, limited liability would be jeopardized by Gravely's participation in the management of the business. In an LP, limited partners become liable as general partners if they take part in the control of the business. ULPA §7; RULPA §303.

Nonetheless it might be possible to form an LP with a corporate general partner, with Gravely and Brigg acting as shareholders, directors, and officers of the corporation. In their capacities as limited partners and participants in a corporation, they would enjoy limited liability for the LP's and general partner's liabilities. There is, however, some case law under ULPA §7 that limited partners who participate in the management of a corporate general partner are deemed to participate in the control of the LP—their limited liability is lost. RULPA §303, on the other hand, specifically allows such a structure without the limited partners becoming subject to partnership liabilities. The theory is that those dealing with the LP will be looking only to the credit of the corporate general partner unless they obtain personal guarantees.

c. Yes. An LLC avoids some of the pitfalls of the traditional LP and corporate forms. Unlike an LP, an LLC permits management roles to be specified in the articles of organization and the operating agreement without jeopardizing the parties' limited liability. Unlike a corporation, an LLC permits flow-through tax treatment, while permitting an unlimited number of investors (including nonresident investors). For these and other reasons, LLCs have become the entity of preference for many smaller businesses that seek limited liability, while maintaining flexibility as to ownership, management, and transferability.

3. a. Yes. LLCs, based on the philosophy of "freedom of contract," allow the parties broad discretion to specify their rights and duties in their operating agreement. Although the default rule in an LLC is equal sharing of profits regardless of the members' contributions to the business, the parties can agree otherwise—as they have here. See

ULLCA §110(a)(1) (stating that operating agreement governs relations of members), §404 (specifying default rule for sharing of profits). Likewise, financial rights need not track management rights. See ULLCA §407 (creating assumption LLC is member-managed, thus providing members with equal management rights).

b. By majority vote—thus, Brigg will need Gravely's agreement to the expansion. An LLC is assumed to be member-managed, unless expressly provided otherwise. See ULLCA §407(a). And in a member-managed LLC, each member has equal management rights unless specified otherwise. ULLCA §407(a). For matters in the ordinary course of the company's business, decisions are by majority vote of the members. See ULLCA §407(b)(3).

   Here, the parties in this member-managed LLC have specified a 50:25:25 management voting structure. Given that expanding into the commercial market would seem to be an ordinary matter for this landscaping business, Brigg (with 50 percent of the votes) must also get the vote of Gravely (with 25 percent), given Pearl's disagreement with the expansion. (If the expansion, however, is seen as outside the company's ordinary business, Pearl's refusal to vote for the expansion would constitute an effective veto. See ULLCA §407(b)(4).)

c. Yes. The LLC is bound. Members can bind an LLC under general agency principles. See Comment to ULLCA §301. Thus, a member's authority to bind the LLC will depend on his actual or apparent authority.

   Here, it is unclear whether the operating agreement gives Brigg authority to act on behalf of the LLC in the ordinary course of its business. But even if such actual authority does not exist, there would be apparent authority if the outside party has a reasonable belief that Brigg is acting on behalf of the LLC, given his position in the company and any past course of dealings. See Comment to ULLCA §301; Restatement (Third) of Agency §3.03, cmt. b (2006). Unless the tractor manufacturer has reason to believe Brigg lacks authority, the assumption is that third parties can rely on the authority of an LLC member with whom there has been a course of conduct—here a prior tractor order.

d. The members are at an impasse, and no profits will be distributed or re-

invested. Distribution of profits (before dissolution) must be agreed to by the members. See ULLCA §404(b) (stating that right to interim distributions arises "only if company decides"). Here, given the 50/25/25 voting structure in this LLC, the distribution of profits would require the approval of Brigg *and* either Pearl or Gravely. Moreover, the decision to re-invest profits in the business would be an ordinary business matter, requiring a majority vote. The parties should have recognized that they created a voting structure with a risk of deadlock.

In an at-will partnership, deadlock of the partners can be resolved by any of the partners withdrawing from the partnership and demanding payment of his share in cash. See §2.2.4 (Liquidity—Ownership and Transferability and Withdrawal). But in an LLC, withdrawal only severs the member's management rights (and fiduciary duties) with the member continuing to have financial rights to any distributions. See ULLCA §603. In an LLC a deadlock can be resolved—absent provisions in the operating agreement allowing for member withdrawal or dissolution of the LLC—only if a member applies to a court for a dissolution order on the ground it is no longer "practicable to carry on the company's activities in conformity with [its certificate] or operating agreement." See ULLCA §701(a)(4).

e. Yes. Members can "transfer" their member interests as collateral. LLC interests are treated as "transferable interests," but the transferee does not acquire rights to participate in the LLC's management, instead only to receive distributions on the same basis as the transferor. See ULLCA §502. If Pearl uses her LLC interest as collateral on a bank loan and fails to repay the loan, the bank can obtain a "charging order" that entitles it to any distributions that would otherwise be paid to Pearl. See ULLCA §504.

f. Yes. Gravely has breached his duty of loyalty. Whether the LLC is member-managed or manager-managed, members are subject to fiduciary duties of care and loyalty, which can only be waived in limited circumstances. See ULLCA §409(a). In particular, the duty of loyalty requires a member to "account for any benefit derived by the member … from a use by the member of the company's property." See ULLCA §409(b)(1)(B); see also Comment to ULLCA §603 ("obligation to safeguard trade secrets and other confidential or proprietary information is incurred when a person is a member").

Gravely will be liable for any damage his disloyal action causes the LLC and the other members. See ULLCA §901 (direct actions by members), §902 (derivative actions by member on behalf of LLC).

g. The LLC is liable, and Brigg is possibly liable for his negligent supervision. Under principles of *respondeat superior*, the LLC is liable for wrongs of its employees. The members of the LLC, however, are not liable personally for the LLC's liabilities (whether in contract or tort), unless the member's own actions or conduct make the person liable. Here, if Brigg negligently supervised the defective work, he could be liable for his own negligence. But Pearl and Gravely are not liable as members for the LLC's liabilities.

Business Organizations (Basics)								
	Formation	**Financial**	**Mgmt**	**Voting**	**Liquidity**	**Liability**	**Change**	**Tax**
Partnership								
General Partnership (GP)	association*	share profits	equal/ agent	equal	no	joint/ several*	unanimous	pass through
Limited Liability Partnership (LLP)	association* + filing*	share profits	equal/ agent	equal	no	limited	unanimous	pass through
Limited Partnership (LP)	filing*	share profits	LP—no GP—yes	agreement	LP—yes GP—no	LP—limited GP—joint/ several*	unanimous	pass through
Corporation								
C Corporation (publicly held)	filing*	dividends	board*	directors*+ fundamental transactions*	yes	limited	board + majority*	entity*
S Corporation (closely held)	filing (and with IRS)*	dividends + salaries	board	directors + fundamental transactions	no (agree)	limited (PCV*)	board + majority	pass through
Limited Liability Company (LLC)								
Member-Managed	filing*	equal distribution	equal/ agent	equal	no	limited (PCV*)	unanimous	pass through
Manager-Managed	filing*	equal distribution	manager	equal	no	limited (PCV*)	unanimous	pass through

*mandatory term