

9-1-1979

*In Defense of the Corporation.* By Robert Hessen.  
Stanford Hoover Institution Press.

Henry G. Manne

Follow this and additional works at: <http://repository.law.miami.edu/umlr>

---

**Recommended Citation**

Henry G. Manne, *In Defense of the Corporation.* By Robert Hessen. *Stanford Hoover Institution Press.*, 33 U. Miami L. Rev. 1649 (1979)  
Available at: <http://repository.law.miami.edu/umlr/vol33/iss5/13>

This Book Review is brought to you for free and open access by Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized administrator of Institutional Repository. For more information, please contact [library@law.miami.edu](mailto:library@law.miami.edu).

## BOOK REVIEW

IN DEFENSE OF THE CORPORATION. By Robert Hessen. Stanford: Hoover Institution Press.

*Reviewed by Henry G. Manne\**

A growing body of new scholarship is at last explaining and analyzing the nature of our large publicly held corporations. The picture emerging is that of a dynamic system of remarkably complex organizations operating in the interest of society in response to strong competitive market forces. This should be welcome news for a business community long concerned about anti-business attitudes and its own ability to mount a popular defense.

The most recent contribution to this fascinating field of "corporate theory" is a short monograph aptly entitled *In Defense of the Corporation* (1979), authored by Dr. Robert Hessen. Hessen organizes his spirited defense of the large corporation around the most recent taunting engaged in by Ralph Nader, Mark Green and Joel Seligman, *Taming the Giant Corporation* (1976). The importance of Hessen's work, however, readily transcends its significance as a rebuttal to the already disarrayed intellectual forces of the Nader camp.

With estimable clarity Hessen develops a little understood but fundamental notion about business corporations: the corporate form does not represent, as has been commonly claimed, a grant from the government or a special privilege that itself justifies political interference with an essentially private activity.

Hessen begins by explaining the crucial difference between the so-called concession and inherence theories of the corporation. Briefly, the former views corporations as coming into existence only as a result of a special concession or grant made by the government. The inherence theory, on the other hand, perceives the corporation as the product of purely private contracts and of market forces. The characteristics of a corporation "inhere" in the voluntary associational activities of individuals; true corporate conception does not imply governmental paternity.

The implications of these two views are substantial. The concession theory implies few constitutional or legal limitations on the

---

\* Distinguished Professor of Law and Director, Law and Economics Center, School of Law, University of Miami.

conditions or regulations the government may impose on corporations. In its extreme form, every corporation becomes an agency of the state. In contrast, the inherence theory logically commands for a corporation all of the legal and constitutional protections and liberties enjoyed by the individuals who make up the organization.

Political economy buffs will see the parallel between this debate and a lively one in the public finance field. There, one side holds that all wealth is initially derived from or attributable to the government. Individuals are "allowed" to realize income, and deductions are basically subsidies or "tax expenditures" granted to certain taxpayers as a matter of governmental discretion. Under the alternative view, taxation simply represents tribute taken by government force from the wealth that individuals have produced by virtue of their own efforts.

Three aspects of "corporateness" relied on by Nader, *et al*, to support the concession theory are examined in depth by Hessen. The first of these is the recognition by the law of the corporation as a separate legal entity or being, especially for purposes of suing or being sued in its own name. This is contrasted to the pattern historically found in partnership law, as illustrated by the requirement that in law suits every individual co-proprietor be listed by name.

Even apart from the obvious fact that the costs and benefits of this alleged "privilege" are perfectly symmetrical, depending on who is suing and who is being sued, Hessen argues forcefully that the "name" given to a particular form of organization like the "university," the "corporation," the "club," etc., is merely a semantic device for classifying different legal relationships individuals have entered voluntarily. Yet, the semantic error commonly goes unrecognized when the subject is a large corporation. Hessen leaves no philosophic leeway to argue that the legal conceptualization of a corporation can be used to justify special economic restraints on the individuals involved therein.

Perpetual existence is the second concession to the corporate form alleged by corporate critics to justify or even require government regulation of corporate activities. Hessen, however, carefully analyzes the real similarities and differences between partnership law and corporation law and correctly finds less difference than is commonly supposed. Perpetual existence, for example, may for all practical purposes be had by partnerships through private contractual agreements. And historically, perpetual existence was as much a benefit to the state as it was to the incorporators. Hessen might have noted that the facilitation of corporate immortality by general corporation laws does reduce certain transaction costs that individ-

uals operating in a totally unlegislated area would incur to achieve organizational permanence. Even so, such minor cost-savings procedures, in no way harmful to anyone else, cannot logically justify economic regulation.

The third concession examined, and the one most frequently referred to by corporate critics, is the limited liability of shareholders. Hessen correctly identifies the problem as being related exclusively to the area of involuntary liability, *i.e.*, tort rather than contract. Voluntary creditors after all are free to establish any limit on liability they wish in their private agreements. To preserve corporations' political purity, however, Hessen would abandon the limitation of individual shareholders' liability for personal injuries and for other risks not voluntarily assumed by injured parties. Given the minimal economic impact of the rule, and the great complexities of administering any alternative rule, Hessen would seem to have taken the whole matter too seriously.

Hessen has performed a valuable service in pointing up the shoddy work product of Nader and his crypto-scholars. His statistics on the number of that crew's citation errors, or their suspect nature, are alone worth the price of the book. But he has perhaps done a minor disservice by even implicitly agreeing that the issue of "privileges" to corporate shareholders presents a serious intellectual challenge to the largely unregulated use of the corporate form of voluntary association.

The entity-aggregate argument, and other parts of the "concession" theory, have long taxed the metaphysical bent of European legal scholars. American writers, from a more pragmatic tradition, have shown a proper disdain for the issue. Indeed, Adolf Berle and Gardiner Means in *The Modern Corporation and Private Property*, (1932), the most influential book ever written about corporations, dismissed the entire "privilege" argument in just two paragraphs—and in a footnote besides!

While Hessen's philosophic arguments regarding the entity theory, perpetual existence, and limited liability are cogent enough, they are less interesting and certainly less formidable than his research into the legal history of the corporation. That history is particularly valuable because it illustrates a fundamental flaw in our legal process which only the eternal vigilance of non-legal scholars like Hessen is apt to ferret out.

The difficulty that Hessen's work uncovers began with the rapid emergence of corporations as the preferred form for multi-investor businesses in England in the late eighteenth century and in the United States about fifty years later. This coincided with the

respective beginnings of modern, large-scale industrialization, especially the building of railroads. As economies of scale resulting from new technology were rapidly exploited by entrepreneurs, the development of new business forms, customs, and conventions proceeded apace. In fact, these developments outdistanced the ability of the law to invent new and specialized responses to the legal disputes that inevitably followed.

The problem was not so much that judges and lawyers could not cope with the business issues presented: there is considerable evidence that the solutions formulated by courts, and later by nineteenth century state legislatures, were well designed to serve the economic and social needs of the nation. Yet, the law did not always introduce satisfactory new language or legal concepts to cope with new legal and business realities. That failure laid the seeds of some modern problems.<sup>1</sup>

The language of pre-industrial corporation law had evolved primarily to deal with the only significant "corporations" then existing, mostly medieval towns, guilds, universities, and churches. None of these institutions encompassed such commercially derived concepts as limited liability, professional managers, proportionate share voting, liquid capital markets, or a market for corporate control. As a result, our nineteenth century courts and later our legal scholars occasionally confused the terminology, and indirectly the law, of modern corporate enterprises with that of ancient crown-grant corporations.

One such legal argument, not noted by Hessen, enormously influenced nineteenth century legal developments, though it had its principal relevance in the fourteenth century. It had become a commonplace notion that a corporate charter represented not merely a contract between the parties mentioned, but also a contract with the state. This was literally true when early English kings placed conditions in charters granted to towns or other corporations in order to raise revenues or to restrict their various powers. It bore no resemblance to modern commercial incorporation procedures.

Yet, this notion of a contract with the state led nineteenth century courts and lawyers into an incredible morass of litigation attempting to delimit properly the corporate powers and purposes purportedly fixed in the articles of incorporation. Indeed, early corporation law treatises discussed little else, and American commer-

---

1. See generally Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967).

cial law history nowhere else reflects such a ridiculous posture. It is quite revealing that even Ralph Nader does not trot out that discredited theory, even though the logic of the argument is at least as compelling as other, less well-publicized aspects of the concession theory.

An even more serious error in the development of modern corporate theory relates to a single provision carried into our early corporation law. The provision was that "the business of the corporation shall be managed by a board of directors," or words to that effect. These words constituted boilerplate language in almost every special charter granted during the nineteenth century and in the general incorporation laws that came to dominate the incorporating process by 1875. They accurately described reality, but the mode of the words used is mandatory and not permissive. The concept of management underlying these words readily fit medieval guilds or towns and also most nineteenth century corporations. A central committee, with authority delegated by the members or shareholders, provided an efficient vehicle for the actual administration of association affairs. So the words were harmless, albeit needless.

A different system of management evolved in the world of large corporations, however, a system both more flexible and more adaptable to varying business circumstances. The era of modern, professional, executive management had begun, and the words ceased to reflect accurately the new managerial reality. If the board were to survive as anything other than just another legal fiction, it would have to have a purpose other than actually managing the company. The melody stopped, but words lingered on.

In fact, an extremely important function for the board of large, publicly-held companies did evolve, thus obviating any pressure to alter the statutory language. The board became principally a monitor of the comparative efficiency of the real executives of the corporation, the professional managers. To be sure, boards of directors continued to perform other tasks as well. Yet the most important job of the board was no longer to manage as such but rather to oversee those who did, ousting or maintaining them as economic circumstances dictated. With some fairly minor exceptions a well managed company had no immediate need for a board at all, though its presence undoubtedly served to remind managers of their responsibilities—and what could happen if they forgot.

But large corporations and their shareholders were definitely not solely reliant on the board to perform this monitoring function. If for any reason the directors failed in their job of overseeing the relative performance of the managers, depersonalized market forces

such as proxy fights, control purchases, tender offers, or mergers would soon correct the problem. Though still not widely recognized, it is this phenomenon of a market for corporate control that guarantees the real identity of interests of owners and management in even the largest of our publicly held companies. Without it our corporate system could never have been the economic success it has been.

By all careful accounts this market for corporate control works admirably. Yet, superficial observers—either heavily influenced by the Berle and Means notion of the separation of ownership and control, or overly mindful of the statutory command for the board “to manage the business”—have been concerned, among other things, about directors who do not direct, or by the failure of directors to keep informed about minute details of corporate operations.

It is unfortunate that earlier legal scholars did not recognize the significance of the market for corporate control and the extent to which it effectively replaced an outmoded managerial function for the board of directors. Perhaps then we would have been spared the current efforts of the SEC, Ralph Nader, and some noisy law professors to invent a corporate form not molded by market forces, one that would quite likely do more harm than good for shareholders and everyone else.

This drive to reinvent the corporation is usually accompanied by a broad proposal for federal chartering of large companies. The advocates of these proposals have tried unsuccessfully to mask their regulatory intent by arguing the failure of our traditional system of state incorporation laws. They describe Delaware as the winner of an infamous “race to the bottom” in corporation law, because it allowed corporate managers more freedom from shareholder or public controls than did any other state. Hessen, however, explains Delaware’s victory differently. He argues that Delaware offered not only a desirable set of substantive laws but the special advantage of a large, free “capital stock” of legal precedents. This significantly lessened uncertainties about the law and thus the likelihood of litigation, an enormous economic benefit for shareholders.

A proper test for settling this difference of views would be to see how the stock market has responded to Delaware incorporations. Two recent, independent studies—one by Professor Barry D. Baysinger of Indiana University,<sup>2</sup> and another by Professors Peter Dodd and Richard Leftwich of the University of Rochester<sup>3</sup>—

---

2. B. Baysinger, *An Efficiency Analysis of Corporate Federalism* (1978) (unpublished working paper, Indiana University Graduate School of Business).

overwhelmingly support Hessen's thesis. They demonstrate clearly that reincorporation in Delaware has always been followed by a higher market price for shares in the company, thus indicating increased benefits for shareholders, not greater costs. Apparently the critics of the race to the bottom had their ladders upside down!

One statement of regret about Hessen's small book is in order. In a day when the traditional corporate director is enormously beset by risks of personal liability, when the clamor is loud for political representation on boards of directors of large companies, when the never-defined concept of corporate social responsibility threatens to destroy the very fabric of our corporate system, a reader may be somewhat perplexed to find that a book entitled *In Defense of the Corporation* addresses none of these issues. To be sure, the author does include a clear, summary criticism of the ill-conceived current efforts to break up big business and to curtail freedom of advertising.

These and other aspects of the work make it clear that Hessen's real obsession is with Nader. He even responds to Nader's argument, surely advanced tongue-in-cheek, for actual shareholder plebiscites on important matters of corporate management. Such fluff should be reckoned as mere padding for Naderite speeches to high school or grade school political activists—now that college students have received wisdom.

The issues that Hessen addresses in this monograph, he addresses well. His polemical style is well-suited to the task he has set for himself. Yet we are still awaiting a truly comprehensive scholarly defense of the American corporate system. That work will have to integrate the vast amount of economic, legal, and historical scholarship now available, including Hessen's. For the moment, however, devotees of corporate theory must still dig out the individual pieces and create their own mosaic.

---

3. P. Dodd & R. Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation* (MERC 78-06, 1978) (working paper, University of Rochester Graduate School of Management).

4. Much of this is now available in *THE ATTACK ON CORPORATE AMERICA: THE CORPORATE ISSUES SOURCEBOOK* (M. Johnson ed. 1978).