THE CYCLICAL TRANSFORMATIONS OF THE CORPORATE FORM: A HISTORICAL PERSPECTIVE ON CORPORATE SOCIAL RESPONSIBILITY

REUVEN AVI-YONAH

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ABSTRACT

This article describes the transformations underwent by the corporate form from its Roman origins to the present. It shows that every time there was a shift in the role of the corporation, three theories of the corporation (the aggregate, artificial, and real entity theories) were brought forward in cyclical fashion. Every time, however, the real entity theory prevailed, and it was the dominant theory during periods of stability in the relationship between the corporation, the shareholders, and the state. The article describes this evolution in detail, and then attempts to derive normative consequences for the legitimacy of corporate social responsibility (CSR). The basic argument is that under the real entity view, which is historically the dominant view of the corporation, CSR is normatively acceptable even when it does not contribute to the long-run welfare of the shareholders.

I. INTRODUCTION

In June 2001, U.N. Secretary General Kofi Annan addressed the U.S. Chamber of Commerce with an impassioned plea for business to "take concerted action against the unparalleled nightmare of AIDS."[1] After discussing the dimensions of the global AIDS crisis, the Secretary General

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[1] Press Release, Secretary-General, Secretary-General Urges United States Business Leaders to Take Concerted Action Against "Unparalleled Nightmare" of AIDS, U.N. Doc. SG/SM/7827, AIDS/13 (June 1, 2001), *available at* http://www.un.org/News/Press/docs/2001/sgsm7827.doc.htm.

went on to argue that business leaders should get involved in the campaign to stop the spread of AIDS "because AIDS affects business . . . the business community needs to get involved to protect its bottom line . . . there is a happy convergence between what your shareholders pay you for, and what is best for millions of people the world over."[2]

The problem with this appeal is that it is unlikely to be true for the majority of Mr. Annan's audience. It is hard to show that combating the AIDS crisis in Africa will have any discernible impact on the bottom line for shareholders of an office equipment manufacturer in Kalamazoo, Michigan. In fact, a recent review of the literature on corporate social responsibility (CSR), the code name for all the various ways for-profit enterprises can help their communities and the world, has shown that it is very hard to demonstrate any significant positive correlation between CSR and the "bottom line."[3]

On the other hand, it is also clear that in many cases, corporations are in a better position to help human development than either governments or not-for-profit organizations. Corporations are typically smaller and more efficient than unwieldy government bureaucracies and, in the developing world, are also less corrupt. Further, corporations possess greater resources, both financial and technical, than most not-for-profit non-governmental organizations (NGOs).

Thus, an important question arises: given that corporations are frequently in the best position to help human development, should they be *permitted* to do so when there is no clear benefit for their shareholders? This is a question that has been frequently addressed by academics in the last half century, and overwhelmingly they have answered in the negative. From Theodore Levitt's classic 1958 article on "The Dangers of Social Responsibility"[4] to Milton Friedman's influential *New York Times* magazine article in 1970,[5] to current writings by Michael Jensen and others,[6] the

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[2] *Id.*

[3] Joshua D. Margolis & James P. Walsh, *Misery Loves Companies: Rethinking Social Initiatives by Business*, 48 ADMIN. SCI. Q. 268, 278 (2003).

[4] Theodore Levitt, *The Dangers of Social Responsibility*, HARV. BUS. REV. 41 (Sept.-Oct. 1958).

[5] Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 33.

[6] *See, e.g.*, Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 BUS. ETHICS Q. 235 (2002); Michael C. Jensen & William Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). For different perspectives on CSR in general, see William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261 (1992); Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1 (2004); Michael J. Philips, *Reappraising the*

consensus is that "social responsibility of business . . . [is] to increase its profits."[7] The reasons given are first, that since management are deploying the shareholders' money, they should not be permitted to do so in ways that do not directly benefit the shareholders;[8] and second, that

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Real Entity Theory of the Corporation, 21 FLA. ST. U. L. REV. 1061 (1994); C.A. Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-first Century*, 51 KAN. L. REV. 77 (2002); Cynthia A. Williams, *Corporate Social Responsibility in an Era of Economic Globalization*, 35 U.C. DAVIS L. REV. 705 (2002).

[7] Chen & Hanson, *supra* note 6, at 37.

[8] *See, e.g.*, Kenneth J. Arrow, *Social Responsibility and Economic Efficiency*, 21 PUB. POLICY 303, 303-07 (1973); Friedman, *supra* note 5, at 122; Friedrich A. Hayek, *The Corporation in a Democratic Society*, *in* WHOSE INTEREST OUGHT IT AND WILL IT BE RUN, IN MANAGEMENT AND CORPORATIONS 99, 108-15 (Melvin Anshen & George L. Bach, eds., 1960). The classic case affirming this "shareholder primacy" doctrine is *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919). See also the classic debate between Berle and Dodd. Adolph A. Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1061 (1931) (stating directors' powers one held in trust for the shareholders as the only beneficiaries of the corporation); Merrick Dodd, *For Whom Are Corporate Managers Trustees*, 45 HARV. L. REV. 1145, 1147-48 (1932) (stating Berle does not think that shareholder profit maximization is the only purpose that corporations exist); Adolph A. Berle, *For Whom Are Corporate Managers Trustees: A Note*, 45 HARV. L. REV. 1365 (1932) (stating profit maximization is not the only purpose of a corporation). The shareholder primacy doctrine has become a mainstay of modern corporate law. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15-22 (1991) (stating that shareholders, as residual claimants, have implicitly contracted for promise that firm will maximize profits in long run); HENRY G. MANNE & HENRY C. WALLICH, THE MODERN CORPORATION AND SOCIAL RESPONSIBILITY (1972) (noting that social responsibility of corporations is shareholder wealth maximizing); Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1921 (1996) (arguing that principal goal of corporate law is to maximize shareholder wealth); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441, 449-51 (2001) (stating that shareholder primacy is likely to dominate future development of corporate law); Michael Bradley et al., *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, 62 LAW & CONTEMP. PROBS. 9, 11 (1999) (examining how the changing dynamic of business organizations impacts and influences the relationship between corporate governance and its constituents); Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1023 (1996) ("[A]ll but the communitarians agree that virtually the sole task of corporate law is to ensure that managers act as agents for the shareholder owners."); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 113 (1987) (asserting that core goal of corporate law is to maximize equity share prices); *cf.* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 201-16 (2004) (discussing need to align managerial incentives with shareholder interests); John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495, 1496 (1990) (discussing role of stakeholders in firm). For arguments on the other side, see Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 310-11 (1999) (positing that where shareholders are widely dispersed, shareholders' voting rights are practically meaningless, given collective action problems, shareholders' rational apathy, and the power top managers exercise in nominating the candidates for the board and in otherwise shaping the voting agenda); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 261-62 (praising case law that reaffirms directors'

permitting more than one measure of managerial success would enhance the agency cost problem and make it impossible to evaluate managers with any reasonable degree of objectivity.[9]

And yet, the debate persists because most managers, in fact, do want to engage (or at least appear to engage) in CSR, arguing (in the face of the evidence) that this is in the "long run" benefit of the shareholders.[10] Moreover, they are permitted to do so by the ALI Principles of Corporate Governance, which state that "[e]ven if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business . . . [m]ay devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes."[11] This formulation represents a compromise between the wishes of management for maximum freedom and the consensus of corporate law academics.

This article will attempt to shed a new light on this debate by putting it in historical perspective. Historically, the corporation evolved from its origins in Roman law in a series of four major transformations. First, the concept of the corporation as a separate legal person from its owners or members had to be developed, and this development was only completed with the work of the civil law Commentators in the fourteenth century. By the end of the Middle Ages, the membership corporation—a corporation with several members who chose others to succeed them—had legal personality (the capacity to own property, sue and be sued, and even bear criminal responsibility), unlimited life, and was well established in both

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discretion to consider nonshareholder interests); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 630-43 (1992) (arguing that courts should modify corporate law to grant stakeholders standing to sue directors when the former are harmed by corporate action); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 936-65 (1993) (arguing that corporate law should be changed to encourage employee representation on the board and standing to sue); Williams, *supra* note 6, at 712 n.15 (stating that it is "debatable whether Hansmann and Kraakman's statement about shareholders' control of the corporation is accurate in the United States; in fact, one of the striking features of American corporate law is how little real control shareholders have, given that they are the 'owners' of the corporation"). *See generally* PROGRESSIVE CORPORATE LAW (Lawrence E. Mitchell ed., 1995) (surveying recent nontraditional approaches to corporate legal scholarship); Chen & Hanson, *supra* note 6, at 37-39; *Developments in the Law—Corporations and Society*, HARV. L. REV. 2176, 2176-77 (2004).

[9] *See, e.g.*, Friedman, *supra* note 5, at 133; Wells, *supra* note 6, at 106.

[10] Margolis & Walsh, *supra* note 3, at 270. On CSR as mere whitewashing, see Andrew A. King & Michael J. Lenox, *Industry Self-Regulation without Sanctions: The Chemical Industry's Responsible Care Program*, 43 ACAD. MGMT. J. 698 (2000).

[11] AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE, ANALYSIS AND RECOMMENDATIONS 2.01(b) (1994). *See also* The Business Roundtable, *Statement on Corporate Governance and American Competitiveness*, 46 BUS. LAW 241, 244 (1990) (recognizing that corporations serve the interests of both its shareholders and society).

civil and common law jurisdictions. The second important step was the shift from non-profit membership corporations to for-profit business corporations, which took place in England and the United States in the end of the eighteenth and beginning of the nineteenth century. The third transformation was the shift from closely-held corporations to corporations whose shares are widely held and publicly traded, and with it the rise of limited liability and freedom to incorporate, which took place by the end of the nineteenth century and the beginning of the twentieth. Finally, the last major transformation was from corporations doing business in one country to multinational enterprises whose operations span the globe, which began after World War II and is still going on today.

Each of these four transformations (as well as a smaller, more temporary change which occurred in the United States in the 1980s with the advent of hostile takeovers) was accompanied by changes in the legal conception of the corporation. What is remarkable, however, is that throughout all these changes spanning two millennia, the same three theories of the corporation can be discerned. Those theories include the aggregate theory, which views the corporation as an aggregate of its members or shareholders; the artificial entity theory, which views the corporation as a creature of the State; and the real entity theory, which views the corporation as neither the sum of its owners nor an extension of the state, but as a separate entity controlled by its managers.[12]

In this article, we will describe the transformations underwent by the corporate form from its Roman origins to the present. In addition, we will show that every time there was a shift in the role of the corporation, all three theories were brought forward in cyclical fashion. Every time the real entity theory prevailed, however, for reasons we will discuss below, it was the dominant theory during periods of stability in the relationship between the corporation, the shareholders, and the state. This evolution will be described in detail, and then an attempt will be made to derive normative consequences for the legitimacy of CSR. The basic argument is that under the real view, which will be argued is historically the dominant view of the corporation, CSR is normatively acceptable even when it does not contribute to the long-run welfare of the shareholders.

The article is divided into three parts. After this Introduction, Part II describes the evolution of the corporate form from Roman law to the present, and shows how in each of the four transformations undergone by the corporation all three theories tended to arise, but that the real theory ended up as the dominant one. Part III draws the normative conclusions,

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[12]These three theories are the standard ones in the literature. *See, e.g.*, Millon, *supra* note 8, at 201.

and argues that if indeed the real theory is the dominant theory of the corporation from a historical perspective, it provides a new way of justifying CSR, even when it is does not benefit the shareholders and involves problems for which the corporation is not responsible, like the AIDS crisis. In addition, Part III puts the three theories of the corporation into a comparative perspective, drawing on the "varieties of capitalism" literature, and argues that each theory exemplifies one type of capitalist structure. This, in turn, explains the different attitudes to CSR in different contemporary capitalist environments.

II. THE CYCLICAL TRANSFORMATIONS OF THE CORPORATE FORM

The corporation as a legal person separate from its owners is a uniquely Western institution. Other legal systems, such as Muslim law, did not (before they were influenced by the West) have a concept of legal personality separate from individual human beings.[13] The corporate form originated in Roman law in its classical period (the first two centuries AD), was further developed in the Middle Ages in both canon (Church) and civil law, and was adopted from civil law by the Anglo-American common law tradition.

In the West, the existence of the corporate form was crucial to the development of several other important institutions, such as the university (whose very name derives from the Latin term for corporation, *universitas*) and Parliament. It has, in fact, been argued that other important Western developments such as the rise of representative democracy and the scientific revolution can be tied to the corporate form.[14]

To get from the Roman origins of the corporate form to today's multinational enterprises, the corporation had to undergo the four transformations described above. In this Part, we will describe these transformations in detail. In addition, we will show that every time there was a shift in the role of the corporation, all three theories (the aggregate, artificial entity, and real entity theories) were brought forward in cyclical fashion. Every time the real entity theory prevailed, however, for reasons discussed below, and it is the dominant theory during periods of stability in the relationship between the corporation, the shareholders, and the state.

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[13] *See* GEORGE MAKDISI, THE RISE OF COLLEGES (1981); George Makdisi, *Madrasa and University in the Middle Ages*, 32 STUDIA ISLAMICA [ISLAMIC STUDIES] 255 (1970).

[14] On representative democracy and its connection to the borough as a corporation, *see, e.g.*, GAINES POST, STUDIES IN MEDIEVAL LEGAL THOUGHT (1964); BRIAN TIERNEY, RELIGION, LAW, AND THE GROWTH OF CONSTITUTIONAL THOUGHT 1150-1650 (1982). On the link between the rise of universities in the West and the scientific revolution, see REUVEN S. AVI-YONAH, THE ARISTOTELIAN REVOLUTION (1986).

A. *First Transformation: The Establishment of the Corporation as a Legal Person*

Scholars have been debating for a long time whether classical Roman Law had, in fact, developed a concept of the corporation as a legal person with legal attributes (owning property, the capacity to sue and be sued) separate not just from its members as individuals but also from its members as a group.[15] The classical texts are, in fact, ambiguous and reflect different views.[16] But one can already discern in them the three views of the corporation outlined above.

The artificial entity view, for example, is reflected in the following excerpt from the classical jurist Gaius:

> Partnerships, *collegia*, and bodies of this sort may not be formed by everybody at will; for this right is restricted by statutes, *senatus consulta*, and imperial *constitutiones*. In a few cases only are bodies of this sort permitted. For example, partners in tax farming, gold mines, silver mines, and salt works are allowed to form corporations. Likewise, there are certain *collegia* at Rome whose corporate status has been established by *senatus consulta* and imperial *constitutiones*, for example, those of the bakers and certain others and of the shipowners, who are found in the provinces too. Those permitted to form a corporate body consisting of a *collegium* or partnership or specifically one or the other of these have the right on the pattern of the state to have common property, a common treasury, and an attorney or syndic through whom, as in a state, what should be transacted and done in common is transacted and done.[17]

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[15]PATRICK W. DUFF, PERSONALITY IN ROMAN PRIVATE LAW (1938) argues in the affirmative; FRITZ SCHULTZ, CLASSICAL ROMAN LAW 88-102 (1951), and OTTO GIERKE, ASSOCIATIONS AND LAW: THE CLASSICAL AND EARLY CHRISTIAN STAGES 128-31 (George Heiman, trans., Univ. of Toronto Press 1977), in the negative.

[16]These texts are taken from the *Corpus Juris Civilis*, the major compilation of Roman Law performed under the Emperor Justinian in 528-534 AD. The *Corpus Juris Civilis* consists of three parts: The Institutes (Inst.), an introduction to the law in general; the Digest (Dig.), a collection of pronouncements of individual jurists, mostly from the classical period (the first two centuries AD); and the Code (Code), a collection of imperial statutes. The views of the classical jurists thus come to us in fragmentary fashion, and with the possibility of later editing or interpolation, so it is hard to be sure what any classical jurist actually said. For the Digest, the text edited by Mommsen and Krueger and translated by Alan Watson (1985) was used.

[17]Dig. 3.4.1 pr.-1 (Gaius, Provindial Edict 3) (Alan Watson trans. 1985).

The emphasis here is on the authority granted to the various types of corporations by the state: without imperial permission, they could not have legal personality, own property, or have an agent who can act in their name. In fact, we know from other sources that the Roman emperors were suspicious of private corporations, especially in the provinces, as potentially seditious, and refused permission to set up such corporations even for seemingly innocuous purposes.[18]

The aggregate view of the corporation as equivalent to its members acting collectively is reflected in the following excerpt from the classical jurist Paul:

> Citizens of a municipality can possess nothing of themselves, because the consent of all is not possible. Hence, they do not possess the marketplace, public buildings, and the like, but they use them in common. The younger Nerva, however, says that they can both possess and usucapt through a slave what he has acquired through his *peculium*; there are, however, those who think differently, since the citizens do not own the slaves themselves.[19]

This refers to the Roman concept of possession (*possessio*), which requires *animus* and *corpus*, the intention to possess and the capacity to hold;[20] Paul is saying that since the members of a corporation cannot have a single *animus*, they cannot actually own anything.[21] A similar aggregate view can also be discerned in the excerpt from Gaius cited above, where he discusses the members acting collectively through an agent. The same view is also

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[18] *See, e.g.*, Emperor Trajan's refusal to allow Pliny to set up a voluntary fire brigade at Nicomadea for fear it may be breeding ground for anti-Roman sedition. Pliny the Younger, Letters and Panegyricus 1.33-34 (Betty Radice trans., Harvard U. Press 1969); FRANCESCO M. DE ROBERTIS, IL FENOMENO ASSOCIATIVO NEL MONDO ROMANO [THE ASSOCIATIVE PHENOMENON IN THE ROMAN WORLD] (1981); SCHULTZ, *supra* note 15, at 97.

[19] Dig. 41.2.1.22 (Paul, Edict 54) (Alan Watson trans. 1985). This could be interpreted as saying that the municipal corporation itself possesses the property (supporting the real view), but this is not how the text was read in the Middle Ages. *See infra* text accompanying notes 27-38.

[20] Dig. 41.2.3.1 (Alan Watson trans. 1985); *cf.* WILLIAM W. BUCKLAND, A TEXTBOOK OF ROMAN LAW FROM AUGUSTUS TO JUSTINIAN 199-202 (3d rev. ed. by Peter Stein, Cambridge, Cambridge University Press, 1972).

[21] In another text, however, he seems to imply that the agent can act for the collective: "A legacy was left to townships, if they took an oath. The condition is not impossible of fulfillment. But how can the towns comply with it? The oath will be sworn by those who conduct the town's affairs." Dig. 35.1.97 (Paul, Neratius 2) (Alan Watson trans. 1985). Ulpian, on the other hand, believed that corporate bodies can be guilty of crimes that require intent. *See* Dig. 4.2.9.1 (Ulpian, Edict 11) (intimidation); *but cf.* Dig. 4.3.15.1 (Ulpian, Edict 11) (fraud).

reflected in the classical prohibition against instituting corporate bodies as heirs because they are "uncertain"—their membership is changing.[22]

The real view, finally, is mostly reflected in the excerpts of the classical jurist Ulpian. For example:

> If members of a municipality or any corporate body appoint an attorney for legal business, it should not be said that he is in the position of a man appointed by several people; for he comes in on behalf of a public authority or corporate body, not on behalf of individuals.[23]

Ulpian here uses *universitas* (corporate body) as equal to the *municipes* (members), and speaks of the representative as acting for the corporate body rather than on behalf of the "individuals," which can be consistent with the aggregate view; but he also states that the representative does not act for the "several people," which favors the real entity view that he acts for the corporation itself. Similarly, he states elsewhere that:

> [i]t has very frequently been written in rescripts that a slave belonging to a municipality [may] be tortured in capital cases affecting the citizens because he is not their slave but the state's, and the same should be said of other slaves belonging to corporate bodies; for the slave appears to belong, not to a number of individuals, but to the body [itself].[24]

This text likewise reflects Ulpian's real entity view of the corporation as separate not just from the individual members but also from the "number of individuals" in aggregate. A slave could not be tortured to give evidence against its master, but he could if the master was a corporation.[25]

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[22]Neither municipalities nor the members of a municipality can be instituted as heirs, because they are uncertain bodies, and cannot all decide to enter the inheritance nor act as an heir, so as to become heirs. EPITOME OF ULPIAN'S REGULAE 22.5. If this fourth century *Epitome* actually reflects Ulpian's views (which is unclear), it seems inconsistent with other excerpts from his writings, which reflect a real entity view of the corporation. This prohibition was gradually relaxed by various emperors and was finally abolished in 469 AD. *See* Code Just. 6.24.8 (Diocletian & Maximian 290 AD); Code Just. 1.12.1 (Arcadius & Honorius 321 AD); Code Just. 6.24.12 (Leo 469 AD).

[23]Dig. 3.4.2 (Ulpian, Edict 10).

[24]Dig. 48.18.1.7 (Ulpian, Duties of Proconsul 8).

[25]Similarly the concept of limited liability: "A debt to a corporate body is not a debt to individuals and a debt of a corporate body is not a debt of individuals." Dig. 3.4.7.1 (Ulpian, Edict 10). But this text is more ambiguous because it can be interpreted as distinguishing the debts owed by the individual members from debts owed by them as a group. *See also* Gaius Inst.

Finally, consider the following:

> As regards decurions or other corporate bodies, it does not matter whether all the members remain the same or only some or whether all have changed. But if a corporate body is reduced to one member, it is usually conceded that he can sue and be sued, since the rights of all have fallen to one and the corporate body continues to exist in name only.[26]

In this text Ulpian envisages the corporate body as remaining unchanged as the membership changes, and he even considers the possibility of a "corporation soul." This is the clearest evidence of the real entity view in the Roman texts; but note that not even Ulpian could imagine a corporation continuing to exist without any members.

The same debate continued through the Middle Ages. Consider the following examples, which come from the *Ordinary Gloss* by Franciscus Accursius (1182-1258) written around 1250, which summarized the previous century's work by the jurists in Bologna commenting on the *Corpus Juris Civilis*.

First, the artificial entity view:

> *Of others*: Which are many: The congregation of any city, village or castle . . . similarly any congregation to uphold justice, such as the Tuscan scholars or the entire university . . . similarly religious congregations. . . . And because certain societies are permitted, as the text says, it is clear that normally they are prohibited. . . . But can a society, such as that of scholars living in one inn, appoint an agent [to sue]? It seems they can, if the case is the society's, as it is a permitted society.[27]

Here, Accursius emphasizes the need for a society to get permission from the state to have legal personality, just as Gaius did in the text he was commenting upon. The identity of the state has changed (the Bolognese

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2.11: What is public is considered to be nobody's property, because it is believed to belong to the corporate body itself. Private goods belong to individual people. Again, the distinction is between property owned by individuals and the collective.

[26]Dig. 3.4.7.2 (Ulpian, Edict 10).

[27]FRANCISCUS ACCURSIUS, GLOSSA ORDINARIA [ORDINARY GLOSS] (1658) on Dig. 3.4.1.1 (cited above) v. aliorum. The translation of this and other medieval texts is the author's.

jurists professed allegiance to the German emperors), as did the identity of the corporations, but the concept is similar.

The aggregate view can be seen in Accursius' definition of the agent as "*Syndicus*: Who acts for any corporate body, but only for the many . . . for he is called *syndicus* because he argues (*dicens*) cases for the single ones (*singulorum*)."[28] Here the agent is seen as speaking for the members as a collective, as opposed to the members as individuals.[29] Similarly, Accursius rejected the concept of limited liability, requiring the members to be liable for debts of the corporation, which again reflects the aggregate view.[30] And he allows departing members to take their share, although not of inheritances or other property that belonged to the corporation itself.[31]

In yet other locations, the real entity view predominates, even when it requires challenging the Roman authorities. For example, "The people are called by trumpet or by bell or by voice, and even though they do not all come, the majority of two thirds can consent. . . . Thus this law conceives they cannot all will together easily. . . . But they can with difficulty."[32]

> It is as if [Paul] said not easily, because they cannot will together easily . . . but they can with difficulty, so as when a bell is tolled, because all are considered to have done what the council or a majority did . . . and they can commit intimidation . . . and obtain possession . . . and elect a tribune

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[28] *Id.* on D.3.4.1.1 (cited above) v. syndicum.

[29] *See also id.* on Code 10.31.30 v. reipublicae: "And say that they all act through the agent or *syndicus* whom they elect"; *id.* on Dig. 3.4.2 v. haberi (cited above): "An agent stipulates for the corporate body, not for its individual members."

[30] "But what if they have nothing common to satisfy creditors? They must be compelled to make collections so that they will have something in common." ACCURSIUS, *supra* note 27, on Dig. 3.4.1.2 v. proconsul.

[31] "Or say that whatever colleges and corporate bodies have also belongs to the single [members], and whoever withdraws receives his portion, because they have something in common through combining goods of the individual members ... but when a legacy is left to a college or a town, it is left only to those who are members of the college, and they divide it, so that if anyone withdraws, he receives nothing, because it does not belong to the single individuals [as such], but to the town's citizens or to the members of the college." ACCURSIUS, *supra* note 27, on Dig. 47.22.1.1 v. competit. "But what if the corporate body is dissolved, can any member demand his portion as a proper and private debt? [Yes], because that is the rule [when the body still exists], here therefore even more so. . . . But if some corporate body has a common grove that is otherwise undivided, should the creditors be given possession of that part that seems to belong to them? I do not think so, because neither the grove nor any part thereof belong to anybody." *Id.*, on Dig. 3.4.7.1 v. non debetur.

[32] *Id.*, on Dig. 50.160.1 v. refertur (citing Dig. 41.2.1.22 (cited above)).

> or leader . . . for this question notes the rarity, not the impossibility [of doing so].[33]

Here Accursius rejects Paul's view that corporate bodies cannot own anything because they cannot will together, referring to the notion that the majority of the members can act for the corporate body.[34] Likewise,

> What if a member of a corporate body injures you, can the corporate body be said to have done it and be sued by you? It seems that not, because he did it out of his own will, not as a corporate body, i.e., after deliberation and sounding a bell or having been otherwise gathered together. On the contrary, yes, because a corporate body is nothing more than the people who are there.[35]

The last sentence clearly reflects the aggregate view. When Accursius considers the question of what happens when the membership changes, however, he seems to reject the aggregate view in favor of the real entity view:

> Some say that goods that belong to a college belong to the people, or to many single individuals . . . but they do not concede that if those [individuals] die the people is dead, because others are considered (*finguntur*) to take their place. Thus the emitted cry perishes, but not your voice. But what is argued to the contrary, that the goods do not belong to

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[33] *Id.*, on Dig. 4.3.15.1 v. facere possunt (cited above).

[34] Similarly: "They are like one body, whether all are present or whether two thirds are, and whatever the majority of this present body does, is valid." ACCURSIUS, *supra* note 27, on Dig. 3.4.3 v. due partes: "[Rogerius said that] members of municipalities cannot possess, but those to whom the administration of the members is entrusted . . . . [Accursius]: They can properly possess through those to whom the municipality's affairs are entrusted." *Id.*, on Dig. 41.2.1.22 v. adquiratur (cited above). Accursius also makes a distinction between what can happen naturally and "by law": "Here it is doubted whether they can all swear by nature, but similarly children and others who are like a corporate body, who cannot swear by nature, but can by law." *Id.*, on Dig. 35.1.97 v. geruntur (cited above). And he rejects the notion that corporate bodies are "uncertain": "It is no objection that a corporate body is said not to be able to consent, because it should be understood as 'easily' . . . or add by the order of those who manage the corporate body." *Id.*, on Dig. 29.2.25.2 v. adibit; *see also id.*, on Dig. 4.2.9.1 v. collegium (corporate bodies can be guilty of fraud and intimidation).

[35] ACCURSIUS, *supra* note 27, on Dig. 3.4.7.1 v. non debetur (above).

> single individuals, is true, as can be proven by the law against torturing slaves.[36]

This text conceives of the membership corporation as unchanging even though the individual members change. This could still be consistent with the aggregate view (the membership remains as a collective), but the rejection of the view that the goods belong to many single individuals and the citation to Ulpian suggests the real entity view.

Finally, consider the following:

> Even though a single person cannot be a corporate body, he still retains the rights of the corporate body, even though a single person cannot constitute a corporate body initially, but only three persons. . . . But can he appoint a *syndicus*, who argues cases for the many, or [at least] for two? It seems so. . . . But what if nobody at all remains, [asks] Johannes [Bassianus]? The college is then dissolved, and the goods belong to nobody, like inherited goods. But if thereafter by authority of the Pope or whoever is in charge of that college, someone is appointed to that college, by the artifice of the law the goods are considered (*fingitur*) to belong to him. . . . Even though some Bishop Moses said that the walls themselves possess even during the existence of the college, which seems very difficult to say and contrary to the law. To the contrary, in no way do the goods belong to anyone, but once the college has been dissolved, by the law they belong to the fisc or the Pope. . . . But it can be said for Moses, that the church is frequently called the place itself which is surrounded by walls and consecrated; and it is also said that the church can have rights and possess and sue . . . thus the location itself, or the walls, possess even while the college exists, through the priest, like a private person through an agent.[37]

In this gloss on Ulpian, Accursius goes beyond his Roman source to ask (following his predecessor Johannes Bassianus) what happens if all members of a corporation die. He then resorts to the artificial entity theory to argue that the state should appoint a replacement; alternatively, he states

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[36] *Id.*, on Dig. 47.22.1.1 v. competit.

[37] *Id.*, on Dig. 3.4.7.2 v. nomen universitatis (cited above).

that the college ceases to exist, consistent with the aggregate view.[38] But he also mentions the possibility that the "location" of the corporation continues to exist, which is closer to the real entity view. There is no resolution: all three views co-exist in this text.

A hundred years later, however, the real entity view comes to predominate. This can be seen in the following examples from the work of Bartolus of Sassoferato (1314-1357), the most important of the Commentators, who were the generation that followed the Glossators in further developing the interpretation of the Roman text. The work of Bartolus was influential well into the nineteenth century, i.e., until the codification movement, which replaced the *Corpus Juris Civilis* as the main source of civil law.[39]

Bartolus clearly adhered to the real entity view of the corporation. First, he rejected the artificial entity view that permission by the state is needed to set up a corporation: "If some people want to settle in some place, and create a city, castle, or village, they can do so, as it is permitted by the law of nations."[40] This is understandable because by Bartolus' time the Holy Roman Empire had ceased to exist as a force in Italian political life and the Italian city-states were independent municipal corporations.[41]

Second, Bartolus clearly envisaged the corporation remaining even if all of its members perish: "What if this university [Perugia] were to perish by pestilence, and nobody remained? . . . The privileges would

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[38]The reference to the Pope may be a reflection of the work of Accursius' contemporary *Innocent IV*, who developed the concept of the corporation as artificial entity and applied it to the Church. *See, e.g.*, INNOCENT IV, *Commentary* on X.2.12.4: "From this we order, and because of it we say, that whenever the priest and all the clergy of a church die, nevertheless the property remains in Christ who lives forever, or in the universal Church, which never dies." Similarly: "A corporate body, like a chapter, the people, and similar [entities], are legal names, not persons, and therefore they cannot be excommunicated." *Id.* on X.5.39.52; "It is proper that they swear through one, because a college in a case of the corporate body is fictively considered a person." *Id.* on X.2.20.57 n.5.

[39]For development of the corporate personality between Bartolus and the nineteenth century, *see, e.g.*, THOMAS J. KILCULLEN, THE COLLEGIATE MORAL PERSON AS PARTY LITIGANT (1947) (canon law); F.M. HUSSEN-DE GROOT, RECHTSPERSONEN IN DE 19E EEUW: EEN STUDIE VAN PRIVAATRECHTLIJKE RECHTPERSONEN IN DE 19E EEUWSE WETGEVING VAN FRANKRIJK, NEDERLAND EN DUITSLAND [JURIDICAL PERSONALITIES IN THE 19TH CENTURY: A STUDY OF PRIVATE LAW JURIDICAL PERSONALITIES IN THE 19TH CENTURY JURISPRUDENCE OF FRANCE, THE NETHERLANDS AND GERMANY] (1976) (France, the Netherlands, Germany); FREDERICK HALLIS, CORPORATE PERSONALITY (1930) (England).

[40]BARTOLUS OF SASSOFERATO, *Commentary* on Dig. 3.4.1.1 (cited above) (1653).

[41]Following the death of Emperor Frederick II (1250), there was a long interregnum which weakened the empire and strengthened the Italian city states. The premature death of Henry VII (1314) effectively eliminated the last chance that the Empire would be restored to the position it held in the middle of the twelfth century. *See* DANTE ALIGHIERI, VITA NUOVA [THE NEW LIFE] (1988).

remain in the place where it was."[42] This commentary was probably written after the Black Death of 1347-1348 swept through Europe, so it reflects the reality of Bartolus' time. But it also goes beyond Accursius and Ulpian to reject the aggregate view.

Instead, Bartolus developed the concept of the corporation as *persona representata*—a legal personality that is separate from both the state and its members—but that had to act through agents. For example:

> A corporate body is a legal name, and it does not have a soul or an intellect. Therefore it cannot commit crimes. . . . Others say, that corporate bodies can commit crimes. . . . We must consider first, whether a corporate body differs from its members? Some say no, like the philosophers and canonists, who hold that the whole does not really differ from its parts. The truth is, that if we speak about reality proper, those say the truth. For a university of scholars is nothing other than the scholars. But according to legal fiction they err. For a university represents a person, which is different than the scholars, or its members. . . . Thus, if some scholars leave and others return, nevertheless the university stays the same. Similarly if all members of a people die and others take their place, the people is the same . . . and thus a corporate body is different from its members, by legal fiction, because it is a represented person. . . . [Thus] a corporate body can commit crimes of omission, because the corporate body itself omits, even though it is done by the negligence of its rulers. . . . [Some crimes of commission] can be committed by corporate bodies, nor can it be said that somebody private did it, but the corporate body itself . . . [murder and other acts of violence] cannot be committed by the corporate body itself, for that requires a real person . . . but they can be committed by its rulers . . . but it cannot be beheaded, as it has no real head, but only a fictive one.[43]

This text shows that Bartolus had a clear vision of the corporation as separate both from the state and from its members. It was a "legal fiction" that could have the basic attributes of legal personality, i.e., the capacity to own property, sue and be sued, and even commit crimes, although in all

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[42] BARTOLUS, *supra* note 40, *Commentary* on Dig. 47.22.4. *See also id.* on Dig. 3.4.7.2: "Even though the individuals change, the corporate body remains the same."

[43] *Id.* on Dig. 48.19.16.10.

these respects it had to act through its agents, and it was not subject to certain kinds of punishment.[44]

What enabled Bartolus to go beyond his Roman and medieval sources to reach this conclusion? In part, it was a natural evolution of moving away from and beyond the ancient text through the process of commentary and debate, which can also be seen in medieval commentary on Aristotle.[45] Interestingly, it was the rise of universities that enabled this unique process of comment and debate to take place in the West, and the rise of universities in turn was premised on the availability of the corporate form.[46]

But Bartolus was also influenced by external factors, the most important of which were the decline of the Holy Roman Empire, which led to the abandonment of the artificial entity theory that corporations needed imperial permission to exist, and the rise of independent corporations in Italy such as the city state and the Italian universities. For these corporations to maintain their independence, they needed to be seen as separate both from the state and from their members, because even the collective membership could perish. Bartolus and his colleagues did not want the privileges and property of the university to revert to the Popes or the Emperors should the membership change all at once. Hence, the natural theory for Bartolus to embrace as representative of the university was the real entity theory, which enabled the university to maintain its independence both from the state and from its members.[47]

We thus see that in the period between the classical Roman jurists in the second century AD and the Commentators in the fourteenth century the concept of the corporation as a legal person gradually evolved, and that as this evolution proceeded all three theories of the corporation (aggregate, artificial entity, and real entity) were brought forward by various legal commentators. We also see that in the end, aided by external factors such as the decline of the state, the real entity theory, which most closely reflects the views and interests of corporate management, emerges as the dominant theory. As we shall see, this pattern of debate among the three theories followed by the triumph of real entity theory is typical of subsequent transformations in the role of the corporation, as well.

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[44]*See also id.*, *Commentary* on Dig. 41.2.2 (corporate body as represented body can possess property); *id.* on Dig. 34.5.21 (an inheritance left to the corporate body is not the same as an inheritance left to its members).

[45]*See, e.g.*, AVI-YONAH, *supra* note 14.

[46]*Id.*

[47]*See* AVI-YONAH, UNIVERSITAS: THE DEVELOPMENT OF CORPORATE PERSONALITY FROM LABEO TO BARTOLUS (1989).

B. *Second Transformation: From Non-Profit to For-Profit Corporations*

The period between Bartolus (mid fourteenth century) and the late eighteenth century was one of relative stability in the development of the corporate form. The corporation was established as a membership corporation, i.e., a corporation made up of members who selected their own successors, as do the President and Fellows of Harvard College to this day, for example. As such, a corporation had legal personality—the rights to own property, sue and be sued, act under a common seal, and other such "chestnuts."[48] Private corporations were used primarily for non-profit purposes (e.g., hospitals and universities), but by the eighteenth century there were also some commercial corporations (e.g., the East India Company).[49]

From our perspective, there were two significant developments in this period. The first was the reassertion of royal control over corporations; in England and other European countries corporations could only be established by royal charter. Blackstone notes that although in Roman law corporations could be established without "the prince's consent," "with us in England, the king's consent is absolutely necessary."[50] Second, some degree of outside control over management was established through the institution of the committee of visitors, which represented the interests of the founder and of the wider community.[51]

But other than in extraordinary cases, the real entity view of the corporation prevailed throughout this period and management (the members) were firmly in control. "A corporation aggregate of many is invisible, immortal, and rests only in intendment and consideration of the law."[52] As such, it was a self-perpetuating body subject to relatively little outside regulation. Corporations, Blackstone notes, are "artificial persons, who may maintain a perpetual succession, and enjoy a kind of legal immortality."[53] When the members

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[48]ROBERT C. CLARK, CORPORATE LAW (1989). As we have seen, these "chestnuts" were not at all self-evident.

[49]See the classification and description of various corporations in 1 WILLIAM BLACKSTONE, COMMENTARIES ch. 18 (1765).

[50]*Id.* at 460; Tipling v. Pexall, 3 Bulstrode 233 (1614) ("the King creates them"). For an example of a charter enumerating corporate legal rights, see *Case of Sutton's Hospital*, 77 Eng. Rep. 937 (1612) (KB).

[51]BLACKSTONE, *supra* note 49, at 467-69.

[52]*Sutton's Hospital*, 77 Eng. Rep. at 973.

[53]BLACKSTONE, *supra* note 49, at 455.

> are consolidated and united into a corporation, they and their successors are then considered as one person in law: as one person, they have one will, which is collected from the sense of the majority of the individuals . . . for all the individual members that have existed from the foundation to the present time, or that shall ever hereafter exist, are but one person in law, a person that never dies.[54]

This one person then acquires all the rights of corporations, including perpetual succession, the right to sue and be sued, the right to own property, to have a common seal, to make by-laws, and to be subject to certain criminal liabilities.[55] The king constituted corporations, and the king or other visitors exercised some degree of supervision over them, but once established, the corporation (i.e., its members) remained subject to relatively little outside regulation.

This situation meant that corporate status was very desirable, especially since the members also enjoyed limited liability for corporate debts.[56] But the English Kings were very cautious with granting corporate charters, especially in the case of for-profit enterprises; only corporations that were clearly vested with a public purpose and benefited the public fisc, like the East India and Hudson Bay Companies, received royal approval, and accumulated vast power. As more capital was required for commercial enterprises this resulted in promoters organizing corporations with transferable shares and claiming that under authority of a lost or obsolete charter the shareholders enjoyed limited liability. After the South Sea Bubble burst in 1720, this problem (and the desire of the South Sea Company to retain its monopoly) led to the Bubble Act, under which it became a crime to organize such corporations without explicit royal consent.[57] Although prosecutions under the Bubble Act were rare, it meant that the entire Industrial Revolution in England (1760-1820) took place outside the corporate form and without limited liability.[58] The Bubble Act

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[54] *Id.* at 456.

[55] *Id.* at 463-64.

[56] Although this was not clear in the Roman sources, it was well established by Blackstone's time for royally chartered corporations. "The debts of a corporation, either to or from it, are totally extinguished by its dissolution, so that the members cannot recover, or be charged with them, in their natural capacities." *Id.* at 472 (citing Ulpian).

[57] The Bubble Act, 6 Geo. I c. 18 (1720). *See* RON HARRIS, INDUSTRIALIZING ENGLISH LAW: ENTERPRENEURSHIP AND BUSINESS ORGANIZATION 64-65 (2000).

[58] For attempts to avoid the Bubble Act which led to prosecutions, see *King v. Dodd*, 103 Eng. Rep. 670 (1808) (K.B.), and *King v. Webb*, 480 Eng. Rep. 658, 663-64 (1811) (K.B.). *See* HARRIS, *supra* note 57.

was ultimately repealed in 1825, after the Industrial Revolution was over, but with the provision of unlimited liability for shareholders, which continued to be the rule in England until 1855.[59]

This situation, which can be seen as a way of maintaining state control over corporations through restrictions on charters, meant that the next great shift in the use of corporate form took place in the fledgling United States. There, once the revolution was over, every state could issue corporate charters. The result was an explosion of charters for commercial enterprises. One of the first treatises written on corporate law was Joseph Angell and Samuel Ames' *Treatise on the Law of Private Corporations Aggregate*, published in Boston in 1832.[60] Angell and Ames begin their book by stating:

> The reader does not require to be told, that we have in our country an infinite number of corporations aggregate, which have no concern whatever with affairs of a municipal nature. These associations we not only find scattered throughout every cultivated part of the United States, but so engaged are they in all the varieties of useful pursuit, that we see them directing the concentration of mind and capital to . . . the encouragement and extension of the great interests of commerce, agriculture, and manufacturing. There is a great difference in this respect between our own country, and the country from which we have derived a great portion of our laws. What is done in England by combination, unless it be the management of municipal concerns, is most generally done by a combination of individuals, established by mere articles of agreement. On the other hand, what is done here by the co-operation of several persons is, in the greater number of instances, the result of a consolidation effected by an express act or charter of incorporation.[61]

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[59]Bubble Act Repeal, 6 Geo. IV c. 91 (1825); Limited Liability Act, 18 & 19 Vict. C. 133 (1855).

[60]Angell and Ames were preceded by the English work of John Kyd, published in London in 1793, but that treatise was devoted primarily to municipal corporations. *See* JOSEPH K. ANGELL & SAMUEL AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE vi (1832). The Angell & Ames treatise was very successful, with eleven editions published until 1875.

[61]*Id.* at v; *see also id.* at 35:

> In no country have corporations been multiplied to so great an extent, as in our own. . . . There is scarcely an individual of respectable character in our community, who is not a member of, at least, one private company or society which is incorporated. . . . Acts of incorporation are moreover continually

The main reason for this proliferation of corporations in the United States was the second great transformation in the role of the corporation in society: from primarily a non-profit to primarily a for-profit enterprise. As Judge Kent stated:

> [T]he multiplication of corporations in the United States, and the avidity with which they are sought, have arisen in consequence of the power which a large and consolidated capital gives them over business of every kind; and the facility which the incorporation gives to the management of capital, and the security which it affords to the persons of its members, and to their property not vested in the corporate stock.[62]

This was a profound shift, and not surprisingly it led to a revival of the centuries-old debate about the nature of the corporate form and its relationship to the shareholders and to the state. This debate can be seen if we examine the opinions on the subject issued by the first great American jurist, John Marshall. Three of Marshall's opinions, written decades apart, are particularly relevant here: *Bank of the United States v. Deveaux* (1809),[63] *Trustees of Dartmouth College v. Woodward* (1819),[64] and *Bank of the United States v. Dandridge* (1827).[65] These opinions represent the evolution of his thinking on corporations, which moved from the aggregate view (Deveaux) to the artificial entity view (Dartmouth College) to the real entity view (Dandridge).

Deveaux involved an attempt by the state of Georgia to tax the Savannah branch of the Bank of the United States, a corporation established by Congress in 1791, during the early struggles around federalism. The Bank was a membership corporation ("The President, Directors and Company of the Bank of the United States") and all the members were citizens of Pennsylvania. The Bank refused to pay the tax and the State sent its collectors to enforce payment, whereupon the Bank sued the collectors in federal court, claiming diversity jurisdiction. The issue facing the court was whether a corporation made up of members from one state could sue citizens of another state in federal court on diversity

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solicited at every session of the legislature.

[62] *Id.* at 36 (citing 2 Kent's Com. 219). The last sentence refers to limited liability, which will be discussed *infra*.

[63] 9 U.S. (5 Cranch) 61, 64-65 (1809).

[64] 17 U.S. (4 Wheat.) 518, 550, 551-54 (1819).

[65] 25 U.S. (12 Wheat.) 64, 91-92 (1827) (Marshall, C.J., dissenting).

grounds. This in turn required deciding between the view that "the individual character of the members is so wholly lost in that of the corporation, that the court cannot take notice of it," and the contrary view that "a corporation is composed of natural persons," i.e., between the entity (artificial or real) and aggregate views.[66]

Marshall decided in favor of the aggregate view. He stated that the corporation itself, "that mere legal entity," cannot be a citizen or sue in federal court, unless it can be regarded as "a company of individuals."[67] However, since the reasons that led Congress to enact diversity jurisdiction applied to corporations as well, Marshall was inclined to see the controversy as being between the members "suing in their corporate character" and their opponents.[68] "The controversy is substantially between aliens, suing by a corporate name, and a citizen . . . in this case the corporate name represents persons who are members of the corporation."[69] The Court therefore held that federal jurisdiction existed.

Ten years later Marshall was faced with another difficult issue involving corporations. In the famous *Dartmouth College* case, the state of New Hampshire attempted to alter the charter of Dartmouth College (incorporated as a membership corporation by George III in 1769, under the name of The Trustees of Dartmouth College) by transferring the appointment of trustees to the state, thereby effectively taking it over. The trustees objected, arguing that the charter constituted a contract and altering it violated the contracts clause of the Constitution.[70]

Marshall held that because the College was a private corporation, its charter was a contract and was protected by the contracts clause. He began by noting that the funds for the College came from private sources and its educational character did not make it public either. He then got to the heart of the question—whether the act of incorporation by the state makes it possible for the state to take it over. In frequently quoted language, Marshall held that "[a] corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence."[71]

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[66] *Deveaux*, 9 U.S. at 63-64.

[67] *Id.* at 86-87.

[68] *Id.* at 87-88.

[69] *Id.* at 91.

[70] *Trustees of Dartmouth College*, 17 U.S. at 557.

[71] *Id.* at 636.

This language reflects the artificial entity view of the corporation. But Marshall then went on to note that, having created the corporation, the state may not treat it as a mere extension of itself: "this being does not share in the civil government of the country, unless that be the purpose for which it was created."[72] Even though its object is to promote governmentally approved aims, this does not make corporations into mere instruments of government. Instead, the corporation exists to represent the interest of the founder and his descendants in the aims for which it was founded.[73] This interest in the United States is protected by the contracts clause, although in England, Marshall recognized that Parliament had the power to annul the charter.[74] In this country, "the body corporate, as possessing the whole legal and equitable interest, and completely representing the donors, for the purpose of executing the trust, has rights which are protected by the constitution."[75]

It should be noted that while Marshall held that the state may not take over a private corporation, even one founded for public ends, the emphasis on the artificial nature of the corporation left ample room for state regulation via the original charter. Since states were busy granting charters by the hundreds, the Dartmouth opinion enabled the states to regulate corporations, should they wish to do so.

Six years later, Marshall was once more called to opine on the nature of corporations in another case involving the Bank of the United States.[76] The case involved a suit by the Bank on a bond executed by Dandridge, one of its cashiers, in which the defendant argued that the bond had never been approved by the Board of Directors, as required by the charter of incorporation. The key issue was whether the level of evidence required of corporations was higher than that required of individuals, since corporations are incapable of acting not in writing. Justice Story, for the Court, held that no distinction should be made: "the same presumptions are . . . applicable to corporations."[77] Marshall, however, dissented. He argued:

> The corporation being one entire impersonal entity, distinct from the individuals who compose it, must be endowed with a mode of action peculiar to itself, which will always

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[72] *Id.*

[73] *Id.* at 642.

[74] *Trustees of Dartmouth College*, 17 U.S. at 642-43.

[75] *Id.* at 654.

[76] *See* Bank of the U.S. v. Dandridge, 25 U.S. (12 Wheat.) 64 (1827).

[77] *Id.* at 70.

> distinguish its transactions from those of its members. This faculty must be exercised according to its own nature. . . . This can be done only in writing.[78]

The Court's view was the more pragmatic one, but Marshall's view was more consistent with the real entity view of the corporation as distinct from its members, individually or collectively. It certainly forms an interesting contrast with the views he expressed in the *Deveaux* case sixteen years earlier.

How can one explain the shift in Marshall's view of the corporation from aggregate (*Deveaux*) to artificial (*Dartmouth College*) to real (*Dandridge*)? In part, this stems from the circumstances of these particular cases. In *Deveaux*, Marshall wanted to confer diversity jurisdiction to protect a federal institution (he was after all a Federalist), and the only way to do so was to look through the corporation to its members. In *Dartmouth College*, the issue involved the relationship between private corporations (albeit "imbued with a public purpose"; the full fledged private/public distinction had not yet evolved) and the state, and Marshall emphasized the role of the state in creating the corporation, while placing clear limits on its ability to regulate corporations thereafter. These limits were required as the result of the proliferation of corporations, especially for-profit business corporations, since otherwise the state would be able to take over purely private businesses. The result in *Dartmouth College* favored in practice the real entity view, because once a private corporation was created, it could no longer be taken over or perhaps even be overly regulated by the state. Thus, it may not be surprising that by the time he came to write his *Dandridge* dissent Marshall took the real entity view, even though it contradicted his opinion in *Deveaux* (which is not mentioned).

Two important legal developments during the same period strengthened the real entity view and weakened the aggregate and artificial entity views of the corporation: the rise of limited liability and the spread of general incorporation laws. Limited liability weakened the aggregate view, and general incorporation weakened the artificial entity view.

First, limited liability: As we have seen, in England limited liability did not exist for corporations until 1855. In the United States, however, most states adopted limited liability in the 1830s.[79] In their second edition, Angell & Ames explain that this was the primary distinction between a partnership and a corporation:

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[78] *Id.* at 91-92.

[79] PHILLIP I. BLUMBERG, THE MULTINATIONAL CHALLENGE TO CORPORATION LAW 11-12 (1993).

> In every private unincorporated company, the members are liable for the debts without limitation, whereas in incorporated societies, they are only liable to the extent of their shares. . . . It is frequently the principal object, in this and in other countries, in procuring an act of incorporation, to limit the risk of the partners to their shares in the stock of the association; and prudent men are always backward in taking stock when they become mere copartners as regards their personal liability for the company debts.[80]

When Angell & Ames wrote this limited liability was by no means a universally established rule for corporations;[81] they were thus trying to establish the law as much as describing the law that existed. Their main argument, familiar from current debates on limited liability,[82] was that "[t]he public, therefore, gain by acts incorporating trading associations, as by such means persons are induced to hazard a certain amount of property for the purposes of trade and public improvement, who would abstain from doing so, were not their liability limited."[83]

Eventually this argument won the day, and by 1840 most of the states established limited liability.[84] Limited liability, in turn, led to a decline in the emphasis on the aggregate theory, because the aggregate view of corporations tends to reduce the distinction between the corporation and its members or shareholders, which is at the heart of limited liability.[85]

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[80] ANGELL & AMES, *supra* note 60, at 23; *see also id.* at 349: "No rule of law we believe is better settled, than that, in general, the individual members of a private corporate body are not liable for the debts."

[81] BLUMBERG, *supra* note 79, at 11-12.

[82] *See, e.g.*, Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 388 (1992); Henry Hansmann & Reinier Kraakman, *Do the Capital Markets Compel Limited Liability? A Response to Professor Grundfest*, 102 YALE L.J. 427 (1992); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991); Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 COLUM. L. REV. 1203, 1204-05 (2002).

[83] ANGELL & AMES, *supra* note 60, at 24. Angell and Ames go on to argue that states who pursue the contrary policy, like Massachusetts, "drive millions of capital into the neighboring states for investment"—an early instance of a "race" (to the top or bottom). *Id.* at 362.

[84] This was subject to one limitation, the "trust fund" doctrine, which held that the capital stock of corporation was to be held in trust for paying corporate debts and thus could not be distributed to shareholders while debts were outstanding. *See* Wood v. Dummer, 30 F. Cas. 435, 439-40 (C.C.D. Me. 1824) (No. 17,944).

[85] *See generally* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 388-90 (2003) (arguing that the main purpose of incorporation in the nineteenth century was to "lock in" capital in the firm because shareholders cannot force distributions, in exchange for limited liability); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J.

The decline of the aggregate view can clearly be seen in two cases from the period 1839-1844, in which the Supreme Court repudiated Marshall's opinion in *Deveaux*. In *Bank of Augusta v. Earle*, the Court held that a corporation incorporated by Georgia may execute a valid contract in Alabama on comity grounds, but it rejected the argument that Alabama was required to accept the contract on the basis of the privileges and immunities clause applied directly to the corporation's members (as required by the aggregate view), stating that *Deveaux* has never been extended that far. Chief Justice Taney emphasized that he rejected the aggregate view because of its implications for limited liability, as well as its implications for state regulation of the corporations operating in it:

> The result of this [aggregate view] would be to make a corporation a mere partnership in business, in which each stockholder would be liable to the whole extent of his property for the debts of the corporation. . . . Besides, it would deprive every state of all control over the extent of corporate franchises proper to be granted in the state.[86]

In *Louisville, Cincinnati, & Charleston Railroad Co. v. Letson*, decided in 1844, the Court explicitly limited *Deveaux* to its facts, holding that diversity jurisdiction may arise even when some of the members of a defendant corporation are citizens of the same state as the plaintiff.[87] The Court stated that the *Deveaux* results "have never been satisfactory to the bar" and that a corporation "seems to us to be a person, although an artificial one, inhabiting and belonging to that state [of incorporation], and therefore entitled, for purposes of suing and being sued, to be deemed a citizen of that state."[88]

This result was required by the proliferation of business corporations having many shareholders in many states, as opposed to the membership corporations of Marshall's early days. As Angell & Ames stated, by 1832 "[j]oint stock companies are composed of persons who seldom know any thing of the business of the company, but who leave the management of it

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387, 393 (2000) (describing the "core defining characteristic of a legal entity" as the "partitioning off of a separate set of assets in which the creditors of the firm have a prior security interest").

[86]Bank of Augusta v. Earle, 38 U.S. (13 Pet.) 519, 586-87 (1839).

[87]43 U.S. (2 How.) 497, 559 (1844).

[88]*Id.* at 555. *See also* Marshall v. Baltimore & Ohio R.R., 57 U.S. (16 How.) 314, 329 (1853) (holding that for diversity purposes a corporation should be deemed a resident of its place of incorporation). This led to the current rule, adopted in 1958, under which a corporation is for diversity purposes a citizen of both the state it is incorporated in and the state in which it has its principal place of business. 28 U.S.C. § 1332(c)(1) (2001).

entirely to a body of directors, and are contented with receiving such periodical dividends as the directors think proper to make."[89] The separation of management from ownership, and the rise of limited liability, rendered the aggregate view implausible.[90]

Second, general incorporation: The granting of corporate charters by state legislatures became in the 1820s and 1830s a process fraught with corruption.[91] Some Jacksonians reacted by advocating elimination of the rights of states to grant corporate charters. But the corporate form was so widely used that this was impracticable; instead, laws were passed in all the states permitting anyone to form a corporation on payment of a fee, without permission by the state legislature.[92] This democratizing move meant that the artificial entity theory, under which the corporation derives its powers from the state, lost most of its appeal because the state was only vestigially involved in creating corporations. Instead, corporations were viewed as

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[89] ANGELL & AMES, *supra* note 60, at 32 (emphasis omitted).

[90] See also Chief Justice Shaw's statement in *Burrill v. Nahant Bank*, 43 Mass. 163 (1840), that

> [a] board of directors of the banks of Massachusetts is a body recognized by law. By the by-laws of these corporations, and by a usage, so general and uniform as to be regarded as part of the law of the land, they have the general superintendence and active management of all the concerns of the bank, *and constitute, to all purposes of dealing with others, the corporation*.

Id. at 166-67 (emphasis added). It is hard to imagine a clearer rejection of the aggregate view. Similarly, in *Hoyt v. Thompson's Executor*, decided by the New York Court of Appeals in 1859, the court held that

> in corporate bodies the powers of the board of directors are, in a very important sense, original and undelegated. The stockholders do not confer, nor can they revoke those powers. They are derivative only in the sense of being received from the State in the act of incorporation. The directors convened as a board are the primary possessors of all the powers which the charter confers, and like private principals they may delegate to agents of their own appointment the performance of any acts which they themselves can perform. The recognition of this principle is absolutely necessary in the affairs of every corporation whose powers are vested in a board of directors. Without it the most ordinary business could not be carried on, and the corporate powers could not be executed.

9 N.Y. 207, 216 (N.Y. 1859). This constitutes a recognition that the aggregate view deriving from the membership corporation could not be maintained as a practical matter in corporations with hundreds or thousands of shareholders, as already existed in the 1850s.

[91] *See* ANGELL & AMES, *supra* note 60, at 35-36

[92] *See, e.g.*, the act adopted in 1837 by Connecticut permitting incorporation of "any lawful business," 1837 Conn. Pub. Acts 49, and various cases upholding such laws, *e.g.*, *Nesmith v. Sheldon*, 48 U.S. (7 How.) 812, 817-19 (1849). See also President Jackson's veto message of the second bank of the United States, *cited in* John Merquez Lindin, *The Law of Equality Before Equality was the Law*, 49 SYRACUSE L. REV. 1137, 1175 (1999) ("If [the government] would confine itself to equal protection, and, as Heaven does its rains, shower its favors alike on the high and the low, the rich and the poor, it would be an unqualified blessing.") (emphasis omitted).

separate from both their shareholders and the state, and the real entity view reigned supreme.[93]

C. *Third Transformation: From Closely-Held to Widely-Held Corporations*

The situation between the 1820s and the end of the Civil War was the proliferation of for profit corporations, incorporated under general incorporation laws with minimal interference by the state, and whose shareholders enjoyed limited liability. Those shareholders were, however, relatively limited in number; despite the Angell & Ames quotation above, few corporations before 1865 required massive amounts of capital, and most were small, closely-held enterprises. This enabled the Civil War income tax on corporate income to be imposed directly on the shareholders of corporations.[94]

This state of affairs began to change with the advent of the railroads, followed by the steel and oil companies. With the rise of large corporate enterprises, massive amounts of capital were required, and between 1865 and the 1890s the widely held, publicly traded, non-owner managed enterprises gradually became the norm for U.S. business activities. This was followed from 1890 to 1906 by a wave of consolidation that left several important business areas dominated by monopolies run by the "robber barons."

The shift from small, closely-held enterprises to massive, publicly-held ones once again necessitated a re-examination of the corporate form, and again all three theories of the corporation appeared. A classic example of the aggregate view is the *Santa Clara* case, ultimately decided by the Supreme Court in 1886.[95] This case is famous for Chief Justice Waite's statement that "[t]he court does not wish to hear argument on the question whether the [equal protection clause] applies to these corporations. We are all of the opinion that it does."[96] Some scholars identified this as an application of the real entity view to corporations, but Professor Horwitz has shown by examining Justice Field's opinion in the court below that it actually represented an application of the aggregate view. Specifically,

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[93]The same result was obtained in England by the adoption of the Regulation and Incorporation Act, 1856, ch. 63, § 2, 19 & 20 Vict. c. 47 (Eng.).

[94]Reuven S. Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1212-15 (2004).

[95]Santa Clara Cty. v. S. Pac. R.R., 118 U.S. 394 (1886).

[96]*Id.* at 396. *See* Morton J. Horwitz, Santa Clara *Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 176-83 (1985).

Field held that the equal protection clause must apply to corporations for the following reasons:

> Private corporations consist of an association of individuals united for some lawful purpose, and permitted to use a common name in their business and have succession of membership without dissolution. . . . But the members do not, because of such association, lose their right to protection, and equality of protection. . . . Whatever affects the property of the corporation—that is, of all the members united by the common name—necessarily affects their interests. . . . So, therefore, whenever a provision of the constitution or of a law guarantees to persons protection in their property . . . the benefits of the provision are extended to corporations; not to the name under which different persons are united, but to the individuals composing the union. The courts will always look through the name to see and protect those whom the name represents.[97]

A clearer statement of the aggregate view can hardly be imagined; most remarkable is Field's reliance on *Deveaux* despite the fact that the Supreme Court overturned its results forty years earlier. Similarly, in *Pembina Consolidated Silver Mining & Milling Co. v. Pennsylvania*,[98] decided two years later, Justice Field, for the Court, stated that "[u]nder the designation of person there is no doubt that a private corporation is included. Such corporations are merely associations of individuals united for a special purpose . . . ."[99]

The artificial entity view, however, was also raised in these cases. In *Santa Clara*, the railroad corporations made the argument that because they were operating under special congressional legislation they should be regarded as an extension of the federal government and therefore California could not tax them.[100] Field rejected this view, citing *Trustees of Dartmouth College*, but noted that "when the instrumentality is the creation of the state, a corporation formed under its laws, and is employed or

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[97]Santa Clara Cty. v. S. Pac. R.R., 18 F. 385, 402-03 (C.C.D. Cal. 1883) (citing United States v. Deveaux, 9 U.S. (5 Cranch) 61 (1809)).

[98]125 U.S. 181 (1888).

[99]*Id.* at 189. *See also* Mason v. Pewabic Mining Co., 133 U.S. 50, 59 (1890) (stating that "we do not see that the right of the parties in regard to the assets of this corporation differ from those of a partnership on its dissolution").

[100]*Santa Clara Cty.*, 18 F. at 387.

adopted by the general government for its convenience . . . it remains subject to the taxing power of the state."[101] And notably, in *Pembina*, Field followed Taney in rejecting the argument that the privileges and immunities clause applied to corporations because they were not "citizens," even though the aggregate view he adopted in *Santa Clara* might have led to the contrary position. Instead, Field emphasized the relationship between the corporation and the incorporating state under the artificial entity view:

> [T]he term citizens, as used in this clause, applies only to natural persons, members of the body politic owing allegiance to the State, not to artificial persons created by the legislature, and possessing only such attributes as the legislature has prescribed . . . a grant of corporate existence was a grant of special privileges to the corporators, enabling them to act for certain specified purposes as a single individual, and exempting them, unless otherwise provided, from individual liability.[102]

Moreover, all three views of the corporation appear in *Hale v. Henkel*, decided by the Supreme Court in 1906. The issue was whether an agent of a corporation could invoke the Fifth Amendment privilege against self-incrimination or the Fourth Amendment protection against unreasonable search and seizure in the name of the corporation. On the Fifth Amendment issue, the Court held that the right against self-incrimination does not apply to corporations:

> The right of a person under the Fifth Amendment to refuse to incriminate himself is purely a personal privilege of the witness. . . . The question whether a corporation is a "person" within the meaning of this Amendment really does not arise . . . since it can only be heard by oral evidence in the person of some one of its agents or employees.[103]

This is closest to the real entity view because it rejects (like Marshall in *Dandridge*) the aggregate position of looking through a corporation to its shareholders and takes into account the special characteristics of the corporation itself.

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[101] *Id.* at 389.

[102] *Pembina Consol.*, 125 U.S. at 187-88.

[103] Hale v. Henkel, 201 U.S. 43, 69-70 (1906).

On the other hand, on the Fourth Amendment issue, the Court at first emphasized the artificial entity view, using it to justify regulation by the state:

> Conceding that the witness was an officer of the corporation under investigation, and that he was entitled to assert the rights of the corporation with respect to the production of its books and papers, we are of the opinion that there is a clear distinction in this particular between an individual and a corporation, and that the latter has no right to refuse to submit its books and papers for an examination at the suit of the State. The individual may stand upon his constitutional rights as a citizen. . . . Upon the other hand, the corporation is a creature of the State. It is presumed to be incorporated for the benefit of the public. It receives certain special privileges and franchises, and holds them subject to the laws of the State and the limitations of its charter. Its powers are limited by law. It can make no contract not authorized by its charter. Its rights to act as a corporation are only preserved to it so long as it obeys the laws of its creation. There is a reserved right in the legislature to investigate its contracts and find out whether it has exceeded its powers. It would be a strange anomaly to hold that a State, having chartered a corporation to make use of certain franchises, could not in the exercise of its sovereignty inquire how these franchises had been employed, and whether they had been abused, and demand the production of the corporate books and papers for that purpose. . . . While an individual may lawfully refuse to answer incriminating questions unless protected by an immunity statute, it does not follow that a corporation, vested with special privileges and franchises, may refuse to show its hand when charged with an abuse of such privileges.[104]

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[104] *Id.* at 74-75. Remarkably, the Court applies this analysis to give powers to the federal government over state corporations:

> It is true that the corporation in this case was chartered under the laws of New Jersey, and that it receives its franchise from the legislature of that State; but such franchises, so far as they involve questions of interstate commerce, must also be exercised in subordination to the power of Congress to regulate such commerce, and in respect to this the General Government may also assert a sovereign authority to ascertain whether such franchises have been exercised in a lawful manner, with a due regard to its own laws. Being subject to this dual sovereignty, the General Government possesses the same right to see that its own laws are respected as the State would have with respect to the special franchises

Having clearly stated its reasons for limiting the application of the constitutional right, however, the Court suddenly reverts to the aggregate view when facing the question whether corporations have any Fourth Amendment rights at all:

> [W]e do not wish to be understood as holding that a corporation is not entitled to immunity, under the Fourth Amendment, against unreasonable searches and seizures. A corporation is, after all, but an association of individuals under an assumed name and with a distinct legal entity. In organizing itself as a collective body it waives no constitutional immunities appropriate to such body. Its property cannot be taken without compensation. It can only be proceeded against by due process of law, and is protected, under the Fourteenth Amendment, against unlawful discrimination. Corporations are a necessary feature of modern business activity, and their aggregated capital has become the source of nearly all great enterprises.[105]

What can explain this remarkable oscillation between the three views? The key is the last sentence quoted. As noted above, the period between 1890 and 1906 marked the height of the debate on the rise of the great corporations. The Court is trying to strike a balance between the rights of the corporations, which can best be protected under either the aggregate or the real entity views, and the regulatory power of the state, which is best reflected in the artificial entity view. On the one hand, as the Court states, "Corporations are a necessary feature of modern business activity" and must be protected.[106] On the other hand, the right of the state to regulate must also be preserved, especially since the context of *Hale v. Henkel* was an antitrust investigation into two major corporations, the American Tobacco Company and McAndrews & Forbes Inc.

> vested in it by the laws of the State. The powers of the General Government in this particular in the vindication of its own laws, are the same as if the corporation had been created by an act of Congress. It is not intended to intimate, however, that it has a general visitatorial power over state corporations.

Id. at 75. This issue came up in the corporate tax debate as well. Avi-Yonah, *supra* note 94, at 1215-16.

[105] *Hale*, 201 U.S. at 76 (citations and emphasis omitted).

[106] *Id.*

Ultimately, however, the real entity view prevailed.[107] This involved first the rejection of the aggregate view. For example, in *Western Turf Association v. Greenberg*, decided just one year after *Hale v. Henkel*, Justice Harlan emphasized that a corporation is a separate entity from its shareholders, and therefore is not a "citizen" for purposes of the privileges and immunities clause or entitled to the protection of the due process clause: "the liberty guaranteed by the Fourteenth Amendment against deprivation without due process of law is the liberty of natural, not artificial, persons."[108] But by itself this position would have led to too much state regulation for the Lochner Court. Thus, in *Southern Railway Co. v. Greene*, decided in 1909, the Court came out clearly for the position that the corporation *as such* was entitled to constitutional protection under the equal protection clause, without any reference to its shareholders: "the corporation . . . is within the meaning of the Fourteenth Amendment, a person within the jurisdiction of the state of Alabama, and entitled to be protected against any statute of the State which deprives it of the equal protection of the laws."[109]

Once again, the triumph of the real entity view can be explained by several factors. The aggregate view was raised by Field and others to protect the rights of corporations, but it was even more incongruous in the context of the mega-corporations of the 1890s, with thousands of shareholders more than in the pre-civil days. It also gave the corporation too many rights vis-à-vis the state, as seen in *Hale v. Henkel* and in *Greenberg*. The artificial entity view gave the state too much power to regulate corporations, as the *Hale v. Henkel* Court came to realize when it laid out its implications. The real entity view was the most congruent with business realities as well as the one most suited to some balance between corporations and the state. By 1909, it was well established as the

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[107]This view was also reflected in contemporary books and law review articles. *See, e.g.*, ERNST FREUND, THE LEGAL NATURE OF CORPORATIONS (1897); George F. Deiser, *The Juristic Person*, 57 U. PA. L. REV. 131, 142 (1908); Harold J. Laski, *The Personality of Associations*, 29 HARV. L. REV. 404, 405-06 (1916); Arthur W. Machen, Jr., *Corporate Personality*, 24 HARV. L. REV. 253, 253 (1911); I. Maurice Wormser, *Piercing the Veil of Corporate Entity*, 12 COLUM. L. REV. 496, 496 (1912) (all rejecting the aggregate view). Compare for a statement of the aggregate view. VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS iii (1882) ("the existence of a corporation as an entity, independent of its members, is a fiction").

[108]W. Turf Ass'n v. Greenberg, 204 U.S. 359, 363 (1907).

[109]S. Ry. Co. v. Greene, 216 U.S. 400, 417 (1910). Remarkably, this case involves a discriminatory state tax similar to the one struck down by Field on aggregate grounds in *Santa Clara*. See also similar statements in *Ludwig v. W. Union Tel. Co.*, 216 U.S. 146, 163-64 (1910); *Pullman Co. v. Kansas*, 216 U.S. 56, 64 (1910); *W. Union Tel. Co. v. Kansas*, 216 U.S. 1, 36 (1910), which finally eliminated the restrictions imposed by *Bank of Augusta v. Earl*, 38 U.S. 519 (1839). *See* Horwitz, *supra* note 96, at 177-78.

dominant view of the corporation, as reflected in contemporary debates surrounding the enactment of the corporate tax.[110]

The rise of the real entity view is also reflected in two other contemporary developments: the rise of the business judgment rule, and the decline of the *ultra vires* doctrine.[111] The business judgment rule rejected the aggregate view in holding that the board of directors held powers that were not delegated from the shareholders and that shareholders could not normally call into question the exercise of those powers. The *ultra vires* doctrine represented the ability of the state to require corporations to adhere to their charter, and was thus based on the artificial entity view; its decline thus reinforced the rejection of that view.

The first full statement of the business judgment rule was made in *Leslie v. Lorillard*, decided by the New York Court of Appeals in 1888. The court held:

> In actions by stockholders, which assail the acts of their directors or trustees, courts will not interfere unless the powers have been illegally or unconscientiously executed. . . . Mere errors of judgment are not sufficient as grounds for equity interference; for the powers of those entrusted with corporate management are largely discretionary.[112]

A year later the same court expanded this statement, holding:

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[110] *See* Avi-Yonah, *supra* note 94, at 1215-25.

[111] Another related development was the strengthening of limited liability resulting from the demise of the "trust fund" doctrine, which held that the capital stock of a corporation must be held in trust for the benefit of its creditors. This doctrine, which originated from Justice Story's opinion in *Wood v. Dummer*, 30 Fed. Cas. 435, 439-40 (C.C.D. Me. 1824), was upheld by the Supreme Court in *Sawyer v. Hoag*, 84 U.S. 610, 620 (1873), on the basis on the aggregate view ("after all, this artificial body is but the representative of its stockholders, and exists mainly for their benefit, and is governed and controlled by them through the officers whom they elect"). *Id.* at 623. *See also* WILLIAM W. COOK, STOCK & STOCKHOLDERS 322 (1887). In 1892, however, the Supreme Court of Minnesota held:

> This "trust-fund" doctrine . . . is not sufficiently precise or accurate to constitute a safe foundation upon which to build a system of legal rules. . . . Corporate property is not held in trust. . . . Absolute control and power of disposition are inconsistent with the idea of trust. The capital of a corporation is its property. . . . [A] corporation is in law as distinct a being as an individual is, and is entitled to hold property (if not contrary to its charter) as absolutely as an individual can hold it.

Hospes v. Nw. Mfg. & Car Co., 48 Minn. 174, 192-93 (Minn. 1892). The doctrine then fell into desuetude, reinforced by the invention of no par stock in the early twentieth century. *See* Horwitz, *supra* note 96, at 194-95.

[112] Leslie v. Lorillard, 110 N.Y. 519, 532 (N.Y. 1888).

> All powers directly conferred by statute, or impliedly granted, of necessity, must be exercised by the directors who are constituted by the law as the agency for the doing of corporate acts. The expression of the corporate will and the performance of corporate functions in the management of a corporation, may originate with its directors. . . . Within the chartered authority they have the fullest power to regulate the concerns of a corporation, according to their best judgment. . . . In the management of the affairs of the corporation, they are dependent solely upon their own knowledge of its business and their own judgment as to what its interests require.[113]

This rule became well established, so that by 1905 a court could write that "it is [the board's] judgment, and not that of its stockholders outside of the board of directors . . . that is to shape [a corporation's] policies or decide upon its corporate acts. This principle is not disputed, and the citation of authorities in its support is unnecessary."[114] The rule reflected the real entity view, which equates the corporation with its management, and rejected the aggregate view of the corporation as an aggregate of its shareholders.[115]

The one potential limitation on the power of the board was the *ultra vires* doctrine, which held that a board could not act contrary to the powers conferred on it by the state. The *ultra vires* doctrine thus represented the artificial entity view. The doctrine originated in the pre-civil war era,[116] but became prominent in the arguments on the relationship of the state and the corporation in the 1880s and 1890s.[117] The artificial entity argument for upholding the limitation was stated clearly by the New York Court of Appeals in 1888:

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[113]Beveridge v. N.Y. Elevated R.R., 112 N.Y. 1, 22 (N.Y. 1889).

[114]Siegman v. Elec. Vehicle Co., 140 F. 117, 118 (C.C.D. N.J. 1905). See also *Manson v. Curtis*, 223 N.Y. 313, 323 (N.Y. 1918), in which the court held that "[d]irectors are the exclusive, executive representatives of the corporation and are charged with the administration of its internal affairs and the management and use of its assets. Clearly the law does not permit the stockholders to create a sterilized board of directors." *Id.* (citations omitted).

[115]It also represented a transition from an agency to a trustee model of the relationship between shareholders and management. *See* Millon, *supra* note 8, at 214-16.

[116]*See, e.g.*, Abbott v. Am. Hard Rubber Co., 33 Barb. 578, 591-92 (N.Y. Sup. Ct. 1861).

[117]*See, e.g.*, the extensive discussion in COOK, *supra* note 111, chs. 19, 38.

> In the granting of charters, the legislature is presumed to have had in view the public interest; and public policy is (as the interests of stockholders ought to be) concerned in the restriction of corporations within chartered limits, and a departure therefrom is only deemed excusable when it cannot result in prejudice to the public or to the shareholders. As artificial creations, they have no powers or faculties, except those with which they were endowed when created. . . . Corporations are great engines for the promotion of the public convenience, and for the development of public wealth, and, so long as they are conducted for the purposes for which organized, they are a public benefit; but if allowed to engage, without supervision, in subjects of enterprise foreign to their charters, or if permitted unrestrainedly to control and monopolize the avenues to that industry in which they are engaged, they become a public menace, against which public policy and statutes design protection.[118]

The doctrine was upheld by the Supreme Court in the following year. Referring to the artificial entity doctrine, the Court stated:

> It may be considered as the established doctrine of this court in regard to the powers of corporations, that they are such and such only as are conferred upon them by the acts of the legislatures of the several States under which they are organized. A corporation in this country, whatever it may have been in England at a time when the crown exercised the right of creating such bodies, can only have an existence under the express law of the State or sovereignty by which it is created. And these powers, where they do not relate to municipal corporations exercising authority conferred solely for the benefit of the public, and in some sense parts of the body politic of the State, have in this country until within recent years always been conferred by special acts of the legislative body under which they claim to exist. But the rapid growth of corporations, which have come to take a part in all or nearly all of the business operations of the country, and especially in enterprises requiring large aggregations of capital and individual energy, as well as their success in

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[118] *Leslie*, 110 N.Y. at 531-33.

> meeting the needs of a vast number of most important commercial relations, have demanded the serious attention and consideration of law makers. And while valuable services have been rendered to the public by this class of organizations, which have stimulated their formation by numerous special acts, it came at last to be perceived that they were attended by many evils in their operation as well as much good, and that the hasty manner in which they were created by the legislatures, sometimes with exclusive privileges, often without due consideration and under the influence of improper motives, frequently led to bad results.[119]

The reference to corporate abuses relates to the rise of trusts, and indeed the *ultra vires* doctrine was used to dissolve sugar and oil trusts under New York and Ohio law.[120] In 1895, however, the Supreme Court rejected an antitrust challenge to the sugar trust on the grounds that the Sherman Act applied only to corporations engaged directly in interstate commerce.[121] In 1896, the Court rejected an *ultra vires* challenge to the ability of the Union Pacific Railway to lease its tracks for 999 years to another railroad, when the charter would not permit an outright sale.[122] This literal decision significantly reduced the power of the *ultra vires* doctrine.[123]

The ultimate demise of the doctrine resulted not from a court decision but from the competition among states to attract corporate charters, which was begun by New Jersey in 1890 and continued by Delaware in the 1900s.[124] This competition meant that New Jersey and

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[119]Oregon Ry. & Navigation Co. v. Oregonian Ry., 130 U.S. 1, 20-21 (1889).

[120]*See* People v. N. River Sugar Ref. Co., 121 N.Y. 582, 626 (1890); State v. Standard Oil Co., 49 Ohio St. 137, 184-85 (Ohio 1892). *See also* Theodore Dwight, *The Legality of Trusts*, 3 POL. SCI. Q. 592 (1888); WILLIAM W. COOK, THE CORPORATION PROBLEM (1893) (defining a trust to be "a combination of competing concerns under one management").

[121]United States v. E.C. Knight Co., 156 U.S. 1, 17(1895).

[122]Union Pac. Ry. Co. v. Chicago, Rock Island & Pac. R.R., 163 U.S. 564 , 594-96(1896).

[123]*See* WILLIAM W. COOK, TREATISE ON STOCK AND STOCKHOLDERS 971-73 (3d ed. 1894) ("The courts are becoming more liberal, and many acts which fifty years ago would have been held to be ultra vires would now be held to be intra vires.") (emphasis omitted). By 1898 Cook wrote that "the doctrine of ultra vires is disappearing." WILLIAM W. COOK, TREATISE ON THE LAW OF CORPORATIONS HAVING A CAPITAL STOCK vii (4th ed. 1898). On this entire development, see Horwitz, *supra* note 96, at 186-88.

[124]*See* RUSSEL CARPENTER LARCOM, THE DELAWARE CORPORATION 1-26 (1937); LINCOLN STEFFENS, THE STRUGGLE FOR SELF-GOVERNMENT 209 (McLure, Phillips & Co. 1906); Edward Q. Keasbey, *New Jersey and the Great Corporations*, 13 HARV. L. REV. 198, 209-11 (1899). On the "race to the bottom/race to the top" debate, see generally Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*,

Delaware had every incentive to relax any limiting elements in their charters that restricted the power of corporate management.[125] Thus, for example, the long-lasting prohibition against corporations owning stock in other corporations, which led to the necessity of "trusts," was eliminated by New Jersey in its 1890 law.[126] As a result, although the Supreme Court still held in 1899 that such a combination was *ultra vires* under New York law, this holding became rather meaningless since most large, publicly traded corporations were incorporated in New Jersey.[127] As the New Jersey statute explains:

> It was formerly the rule in this State that acts of a corporation in excess of its express powers, or those necessarily implied, were void, and contracts which were *ultra vires* the corporation were incapable of enforcement or ratification. . . . This rule no longer obtains.[128]

The decline of the *ultra vires* doctrine was sealed by the spread of corporate laws permitting incorporation "for any lawful purpose." With the doctrine gone, the artificial entity view of the corporation became less plausible, and the real entity view reigned supreme again.[129]

D. *A Failed Transformation: The Hostile Takeover Crisis*

In 1926 John Dewey published an article in the *Yale Law Journal* in which he dismissed as irrelevant the debate among the aggregate, artificial entity, and real entity views of the corporation. These views, he explained, could be deployed to suit any purpose; and he used examples relying on the

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105 HARV. L. REV. 1435 (1992); William L. Cary, *Federalism and Corporate Law: Reflections on Delaware*, 83 YALE L.J. 663 (1974); Robert Daines, *Does Delaware Law Improve Firm Value?* 62 J. FIN. ECON. 525 (2001); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

[125] *See* JAMES DILL, TRUSTS—THEIR USES AND ABUSES (1901); *New Jersey Legislating for the United States*, INDIANAPOLIS J., Nov. 11, 1901.

[126] General Corporation Act of New Jersey sec. 51 (1890 rev.). *See also id.* sec. 104 (authorizing mergers); WILLIAM W. COOK, A TREATISE ON THE LAW OF CORPORATIONS vi (4th ed. 1898) (discussing the role of trusts in American corporation law).

[127] De La Vergne Refrigerating Mach. Co. v. German Sav. Inst., 175 U.S. 40, 58 (1899).

[128] General Corporation Law of New Jersey sec. 2 (1896).

[129] *See* Machen, *supra* note 106, at 257-58. Another significant development in this period was states passing statutes that allowed a majority of shareholders to sell corporate assets (before the 1890s, shareholder unanimity was required). This greatly facilitated mergers and also represented the decline of the aggregate view. *See* Horwitz, *supra* note 96, at 201-02.

cyclical nature of these theories. His conclusion was that theory should be abandoned for an examination of reality.[130]

Dewey was influential in that the theoretical debate on corporate personality largely disappeared until the 1970s. As a practical matter, however, the real entity view predominated for large, publicly traded corporations. The board ran the corporation as it saw fit, protected from the shareholders by the separation of ownership from management noted by Berle and Means in the 1930s, and by the business judgment rule, and protected from the state by the relaxation of corporate law limits begun by New Jersey and continued by Delaware.[131]

The next significant practical change in this state of affairs only arose in the 1980s. As a result of the invention of the junk bond market, it suddenly became possible for hostile raiders to threaten takeovers of even the largest corporations. After RJR Nabisco was taken private for $25 billion in 1988, it was clear that no board was safe. As a result, debates on the nature of the corporation and its relationship to the shareholders and the state, which began in the academic literature in the 1970s, once again became a matter of practical concern. Once again all three theories of the corporation reappeared, as can be seen if one examines three seminal cases decided between 1982 and 1989 by the Supreme Courts of the United States and of Delaware.

Edgar v. MITE Corp.,[132] decided by the U.S. Supreme Court in 1982, involved the constitutionality of an anti-takeover act enacted by the state of Illinois.[133] Under the Illinois Business Take-Over Act, a hostile tender offer for the shares of a company covered by the act had to be registered by the Secretary of State and the offeror had to give both the target and the state a twenty day notice during which only the target could communicate with its shareholders regarding the offer. The act applied both to corporations ten percent of whose shareholders were residents of Illinois and to

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[130]John Dewey, *The Historic Background of Corporate Legal Personality*, 35 YALE L.J. 655, 673 (1926).

[131]This state of affairs prompted Adolph Berle, the prime intellect behind the shareholder primacy doctrine in the 1930s, to concede defeat in 1956. See Adolph A. Berle, Jr., *Rosenthal Lectures at Northwestern University*, *in* RICHARD EELLS, CORPORATION GIVING IN A FREE SOCIETY 29 (1956):

> Twenty years ago, the writer had a controversy with the late Professor E. Merrick Dodd, of Harvard Law School, the writer holding that corporate powers were powers in trust for shareholders while Professor Dodd argued that these powers were held in trust for the entire community. The argument has been settled (at least for the time being) squarely in favor of Professor Dodd's contention.

[132]457 U.S. 624 (1982).

[133]*Id.* at 626.

corporations that were either incorporated in the state or had their principal office in it. The MITE corporation made a hostile offer for an Illinois corporation and refused to comply with the act, arguing that it violated the commerce clause.

The Supreme Court agreed with MITE. Writing for a 5-4 majority, Justice White held that the Illinois act was unconstitutional because it could apply to tender offers that did not affect a single Illinois shareholder; "the state has no legitimate interest in protecting nonresident shareholders."[134] Moreover, the fact that the target corporation was an Illinois corporation was irrelevant since state regulation only applied to the corporation's "internal affairs": "[t]ender offers contemplate transfers of stock by stockholders to a third party and do not themselves implicate the internal affairs of the target company."[135] Instead, the focus should be entirely on the impact of blocking the tender offer on the company's shareholders and their relationship with management:

> The effects of allowing the Illinois Secretary of State to block a nationwide tender offer are substantial. Shareholders are deprived of the opportunity to sell their shares at a premium. The reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition, is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced.[136]

This part of the opinion clearly reflects the aggregate view: The focus is entirely on the impact on the corporation's shareholders, and the corporation itself (including its management) barely exists, as indicated by the statement that a change in corporate control has no relevance to the internal affairs of the corporation. The market for corporate control is praised because of its ability to overcome the agency cost problem and the incentive it provides for management to maximize stock prices. Moreover, White quotes the work of Easterbrook and Fischel, who are among the principal proponents of the "nexus of contracts" theory of the corporation, according to which the corporation is merely a convenient legal term for a

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[134] *Id.* at 644.

[135] *Id.* at 645.

[136] *Edgar*, 457 U.S. at 643 (referring to Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1173-74 (1981); Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 5, 27-28, 45 (1978); H.R. REP. NO. 94-1373, at 12 (1976)).

series of contracts, the most important of which is the contract between shareholders and management.[137]

This part of the opinion, which rejects both the artificial entity and the real entity theories, evoked some misgivings on the part of Justice Powell, even though he joined it to provide the crucial fifth vote. Powell noted that in some cases the state may have a legitimate interest because the corporation has a real presence that goes beyond a contract between management and the shareholders, reflecting both the artificial and real entity views:

> I join Part V-B because its Commerce Clause reasoning leaves some room for state regulation of tender offers. This period in our history is marked by conglomerate corporate formations essentially unrestricted by the antitrust laws. Often the offeror possesses resources, in terms of professional personnel experienced in takeovers as well as of capital, that vastly exceed those of the takeover target. This disparity in resources may seriously disadvantage a relatively small or regional target corporation. Inevitably there are certain adverse consequences in terms of general public interest when corporate headquarters are moved away from a city and State.*
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> * The corporate headquarters of the great national and multinational corporations tend to be located in the large cities of a few States. When corporate headquarters are transferred out of a city and State into one of these metropolitan centers, the State and locality from which the transfer is made inevitably suffer significantly. Management personnel—many of whom have provided community leadership—may move to the new corporate headquarters. Contributions to cultural, charitable, and educational life—both in terms of leadership and financial support—also

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[137] *See* Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1273 (1982). Fischel stated that "[a] corporation . . . is nothing more than a legal fiction that serves as a nexus for a mass of contracts which various individuals have voluntarily entered into for their mutual benefit." *Id.* The point that the nexus of contracts theory is a reinvention of the aggregate view has been made repeatedly. *See, e.g.*, William W. Bratton Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1471 (1989); Millon, *supra* note 8, at 229.

> tend to diminish when there is a move of corporate headquarters.[138]

Five years later Powell had the opportunity to translate these misgivings into an opinion for the Court that emphasized instead the artificial entity view of the corporation. *CTS Corp. v. Dynamics Corp. of America* involved a so-called "second generation" anti-takeover statute, i.e., one that was drafted to get around the problems which the Illinois statute struck down in MITE.[139] The Indiana statute applied only to corporations incorporated in Indiana, which have a specified number of shareholders within the state, and which opt for its protection. Under the statute, an acquirer who acquired "control shares" in such an Indiana target could vote them only with the approval of a majority of the pre-existing disinterested shareholders, to be obtained in a meeting within fifty days after the acquisition.

The court of appeals followed MITE and declared the statute unconstitutional under the commerce clause, because it interfered with the market for corporate control:

> "Even if a corporation's tangible assets are immovable, the efficiency with which they are employed and the proportions in which the earnings they generate are divided between management and shareholders depends on the market for corporate control—an interstate, indeed international, market that the State of Indiana is not authorized to opt out of."[140]

The Supreme Court reversed. Justice Powell, writing for a 5-4 majority, stated:

> No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders . . . . We think the Court of Appeals failed to appreciate the significance for Commerce Clause analysis of the fact that state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law. As Chief Justice

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[138] *Edgar*, 457 U.S. at 646.

[139] 481 U.S. 69, 80 (1987).

[140] *Id.* at 77 (quoting Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 264 (7th Cir. 1986)).

> Marshall explained: "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created."[141]

Powell thus rejected the view that states do not have the right to regulate transactions affecting shareholders, including shareholders in other states. He argued that the "free market system depends at its core upon the fact that a corporation . . . is organized under, and governed by, the law of a single jurisdiction. . . . A State has an interest in promoting stable relationships among parties involved in the corporations it charters."[142] He explicitly rejected the market for corporate control and its underlying aggregate theory:

> The Constitution does not require the States to subscribe to any particular economic theory . . . there is no reason to assume that the type of conglomerate corporation that may result from repetitive takeovers necessarily will result in more effective management or otherwise be beneficial to shareholders . . . the very commodity that is traded in the "market for corporate control"—the corporation—is one that owes its existence and attributes to state law.[143]

This entire opinion, with its quotation from *Dartmouth College*, is clearly based on the artificial entity view that the corporation owes its existence to the incorporating state and that state may therefore regulate it, including in ways that affect shareholders' ability to sell their shares. Not surprisingly, Justice White dissented, arguing that while the statute may help Indiana corporations "particularly in helping those corporations maintain the status quo," it is inimical to the interests of the shareholders and constitutes "economic protectionism."[144]

After *CTS*, the battle for corporate control moved to state law, and the most important state in this regard was Delaware, in which most major

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[141] *Id.* at 89 (citing Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819)).

[142] *Id.* at 90-91.

[143] *CTS Corp.*, 481 U.S. at 92-94 (citations and emphasis omitted).

[144] *Id.* at 98-100.

U.S. corporations are incorporated. Delaware law was favorable to hostile takeovers until 1989, when the Supreme Court of Delaware issued an opinion in *Paramount Communications, Inc. v. Time, Inc.* that in practice ended the hostile takeover boom.[145] Paramount had made a $175 (later raised to $200) per share offer for Time at the time when Time was about to enter into a $70 per share merger with Warner. Paramount argued that under the previous decisions of the Delaware Supreme Court in *Unocal* (1985)[146] and *Revlon* (1986),[147] Time was "up for sale" and therefore the business judgment rule was suspended and Time's board was required to maximize shareholder value by accepting the much higher Paramount bid.

The Delaware Supreme Court held in favor of Time. It stated that:

> Two key predicates underpin our analysis. First, Delaware law imposes on a board of directors the duty to manage the business and affairs of the corporation. This broad mandate includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of "long-term" versus "short-term" values is largely irrelevant because directors, generally, are obliged to charter a course for a corporation which is in its best interest without regard to a fixed investment horizon. Second, absent a limited set of circumstances as defined under *Revlon*, a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover.[148]

The court thus rejected the view that maximizing short-term shareholder value was always required; instead, the board was permitted to pursue its view of the best long-term corporate strategy:

> Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives. The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders. Directors are not obliged to

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[145]571 A.2d 1140 (Del. 1989).

[146]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[147]Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

[148]*Paramount*, 571 A.2d at 1150 (citations omitted).

> abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.[149]

Thus, the board was permitted to prefer preservation of the "Time culture" (its stated goal, instead of maximizing the cash return to shareholders). This effectively killed the takeover threat, because any board could find good long-term share value maximization reasons to reject a superior cash bid. The Delaware court, in enhancing managerial power, effectively endorsed the real entity view: a corporation was an entity with its own corporate culture, which should not be subordinated to the shareholders or to the state. This view was ratified when the ALI Corporate Governance Project adopted a rule that corporate boards may take into account the interests of other "stakeholders," not just the shareholders.[150]

Why did the real entity view prevail? The obvious answer was that corporate management determines the state of incorporation, and therefore the Delaware Supreme Court felt that it had to side with management once the U.S. Supreme Court had approved the anti-takeover laws of other states, lest corporations choose to relocate there. It seems unlikely, however, that this was the only reason; Delaware is very well established as the preferred state of incorporation, and stock values would likely decrease if shareholders perceived that management was leaving Delaware just to protect themselves. Instead, it seems likely that the Delaware Supreme Court genuinely believed that a corporation like Time had a corporate existence and culture with implications for other stakeholders, and therefore rejected the aggregate view equating the corporation with its shareholders. In that way, its concerns were similar to those raised by Justice Powell in his concurrence in MITE: A corporation is more than a "nexus of contracts," and courts and legislatures are allowed to take the interests of other stakeholders into account.[151]

E. *Fourth Transformation: From National Corporations to Multinational Enterprises*

The last transformation in the nature of the corporation began in the 1950s and is still going on, so that its ultimate outcome is hard to judge. This is the transformation from corporations based mostly in one country to multinational enterprises based in many countries.

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[149] *Id.* at 1154 (citations omitted).

[150] ALI, *supra* note 11, § 2.01(b)(3).

[151] *Edgar*, 457 U.S. at 646-47.

Multinationals, in the sense of corporations owning assets overseas, have existed since the seventeenth century.[152] As recently as the 1950s, however, the shareholders and other sources of capital, the management, most of the production facilities, and most of the markets of even large multinationals tended to be in one country, so that "what was good for G.M. was good for America."[153] By the 1990s, however, this had changed profoundly. As more countries opened up to foreign direct investment, communications improved, many products became lighter and easier to ship, and more and more corporations became "globalized." In a globalized multinational corporation, the sources of capital are in many countries: the shares of large multinationals trade on as many as twenty exchanges, and borrowing facilities are similarly diversified. Research and development and production facilities are likewise spread throughout the globe, as are markets. The only thing that usually ties a modern multinational to its home country is the location of management.

In this context, the debate over the nature of the corporation has re-opened. There is abundant academic writing on the relationship between multinationals and the state, and most writers from both the left and the right concede that this relationship has changed profoundly so that the home state (the state of incorporation) has become powerless to control "its" multinationals; it is hard even to identify to which country multinationals "belong."[154] On a practical level this situation has led to attempts by home states to control the behavior of multinationals abroad in areas as diverse as trading with the enemy, antitrust, corruption and others, with varying success.[155] The most recent development in this regard has been "inversion" transactions, in which the management changes the country of incorporation of a multinational's parent corporation.[156] These transactions are undertaken primarily for tax reasons, but they have corporate governance implications as well.[157] Specifically, the artificial

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[152]HARRIS, *supra* note 57, at 39-59.

[153]Reuven S. Avi-Yonah, *For Haven's Sake: Reflections on Inversion Transactions*, 95 TAX NOTES 1793, 1796 (June 17, 2002).

[154]EDWARD M. GRAHAM & PAUL R. KRUGMAN, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES 86-93 (1995); Robert B. Reich, *Who is Us?*, 32 HARV. BUS. REV. 53, 53-54 (1990); *but see* Laura d'Andrea Tyson, *They Are Not Us: Why American Ownership Still Matters*, AM. PROSPECT 47-49 (Winter 1991).

[155]PETER T. MUCHLINSKI, MULTINATIONAL ENTERPRISES AND THE LAW 126-56 (1996); RAYMOND VERNON, IN THE HURRICANE'S EYE 215-16 (1998); Reuven S. Avi-Yonah, *National Regulation of Multinational Enterprises: An Essay on Comity, Extraterritoriality, and Harmonization*, 42 COLUM. J. TRANSNAT'L L. 5, 17-31 (2003); BLUMBERG, *supra* note 79, at 193-94.

[156]Avi-Yonah, *supra* note 153, at 1793.

[157]*Id.* at 1794-97.

entity theory becomes hard to maintain when management can pick weak countries like Bermuda as the country of incorporation for the parent of a multinational.

The relationship with shareholders has also undergone changes as shareholders now tend to come from many countries. One implication of this has been that the securities laws of the weakest country tend to dominate because of cross-country price arbitrage.[158] Another is academic proposals to let management choose the country of securities law as well as the country of incorporation.[159] On a practical level globalization has led the SEC to relax requirements for some foreign issuers.[160] This trend has tended to weaken the applicability of the aggregate view as well. It is hard to predict where these trends will lead, but at the moment they appear once more to favor the real entity view.

To summarize: Throughout all the transformations we have studied, the same pattern recurs. As the relationship of the corporation to the state, to society and to its members or shareholders changes, all three views of the corporation emerge, submerge and then re-emerge in a slightly different but fundamentally similar form. In the end, however, the real entity view prevails.

Why does the real entity view prevail? In part, this is no doubt due to the fact that it represents the most congenial view to corporate management, because it shields them from undue interference from both shareholders and the state. Corporate management wields political power and it influences the outcome of the debate; judges again and again refer to the importance of corporations, by which they mean corporate management. But the very fact that corporate management wields this power shows that there is another reason why the real entity view prevails: It fits reality much more than the other two. In some periods (e.g., the Roman Empire or eighteenth century Europe), the power of the state is overwhelming and the artificial entity view seems plausible, and in other periods (the medieval membership corporation, the nineteenth century close corporation) the aggregate view seems plausible, but in most periods equating the corporation either with the state or with shareholders must

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[158]Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 VA. J. INT'L L. 563, 591 (1998).

[159]Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer's Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335 , 1337(1999) (referencing Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 907-08 (1998); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2361-62 (1998)).

[160]Merritt B. Fox, *The Political Economy of Statutory Reach: US Disclosure Rules in a Globalizing Market for Securities*, 97 MICH. L. REV. 696, 713-14 (1998).

have seemed to most non-academics highly implausible.[161] The real entity view prevailed because it was more *real* than the others. This observation enables us to move from the historical to the normative part of the discussion and ask what implications does the reality of corporations have for corporate law and regulation.

III. NORMATIVE IMPLICATIONS FOR CORPORATE SOCIAL RESPONSIBILITY

What are the implications of these cyclical transformations of corporate theory for the problem of CSR? Can we draw any conclusions on the legitimacy of CSR from the history described above? It would be argued that the answer is "yes," and that the dominance of the real entity theory for most of corporate history has far reaching implications for the legitimacy of CSR activities for the reasons explained below.

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[161] The real entity view is clearly the dominant one in sociology and some branches of economics. As one sociologist has stated, "The recurrent problem in sociology is to conceive of corporate organization, and to study it, in ways that do not anthropomorphize it and do not reduce it to the behavior of individuals or of human aggregates." Guy E. Swanson, *The Tasks of Sociology*, 192 SCI. 665, 666 (1976). A whole branch of economic sociology centers on the study of organizations, and there are numerous books devoted to the topic. Most of these books revolve around the study of large corporations, since these are the dominant forms of organization in this society. *See generally* THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS (Walter W. Powell & Paul J. DiMaggio eds. 1991); JEFFREY PFEFFER & GERALD R. SALANCIK, THE EXTERNAL CONTROL OF ORGANIZATIONS: A RESOURCE DEPENDENCE PERSPECTIVE (1978, reissued 2003); W. RICHARD SCOTT, ORGANIZATIONS: RATIONAL, NATURAL, AND OPEN SYSTEMS (5th ed. 2003); JAMES D. THOMPSON, ORGANIZATIONS IN ACTION: SOCIAL SCIENCE BASES OF ADMINISTRATIVE THEORY (1967, reissued 2003); THE HANDBOOK OF ECONOMIC SOCIOLOGY (Neil J. Smelser & Richard Swedberg eds. 1994), especially Part II, Section C, The Sociology of Firms, Organizations, and Industry. Moreover, they are informed by the economic perspective inaugurated by R.H. Coase in his classic "Nature of the Firm" article from 1937, and developed by Oliver Williamson and others into transaction cost economics. Ronald Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); Oliver E. Williamson, *Transaction Cost Economics and Organization Theory*, *in* THE HANDBOOK OF ECONOMIC SOCIOLOGY, *supra*, at 77-107; for a critique see Mark Granovetter, *Economic Action and Social Structure: The Problem of Embeddedness*, 91 AM J. SOC. 481 (1985). This branch of economics, which now forms part of the "new institutional economics," begins by recognizing that the firm is fundamentally different from the market because of its hierarchical structure, and proceeds to investigate when operating as a firm as opposed to buying in the market makes sense (the "make or buy" issue). Recently, transaction cost economics has become the leading explanation for the most recent transformation of the corporation—the rise of multinational enterprises. CHRISTOS PITELIS & ROGER SUGDEN, THE NATURE OF THE TRANSNATIONAL FIRM (1991).

A. *The Three Theories and CSR*

Each of the three theories of the corporation permits a different level of CSR, as indicated in the following table:

Table 1: Theories of the Corporation and CSR

	THEORY		
Type of CSR	**Aggregate**	**Artificial**	**Real**
For long-run benefit of shareholders	Yes	Yes	Yes
Not for shareholders, Corporation responsible	No	Yes	Yes
Not for shareholders, Corporation not responsible	No	No	Yes

The first type of CSR involves activities that can clearly and demonstrably benefit shareholders in the long run. For example, actions that prevent environmental disasters or comply with legal and ethical rules can have a significant positive effect in preventing disastrous corporate calamities, even if they cost money in the short run. Thus, even proponents of the aggregate theory, the currently dominant theory of the corporation in academic circles, would support this type of CSR.

The second type of CSR involves activities that are designed to mitigate social harms the corporation was responsible for, even when there is no direct legal responsibility, and when no benefit to the shareholders can be shown. Under the aggregate theory, such activities should not be permitted because they do not benefit shareholders. But under the artificial entity theory, since it emphasizes the benefits of corporate existence derived from the state, an implicit contract can be inferred that the corporation will help the state in mitigating harms that it causes even in the absence of legal responsibility. Otherwise, the state will have to bear this burden imposed by the corporation it created.

Finally, the third type of CSR involves activities like AIDS prevention, for which the corporation is not responsible and which in most cases do not benefit its shareholders, even in the long run. This type of CSR would not be permitted under the aggregate or artificial entity theories. But under the real entity theory, since the corporation is regarded as a person just like individuals, it is permitted to act philanthropically just

like individuals are, and should, in fact, be praised to the extent it does so.[162]

Thus, under the real theory, even CSR activities that have nothing to do with benefiting shareholders or with direct corporate responsibility are permitted. This still requires an answer to the two arguments advanced by Levitt, Friedman, Jensen, and their colleagues.[163]

First, there is the argument that the money being spent on CSR belongs to the shareholders and therefore management have no right to spend it according to their preferences in ways that are not related to maximizing shareholder value. As long as the corporation's CSR activities are adequately disclosed to the shareholders (and the securities laws are designed to assure such disclosure is made), it is not clear that they have a right to complain. If the shareholders do not like the firm engaging in CSR activities, they can sell the shares and invest solely in firms that do not engage in such activities. Even in today's world, it is unlikely that shareholders will find it difficult to eschew firms that engage in CSR, although most large publicly traded firms do so.

Moreover, it can be argued that the majority of current shareholders, namely those who invest through mutual funds and pension funds, invest primarily to obtain a secure return and not for maximum, but risky, gains. In this sense, most shareholders today are more like bondholders or preferred shareholders, who care more about a stable return than about value maximization. For those shareholders, firms that promise a secure, reasonably high return are a good investment, even if they reduce the chances of obtaining returns over that limit by engaging in CSR. Those shareholders who seek to maximize returns are then free to invest in firms that do not engage in CSR.

Second, there is the argument that if firms are free to engage in CSR, it will be more difficult to evaluate management performance since there will be no single benchmark like earnings per share. This may be true, but in a complex world, we are used to evaluating leaders on more than one benchmark. We would not seriously argue that political leaders, for example, must be evaluated only on their economic performance and on no other measure. If we can use complex measures to evaluate politicians, we can do the same for CEOs.

Finally, as Chen and Hanson point out, there is an internal inconsistency in Milton Friedman's argument, because if markets are efficient they should prevent managers from engaging in actions that are

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[162] JAMES BOYD WHITE, FROM EXPECTATION TO EXPERIENCE: ESSAYS ON LAW & LEGAL EDUCATION 111-23 (1999).

[163] *See* articles cited *supra* note 8.

not in the best interest of shareholders.[164] Friedman may, in fact, have believed that to be the case, but the dominance of the real entity view of the corporation through 2,000 years of corporate history suggests that management usually finds a way to do as they wish, including engaging in CSR when it may not be in the long-term interest of shareholders. Since the courts are unable to effectively police such behavior and markets are an insufficient constraint, it is unclear what in practice is gained by arguing in favor of shareholder primacy and against CSR.

Thus, if the historical argument advanced above is correct, and real entity theory is, in fact, the dominant theory of the corporation for most of its history because it is a more accurate description of reality than either the artificial entity or aggregate theories, this can justify CSR to a much greater extent than is commonly accepted by most corporate law academics. Why, then, has the aggregate (nexus of contracts) theory achieved such success in U.S. academic circles? The answer requires a comparative perspective.

B. *The Three Theories and Varieties of Capitalism: A Comparative Perspective*

Political economists distinguish among three types of advanced capitalist societies. Under the "varieties of capitalism" framework, economies can be differentiated by their comparative institutional advantages. In general, economies can be characterized as either liberal (market economies, such as the United States and the United Kingdom), corporatist (organized market economies that rely on tightly integrated private and networked associations to resolve significant dilemmas of economic integration, such as Germany and Japan), or statist (depending on hierarchical solutions in resolving coordination problems, such as France).[165]

The varieties of capitalism framework suggests that firms in each of the three models of economic governance will distinguish themselves in different fields. In liberal market economies, the advantages of a flexible regulatory structure benefits industries targeting low costs and those operating in sectors characterized by radical innovation (e.g., software, bio technology). In corporatist economies, high levels of business coordination benefit sectors that rely on long-term contracts, and firms that specialize in high quality, scale intensive and specialized supplier industries (autos, machine tools, chemicals). Statist economies favor large scale-intensive

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[164]Chen & Hanson, *supra* note 6, at 42-66.

[165]VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE (Peter A. Hall & David Soskice eds. 2001).

industries that have long time horizons or require major capital investment (autos, transport).[166]

There is an obvious correlation between the three varieties of capitalism described by political economists and the three historical theories of the firm outlined above. The liberal model of the United Kingdom and the United States, with its emphasis on arm's-length relationships and public trading, best fits the aggregate theory of the firm. The statist, hierarchical model of France, with its emphasis on the relationship between the firm and the state, best fits the artificial entity model. The German and Japanese style corporatist model best fits the real entity theory.

This relationship can also explain why in Europe CSR is much less controversial than in the United States Practically every European Union government (including even the United Kingdom) has programs designed to foster CSR.[167] These kind of programs are hard to imagine in the U.S. context given the widespread hostility to CSR.

Fundamentally, therefore, the debate around CSR is linked to another wide-spread debate in corporate law: Whether corporate law is destined to "converge" on the U.S. model of publicly traded corporations with dispersed share ownership, or whether other models (such as the German and Japanese models) are viable. The aggregate, nexus of contracts theory is closely linked to the U.S. corporate governance model, while other models are much more open to CSR. Recent literature has given rise to doubts about the convergence hypothesis, but this debate will no doubt continue.[168]

The purpose of this article has been to show, however, that even in the U.S. context the aggregate theory has not always been dominant. In fact, throughout most of the history described above, the real theory was the dominant one, and it can be argued that in practice most corporations are still operating on the basis of the real theory, not the aggregate one. Thus, CSR is most easy to justify in all its forms on the basis of the real theory of the corporation and is likely to remain practiced for the future. The debate on CSR should, therefore, shift from whether CSR is acceptable to how to

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[166]ORFEO FIORETOS, VARIETIES OF CAPITALISM, INSTITUTIONAL CHANGE, AND MULTILATERALISM IN POST-WAR EUROPE 11-12 (2004).

[167]EUROPEAN COMMISSION, CORPORATE SOCIAL RESPONSIBILITY: NATIONAL PUBLIC POLICY IN THE EUROPEAN UNION (2004).

[168]Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127, 127 (1999); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991); Mark D. West, *The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States,* 150 U. PA. L. REV. 527, 601 (2001).

make it more accountable and effective in obtaining social goals—but that is an issue for another day.[169]

[169] *See* James P. Walsh & Reuven S. Avi-Yonah, The Unfettered Corporation: Corporate Social Responsibility and the Coming Crisis of Corporate Control (unpublished manuscript, on file with author).