

The Theory of the Corporation

by Norman Barry

Ever a topic of dispute for observers of capitalism, the corporation has been undergoing increased scrutiny in the light of current business scandals. While other forms of capitalist enterprise, such as partnerships and single proprietorships, have avoided some of the wrath of socialist agitators, the limited-liability corporation, public or private, has had to endure the criticism of some market advocates as well as socialists. Of course, now that most sensible collectivists know that real socialism doesn't work, they have had to use a different intellectual methodology to buttress their anti-capitalist predilections. They have chosen *morality*. This has turned out to be quite effective. Moral arguments are pretty much irrefutable, whereas economic ones can be subjected to some kinds of theoretical and empirical tests. Hence the craze for the "social responsibility" of business.

As a matter of fact, the invention of the corporation is the great achievement of Anglo-American capitalism, contributing both to its prosperity and to the freedom it promotes. But it has to be constantly defended. The most obvious advantages of the corporate form are its ability to raise capital for investment and the liquidity that

share ownership provides. Free transfer of shares, the main feature of corporate capitalism, produces that flexibility which is the envy of other free enterprise forms.

The major problem is its apparent "privileges"; that is, it is claimed that the corporation can do things that private individuals or business partnerships cannot do, and critics argue that these advantages have to be paid back to society. In other words, the corporation operates under some kind of politically granted license, which has to be earned. Business ethics starts from this assumption. Thus Thomas M. Jones wrote: "the corporation which acts in a socially responsible manner may simply be paying back society for the social costs of doing business, costs for which firms rarely receive an invoice."¹ When he was secretary of labor in the first Clinton administration, Robert Reich repeatedly threatened to withdraw "privileges" from uncooperative firms and promised to reward socially responsible ones with tax and regulatory advantages.

What are these privileges, these gifts of society that grateful corporations must pay for with the sacrifice of shareholder value for the benefit of "society"? First there is entity status; that is, the corporation is allegedly an artificial person, separate from its owners, which can sue and be sued. Then there is limited liability for debt and for torts—stockholders are liable only up to the value of their investments; their private assets are protected. A third "privilege" is permanent life.

Contributing editor Norman Barry (norman.barry@buckingham.ac.uk) is professor of social and political theory at the University of Buckingham in the U.K. He is the author of An Introduction to Modern Political Theory (St. Martin's Press) and Business Ethics (Macmillan).

Limited liability (especially for torts) has angered even some libertarians for it seems, superficially, to disadvantage creditors and allows individuals to repudiate debts and evade personal responsibility for (civil) wrongs. It is also argued that separation of ownership from control, a product of the division of labor, makes it efficient for owners to delegate management to specialists, leaving only loose authority for owners through the board of directors. Thus irresponsible managers have become the new dictators even though they are not normally owners.²

Privileges or Rights?

But are these privileges? The most thorough analysis of the corporation, by Robert Hessen, maintains persuasively that they are not. If, as he maintains, the corporation “throughout its growth . . . is a voluntary association based exclusively on contract,” then a major argument for its heavy regulation falls to the ground and the demands of business ethicists become no more than the meretricious moral pleas of archbishops, professors of ethics, and other anti-capitalist zealots.³ Would the corporation and its defining features have emerged spontaneously with no help from the state or statutory law? If this is so, then it really is no different logically from any other free-market institution.

Hessen’s major achievement is to show that the critics confuse two types of corporation. The first are those created in medieval England, when bodies such as churches and boroughs were given certain corporate privileges in return for fealty to the Crown. In the early years of the American Republic, some states granted similar advantages to organizations that acted for the public; for example, they built canals and bridges.

The other type, the modern business corporation, which is solely responsible to its owners, the shareholders, was treated similarly. But Hessen argues that the business corporation is nonetheless very different. It emerges through contract and does not depend at all on the state (apart from having

the convenience of registering with it). Although in modern Western democracies corporations are now governed under various companies acts, that need not have been the case. We have to use the state’s money, but we all know that private money is perfectly feasible. Corporate governance is the same.

There is nothing special about entity status. Individuals get together and pool their resources. They decide by contract to accept a new legal status. They can sue and be sued as a collective body, unlike a partnership, in which several or joint responsibility applies. Indeed, a corporation is better viewed as a “nexus of contracts,” rather than in strict ownership terms. The various participants operate under different types of agreement. That is why the shareholders of a large company cannot enter the company’s premises without permission though they are its owners. A contract will specify who has the right to do what. What Hessen rightly wants to dismiss is the notion that entity status is conferred by the state, since this notion implicitly gives government the authority to regulate the firm beyond the requirements of regular civil and criminal law. The attribute of permanent life is meaningless. Corporations are not immortal; they regularly go bankrupt.

Of course, there is also an economic rationale for the creation of firms as corporations. If everybody dealt with one another through pure market transactions, transaction costs would make efficient business impossible.⁴ It is rational, therefore, for firms to develop via bilateral contracts, which give managements control over workers. The latter are of course free to leave. Corporations are firms, though not all firms are corporations.

Limited Liability

Limited liability is perfectly explicable in contracting terms. No creditor is compelled to accept it, and sometimes it is circumvented when one or more of the shareholders guarantee debts beyond their investment in the company. Indeed, it is merely conve-

nient that a company should claim limited liability as a whole rather than for the creditor to negotiate with each shareholder individually. There is an implicit contract of limited liability unless it is explicitly stated to the contrary. It is quite wrong to assume, then, that the formation of the corporation is a device by which unscrupulous individuals can escape debts. Indeed, there are procedures by which creditors can recover money from shareholders if companies were to distribute high dividends in advance of a debt.

Although limited liability was a feature of the various companies acts that were passed in nineteenth-century Britain and America, it had already emerged through free contracting. If creditors had felt especially victimized by limited liability it would not have developed spontaneously. And, of course, it has great utilitarian value in the raising of capital. Furthermore, it is not a feature exclusive to corporations. Limited partnerships have it also.

Limited liability for torts, however, is another matter, for one can't imagine potential tort victims freely contracting to limit their claims for damages for the (unintentional) wrongful actions of a corporation. Hessen argues that limited liability for torts should not have occurred and only did so because of the difficulty of extending the notion of vicarious liability (whereby the master is liable for the wrongful actions of his servant) to the corporation.⁵ He thinks that this idea was an unfortunate consequence of the entity concept, as if the corporation were something separate from its owners. Hessen is critical of the deliberate creation of one-man corporations, which have the sole purpose of avoiding tort liability, ("I didn't do it; the company did.")

Contrary to some opinion, it is quite conceivable that capitalism could function adequately without limited liability for torts. Large companies could pay the costs of actions (even under American tort law), and smaller companies would be advised to take out insurance. Still there are some interesting points here. If companies lost limited liability for torts, they would have an incentive to supervise their staff more carefully. How-

ever, if they took out insurance, that might well produce a moral-hazard problem: the protection that insurance offers itself might produce laxness on the part of companies and severe problems for the insurance market. We have already seen this in the current travails of the Lloyds insurance market in London. It had historically been a curious unlimited-liability company, and its members ("Names") were badly hit by the tort claims it has had to pay in the last ten years. In the future all new Names will have to offer limited liability.

If corporations were to lose limited liability for torts, it would produce some change in corporate behavior, but it is not the sort of change that capitalism could not cope with. After all, moral hazard has been a problem ever since insurance began, and methods have been found to mitigate its worst effects. What is interesting, however, is how limited liability for torts first came about. Of course, it is now in statute, but it began, presumably, in common-law processes. It must be the only example in American law that reduces the claims of tort victims. That should make libertarians think a little more carefully about the supposed sanctity of the common law. I can't imagine a libertarian law code being designed to let obvious tortfeasors evade their responsibilities.

Corporate Crime

A serious danger in the entity theory of the corporation has turned out to be the attribution of criminal liability. If the corporation exists as an artificial person separate from the individuals who compose it, then it is not surprising that it should be said to have some kind of surrogate "mind" enabling it to act with a *mens rea*, that is, from a guilty motive. It is true that the original prosecution of the Ford Motor Company for reckless homicide in the famous Pinto case failed, but since then there have been a number of successful prosecutions of companies for actions that one would have thought only real, live humans could commit.⁶ The Boeing Corporation was found guilty of corporate

An explanation of the genesis of the corporation suggests that its responsibilities are not to that nebulous entity "society," but to those who create it and invest their money in it. Any obligations that they owe to anyone else must be a function of their decisions as private persons. And the managers of the enterprises that they create owe duties only to the owners, or to anyone else in a contractual relationship with the firm.

theft, and the prosecution and persecution of Exxon in the Alaskan oil spill proceeded over a (fairly minor) criminal offense.⁷ There have been more serious examples.

The United Kingdom has been vexed by this issue. Following the Zeebrugge ferry disaster, in which over 200 people were drowned, there have been endless demands that corporations be charged with manslaughter.⁸ In that case, there was such a prosecution, but the judge threw it out on the ground that the whole range of individual wrongs that occurred could not be aggregated into a corporate wrong. The company charged, P&O, was not actually involved in the tragedy. It had simply later taken over the firm thought to be responsible. But it is noteworthy that the prosecution did not try the individuals directly responsible for the tragedy. We seem to have come a long way from the traditional idea of personal culpability for action.

Oddly enough, the only prosecution for corporate manslaughter that has succeeded in the United Kingdom involved a one-man corporation. Here, of course, a clear line of responsibility could be established. It might be difficult to do so in a large corporation, but that is not a reason to use the entity idea of the corporation as a substitute for individual wrongdoing.

When we examine the idea of the corporation legally and morally, it is not such a remarkable institution, since some of its features appear in business organizations that do not take the corporate form, such as partnerships and trusts. What is distinctive about it is the easy transfer of shares, which arose

out of the original joint-stock companies. Indeed, Hessen suggests a continuum in which a business starts out in single-proprietor form, develops into a partnership, and finally emerges as a corporation.⁹

Business Ethics

An explanation of the genesis of the corporation suggests that its responsibilities are not to that nebulous entity "society," but to those who create it and invest their money in it. Any obligations that they owe to anyone else must be a function of their decisions as private persons. And the managers of the enterprises that they create owe duties only to the owners, or to anyone else in a contractual relationship with the firm. In a famous essay written 30 years ago, Milton Friedman said that the social obligations of business agents were to increase the profits of the companies for whom they worked, subject only to the basic rules of society, "both those embodied in the law and those embodied in ethical custom."¹⁰

But there is a problem with "ethical custom." It has ceased to be limited to the do's and don'ts of any civilized order, and has now been expanded widely. It includes what philosophers call *supererogatory* duties, that is, worthy but not compelling. Those virtuous actions, such as employing ethnic minorities irrespective of marginal-productivity considerations, taking special care of the environment, not trading with certain unfashionable nations, and building swimming pools for deprived children, have now become as compulsory as the basic

moral and legal rules. But these new duties can hardly be described as ethical, since corporate executives normally perform them with shareholders' money and often without their permission.

Company annual reports are replete with mission statements that boast the firms' moral profile. Is this what Friedman meant by customary morality? I hardly think so, but in these morally ambiguous times it is difficult to know what that is. Some shareholders themselves may not object to such morality, and the new activists seem more anxious to tilt the firm in the right moral direction than to chivvy managements to produce better results. The moral argument has been helped by the separation-of-ownership-and-control thesis: if the dispersed shareholders can no longer hold the management to account, then why should not society set the agendas of companies?

Law and practice are confused about this. On the one hand, company executives have a fiduciary duty to the stockholders and may only pursue noncommercial activity if it has some positive effect on shareholder value.¹¹ But on the other, corporations are recognized as part of society with a concomitant duty to advance its well-being even if that might entail some loss to shareholders.¹²

An equally dangerous idea is that property owners should not be decisive in the management of a company, but that other "stakeholders" should be influential in such things as plant relocation, remuneration, and takeovers. Of course, it is easy to show that with a number of stakeholder groups holding divergent goals, no rational decision could ever be reached. There would be only endless conflict.¹³ At least stockholders can be assumed to have one overriding goal, to maximize the value of their stock. But most of the corporate moral activists are Kantians, believing that certain absolutely binding moral duties should always trump utility. Whatever contracts these stakehold-

ers have, they are unlikely to be contracts of ownership.

The striking thing about business's current problems is that they illustrate an old issue in corporate governance. For all the advantages of financing by freely transferable stock, it does generate an agency problem. How do we ensure that the agents, the employees, act on behalf of the principals, the owners? Won't they shirk on the job and divert to themselves income that should go to the stockholders? Adam Smith's objections to the joint-stock company were on these efficiency grounds rather than derived from moral reasons. He thought that only a single proprietor would have the incentive to act efficiently. Of course, he was not prescient and did not anticipate the devices, including the takeover, that capitalism would develop to ensure that managers would pursue owner value.

It is interesting to note that none of the proponents of the separation-of-ownership-and-control thesis, from Adolph Berle and Gardiner Means through to J.K. Galbraith and modern business ethicists, ever inquired into these new developments. They were simply against the corporation, unless it could be compelled to do good. □

1. Quoted in John Hood, "Do Corporations Have Social Responsibilities?," *Ideas on Liberty*, November, 1998, p. 680.

2. See Adolph A. Berle, Jr., and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).

3. Robert Hessen, *In Defense of the Corporation* (Stanford, Cal.: Hoover Institution, 1979), p. 43.

4. See Ronald Coase, "The Nature of the Firm," *Economica*, vol. IV, 1937, pp. 386–405.

5. Hessen, pp. 18–21.

6. See Norman Barry, *Business Ethics* (London: Macmillan, 1998), pp. 57–58.

7. *Ibid.*, p. 62.

8. *Ibid.*, pp. 65–66.

9. Hessen, chapter 4.

10. Milton Friedman, "The Social Responsibility of Business Is to Increase Its Profits," reprinted in Thomas E. Beauchamp and Norman E. Bowie, *Ethical Theory and Business*, sixth ed. (Englewood Cliffs, N.J.: Prentice Hall, 2001), p. 51.

11. *Dodge v. Ford* (1919).

12. *A. P. Smith Manufacturing Co. v. Barlow* (1953).

13. See Norman Barry, "The Stakeholder Theory of Corporate Control Is Illogical and Impractical," *The Independent Review*, Spring 2002, pp. 541–54.