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AN INTRODUCTION TO THE LAW OF BUSINESS ORGANIZATIONS

CASES, NOTES AND QUESTIONS

Second Edition

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still in its infancy, it does appear that for many matters, most prominently shareholder liability for entity debts when shareholders abuse their power to the detriment of third parties ("piercing the corporate veil"), the law of LLC's tracks that of corporations.

B. A SHORT HISTORY OF THE CORPORATION

As we will soon see, there is now and has been for some time considerable debate about the social responsibility of American corporations. At one time it might have been said that there was a burden of proof that incorporators had to meet before the monarch, or the legislature, as a matter of discretion, would confer what was then regarded as the *privilege* of incorporation. That privilege was only to be granted if incorporation served the public good, and that notion is not completely absent from the law even today. Still, it is more common to view incorporation as a ministerial act, one to which any incorporators meeting simple and formal registration requirements can claim a right. The view of incorporation as a privilege granted to serve the public interest, however, was central to corporate existence through many centuries, and a full understanding of the law of corporations and the policies it seeks to implement is impossible without some consideration of this history.

The corporate form dates back to the early Roman Empire, but its use for private commercial enterprise is considerably more recent. Blackstone attributed the idea for the corporate form to Numa Pompilius, a Roman who helped the warring factions of Sabines and Romans incorporate as separate municipal entities, believing that if the groups could govern and view themselves as independent, it would reduce bloodshed.[12]

The life of the corporation as a creature of English law began in England during the twelfth and thirteenth centuries, as towns sought independence from feudal and ecclesiastical control and were incorporated as self-governing municipalities. During the same era, general merchant or crafts guilds were the most important form of commercial organization, and in exchange for substantial fees to the crown, enjoyed a monopoly of their trade within a city's walls.[13] These merchant guilds were perhaps more like trade unions than modern corporations, as they were principally concerned with supervising apprenticeships, determining who ought to be admitted to the trade, and taking other steps to protect guild members' interests and their exclusive right to carry on trade. In the manner in which they functioned, however, the guilds can properly be viewed as prototypical corporate forms. The Guilds were governed by a council, similar to the modern corporate board of directors, and as early as 1437, the guilds had to be registered with and approved

12. Douglas Arner, *Article in Tribute: Development of the American Law of Corporations to 1832*, 55 SMU L. Rev. 23, 25 (2002).

13. John Micklethwait & Adrian Wooldridge, *The Company: A Short History of a Revolutionary Idea* 23 (Weidenfeld and Nicolson 2003).

by the town where they were established.[14] Beginning in the fifteen century, the crafts guild and the municipal borough were viewed as d tinct in function, with the municipal corporation acting as a governi body while the crafts guild served as an economic tool only for its me bers, although the corporate forms of the two types of entities were ide tical and both ensured survival of the institutions themselves, ev though the governing persons and the individual members would eve tually pass on. Both types of corporations could include either natur members or "bodies incorporate and political," indicating that corpor tions could be part of other corporations.[15]

Nineteenth century American legal scholars Joseph K. Angell a Samuel Ames and English economist Adam Smith divided early ec nomic corporations into two classes: regulated companies and joint sto companies.[16] Regulated companies were state-chartered monopoli authorized to pursue interests beneficial to the state and were depe dent on the state for their continued power and success. The most su cessful of the regulated companies was the Staple of London, founded 1248 to control wool exports and granted power in 1357 to collect tax on wool exports in return for helping finance Edward III's French wars. Joint stock companies, which emerged during the sixteenth and seve teenth centuries, more closely resemble the modern business corpor tion, as they involved owners who left the management of the busine entirely to a body of directors.[18] Joint stock companies did not invent th selling of shares on the open market—an idea that dates back to at lea the thirteenth century when shares in mines and ships were common sold—but they did substantially advance the technique of selling share as a means of raising large amounts of corporate capital.[19]

Shareholders in joint stock companies also enjoyed some limite liability, enhanced by the fact that the company itself usually held sul stantial assets in land, and exposure to tort liability during this perio was rare. Generally, shareholders would agree to be responsible for th contribution of a certain amount of total capital, even though they woul customarily not pay the entire amount as an initial investment. Th result was that even though the shareholder could be liable for mor than his initial investment, his liability was capped at that agreed-upo amount.[20] Joint stock companies appear to have gradually developed du to the activities of wealthy merchants, property owners, and successfu tradesmen who combined their resources to undertake ventures beyon their individual means or tolerance for risk, and utilizing the now avai able corporate form in a manner very different from that of the earl incorporated towns and guilds. This development reflects the genera

14. Arner, *supra* n. 12 at 26

15. *Id.* at 29–30, citing Coke 5. Co. Rep. 23, 29b (1526–1616).

16. *Id.* at 26 and 38.

17. Mickelthwait and Wooldridge, *supra* n. 13 at 24.

18. Arner, *supra* n. 12 at 26, citing Joseph K. Angell and Samuel Ames, *Trea tise on the Law of Private Corporation Aggregate* 32 (reprint N.Y. Arno Press 197 (1832).

19. Mickelthwait and Wooldridge, *supr* n. 13 at 26.

20. Arner, *supra* n. 12 at 39.

expansion of markets and private capital investment, which became as important to commerce as the specialized skills of merchant craftsmen had been earlier.[21]

In the first two decades of the seventeenth century, forty joint stock "colonizing" companies were granted charters and trading monopolies in exchange for the crown's rights to the land discovered or settled by the corporations. The trade monopolies granted to these corporations encouraged shareholders to invest in these high risk ventures, even though their liability was not fully limited.[22] In addition, the shares held in these corporations were not fully protected as an individual property right, since the monarch retained the prerogative to refuse to renew or to withdraw the corporate charter. Nevertheless, interests in those corporations were widely traded on a stock exchange, much in the manner they are now.[23] As with earlier regulated corporations, the division between those that ought to be regarded as purely private and those that might be classified as "public" was often difficult to determine—directors of the British East India Company, for example, a concern that made many of its individual investors wealthy men, reported that "the Company traded more for the benefit of the nation [England] than for itself."[24]

The English "Bubble Act" of 1720 marks a definitive point in the history of modern business corporations. When the South Sea Company took over the British national debt in an attempt to retire it by selling shares on the open market to individuals, other corporations fought to participate in this emerging public debt market. The South Sea Company lobbied for the Bubble Act to be passed, in an attempt to restrict competing enterprises. The act, among other things, made it clearly illegal for any joint stock company to operate without a charter from parliament or the king.[25] As formalized charters were relatively difficult to obtain for most businesses, the act essentially cut off the growth of the private corporation in England until the nineteenth century, leaving contract-formed partnerships to emerge as the preferred vehicle of business in England.[26] The Bubble Act was extended to the colonies in 1741 and, along with the general political unrest that characterized the colonies in the eighteenth century, slowed the development of the corporation there. To circumvent the Bubble Act, many colonial businesses were formed according to private articles of agreement, and although legally partnerships, these businesses were able to approximate the joint stock form.[27]

21. *Id.* at 27.

22. Janet McLean, *The Transnational Corporation in History: Lessons for Today?*, 79 Ind. L.J. 363, 365–66 (2004).

23. *Id.* at 370 n.43

24. *Id.* at 369 n. 33, citing K.N Chaudhuri, *The Trading World of Asia and the English East India Company, 1660–1760* 121 (1978).

25. Mickelthwait and Wooldridge, *supra* n. 13 at 40–41.

26. Arner, *supra* n. 12 at 33–34.

27. *Id.* at 43, citing Shaw Livermore, Unlimited Liability in Early American Corporations, 43 J. of Pol. Econ. 674, 674 n.2 (1935).

After the American Revolution, it was commonly understood th the power to grant corporate charters, which in England had eventual come to be shared by the king and parliament, was possessed in Ameri solely by the state legislatures.[28] Colonial legislatures had made fr quent use of the corporate form to organize religious congregations a units of local government, and general incorporation statutes for crea ing these organizations were passed in many states shortly after t Revolution.[29] Forming a private business corporation, however, requir more formalities. State legislatures had to pass a special act of incorp ration for each new entity, which was required first to demonstrate th its operation would confer a public benefit. A charter might then granted, which gave legal standing to the corporation and might al confer special franchise rights such as monopolies. As a result, t majority of early American corporations might be characterized as clo to "public utilities," and included banks, insurance companies, univers ties, and companies engaged in constructing turnpikes, bridges a canals.[30] These early American corporations were usually limited to 5 30-year terms, with perpetual duration of corporations remaining ra until after the Civil War.[31]

In the nineteenth century, four important developments in Amer can business and politics combined to produce changes that led to t form of business corporation we have today, which entity does, perhap represent American law's greatest contribution to world commerce.

The first important event was a clarification of the Constitution status of the American corporation, through one of the most importa decisions ever rendered by the United States Supreme Court. In *Dar mouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 4 L.Ed. 629 (181 the Court held that the charter of Dartmouth College (organized as corporation) was a contract conferring private rights on the incorpor tors and their successors. The charter, then, was understood to be t valuable private property of the corporation, rather than property hel in trust for the state, as had previously been the more commonl accepted view. Prior to *Dartmouth College*, it was understood that t granting of a corporate charter by a state legislature was no differe from any other legislative act, and that as was true for any other law, t grant of a charter might be amended or repealed if the operation of t corporation was deemed by the legislature no longer to be in the publ interest.[32] Because the corporate charter was held to be a contract i *Dartmouth College*, this brought into play Article I, Section 10, clause of the United States Constitution, which provides in pertinent part th

28. E. Dodd, *American Business Corporations Until 1860* 196 (1954).

29. Ronald E. Seavoy, *The Origins of the American Business Corporation, 1784–1855: Broadening the Concept of Public Service During Industrialization* 4–5 (1982).

30. James Willard Hurst, *The Legitimacy of the Business Corporation in the Law of the United States 1780–1970* 18 (Press of Va. 1970).

31. Lawrence Friedman, *A History American Law* 188–192 (2d ed. 1985).

32. See, for the leading case expressi this view, Currie's Administrators v. T Mutual Assurance Society, 14 Va. 3 (1809).

"No State [legislature] shall ... pass any ... Law impairing the Obligation of Contracts." This meant, then, that no state legislature could alter any corporate charter unless it had reserved the right to do so in the original grant. Writing for the Court in *Dartmouth College*, Chief Justice John Marshall observed that private colleges were essential in America, and that no one would ever found or invest in a college or other corporation while "believing that it is immediately to be deemed a public institution, whose funds are to be governed and applied, not by the will of the donor, but by the will of the legislature."[33] Justice Story, in his concurrence in the case, suggested that private colleges were like privately-funded banks, and that while both performed functions that were beneficial to the public, neither should be regarded as "public corporations," but rather as private entities, the private property of which required insulation from legislative interference. As Story put it, "the mere act of incorporation will not change the charity from a private to a public one."[34]

The second important development was the rise of the railroads, the first national-scale businesses. Administering these enterprises required the creation of a complex hierarchy of managers who, although they did not own the businesses with which they were involved, came to stake their professional careers on enabling enterprise to grow and prosper. This separation of management and ownership also further accelerated the development of large-scale public markets for the sale of shares, since it was now possible for investors passively to reap the rewards of investment in corporations without participating in management. By 1898, railroads accounted for over 60% of the publicly-issued stock in the US.[35]

The third development was the formation of large-scale manufacturing, mining and other industrial concerns which created a rapid increase in the number of charters granted to businesses that did not directly perform a public benefit. As requests for such charters became more frequent and were granted, the understanding that corporate charters were a privilege granted only to those who served the public began to erode. As corporations became more common and legislators became more familiar with the corporation as an instrument of private business, political, legal and structural changes followed. In what, as you will see, has been characterized as a "race to the bottom" that began in the 1820s and purportedly continues today, states began to loosen their regulation of corporations and to make it easier to incorporate. This occurred not only because the economic operations of corporations might be beneficial to the state of incorporation, but also because incorporators began to understand that they had some choice in determining in which state they might incorporate, and states found that incorporation and franchise fees could be an important source of state income.[36]

33. 17 U.S. (4 Wheat.) at 647.

34. *Id.* at 671.

35. Micklethwait and Wooldridge, *supra* n. 13 at 66.

36. Hurst, *supra* n. 30 at 18.

These changes led to the the passage of general incorporation laws that removed the requirement of the legislature's individual approval for each entity and, eventually, evolved into a system that made incorporation an option for almost any enterprise. The standard general incorporation acts of the 1880s made corporate status available through simple administrative procedures, but required very strict compliance with limits on capitalization, corporate organization and share structure.[37] By the1930s, a more liberalized type of general incorporation had been put in place throughout the country, providing a standard corporate structure but allowing variations as the drafters of individual corporate bylaws desired.[38] Throughout the twentieth century, general incorporation statutes came to grant expansive power for incorporators to vary, through contracts, charter or bylaws, the terms that the law might otherwise impose for corporate organization and governance.[39]

Finally, in what may have been the most important of these developments, limited shareholder liability became commonplace during the nineteenth century. Some firms chartered in the eighteenth and early nineteenth centuries were granted a form of limited liability, perhaps in exchange for the firms' building of public improvements without the expenditure of public funds.[40] Although limited liability was thus not unknown in the eighteenth century, there is at least one instance of a corporate charter's dictating that shareholders had *unlimited* liability for the enterprise's debts.[41] Unlimited liability became even more common in the first part of the nineteenth century, as a legislative policy of protecting corporate creditors took hold in many American jurisdictions.[42] This policy was based, at least in part, on the belief that corporations could more easily amass the necessary capital from creditors' loans if creditors knew that there was recourse against the individuals involved. Making capital more easily available from creditors, so the argument ran, would itself benefit fledgling entrepreneurs, and this would ultimately benefit the public. By 1840, however, perhaps as private equity investment became a preferred means of raising capital, many states' legislators amended their corporate laws to provide for limited shareholder liability. This legislative change was supported not only by the economic argument that lowering liability would lead to additional investment in the state's businesses, but also by the notion that by removing the threat of unlimited liability, shareholders of modest means would be able to invest in corporations, thus democratizing corporate ownership.[43]

One of most recent and most important developments in the operations of private corporations, one that has led to an explosion of corporate development in the twentieth and on into the twenty-first century,

37. *Id.* at 69.

38. *Id.* at 70.

39. *Id.* at 120.

40. Seavoy, *supra* n. 29 at 257–58.

41. Dodd, *supra* n. 28 at 227.

42. *E.g.*, Handlin and Handlin, *Origins of the American Business Corporation*, 5 J. Econ. Hist. 1, 10 (1945).

43. Seavoy, *supra* n. 29 at 115.

is the increasing prevalence of subsidiary and affiliated corporations. These are corporations owned by each other, or sister corporations for whom ownership is identical, often in another corporation. Giant global business entities, many incorporated in the state of Delaware, now function all over the world through separately-incorporated subsidiaries and affiliates. As we will see in Chapter Four, it is now universally accepted that absent an abuse of the corporate form, a corporate shareholder has the same limited liability for the debts of its subsidiaries and affiliates as does an individual investing in a corporation. The rise of operation through subsidiaries and affiliates appears to have come about in tandem with the wide dispersal of passive shareholder investors, and the rise of professional managers. The number of individuals owning shares in corporations rose from two million in 1920 to over ten million in 1930. Current estimates suggest that approximately sixty percent of American households can be regarded as investors in corporations, and, during the 2004 Presidential election, some commentators suggested that "investor interests" were important in the reelection of the Republican candidate, George W. Bush.

In the 1960s, diversified conglomerate corporate entities emerged and grew to be a powerful economic force by taking over divisions of other corporations, either through friendly negotiated buyouts or hostile "takeovers." By 1973, fifteen of the top 200 American manufacturing corporations were conglomerates, but by then this particular wave of mergers and acquisitions was ending, as the conglomerates failed to deliver expected returns and the stock value of these huge businesses declined.[44]

Even so, the urge to merge grew again as financing became more generally available in the 1980s. Large corporations grew even larger and more diverse through the "merger boom" of the 1980s, but all was not well.[45] From 1970 to 1990, the rate at which large American companies left the Fortune 500 increased four times, and many large conglomerates found it more profitable to slim down and focus on core businesses.[46] The business of many American corporations also changed radically toward the turn of the Century. By 1999, the most valuable American export was probably intellectual capital, as old-style manufacturing gave way to the "information age" and the "service economy" and new groups of entrepreneurs found success in small, flexible upstart corporations.[47]

By the end of the twentieth century, there seemed to be a discernable trend for state and national governments to set the corporation free by deregulating markets, simplifying general incorporation procedures, and loosening trade barriers. At the same time, however, and somewhat paradoxically, the state legislatures and Congress increasingly regulated the ongoing operations of corporations through laws governing account-

44. *Id.* at 120.

45. *Id.* at 138.

46. *Id.* at 125.

47. *Id.* at 139.

ing procedures, the health and safety of workers, the environment, affi mative action, and the protection of employee, consumer and even inve tor rights.[48] Although general incorporation statutes had been simplifie and streamlined such that the act of incorporation seemed little mo than a formality, modern corporations still needed some form of gover ment authorization to exist, and the corporate laws and other regulato measures of particular states continued to have great influence on whe businesses chose to incorporate. In 1999, most of the largest America companies were incorporated in Delaware, a state whose laws favor the discretion of managers and majority shareholders over the purport corporate governance rights of minority shareholders.

We will explore several of the implications of this brief history corporations, but this whistle-stop tour should give you enough inform tion to reach some preliminary conclusions. Are you comfortable with th ubiquity of the corporation (and other similar business vehicles such the limited liability company (LLC))? Is the history of the developme of the corporation, and the emergence of the modern American busine corporation (the model for the rest of the world) an unqualifiedly nob human achievement? How should the corporation be regulated in th public interest? Consider the implications of *Ford v. Dodge* and *Smith Barlow*, which follow.

C. THE PURPOSE OF THE CORPORATION

DODGE v. FORD MOTOR CO.

Supreme Court of Michigan.
204 Mich. 459, 170 N.W. 668, 3 A.L.R. 413 (1919).

OSTRANDER, J. *(after stating the facts).* The authorized capital stock the defendant company is $2,000,000. Its capital, in July, 1916, investe in some form of property, including accounts receivable, wa $78,278,418.65, and, less liabilities other than capital stock, was mo than $60,000,000. Besides this, it had and was using as capital near $54,000,000 in cash or the equivalent of cash.

* * *

* * * [T]he case for plaintiffs must rest upon the claim, and th proof in support of it, that the proposed expansion of the business of th corporation, involving the further use of profits as capital, ought to b enjoined because inimical to the best interests of the company and it shareholders, and upon the further claim that in any event the withhold ing of the special dividend asked for by plaintiffs is arbitrary action the directors requiring judicial interference.

The rule which will govern courts in deciding these questions is n

48. *Id.* at 146.