A Short History of the Corporation*

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Abstract

This module explores the history of business corporations. It provides background information useful for a unit or course on business government and society, business ethics, and corporate governance. The corporation is presented as the practical solution to a series of related historical problems such as providing for orderly transfer of property, pooling capital, and spreading financial risk. This module has been developed as a part of a project funded by the National Science Foundation, "Collaborative Development of Ethics Across the Curriculum Resources and Sharing of Best Practices," NSF-SES-0551779.

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1 Introduction

In this module you will learn about the history of corporations. Antecedants of the modern corporation can be found in the Middle Ages, the Renaissance, and in the Industrial Revolution in Great Britain and the United States. Corporations have evolved into their present form as the synthesis of discrete solutions to specific historical problems that have arisen in the practice of business. This module has been designed for courses in (1) business, society, and government, (2) business ethics, (3) corporate governance, and (4) corporate social responsibility.

2 What you need to know ...

2.1 The History of the Corporation

This historical process has produced five functions that characterize the modern corporation. Corporations have emerged as...

1. "Passive devices" that hold property
2. Structures designed to exert monopoly control over and regulate a domain of specialized knowledge and skill
3. Means designed to pool capital and resources including human resources
4. A legal shield that protects owners and investors from liability and helps to spread and distribute financial, moral, and legal risk
5. Organizational decision-making structures that subordinate and synthesize the actions of human agents to bring about collective goals such as building a railroad, designing and manufacturing automobiles, and pursuing legitimate business ventures.

2.1.1 Passive Devices that hold property

When the abbot of a medieval monastery died, public officials had difficulty determining to whom its property, wealth, and resources passed. While this is hard to conceptualize from a modern standpoint, during the Middle Ages, no legal distinction could be made between (1) managing property owned by others, (2) exercising stewardship over property owned by others, and (3) owning property. Moreover, the concept and practice of owning property is complex. "Property" in its modern sense has been spelled out as a bundle of distinct rights including "the right to possess, control, use, benefit from, dispose of and exclude others from the property." (DesJardins: 37) These distinct rights are not given as entailments of a natural concept of property but represent legally endowed capacities designed to respond to specific practical problems. So, to return to the problem created by the death of the abbot, a legal entity (called the church) was created and endowed with the one of the bundled rights accompanying the notion of property, namely, the right to possess and hold property (Stone 1974: 11)

2.1.2 Structures that exert monopoly control and regulate a domain of specialized

Those familiar with European history know that the university came from student guilds. Students banded together to hire noted scholars willing to teach their research. Other guilds were formed around practical occupations as butchering or shoe making. Eventually, guilds evolved to address a series of practical problems: (1) how to educate individuals concerning the skills and knowledge required by the practice, (2) how to identify those responsible for the improper practice of the craft, (3) how to control who could and could not participate in (and profit from) the craft, and (4) how to regulate the craft to promote the interests of its practitioners and its beneficiaries or clients. Guilds became responsible for controlling the privileges of a trade, establishing rules and standards of practice, and holding courts to adjudicate grievances between participants. (Stone: 11-13)

2.1.3 A set of means specially designed to pool capital and resources including human resources.

As business ventures became more ambitious, their successful execution required raising considerable funds and capital along with the coordination of the activities of diverse human agents. Organizational structures were created slowly over time to raise money, acquire capital, and manage these complex ventures. This included creating roles that were coordinated through complex organizational systems. The distinction between the **owner** and **manager** functions, so crucial to the structure of the modern corporation, emerged slowly during this period. Owners provided money and capital and determined the overall goals pursued by the organization. Managers carried out administrative tasks concerned with day to day operations; their moral and legal duty was to remain faithful to the aims and interests of the owners. Unchartered joint stock companies served as proto-corporations that generated capital, protected monopolies of trade and craft, and managed complex ventures such as importing spices and tea from the Orient. As these structures evolved, they increasingly embodied the important distinction between the ownership and management functions.

2.1.4 Providing a legal shield to limit owner and operator liability

Scandals in 18th century Great Britain revealed another set of problems besetting the emerging corporation. When the unchartered joint stock company, the South Sea Company, went bankrupt, all the investors and owners found themselves responsible for covering the huge debt created when risky investments and questionable ventures went sour. This debt went well beyond resources of the investors destroying their personal fortunes and placing many of them in debtor's prison. (This and other fiascoes were dramatized by Charles Dickens in his novel, **Little Dorrit**.) The specter of unlimited liability scared off potential investors and set back the development of the corporation. It became necessary to endow joint stock companies with powers and devices that limited and distributed financial, moral, and legal risk. (Both owners and managers required protection although in different ways.) Individuals would invest in joint stock companies only when the associated risks became manageable and widely distributed.

2.1.5 Organizational structure that subordinate and synthesize the actions of human agents

Negatively, the development of the modern corporation was facilitated by creating a shield that limited the liability of owners and managers. Liability for owners was limited legally to the amount invested. Liability for managers required proving that they failed to remain faithful to the interests of the stockholders, the principals or originators of their actions. This broke down into demonstrating failure to exercise "sound business judgment" by, among other things, allowing outside, competing interests to corrupt their business judgment. **Positively**, the corporation emerged out of a series of legal innovations designed to establish and then control the collective power of corporate organizations. Complex organizational structures were created that designed differentiated roles filled by employees. These structures served to channel the activities of employees toward corporate ends. The investor role stabilized into that of **stockholders** who owned or held shares of the corporation. To promote their interests and to establish the cardinal or fundamental objectives of the corporation, the stockholders elected representatives to serve on a board of directors. The directors then appointed managers responsible for running the corporation and realizing the interests and objectives of the stockholders. Managers, in turn, hired and supervised employees who executed the company's day to day operations (**line** employees) and provided expert advice (**staff** employees). These roles (and the individuals who occupied them) were related to one another through complex decision-making hierarchies. Davis (1999) in his discussion of the Hitachi Report shows how many modern companies have dropped or deemphasized the staff-line distinction. Others (Stone, Nader) cite instances where managers have become so powerful that they have supplanted the directorial role. (They hand pick the directors and carefully filter the information made available to stockholders.) But these two distinctions (staff v. line and owner v. operator) remain essential for understanding and classifying modern corporations. (See Fisse, Stone, and Nader.)

2.1.6 Profile of the Modern Corporation

Corporations became full blown legal persons. They acquired **legal standing** (can sue and be sued), have been endowed with **legal rights** (due process, equal protection, and free speech), and have acquired **legal duties** (such as tax liabilities). (See table below for the common law decisions through which these corporate powers and rights have been established.) The powers of the corporation were regulated by the state through founding charters which served roughly the same function for a corporation as a constitution did for a state. Initially, charters limited corporate powers to specific economic activities. Railroad companies, for example, had charters that restricted their legitimate operations to building and operating railroads. When they sought to expand their operations to other activities they had to relate these to the powers authorized in the founding charter. If a charter did not specifically allow an operation or function, then it was literally **ultra vires**, i.e., beyond the power of the corporation (Stone: 21-22). This method of control gradually disappeared as states, competing to attract business concerns to incorporate within their boarders, began to loosen charter restrictions and broaden legitimate corporate powers in a process called "charter mongering." Eventually charters defined the legitimate powers of corporations so broadly that they ceased to be effective regulatory vehicles.

Given this vacuum, governments have had to resort to other measures to control and direct corporations toward the public good. The practice of punishment, effective in controlling human behavior, was extended to corporations. But Baron Thurlow (a British legal theorist) framed the central dilemma in corporate punishment with his oft quoted comment that corporations cannot be punished because they have "no soul to damn" and "no body to kick." The unique attributes of corporations has given rise to creative options for corporate control and punishment: fining, stock dilution, court-mandated changes in corporate structure, adverse publicity orders, and community service. (See Fisse) Most recently, Federal Sentencing Guidelines have sought to provide incentives for corporations to take preventive measures to avoid wrongdoing by developing ethics compliance programs. These guidelines adjust punishments in light of ethics programs that the corporations have designed and implemented to prevent wrongdoing. Corporations found guilty of wrongdoing would still be punished. But punishments can be reduced when guilty corporations show that they have developed and implemented compliance programs to promote organizational ethics and to prevent corporate wroingdoing. These include compliance codes, ethics training programs, ethics risk identification measures, and corporate ethical audits.

History of Corporation

Problem	Solution	Organizational Form
Successfully transferring stewardship over church holdings to new abbot	Create a "passive device to hold property"	Proto-corporation
Control over and regulation of a practice or skill	Create a device to (a) hold the privileges of some particular trade, (b) establish rules and regulations for commerce, and (c) hold courts to adjudicate grievances among members.	Medieval guilds that evolve into regulated companies.
		continued on next page

Pooling capital and resources and directing complex ventures	Create a device (a) to hold provileges of trade, (b) where investors provide capital, and (c) that delegates operations to managers	Unchartered joint stock companies
Limiting investor liability, limiting manager liability, and balancing the two	Corporation evolves into a legal person with (a) legal rights and duties, (b) owned by shareholders, (c) run by managers, (d) regulated through state charter	Limited corporation whose operations are defined in and limited by the charter
Ultra Vires (charter prevents growth) and Charter Mongering	Granted broad powers through more broadly defined charters	Full Blown Corporation
Finding agent responsible for wrongdoing	(a) Due process, equal protection, and free speech rights, (b) legal duties, (c) legal standing, (d) Federal Sentencing Guidelines, and Sarbanes-Oxley Act	Corporation as **Legal** Person

Table 1: Modified from Christopher Stone, Where the Law Ends

Options for Corporate Punishment (Fisse and French)

	Description	**Example**	**Target of Punishment**	**Deterrence Trap Avoided?**	**Non-financial Values Addressed?**	**Responsive Adjustment**	**Interference with Corporate Black Box**
Monetary Exaction	Fines	Pentagon Procurement Scandals	Harms innocent	Fails to Escape	Few or None Targeted	None	No interference
Stock Dilution	Dilute Stock and award to victim		Stockholders (Not necessarily guilty)	Escapes by attacking future earnings	Few or None	Limited	No interference
Probation	Court orders internal changes (special board appointments)	SEC Voluntary Disclosure Program	Corporation and its Members	Escapes since it mandates organizational changes	Focuses on management and subgroup values	Passive adjustment since imposed from outside	Substantial entry into and interference with corporate black box

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Court Ordered Adverse Publicity	Court orders corporation to publicize crime	English Bread Acts (Hester Prynne shame in **Scarlet Letter**)	Targets corporate image	Escapes (although adverse publicity indirectly attacks financial values)	Loss of prestige / Corporate shame / Loss of Face/Honor	Active adjustment triggered by shame	No direct interference (corporation motived to restore itself)
Community Service Orders	Corporation performs services mandated by court	Allied chemical (James River Pollution)	Representative groups/individuals from corporation	Escapes but targets non-financial values	Adds value to community	Passive or no adjustment: sometimes public does recognize that cs is punishment	None

Table 2

Citation for Table
This table provides a close summary of Fisse, B. (1985). "Sanctions Against Corporations: The Limitations of Fines and the Enterprise of Creating Alternatives" in **Corrigible Corporations and Unruly Law**, editors Brent Fisse and Peter A. French. San Antonio, TX: Trinity University Press, 137-157. Summary in tabular form of the taxonomy developed by Fisse to classify and compare forms of corporate punishment.

Requirements of Sarbanes-Oxley (Summarized by Dyrud: 37)

- Provide increased protection for whistle-blowers
- Adhere to an established code of ethics or explain reasons for non-compliance
- Engage in "full, fair, timely and understandable disclosure"
- Maintain"honest and ethical" behavior.
- Report ethics violations promptly
- Comply with "applicable governmental laws, rules, and regulations"
- Dyurd cites: ELT, **Ethics and Code of Conduct**, n.d.; http://www.elt-inc.com/solution/ethics_and_code_of_conduct_training_obligations.html

Amended Federal Sentencing Guidelines (Taken from Dyrud: 37)

1. Establishing standards and procedures to prevent and detect criminal conduct
2. Promoting responsibility at all levels of the program, together with adequate program resources and authority for its managers
3. Exercising due diligence in hiring and assigning personnel to positions with substantial authority
4. Communicating standards and procedures, including a specific requirement for training at all levels
5. Monitoring, auditing, and non-internal guidance/reporting systems
6. Promiting and enforcing of compliance and ethical conduct
7. Taking reasonable steps to respond appropriately and prevent further misconduct in detecting a violation

2.2 Legal Trail Toward Corporate Moral Personhood: A Table Summary

Date	Decision	Legal Right Affirmed
1889	Minneapolis and St. L. R. Co. v. Beckwith	Right for judicial review on state legislation
1893	Noble v. Union River Logging R. Col,	Right for judicial review for rights infringement by federal legislation
1906	Hale v. Henkel	Protection "against unreasonable searches and seizures (4th)
1908	Armour Packing C. v. United States	Right to trial by jury (6th)
1922	Pennsylvania Coal Co. V. Mahon	Right to compensation for government takings
1962	Fong Foo v. United States	Right to freedom from double jeopardy (5th)
1970	Ross v. Bernhard	Right to trial by jury in civil case (7th)
1976	Virginia Pharmacy Board v. Virginia Consumer Council)	Right to free speech for purely commercial speech (1st)
1978	First National Bank of Boston v. Bellotti	Right to corporate political speech (1st)
1986	Pacific Gas and Electric Company v. Public Utility Commn of California	Right against coerced speech (1st)

Table 3: From Ritz, Dean. (2007) "Can Corporate Personhood Be Socially Responsible?" in eds. May, S., Cheney, G., and Roper, J., Oxford, UK: Oxford University Press: 194-195.

2.3

3 What you will do ...

3.1 Exercise One: Other People's Money

Watch the shareholder's meeting in the movie, " Other People's Money." Then answer the questions below. Think generally about what the manager of a corporation should do with the money its stakeholders have invested in it.

- What is Larry the Liquidator's basic argument? What is Andrew Jorgensen's basic argument?
- What is Larry the Liquidator's conception of the nature and value of the corporation? What is Andrew Jorgensen's conception of the nature and value of the corporation?
- What is the social responsibility of a corporation according to Larry the Liquidator? What is it according to Andrew Jorgensen?
- Write a paragraph on which argument you find most persuasive, that of Larry or that of Andrew. Explain why you find it persuasive.

3.2 Exercise Two: How to punish Arthur Andersen

Watch the documentary, "The Smartest Guys in the Room," paying special attention to the role played in the Enron fiasco by the accounting firm, Arthur Andersen. Then answer the following questions.

- How important should AA's former, excellent reputation have been in determining how to punish it in the role it played in the Enron case? Explain your answer.
- Enron was only the last of a series of ethics scandals that AA had fallen into. How should it have adjusted to prior scandals? (Are the Federal Sentencing Guidelines of any help here?)
- Consider that Sarbanes-Oxley was passed largely in response to Enron. Do its provisions go far enough to prevent future Enrons? Do they go too far?.
- Using the table that summarizes punishment options provided by French and Fisse, how would you construct a punishment for Arthur Andersen? Who should be targeted? Should the company's black box be left alone? Is it better to attack financial or non-financial values? Should Arthur Andersen and other corporate offenders be encouraged to reform themselves or should those reforms be designed and directed from the outside?

3.3

4 What did you learn?

Peter French speculates on the possibility that a corporation could consist of nothing more than a sophisticated software program. He also holds forth the notion of corporate moral personhood (as opposed to natural personhood). Now that you have had an opportunity to study the history of and structure of the modern corporation, what do you think about the nature of corporations?

5 Appendix

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6 EAC ToolKit Project

6.1 This module is a WORK-IN-PROGRESS; the author(s) may update the content as needed. Others are welcome to use this module or create a new derived module. You can COLLABORATE to improve this module by providing suggestions and/or feedback on your experiences with this module.

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