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## Scylla or Charybdis? Historical Reflections on Two Basic Problems of Corporate Governance

Shareholders in corporations face two very different types of governance problems: expropriation by controlling shareholders or managers; and expropriation by greedy rulers or, more generally, by the state. The problem is that the more successful investors are in protecting their capital from the grabbing hand of the state, the less they are able to call upon the state to protect it from the grabbing hand of corporate insiders. Conversely, the more investors are able to call upon government to restrain insiders, the more they are vulnerable to expropriation by the state. Although the terms of this tradeoff have changed over time as modern democratic polities replaced absolutist monarchies, both types of threats are still very much with us.

**S**carcely had the twenty-first century opened when a series of major business failures demonstrated that misdeeds by corporate insiders could still wreak havoc on the U.S. economy. At Enron, the first of the companies to fail, investigators found that executives had deliberately obscured the company's high levels of debt by shifting liabilities

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off the balance sheet to a series of special-purpose partnerships. The managers who ran these partnerships profited greatly from the deals, and some were even able to cash out on the eve of the company's collapse, selling off their stockholdings at high prices, while other shareholders (including many Enron employees who had invested the bulk of their pension funds in the company) ended up with worthless securities.<sup>1</sup> Subsequent failures at WorldCom, Tyco International, Adelphia Communications, and a number of other major U.S. companies led to similar revelations. In each case, it became apparent that executives had used a variety of accounting tricks to cover up deals that had benefited themselves personally but had also seriously endangered the solvency of their companies.

Many commentators immediately blamed the scandals on the deregulatory movement of the last quarter of the twentieth century, claiming that by undermining the vigilance with which agencies such as the Securities and Exchange Commission (SEC) pursued their duties, it had effectively exempted corporate officials from government oversight. Although this interpretation met with determined opposition from supporters of deregulation, just a few years later the subprime debacle drove home the dangers of lax supervision even more forcefully.<sup>2</sup> As the economy suffered from the most serious financial crisis since the Great Depression, the intellectual justification for deregulation lost much of its power, and the pendulum began to swing back in the direction of greater regulation.

Although I strongly support this reversal of policy, I want to sound a cautionary note in this essay. Just as dangers arise when regulation becomes too lax, so too are there perils from oversight becoming too strict. I make this point by surveying the history of the corporate form of organization. From the very beginning, I argue, there have always been two alternative types of corporate-governance problems. The first is the familiar danger illustrated so vividly by the Enron scandal: expropriation by greedy (or power-hungry) managers. I call this internal threat the Type I problem of corporate governance. The second, or Type II problem, is an external threat: expropriation by greedy (or power-hungry) rulers, or more generally by the state. Although this danger is much less familiar, and indeed in the U.S. case has largely receded since the mid-nineteenth century, it still lurks in the background. The basic dilemma

<sup>1</sup>For an overview of the Enron story, see Paul M. Healy and Krishna G. Palepu, "The Fall of Enron," *Journal of Economic Perspectives* 17 (Spring 2003): 3–26.

<sup>2</sup>Contrast, for example, Guy Fooks, "Auditors and the Permissive Society: Market Failure, Globalization and Financial Regulation in the US," *Risk Management* 5, no. 2 (2003): 17–26; and Frank H. Easterbrook, "Derivative Securities and Corporate Governance," *University of Chicago Law Review* 69 (Summer 2002): 733–47.

is that the more successful members of corporations are in solving Type II problems—that is, in protecting their organizations from interference by the state—the less they are able to call upon the state to protect them from corrupt managers. They therefore become more vulnerable to Type I problems. Conversely, the more members of corporations are able to call upon the state to restrain the manager (and protect them from the Type I problems of corporate governance), the more vulnerable they are to expropriation by the state.

Societies have attempted to steer a course between this Scylla and Charybdis of corporate governance in different ways, sometimes drifting too close to one monster and sometimes sailing too near the other. During the nineteenth century, U.S. corporations obtained greater protection against expropriation by the government than against expropriation by managers or controlling shareholders. Although this outcome seems to have been conducive to rapid economic development, it also led to numerous cases of abuse of minority investors and a reluctance on the part of many small- and medium-sized enterprises (SMEs) to use the corporate form. These problems have been to a great extent mitigated in the twentieth century by the formation of the Securities and Exchange Commission (SEC) and by an expansion of the menu of organizational forms. As recent events have underscored, however, they have by no means gone away. The critical question is how to take corrective action without veering too close to the other monster.

### Protecting Pools of Capital in the Early Modern World

Although there were (and are) many different types of corporations, in this essay I focus on those organized for business purposes. I consider the corporation, at the most basic level, to be a device to permit the accumulation of economic resources (capital). It was one of a number of different devices for this purpose that emerged in various parts of the world before modern times. Although the corporation has a long history, it was first used as a business form in Europe during the late Middle Ages, when monarchs began to organize trading corporations to promote, and gain control of, trade with the East.<sup>3</sup>

It might be thought that businesspeople did not need a special device to accumulate capital—that all they had to do was discipline themselves not to consume all their profits. A little further consideration will

<sup>3</sup> Ron Harris, “The Institutional Dynamics of Early Modern Eurasian Trade: The Corporation and the Commenda,” *Journal of Economic Behavior and Organization* (forthcoming); and John Joseph Wallis, Barry R. Weingast, and Douglass C. North, “The Corporate Origins of Individual Rights,” unpublished paper (2006).

suggest, however, that willpower alone is not sufficient if the business involves more than one person or if the saver wishes the pool of capital to survive his or her death. It is unlikely that accumulations will remain intact if any of the individuals who contribute to them can withdraw their capital when they wish. Nor can they remain intact if they must be divided to settle the estate of a deceased contributor. Businesspeople need special, legally enforceable devices, such as the corporation, to guard against these contingencies. In a corporation, for example, investments are sunk. They cannot be withdrawn at the behest of an investor's heirs or creditors, or even by the original investor.<sup>4</sup>

The legal enforcement that devices like the corporation require comes at a cost, often in the form of taxes. This cost is to be expected, and investors must balance it against the magnitude of the benefits they expect to derive from the ability to accumulate capital. More problematic are other perils that arise once wealth begins to amass in these entities. On the one hand, hard-pressed (or simply greedy) rulers may be tempted to confiscate some or all of it. On the other, those who manage the capital may be tempted to consume it in the form of perks or to use it to further their own interests. Both threats are potentially important impediments to economic development. Basic economic theory tells us that savers will not put their money in devices like the corporation if they fear that their returns (or, even worse, their investments) will be expropriated, regardless of whether the expropriator is the ruler or the manager.<sup>5</sup>

One possible solution is to call upon a third-party enforcer who can

<sup>4</sup>Henry Hansmann, Reinier Kraakman, and Richard Squire make a convincing case that this attribute of the corporation (they call it "entity shielding") is much more important for economic development than limited liability (or "owner shielding") and that it cannot be obtained contractually. See "Law and the Rise of the Firm," *Harvard Law Review* 119 (Mar. 2006): 1335–403. See also Margaret Blair, "Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century," *UCLA Law Review* 51 (Dec. 2003): 387–455. Other scholars have argued that the essential attributes of the corporation can be achieved contractually without the need for a special, state-sanctioned organizational form, though in my view they understate the contractual difficulties involved and the need for the state to enforce the resulting contracts. See, for example, Gary M. Anderson and Robert D. Tollison, "The Myth of the Corporation as a Creation of the State," *International Review of Law and Economics* 3 (Dec. 1983): 107–20; and Joshua Getzler and Mike Macnair, "The Firm as an Entity before the Companies Act," in *Adventures of the Law: Proceedings of the Sixteenth British Legal History Conference, Dublin, 2003*, ed. Paul Brand, Kevin Costello, and W. N. Osborough (Dublin, 2005), 267–88.

<sup>5</sup>I am deliberately posing the problem in the simplest possible way for the sake of clarity, but the dangers should be thought of as broader than simple expropriation. For example, minority shareholders may be worried less about outright expropriation than about the possibility that controlling shareholders or managers may pursue business strategies they think will imperil the enterprise. Similarly, government officials may use their authority over corporations to pursue policies desired by interest groups whose support is needed to keep the officials in power.

keep both the ruler and the manager in line. Religious authorities have performed this function under some circumstances. For example, in Islamic societies wealthy merchants could protect some of their assets from being divided among heirs by putting them in a trust (*waqf*) whose profits would be dedicated to performing some useful social purpose, such as building a road or a school or providing alms. Members of these societies believed that endowments in *waqfs* were sacred. Because rulers who developed a reputation for impiety lost legitimacy in the eyes of their subjects, clerics were able to protect these trusts from confiscation. However, to fend off rulers they also had to ensure that the endowments were used for their stated social purposes. According to Timur Kuran, one drawback to this solution was that clerical enforcement could be so inflexible that it prevented funds from being reallocated to productive uses when the original purpose of the trust was no longer viable. Another was that the clerics themselves could be corrupted and, in exchange for a share of the rents, could be induced to turn a blind eye to managerial expropriation. Over time, Kuran shows, corruption undermined the legitimacy of the trust device and laid funds in *waqfs* open to confiscation.<sup>6</sup>

Where religious authority was less monolithic, savers could protect pools of wealth from rulers by dedicating them to a sacred purpose, but such designations offered little protection from the grabbing hand of managers. For example, Madeleine Zelin has shown that Chinese families were able to safeguard funds from external threats by depositing them in lineage trusts, whose purpose was to ensure that families had the resources to honor their ancestors properly. Because there was no external enforcement of this purpose, it is likely that a great deal of wealth was frittered away in consumption or investment in insiders' businesses. Nonetheless, managers' autonomy from the state enabled them to invest the funds in their charge in response to new business opportunities. Indeed, Zelin has argued that the viability of this means of safeguarding accumulations of capital helps to explain why the corporation had relatively little appeal when it was finally introduced in China in the late nineteenth century.<sup>7</sup>

<sup>6</sup>Timur Kuran, "The Provision of Public Goods under Islamic Law: Origins, Impact, and Limitations of the Waqf System," *Law and Society Review* 35, no. 4 (2001): 841–97.

<sup>7</sup>Madeleine Zelin, "The Firm in Early Modern China," *Journal of Economic Behavior and Organization* (forthcoming). See also William C. Kirby, "China Unincorporated: Company Law and Business Enterprise in Twentieth-Century China," *Journal of Asian Studies* 54 (Feb. 1995): 43–63; and William Goetzmann and Elisabeth Köll, "The History of Corporate Ownership in China: State Patronage, Company Legislation, and the Issue of Control," in *A History of Corporate Governance around the World: Family Business Groups to Professional Managers*, ed. Randall K. Morck (Chicago, 2005), 149–81. As Goetzmann and Köll note, when the corporate form was introduced in China around the turn of the twentieth century, it became a vehicle for state control of the emerging industrial economy.

Although there has been considerable debate over the origins of the corporation in Europe, the church's need for an organizational form whose existence was independent of the people who made it up encouraged the development of the device during the Middle Ages. The corporation then proved useful for a variety of other entities, such as guilds, colleges, and cities or boroughs. In some cases, the church directly protected these entities from the state. In others, the organizations' claims of independence derived substance from the application of principles directly analogous to those used to defend church corporations.<sup>8</sup> In the sixteenth century, however, two developments forced a different solution to the problem of protecting corporations from the state. The first, the Protestant Reformation, meant that in some countries, most notably England, the church no longer exercised an independent check on the ruler, because the ruler was the head of the church. The second, monarchs' use of the corporation for the secular purpose of promoting trade with the East Indies and elsewhere, meant that the interests of the ruler became increasingly intertwined with those of corporations.

The solution that emerged in England by the end of the seventeenth century was for Parliament to check the authority of the king. In the turbulent era that followed the English Civil War, the Stuart kings had begun to intervene more actively in the internal affairs of corporations in order to raise funds and place their supporters in positions of power. Wherever their efforts met with serious resistance, as occurred in London and a number of other incorporated boroughs, they moved to have their charters revoked.<sup>9</sup> Ultimately, of course, the Stuarts were deposed in the Glorious Revolution, and a now supreme Parliament restored the revoked charters. In the aftermath of this struggle, moreover, the House of Lords, sitting as an appeals court in a case involving a corporation, definitively established the legal principle that the king could not alter or abolish a corporate charter or intervene in a corporation's internal affairs. Only Parliament had that power.<sup>10</sup>

Parliament thus protected corporations from expropriation by the

<sup>8</sup>Harris, "Institutional Dynamics of Early Modern Eurasian Trade"; Wallis, Weingast, and North, "Corporate Origins of Individual Rights."

<sup>9</sup>Jennifer Levin, *The Charter Controversy in the City of London, 1660–1688, and Its Consequences* (London, 1969); Mark Freeman, Robin Pearson, and James Taylor, *Shareholder Democracies? Corporate Governance in Britain before 1850* (Chicago, forthcoming), ch. 1; Bruce G. Carruthers, *City of Capital: Politics and Markets in the English Financial Revolution* (Princeton, 1996).

<sup>10</sup>*Phillips v. Bury*, 1 Ld. Raym. 5 (1694). See Sir William Blackstone, *Commentaries on the Laws of England* (Oxford, 1765–1769), 1: ch. 18, 471–73; Bruce A. Campbell, "Dartmouth College as a Civil Liberties Case: The Formation of Constitutional Policy," *Kentucky Law Journal* 70, no. 3 (1981–82): 648–49; and Ruth H. Bloch and Naomi R. Lamoreaux, "The Private Rights of Organizations: The Tangled Roots of the Family, the Corporation, and the Right to Privacy," unpublished paper (2008).

king. But it could, and did, expropriate itself. For example, Parliament periodically extracted loans from the Bank of England as a condition for extending its charter, offering monopoly privileges in exchange and thereby ensuring that the Bank could continue to supply it with funds. To get a big loan in 1697, it gave the Bank a new charter, in which it promised not to incorporate any competing banks. When Parliament needed funds again in 1708, it went even further to protect the Bank's monopoly and prohibited unincorporated joint-stock companies with more than six partners from doing business as banks.<sup>11</sup> Although Parliament treated the East India Company and the other great trading companies in much the same way, it seems to have been more restrained in its dealings with most corporations, either respecting the rights "vested" in their charters or providing compensation for any infringement on corporate privileges.<sup>12</sup> It is likely that the potential returns to intervention were simply too small for Parliament to risk the political opposition that tampering with corporations on such a broad scale would inevitably entail.

Members of Parliament did, however, extract rents from these smaller corporations during the chartering process when they could obtain bribes (often in the form of shares) from companies applying for charters or from others seeking to prevent the incorporation of a competitor.<sup>13</sup> Over time, however, as more and more businesses sought corporate privileges, political opposition to this type of corruption mounted, until Parliament passed legislation in 1844 permitting businesspeople to incorporate their enterprises simply by registering their articles of association and paying a uniform fee.<sup>14</sup> Similar political pressures forced

<sup>11</sup>J. Lawrence Broz and Richard S. Grossman have shown that Parliament offered the bank new charters in exchange for loans whenever it was running a big budget deficit. See "Paying for Privilege: The Political Economy of Bank of England Charters, 1694–1844," *Explorations in Economic History* 41 (Jan. 2004): 48–72. See also Carruthers, *City of Capital*, ch. 6.

<sup>12</sup>Ron Harris, "The English East India Company and the History of Company Law," in *VOC 1602–2002: Four Hundred Years of Company Law*, ed. Ella Gepken-Jager, Gerard van Solinge, and Levinus Timmerman (Deventer, the Netherlands, 2005), 217–47; Freeman, Pearson, and Taylor, *Shareholder Democracies*, ch. 1; Armand Budington DuBois, *The English Business Company after the Bubble Act, 1720–1800* (New York, 1971; 1st ed. 1938), 118–27; and Douglass C. North, John Joseph Wallis, and Barry R. Weingast, *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History* (New York, 2009), ch. 6.

<sup>13</sup>James Taylor, *Creating Capitalism: Joint-Stock Enterprise in British Politics and Culture, 1800–1870* (Woodbridge, Suffolk, 2006); Dan Bogart and John Majewski, "Population Densities, Political Structures, and the Early Corporation: The Transportation Revolution in the U.K. and United States," unpublished paper (2008).

<sup>14</sup>Shareholders in corporations formed in this way bore unlimited liability, but in 1855–56 Parliament amended the law to permit them to obtain limited liability. On the advent of general incorporation, see Ron Harris, *Industrializing English Law: Entrepreneurship and Business Organization, 1720–1844* (Cambridge, U.K., 2000); Taylor, *Creating Capitalism*, ch. 4; and Freeman, Pearson, and Taylor, *Shareholder Democracies*, ch. 2. See also North, Wallis, and Weingast, *Violence and Social Orders*, ch. 6.

Parliament to level the economic playing field by stripping the great “monied” or trading corporations of their monopoly privileges. Although the Bank of England retained its exclusive right to issue currency, the advent of general incorporation in banking transformed it into something more like a modern central bank with a quasi-governmental responsibility for the smooth functioning of the financial system.<sup>15</sup> These changes removed the element of quid pro quo that had fueled Parliament’s ongoing intervention, and the idea that Parliament should not interfere with corporations unless they violated the terms of their charters attained the status of a fundamental principle.<sup>16</sup>

In the aftermath of the Glorious Revolution, Parliament had assumed responsibility as well for protecting corporations from the internal dangers posed by greedy management. Minority shareholders who felt their interests had been trampled by the majority could, and did, petition Parliament for redress, and sometimes these pleas sparked the formation of an investigating committee. But here, too, Parliament’s interventions were, for the most part, limited to companies like the East India Company or the Hudson’s Bay Company, where there were important national interests at stake, or to cases like that of the Charitable Corporation, where there were major public outcries against corporate fraud.<sup>17</sup> As a general rule, redress of such grievances was left to the courts, which, as the number of corporations increased, necessarily raised the bar for intervention. By the middle of the nineteenth century, the relevant court (chancery) was applying to corporations precedents it had developed to reduce the flow of lawsuits involving partnerships. In a key case, *Foss v. Harbottle* in 1843, it declared that minority shareholders could not bring suit against corporate officers for malfeasance if the shareholders meeting as a body could potentially take action. Corporations were supposed to govern their own affairs. “The majority of the proprietors . . . [had] power to bind the whole body,” and every shareholder knowingly subjected him- or herself to this authority when he or she purchased stock. Only in the most egregious cases of fraud would the courts intervene.<sup>18</sup> As Parliament increasingly refrained from interfering in the internal affairs of corporations, the dangers of Type II corporate governance problems receded, but minority shareholders were left with little or no protection against the Type I danger posed by controlling shareholders.

<sup>15</sup> Harris, “English East India Company”; and Broz and Grossman, “Paying for Privilege.”

<sup>16</sup> DuBois, *English Business Company*, 118–27.

<sup>17</sup> *Ibid.*, 122–23.

<sup>18</sup> *Foss v. Harbottle*, 2 Hare 461 (1843). See Bert S. Prunty, “The Shareholders’ Derivative Suit: Notes on its Derivation,” *New York University Law Review* 32, no. 5 (1957): 980–94; and A. J. Boyle, “The Minority Shareholder in the Nineteenth Century: A Study in Anglo-American Legal History,” *Modern Law Review* 28 (May 1965): 317–29.



From *Dartmouth College* to the  
Securities and Exchange Commission

In the United States, events followed much the same course in the nineteenth century as they did in Britain. After the American Revolution, responsibility for chartering corporations had devolved on the various state legislatures. These bodies initially assumed that they had powers akin to those of Parliament to alter or revoke charters, and they did not hesitate to meddle in corporate affairs. Perhaps it is not surprising that legislators felt free to revise charters granted by the government against which they had rebelled, but they also did not hesitate to attack charters granted by post-Revolutionary republican legislatures. In the turbulence of the period, the composition of the various state assemblies could change dramatically from one election to the next. Succeeding legislatures often sought to undo what their predecessors had done, and one legislature might grant a corporate charter, only to see it altered, or even repealed, at a subsequent legislative session. Such actions were especially likely where special privileges granted to particular corporations touched off storms of protest.<sup>19</sup> After the Virginia assembly chartered the Richmond James River Company in 1804, for example, a deluge of complaints led it to amend the charter the next year over the objections of the company and exempt small boats from tolls.<sup>20</sup> In Pennsylvania, charges that the 1781 charter of Bank of North America gave the bank too much power led the legislature to repeal it in 1785. Two years later, a politically reconfigured assembly passed another, this time more restrictive, act of incorporation for the bank.<sup>21</sup> Similar criticism of the Massachusetts Bank, which had been modeled after the Bank of North America, induced that state's legislature to pass an "Addition" to the bank's charter in 1792 that placed greater limits on its operations.<sup>22</sup> In Virginia, complaints by rural shareholders of the Mutual Assurance Society against Fires on Buildings that urban shareholders were running roughshod over their interests led the state assembly to pass an act declaring that legislators would represent all absent owners at the corporation's general meetings. With this assistance from the legislature, the

<sup>19</sup> See Bloch and Lamoreaux, "Private Rights of Organizations."

<sup>20</sup> Bruce A. Campbell, "John Marshall, the Virginia Political Economy, and the *Dartmouth College* Decision," *American Journal of Legal History* 19 (Jan. 1975): 45–46.

<sup>21</sup> Pauline Maier, "The Revolutionary Origins of the American Corporation," *William and Mary Quarterly* 50 (Jan. 1993): 76–77; Bray Hammond, *Banks and Politics in America, from the Revolution to the Civil War* (Princeton, 1957), 53–64; and Andrew M. Schocket, *Founding Corporate Power in Early National Philadelphia* (DeKalb, Ill., 2007), 49.

<sup>22</sup> Pauline Maier, "The Debate over Incorporations: Massachusetts in the Early Republic," in *Massachusetts and the New Nation*, ed. Conrad Edick Wright (Boston, 1992), 110–11.

country members were able to reorganize the company to suit their own interests.<sup>23</sup>

In 1819, the U.S. Supreme Court moved to put a stop to such interventions with its *Dartmouth College* decision. Dartmouth's trustees had filed a lawsuit challenging an act of the New Hampshire legislature revising the college's governing board, and they had maneuvered successfully to get the case heard by the Supreme Court.<sup>24</sup> Writing for the Court, Chief Justice John Marshall declared that state legislatures did not inherit Parliament's boundless powers over corporations but, rather, had to acknowledge the superior authority of the Constitution. Dartmouth College was a private corporation and, as such, was protected by the contract clause of the Constitution, which holds that "no State shall pass any bill of attainder, ex post facto law, or law impairing the obligation of contracts." Thus, New Hampshire could not alter unilaterally the composition of the board or any other aspect of the college's charter.<sup>25</sup>

Although states could, and did, get around the *Dartmouth* decision by inserting clauses into charters that reserved their right subsequently to alter the terms of the grant, the problem of state intervention in the internal affairs of corporations largely disappeared over the next several decades. The reasons were similar to those already discussed for the case of Britain. Initially, corporations in the United States, as in Britain, could only be chartered by special legislative act. Such acts gave those who were able to obtain them privileges that others did not possess. At the most basic level, corporate charters conferred legal personhood and organizational permanence, but they often included other privileges that ranged from fairly common boons, such as limited liability, to rarer powers, such as eminent domain or the right to issue currency.<sup>26</sup>

Because the privileges embodied in corporate charters could be very valuable, they were an opportunity for expropriation—for Type II problems of corporate governance—and, as in the case of Britain, they often led to some kind of quid-pro-quo relation with the state. The extraction in which legislatures engaged could be on a broad government-

<sup>23</sup> Campbell, "John Marshall," 49–50.

<sup>24</sup> Virtually all colleges faced similar assaults on their autonomy in the late-eighteenth and early-nineteenth centuries. See Campbell, "*Dartmouth College* as a Civil Liberties Case," 671–91.

<sup>25</sup> *Dartmouth College v. Woodward*, 17 U.S. 518, 625, 649 (1819). For an overview of the case, see G. Edward White, *The Marshall Court and Cultural Change, 1815–35* (New York, 1988), 174–81, 612–28. See also Bloch and Lamoreaux, "Private Rights of Organizations."

<sup>26</sup> For examples of other kinds of special privileges embodied in charters, see Maier, "Revolutionary Origins of the American Corporation," 66–69; Oscar Handlin and Mary Flug Handlin, *Commonwealth: A Study of the Role of Government in the American Economy, 1774–1861*, rev. ed. (Cambridge, Mass., 1969), 106–33; Louis Hartz, *Economic Policy and Democratic Thought: Pennsylvania, 1776–1860* (Cambridge, Mass., 1948), 37–81; and Naomi R. Lamoreaux, *Insider Lending: Banks, Personal Connections, and Economic Development in Industrial New England* (New York, 1994), 29–51.

tal scale, justified as being in the interests of society as a whole. For example, states might require corporations to pay bonuses or special fees to get a charter, lend the government money, or invest some of their assets in public-works projects, such as canals.<sup>27</sup> Or the extraction could take the form of what were, in effect, demands for bribes by individual politicians.<sup>28</sup>

Spurred by mounting political opposition to the idea that government-granted privileges were available to those who were politically well connected or wealthy enough to pay for them, most states passed general incorporation laws during the middle third of the nineteenth century that made the right to form a corporation available cheaply to all.<sup>29</sup> Legislatures nonetheless continued to grant special charters of incorporation for many years thereafter.<sup>30</sup> Indeed, all the banks formed in Massachusetts during the 1850s sought special charters rather than organizing under the state's new general incorporation act, because they did not like the costs the law imposed on them.<sup>31</sup> Over the next several decades, however, voters in most states closed off this loophole by securing amendments to their state constitutions mandating that all corporations be chartered under the general laws.<sup>32</sup>

As in Britain, an unintended consequence of this withdrawal of state governments from active intervention in corporate affairs was to weaken minority shareholders' ability to protect their interests from greedy controlling shareholders (that is, to increase the potential for

<sup>27</sup> See also Richard Sylla, John B. Legler, and John J. Wallis, "Banks and State Public Finance in the New Republic: The United States, 1790–1860," *Journal of Economic History* 47 (June 1987): 391–403; and Handlin and Handlin, *Commonwealth*, 129–30, 174–75. Most of the New England states included provisions in early nineteenth-century bank charters requiring the banks to lend the government money on demand. In 1836, Maine's treasurer discovered that he could make some money for the state by borrowing from banks at the legally mandated rate of 5 percent and then investing the proceeds in bank stock, and the legislature voted him limited authority to borrow for this purpose. Lamoreaux, *Insider Lending*, 29.

<sup>28</sup> For examples, see Howard Bodenhorn, "Bank Chartering and Political Corruption in Antebellum New York: Free Banking as Reform," in *Corruption and Reform: Lessons from America's Economic History*, ed. Edward L. Glaeser and Claudia Goldin (Chicago, 2006), 231–57.

<sup>29</sup> On the spread of general incorporation laws, see James Willard Hurst, *The Legitimacy of the Business Corporation in the Law of the United States, 1780–1970* (Charlottesville, 1970), 13–57; John Joseph Wallis, "The Concept of Systematic Corruption in American History," in *Corruption and Reform*, ed. Glaeser and Goldin, 23–62; and Wallis, "Constitutions, Corporations, and Corruption: American States and Constitutional Change, 1842 to 1852," *Journal of Economic History* 65 (Mar. 2005): 211–56.

<sup>30</sup> Susan Pace Hamill, "From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations," *American University Law Review* 49 (Oct. 1999): 81–180.

<sup>31</sup> Lamoreaux, *Insider Lending*, 57; Kenneth Ng, "Free Banking Laws and Barriers to Entry in Banking, 1838–1860," *Journal of Economic History* 48 (Dec. 1988): 877–89.

<sup>32</sup> For a chronology of the relevant state constitutional provisions, see George Heberton Evans Jr., *Business Incorporations in the United States, 1800–1943* (New York, 1948), 11; and Hamill, "From Special Privilege to General Utility," 177.

Type I problems of corporate governance), and for much the same reason. In theory, minority shareholders in the United States had somewhat greater access to the courts than their British counterparts. Whereas the precedent set by *Foss v. Harbottle* gave shareholders in Britain little or no recourse against an oppressive majority, in the United States they could exercise a derivative right to sue if they could demonstrate that those who were abusing their positions effectively controlled the corporation.<sup>33</sup> In practice, however, minority shareholders still faced substantial legal hurdles in obtaining redress of their grievances. To keep the number of cases manageable, the courts required these shareholders to show that the corporation's refusal to take action on their behalf was fraudulent—that directors (or the controlling shareholders behind them) were not simply pursuing policies at variance with those that the minority thought should be adopted. If the refusal was simply a matter of business judgment, the courts would not intervene, even if the corporation had sustained heavy losses as a result of the directors' decisions.<sup>34</sup> It was a well-established principle that “directors acting in good faith and with reasonable care and diligence, who nevertheless [fell] into a mistake, . . . [were] not liable for the consequences.”<sup>35</sup> The burden of proof, moreover, was on the shareholders bringing the suit. As the Massachusetts Supreme Court later explained, “It is always assumed until the contrary appears, that [corporate directors and officers] obey the law, and act in good faith towards all their members.”<sup>36</sup>

What these principles meant for minority shareholders became clear in the aftermath of the scandal that blew up around *Crédit Mobilier of America*, the construction company that built the Union Pacific Railroad. Owned by a subset of the Union Pacific's directors, *Crédit Mobilier* had managed, through a series of subterfuges, to secure the contract to build the railroad at a cost that earned its stockholders exorbitant profits, according to critics.<sup>37</sup> Media attention focused less on this abuse of power by corporate insiders, however, than on the shares in *Crédit Mobilier* that members of the “railroad ring” had distributed to

<sup>33</sup> See Bloch and Lamoreaux, “Private Rights of Organizations”; and Naomi R. Lamoreaux and Jean-Laurent Rosenthal, “Corporate Governance and the Plight of Minority Shareholders in the United States before the Great Depression,” in *Corruption and Reform*, ed. Glaeser and Goldin, 125–52. See also Prunty, “Shareholders' Derivative Suit”; and Boyle, “Minority Shareholder.”

<sup>34</sup> Bloch and Lamoreaux, “Private Rights of Organizations”; and Lamoreaux and Rosenthal, “Corporate Governance.”

<sup>35</sup> *Hodges v. New England Screw Co.*, 3 R.I. 9, 18 (1853). See also *Hodges v. New England Screw Co.*, 1 R.I. 312 (1850).

<sup>36</sup> *Dunphy v. Traveller Newspaper Association*, 146 Mass. 495, 497 (1888).

<sup>37</sup> For a detailed account of the deals and the infighting among directors that resulted, see David Haward Bain, *Empire Express: Building the First Transcontinental Railroad* (New York, 1999).

influential congressmen. Nineteenth-century Americans were much less concerned about internal problems of corporate governance than about the corrupting influence of Type II problems.<sup>38</sup> The scandal led the federal government to withdraw from the business of subsidizing railroads, but there was no coincident effort to prevent the abuse of directorial power that *Crédit Mobilier* represented.

Indeed, in the period after the *Crédit Mobilier* scandal, the position of minority shareholders in corporations if anything became weaker. There was a longstanding legal rule that contracts tainted by conflict of interest (such as the Union Pacific's contract with *Crédit Mobilier*) were voidable. This rule had always been an absolute one and included contracts that otherwise were completely reasonable, so that, in the words of a Michigan justice, it was "immaterial . . . whether there has been any fraud in fact, or any injury."<sup>39</sup> In 1881, however, the U.S. Supreme Court qualified the rule as it applied to corporations, making fraud a necessary condition for a lawsuit. Such contracts would henceforth be voided only "where the board of directors, or a majority of them, are acting for their own interest, in a manner destructive of the corporation itself, or of the rights of the other shareholders" or where "such a fraudulent transaction . . . will result in serious injury to the corporation, or to the interests of the other shareholders."<sup>40</sup> In other words, the Court sanctioned applying what was in effect a reasonableness standard. Minority investors now faced the same high bar for cases involving conflict of interest that they did for other types of abuse by controlling shareholders.<sup>41</sup>

<sup>38</sup>Details of the *Crédit Mobilier* manipulation had been reported in the press since at least 1869, but they attracted little attention until the *New York Sun*, which opposed the reelection of President Ulysses S. Grant, broke the bribery story in September 1872. See Bain, *Empire Express*, 599–600, 602, 627–28, 676. For an intriguing contrary example, however, see Eric Hilt's account of the New York State legislature's response to a major corporate-governance scandal in the 1820s, "Wall Street's First Corporate Governance Crisis," unpublished paper (2008). The legislature's Revised Statutes of 1827 for a time heightened protections for investors, especially in "moneyed corporations."

<sup>39</sup>*Flint & Pere Marquette Railway Co. v. Dewey*, 14 Mich. 477, 487–88 (1866).

<sup>40</sup>*Hawes v. Oakland*, 104 U.S. 450, 460 (1881). The shift away from an absolute prohibition against self-dealing by corporate officers was noted with puzzlement by Harold Marsh Jr. ("'Are Directors Trustees?' Conflict of Interest and Corporate Morality," *Business Lawyer* 22 [Nov. 1966]: 35–76), who asserted, "One searches in vain in the decided cases for a reasoned defense of this change in legal philosophy, or for the slightest attempt to refute the powerful arguments which had been made in support of the previous rule" (p. 40). The mystery largely disappears, however, when the cases are viewed in terms of the broader legal history of minority shareholders' rights. See Lamoreaux and Rosenthal, "Corporate Governance," and Bloch and Lamoreaux, "Private Rights of Organizations."

<sup>41</sup>The one exception was the state of Pennsylvania, which held its state constitutional convention around the time of the scandal and wrote into the document a prohibition against self-dealing by officers, directors, and employees of railroad and canal companies. See William W. Cook, *Corporations: As Created and Regulated by Statutes and Constitutions of the Various States and Territories, also of the Federal Government, and of England, Canada, France, and Germany* (New York, 1889), 88–89.

The situation for minority shareholders became even worse with the passage of a wave of more “liberal” or “permissive” general incorporation laws in the aftermath of New Jersey’s pathbreaking 1888 statute. These acts typically included provisions that reduced the ability of minority stockholders to block managerial decisions that fundamentally altered the business of their enterprise, placing the individual shareholder, as one writer later put it, “in the position of holding a ‘pig-in-a-poke’”—“more dependent with each new statute upon the desire of the management and the majority which often is only another name for management.”<sup>42</sup> These statutes also provided the legal framework for the great merger wave of the turn of the century. The multifirm consolidations formed during this period were the first industrials to market their securities widely, and they paved the way for an expansion in shareholding by ordinary investors.<sup>43</sup>

The financiers who promoted the consolidations’ stock found ways to overcome investors’ fears, despite the lack of legal protection. Preferred stock was one technique that allowed corporate leaders to commit credibly to limit their expropriation.<sup>44</sup> Investing in reputation was another. For example, the governing body of the New York Stock Exchange instituted a rule change in 1896 that made the publication of audited balance sheets a requirement for listing. Although a few firms had already begun to provide this kind of information on their own, the new rule helped to make the exchange an imprimatur of quality, increasing trading, the value of listed shares, and, not coincidentally, the price of a seat on the exchange.<sup>45</sup> To give another example, investment bankers like J. P. Morgan exploited the reputations for probity they had built up over the years to sell securities of the companies they promoted. Morgan had worked out a technique for building investors’ confidence when he reorganized bankrupt railroads during the 1890s, putting his own people on the boards of directors to reassure stockholders that the business would be run in their interests. The railroads’ return to profitability enhanced his reputation, and Morgan used the same method to

<sup>42</sup>Wiley B. Rutledge Jr., “Significant Trends in Modern Incorporation Statutes,” *Washington University Law Quarterly* 22 (Apr. 1937): 337. More generally, see Harwell Wells, “The Rise of the Close Corporation and the Making of Corporation Law,” *Berkeley Business Law Journal* (forthcoming).

<sup>43</sup>Thomas R. Navin and Marian V. Sears, “The Rise of a Market for Industrial Securities, 1887–1902,” *Business History Review* 29 (June 1955): 105–38. See also Mary O’Sullivan, “What Drove the U.S. Stock Market in the Last Century?” unpublished paper (2004).

<sup>44</sup>See Jonathan Barron Baskin and Paul J. Miranti Jr., *A History of Corporate Finance* (New York, 1997), 151–57.

<sup>45</sup>Larry Neal and Lance E. Davis, “Why Did Finance Capitalism and the Second Industrial Revolution Arise in the 1890s?” in *Financing Innovation in the United States*, ed. Naomi R. Lamoreaux and Kenneth L. Sokoloff (Cambridge, Mass., 2007), 129–61.

promote the securities of giant consolidations at the turn of the century. Studies by J. Bradford De Long and Miguel Simon suggest that stockholders flocked to buy the securities of “Morganized” firms and also typically profited handsomely from these purchases.<sup>46</sup>

As more and more small investors bought shares in corporations, concerns about internal (Type I) problems of corporate governance emerged as a political issue in a sustained way for the first time. These concerns became more pressing as the role of investment bankers like Morgan declined and it became apparent that control of many of the nation’s largest corporations resided with salaried managers, rather than investors with large ownership stakes.<sup>47</sup> Little was done, however, until accusations of securities fraud in the aftermath of 1929 stock-market crash led Congress to take steps to protect outside investors by passing the Securities Act of 1933 and the Securities Exchange Act of 1934. These laws required companies that sold stock to the public, or whose securities were publicly traded, to file detailed annual financial reports. The 1934 Act also created the SEC, which was charged with enforcing the law, regulating the exchanges on which securities were traded, and promulgating regulations for safeguarding investors against corporate fraud and abuse.<sup>48</sup>

The outcome of a bargaining process mediated by the savvy New Dealer James M. Landis, the SEC was consciously set up to be a third-party enforcer.<sup>49</sup> Unlike other federal regulatory agencies, it did not set prices or control entry. Rather, its job was simply to establish procedures to prevent those in control of corporations from exploiting minority shareholders. Much like the clerics of early modern Islam, the

<sup>46</sup>Vincent P. Carosso, *The Morgans: Private International Bankers, 1854–1913* (Cambridge, Mass., 1987); J. Bradford De Long, “Did J. P. Morgan’s Men Add Value? An Economist’s Perspective on Financial Capitalism,” in *Inside the Business Enterprise: Historical Perspectives on the Use of Information*, ed. Peter Temin (Chicago, 1991), 205–49; Miguel Cantillo Simon, “The Rise and Fall of Bank Control in the United States: 1890–1930,” *American Economic Review* 55 (Dec. 1998): 1077–93.

<sup>47</sup>The most famous expression of this concern was by Adolf A. Berle Jr. and Gardiner C. Means, in *The Modern Corporation and Private Property* (New York, 1933). Kenneth Lipartito and Yumiko Morii have recently argued that Berle and Means were as worried about the abuse of power by those with controlling interests in large-scale businesses as they were about the separation of ownership and control, the issue that later interpreters of their work brought to the fore. See Kenneth Lipartito and Yumiko Morii, “Rethinking the Separation of Ownership from Management in American History,” unpublished paper (2007).

<sup>48</sup>See Thomas K. McCraw, *Prophets of Regulation: Charles Francis Adams, Louis D. Brandeis, James M. Landis, Alfred E. Kahn* (Cambridge, Mass., 1984), 153–209. Before the passage of federal legislation, states had begun to regulate public offerings of securities by passing “blue sky laws.” See Louis Loss and Edward M. Cowett, *Blue Sky Law* (Boston, 1958). For an exceptional earlier regulatory effort, see Hilt, “Wall Street’s First Corporate Governance Crisis.”

<sup>49</sup>McCraw, *Prophets of Regulation*.

SEC's function was to curb Type I problems of corporate governance without exposing businesses to expropriation by the state. Indeed, the trust vested in the appointed members of the commission was quasi-religious in character. Early-twentieth-century Americans had enormous faith in the ability of experts to solve the problems of the modern economy—to sort through the confusing welter of evidence, of claims and counterclaims, and to chart a fair course of action. They had already turned to independent agencies staffed by experts to regulate railroad rates and curb monopolistic practices by large-scale businesses, and they would create a number of other such commissions before the decade was out.<sup>50</sup> Although some scholars have been skeptical that the SEC had any real effect, the more general view is that the agency improved corporate-governance practices and increased protections for small investors. Certainly, Americans believed the SEC mattered.<sup>51</sup>

The SEC may have helped to assuage worries about Type I corporate-governance problems for investors in companies with publicly traded securities, but it offered little comfort to investors in corporations whose shares were closely held—the vast majority. Indeed, fear of oppression by controlling shareholders seems to have induced a large number of businesspeople to eschew the corporate form altogether. Data from the U.S. Census of Manufactures reveal that as late as 1900—that is, more than half a century after most states passed general incorporation laws—partnerships still constituted more than 60 percent of the manufacturing firms that took multiowner forms. Although the proportion organized as partnerships fell during the early twentieth century as the scale of enterprise rose, dropping to about 40 percent by 1920, it did not fall much further until after World War II. According to Internal Revenue Service (IRS) data, as late as 1947 partnerships constituted fully 40 percent of manufacturing enterprises taking multiowner forms, and their

<sup>50</sup> There is an enormous literature on Progressive-Era Americans' faith in experts, but see especially Robert Wiebe, *The Search for Order, 1877–1920* (New York, 1967). For a survey of the growth of regulatory agencies, see David Vogel, "The 'New' Social Regulation in Historical and Comparative Perspective," in *Regulation in Perspective: Historical Essays*, ed. Thomas K. McCraw (Cambridge, Mass., 1981), 155–85.

<sup>51</sup> For an example of the skeptical view, see George J. Benston, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934," *American Economic Review* 63 (Mar. 1973): 132–55. On the value of the SEC, see McCraw, *Prophets of Regulation*, 153–54; Robert A. Prentice, "The Inevitability of a Strong SEC," *Cornell Law Review* 91 (May 2006): 775–839; and Bengt Holmstrom and Steven N. Kaplan, "The State of U.S. Corporate Governance: What's Right and What's Wrong?" NBER working paper 9613 (2003). Statements about popular (and business) faith in the SEC abound in the literature. See, for examples, Jonathan R. Macey and Maureen O'Hara, "Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective," *Journal of Legal Studies* 28 (Jan. 1999): 17–54; and John C. Coates IV, "Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis," *Virginia Journal of International Law* 41 (Spring 2001): 531–82.



proportion of multiowner enterprises in the economy as a whole still exceeded 60 percent.<sup>52</sup>

### Modern Alternatives to the Corporation

On the European continent, governments generally remained deeply involved in the affairs of corporations until late in the nineteenth century, restricting the availability of charters, using corporations to further the interests of the state or its rulers, and sometimes even deciding which corporate securities could be traded on the national exchanges. Restricted access to the corporate form did not generate as much political opposition on the continent as in Britain and the United States, however, because there were other organizational forms that enabled businesspeople to obtain some of the advantages of incorporation without exposing themselves to government intervention. In particular, they could form limited partnerships. Although at least one partner had to bear unlimited liability, the rest risked only their investments in the enterprise. Moreover, by making the shares of the limited partners tradable, businesses could use this form to raise capital from the public without securing a corporate charter from the state.<sup>53</sup>

Because the limited partnership with tradable shares was an inferior substitute for the corporation, however, pressure built slowly in the mid-nineteenth century to make the corporate form available to all. France finally passed a general incorporation law in 1867. Many of the German states followed over the next several years, and the Prussian version of the statute became Reich law in 1871.<sup>54</sup> Although the availability

<sup>52</sup>The data from the U.S. Census of Manufactures are analyzed in Naomi R. Lamoreaux and Jean-Laurent Rosenthal, "Contractual Tradeoffs and SME's Choice of Organizational Form: A View from U.S. and French History," NBER working paper W12455 (2006). For the IRS data, see Susan B. Carter et al., *Historical Statistics of the United States: Earliest Times to the Present* (New York, 2006), 3: series Ch1–18.

<sup>53</sup>The limited-partnership form was not available in Britain until 1907. It was available in the United States, but adverse court decisions kept the number of firms using it comparatively small. See Timothy W. Guinnane, Ron Harris, Naomi R. Lamoreaux, and Jean-Laurent Rosenthal, "Putting the Corporation in its Place," *Enterprise and Society* 8 (Sept. 2007): 687–729; and "Pouvoir et propriété dans l'entreprise: Pour une histoire internationale des sociétés à responsabilité limitée," *Annales: Histories, Sciences Sociales* 63 (Jan.–Feb. 2008): 73–110. An English version of the latter article is available as "Ownership and Control in the Entrepreneurial Firm: An International History of Private Limited Companies," Yale University Economic Growth Center discussion paper #959 (Dec. 2007). For an intriguing discussion of how the form was used in the United States, see Eric Hilt, "Partnerships without Kinship: The Effect of New York's 1822 Limited Partnership Act," unpublished paper (2008).

<sup>54</sup>Charles E. Freedeman, *Joint-Stock Enterprise in France, 1807–1867* (Chapel Hill, 1979); Nobert Horn, "Aktienrechtliche Unternehmensorganisation in der Hochindustrialisierung (1860–1920)," in *Recht und Entwicklung der Grossunternehmen im 19. und frühen 20. Jahrhundert*, ed. Norbert Horn and Jürgen Kocka (Göttingen, 1979), 128 and note 22.

of alternative forms of organization kept the number of corporations in both France and Germany below their levels in Britain and the United States, businesspeople took out significant numbers of charters. Indeed, in Germany there was a big surge in incorporations in the 1870s, when the rapid payment of the indemnity imposed on France after the Franco-Prussian war produced a stock-market bubble. After the bubble collapsed, accounts of corporate misdeeds led the Reichstag to pass a reform act in 1884 that significantly increased the costs of forming a corporation. Among other things, the new law mandated the detailed disclosure of financial information, raised the minimum size of a share tenfold, and required that shareholders pay in at least 25 percent of the value of their shares before the charter could take effect. The number of new corporations plunged dramatically in response.<sup>55</sup>

By the late 1880s, there were increasing calls to revise the 1884 reforms. Although some critics argued for reducing the regulatory burden on corporations so that more would be formed, the solution the government adopted was to create an entirely new form of organization, the *Gesellschaft mit beschränkter Haftung* (company with limited liability, later usually abbreviated GmbH). Owners of GmbHs had to forgo the ability to market their shares publicly, but they all obtained limited liability. They also obtained an extraordinary degree of contractual flexibility that gave minority owners the tools they needed to protect themselves against expropriation by controlling shareholders. Although the law specified a set of default rules, businesspeople were free to write alternative provisions into their articles of association. By insisting on supermajority voting rules as a condition of investment, for example, minority shareholders could ensure that they exercised veto power over important decisions. Thus, in one case, a shareholder protected her husband from being fired as manager of a GmbH by securing a provision in the firm's articles of association requiring stockholders' unanimous consent to dismiss him.<sup>56</sup>

Once Germany led the way, other countries passed similar enabling legislation for private limited-liability companies (PLLCs). In Britain, the sequence of events was remarkably similar to that in Germany. After

<sup>55</sup> Guinnane et al., "Putting the Corporation in its Place," 697–98; and "Pouvoir et propriété dans l'entreprise."

<sup>56</sup> In exchange for this provision and others ensuring that the majority investors could not force a dissolution of the enterprise, she agreed that the majority would receive a greater than normal share of the firm's profits. See Guinnane et al., "Pouvoir et propriété dans l'entreprise." Under German law, there was considerable contractual flexibility in the corporate form as well, but many provisions that one observes in GmbH contracts were not compatible with tradable shares. Not only were GmbH shares not tradable, but shareholders could insist on the right to vet all potential purchasers of shares. See also Guinnane et al., "Putting the Corporation in its Place."

a series of scandals involving public issues of corporate securities, Parliament passed a new Companies Act in 1900 that significantly increased the cost of forming a corporation by mandating the disclosure of greater amounts of financial information, and by holding directors personally liable if they failed to conform to the provisions of the law. As in Germany after 1884, the number of new corporations plunged, and there were mounting demands that the law be repealed. Also as in Germany, Parliament responded with a statute permitting businesses to avoid the high costs of incorporation by organizing instead as limited-liability companies whose securities could not be publicly traded.<sup>57</sup> French entrepreneurs gained access to a GmbH-like device as a result of World War I. A number of GmbHs operated in Alsace and Lorraine on the eve of the war, and their owners did not wish to give up the advantages of the form when France regained control of these provinces. Although a bill that essentially translated the GmbH law into French failed in 1919, there was widespread support in the business community for some such statute, and the Assembly enacted an enabling statute for a French version of the form, the *société à responsabilité limitée* (SARL), in 1925.<sup>58</sup>

Although the PLLC had somewhat different features in each of these countries, its attraction everywhere was that it offered businesspeople many of the advantages of the corporate form (including limited liability) while allowing them to structure their enterprises in ways that reduced the risk of internal problems of corporate governance. Wherever and whenever the form became available, it quickly dwarfed the corporation in popularity. In Prussia, more than half of new firms founded during the early 1930s organized as GmbHs, and less than 5 percent organized as corporations. In France at the same time, about 60 percent to 70 percent of new firms organized as SARLs, and only about 20 percent formed as corporations. In Britain by the early 1930s, the ratio of private to public limited companies was more than ten to one.<sup>59</sup>

Businesspeople choosing this new form of organization did not bear much risk of expropriation from the state. Indeed, the basic idea behind the enabling legislation was that entrepreneurs would give up their ability to raise shares from the general public in exchange for being left alone to organize their enterprises pretty much as they wished. So many PLLCs were formed in the aftermath of the enabling legislation, moreover, that it would have been politically dangerous for the state to renege on this understanding.

<sup>57</sup> Guinnane et al., "Putting the Corporation in its Place"; and "Pouvoir et propriété dans l'entreprise."

<sup>58</sup> Ibid.

<sup>59</sup> Ibid.

## The Resurgence of Type II Problems of Corporate Governance

It might be thought that, in the countries where the form was available, the PLLC would have resolved the tradeoff between Type I and Type II problems of corporate governance once and for all. Most businesses could choose a form that allowed them to accumulate capital without fear of expropriation by the state. Moreover, the contractual flexibility that characterized PLLCs allowed minority investors to protect themselves against oppression by controlling shareholders. Nonetheless, the coming of the PLLC does not seem to have been the end of the story. To the contrary, in countries where the form was readily available, the PLLC's popularity may have exposed corporations to greater risk of expropriation by the state for a simple reason: so few of them were formed that only a small proportion of businesspeople cared about protecting their interests. This exposure, moreover, was likely worsened by the requirement that corporations publish their financial information. High profits could easily attract unfavorable attention, especially since owners of SMEs had a tendency to see big businesses as adversaries whose size gave them unfair competitive advantages.

Certainly, the mid-twentieth century witnessed a resurgence of state involvement in the affairs of large corporations in all these countries. The rise of *dirigisme*, as it is often called, was first and foremost a response to the economic turbulence of the Great Depression, World War II, and the postwar reconstruction, but it stands to reason that the abandonment of the corporate form by most SMEs eliminated an important element of resistance to government intervention in the corporate sector.<sup>60</sup> Sometimes this intervention took the extreme form of nationalization. Beginning in the interwar period and accelerating in the aftermath of World War II, for example, the British government nationalized the coal, steel, electricity, railroad, aviation, and other industries, and also the Bank of England.<sup>61</sup> In France, nationalization came a bit earlier but affected many of the same industries, as well as large segments of the chemical, automobile, aviation-equipment, petroleum-

<sup>60</sup> On the rise of *dirigisme*, see Ivan T. Berend, *An Economic History of Twentieth-Century Europe: Economic Regimes from Laissez-Faire to Globalization* (Cambridge, U.K., 2006). See also Raghuram G. Rajan and Luigi Zingales, "The Great Reversals: The Politics of Financial Development in the Twentieth Century," *Journal of Financial Economics* 69 (Fall 2003): 5–50; Enrico C. Perotti and Ernst-Ludwig von Thadden, "The Political Economy of Corporate Control and Labor Rents," *Journal of Political Economy* 114 (Feb. 2006): 145–74; and Mark J. Roe, "Legal Origins, Politics, and Modern Stock Markets," *Harvard Law Review* 120 (Dec. 2006): 460–527.

<sup>61</sup> Mary E. Murphy, "Nationalization of British Industry," *Canadian Journal of Economics and Political Science* 18 (May 1952): 146–62.

refining, banking, and insurance industries.<sup>62</sup> In other countries, however, dirigisme had more of a corporatist bent: stockholders in large firms shared monopoly rents with interests the state regarded as important for its stabilization (mainly labor) in exchange for tariffs or some form of protection against competition. In West Germany, for example, the government allowed large firms to impose cartel-like restrictions on competition, but it required them to share the resulting monopoly returns with labor, which obtained representation on their supervisory boards.<sup>63</sup>

In the United States, where the PLLC was, for all practical purposes, not available until later in the twentieth century, there was no similar move toward state capitalism after World War II. The government played an active role in managing the economy during the war, but then for the most part eschewed microeconomic intervention in businesses' affairs, adopting instead, particularly under the presidency of Dwight D. Eisenhower, a conservative form of Keynesian macroeconomic stabilization policy.<sup>64</sup> The government's most dramatic step in a dirigiste direction, President Harry Truman's attempt to seize control of the steel industry to prevent a strike in 1952, proved highly unpopular. Excoriated in the media as the first salvo in a general attack on property rights, it was quickly struck down by the U.S. Supreme Court.<sup>65</sup>

The increased intervention in corporate affairs that occurred in Europe during the post-World War II period was the work of democratically elected governments. Undertaken ostensibly to further the social good, it certainly facilitated recovery from the devastation of the war, and for a time these economies experienced impressive rates of growth.<sup>66</sup> Nonetheless, within a couple of decades the dirigiste economic engine

<sup>62</sup> Richard B. Du Boff, "The Decline of Economic Planning in France," *Western Political Quarterly* 21 (Mar. 1968): 98–109.

<sup>63</sup> See Peter Alexis Gourevitch and James J. Shinn, *Political Power and Corporate Control: The New Global Politics of Corporate Governance* (Princeton, 2005). In Germany the government defined the firms subject to these "codetermination" rules by number of employees. Although technically large GmbHs had to create supervisory boards with the required proportion of labor representatives, it was easy for owners of GmbHs to reduce the board's status to symbolic significance. See Herbert Wiedemann, "Codetermination by Workers in German Enterprises," *American Journal of Comparative Law* 28 (Winter 1980): 79–92.

<sup>64</sup> See Robert M. Collins, *The Business Response to Keynes, 1929–1964* (New York, 1981). Government policy in selling off the plants it built during the war was to reduce monopoly rents. See, for example, George David Smith, *From Monopoly to Competition: The Transformations of Alcoa, 1888–1986* (New York, 1988). This is not to say that businessmen did not gain advantages by lobbying Washington, but rather that the level of intervention was significantly lower than in Europe. See Stephen B. Adams, *Mr. Kaiser Goes to Washington: The Rise of a Government Entrepreneur* (Chapel Hill, 1997).

<sup>65</sup> Maeva Marcus, *Truman and the Steel Seizure Case: The Limits of Presidential Power* (New York, 1977).

<sup>66</sup> Barry Eichengreen, *The European Economy since 1945: Coordinated Capitalism and Beyond* (Princeton, 2007).

had stalled. Part of the problem was the inefficiency of the nationalized companies. But another part was the protection from competition that large-scale enterprises obtained under the corporatist *quid pro quo*. As resentment of the cozy relations between government officials and big-business managers mounted, there was a general movement toward more *laissez-faire* policies.<sup>67</sup> With the decline of dirigisme, however, came the resurgence of internal problems of corporate governance. By the early twenty-first century, scandals at Vivendi, Parmalat, Hollinger, and other European companies competed for media attention with those at WorldCom, Tyco, and Adelphia.<sup>68</sup>

### Scylla or Charybdis?

The European experience suggests that both Type I and Type II problems of corporate governance are still very much present in modern democratic societies, as is the tradeoff between them. The passage of enabling legislation for the PLLC gave firms that did not intend to raise equity from the public (the vast majority) a form more suited to their needs than the corporation. As businesspeople switched to the PLLC in droves, however, they left large corporations politically exposed, facilitating the mid-twentieth-century shift toward dirigisme. Later, as governments retreated from this kind of micro-involvement in the economy, corporate insiders took advantage of the change to pursue their own ambitions, sometimes feathering their own nests in the process.

In the United States, the menu of organizational forms available to businesspeople has become increasingly like that of Europe over the course of the second half of the twentieth century. When high personal income-tax rates induced more and more firms to organize as corporations in the aftermath of World War II, states began to modify their general incorporation laws so as to give closely held corporations greater contractual flexibility, enabling them in effect to mimic the PLLC form.

<sup>67</sup> See Rajan and Zingales, "Great Reversals"; and Gourevitch and Shinn, *Political Power and Corporate Control*. On the decline of dirigisme, see Vivien A. Schmidt, *From State to Market? The Transformation of French Business and Government* (Cambridge, U.K., 1996); Monica Prasad, *The Politics of Free Markets: The Rise of Neoliberal Economic Policies in Britain, France, Germany, and the United States* (Chicago, 2006); Berend, *Economic History of Twentieth-Century Europe*; and Eichengreen, *European Economy since 1945*. There is intriguing evidence that center-left parties have pushed for improved corporate governance rules as a way of attacking dirigiste alliances between corporate managers and the state. See John W. Cioffi and Martin Höpner, "The Political Paradox of Finance Capitalism: Interests, Preferences, and Center-Left Party Politics in Corporate Governance Reform," *Politics and Society* 34 (Dec. 2006): 463–502.

<sup>68</sup> Gourevitch and Shinn, *Political Power and Corporate Control*, 1.

Then, beginning in the late 1980s, in the wake of tax reforms that made the corporation relatively less attractive, states passed laws enabling firms to organize as various types of PLLCs: limited-liability companies (LLCs), limited-liability partnerships (LLPs), and other more exotic forms.<sup>69</sup>

Businesses in the United States seem eagerly to have taken up the new forms, just as they did earlier in Europe. Although there is no information on the number that took advantage of the increased contractual flexibility that the states' revised general incorporation laws made possible, the proportion of firms taking multiowner forms that organized as corporations increased from 40 percent in 1949 to 66 percent in 1979 to 70 percent in 2002. Of course, tax considerations were a big part of the story, but the advent of the LLC thus far has had comparatively little effect on the stock of corporations, suggesting that the new statutes did in fact remedy many of the disadvantages of the corporate form. The proportion of multiowner firms that were LLCs increased from 1 percent in 1993 (the first year for which figures are available) to 12 percent in 2002, whereas the proportion that were corporations fell only slightly from 73 percent to 70 percent. Nonetheless, there is evidence that the LLC will eventually surpass the corporation as the form of choice for SMEs. In 2006, states registered more than 50 percent more LLCs than corporations.<sup>70</sup>

As a result of the states' late-twentieth-century legislative initiatives, therefore, investors in SMEs in the United States now have the same ability as their counterparts in Europe to adopt alternative organizational forms that allow them to minimize internal problems of corporate governance. More recently, moreover, there has been convergence toward the European model along another dimension as well. In the aftermath of the Enron scandal, Congress took steps to beef up the SEC by passing in 2002 what is known as the Sarbanes-Oxley bill. Among other things, the law stiffened financial reporting and disclosure requirements: corporations' accounts now must be regularly scrutinized by professional auditors selected from a list approved by a new Public

<sup>69</sup>W. Elliot Brownlee, *Federal Taxation in America: A Short History* (New York, 1996), 89–129; F. Hodge O'Neal, "Developments in the Regulation of the Close Corporation," *Cornell Law Quarterly* 50 (Summer 1965): 641–62; Kelvin H. Dickinson, "Partners in a Corporate Cloak: The Emergence and Legitimacy of the Incorporated Partnership," *American University Law Review* 33 (Spring 1984): 559–600; Robert R. Keatinge et al., "The Limited Liability Company: A Study of the Emerging Entity," *Business Lawyer* 47 (Feb. 1992): 375–460; Fallany O. Stover and Susan Pace Hamill, "The LLC Versus the LLP Conundrum: Advice for Businesses Contemplating the Choice," *Alabama Law Review* 50 (Spring 1999): 813–47.

<sup>70</sup>Carter et al., *Historical Statistics of the United States* 3: series Ch193–204; *SOI Bulletin*, various issues; International Association of Commercial Administrators (IACA), *2007 Annual Report of Jurisdictions*.

Company Accounting Oversight Board, and the auditors must be hired by committees composed entirely of external directors. The bill also requires the chief executive and financial officers personally to sign their company's financial statements, and it imposes severe criminal penalties for willfully misreporting financial data and for other kinds of corporate misconduct.<sup>71</sup> Scholarly opinion about Sarbanes-Oxley runs the gamut from complaints that the act did not go far enough to the prediction that it will actually make corporate governance problems worse.<sup>72</sup> There is general agreement, however, that the bill increases the costs that securities regulation imposes on public companies, that the additional costs are particularly burdensome for small public companies, and that the numbers of small companies going private are rising as a consequence.<sup>73</sup> In other words, the United States may be repeating earlier experiences in Germany and Britain, where the passage of similarly tough statutes led to sharp drops in the number of new corporations. One consequence of Sarbanes-Oxley, therefore, may be to accelerate the emergence of a bifurcated European-style economy featuring relatively small numbers of public corporations (most of them very large) and relatively large numbers of private companies that range from the very small to the very large.

Whether these changes will leave corporations politically exposed to Type II programs of corporate governance remains to be seen, but the popularity of the 2003 documentary film *The Corporation*, in which a psychologist administers a test for personality disorders and determines that the corporation is a psychopath, suggests that attention is increasingly focusing on corporations in general, rather than on specific large-scale businesses, as the root cause of problems in American society.<sup>74</sup> A recent spate of books has similarly highlighted the "evils" of the

<sup>71</sup> For a section-by-section summary of the bill, see Larry E. Ribstein, "Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002," *Journal of Corporation Law* 28 (Fall 2002): 62–67.

<sup>72</sup> Contrast Joseph F. Morrissey, "Catching the Culprits: Is Sarbanes-Oxley Enough?" *Columbia Business Law Review* 2003, no. 3 (2003): 801–57, with Ribstein, "Market vs. Regulatory Responses." For an intermediate position, see Holmstrom and Kaplan, "State of U.S. Corporate Governance."

<sup>73</sup> Nathan Wilda, "David Pays for Goliath's Mistakes: The Costly Effect Sarbanes-Oxley Has on Small Companies," *John Marshall Law Review* 38 (Winter 2004): 671–92; Andrew Skouvakis, "Exiting the Public Markets: A Difficult Choice for Small Public Companies Struggling with Sarbanes-Oxley," *Penn State Law Review* 109 (Spring 2005): 1279–96; Paul Rose, "Balancing Public Market Benefits and Burdens for Smaller Companies Post Sarbanes-Oxley," *Willamette Law Review* 41 (Fall 2005): 707–48; Ginger Carroll, "Thinking Small: Adjusting Regulatory Burdens Incurred by Small Public Companies Seeking to Comply with the Sarbanes-Oxley Act," *Alabama Law Review* 58 (Winter 2006): 443–72.

<sup>74</sup> *The Corporation*, released in 2003 by Big Picture Media Corporation, was written by Joel Bakan and codirected by Mark Achbar and Jennifer Abbott. See also Joel Bakan, *The Corporation: The Pathological Pursuit of Profit and Power* (New York, 2004).



corporation, and there have been new intellectual efforts to justify the federal government's intervention in internal corporate affairs, using, for example, the corporate income tax as a regulatory tool.<sup>75</sup> More important, the government's response to the worsening financial crisis in the fall of 2008 suggests that resistance to dirigiste policies has substantially weakened in the United States. The Treasury Department's purchase of equity stakes in the nation's largest banks in 2008 elicited remarkably little opposition, and the reaction was similarly muted to bailout terms that dramatically increased government oversight of automobile companies.

Whether one views these changes as ominous or not depends on how one weighs the relative risks and costs of Type I and Type II problems of corporate governance. Although basic economic theory suggests that both should inhibit investment and hence economic growth, the record of the last two centuries suggests that expropriation by government has more serious negative effects than expropriation by managers. As we have seen, investors' concerns about expropriation can, to a considerable extent, be overcome by private investments in reputation and by the voluntary adoption of corporate-governance rules that afford protections to minority shareholders. Indeed, scholars have attributed the first major expansions in stockholding to such efforts.<sup>76</sup> Political leaders can reassure investors as well, but the main way in which they can credibly commit not to expropriate is to take ownership stakes (either for themselves or on behalf of the government) in the enterprises concerned and thus align their own economic interests with those of private investors. The problem, however, is that this alignment of interests induces politicians to take steps to protect the firms from

<sup>75</sup>See Charles Derber, *Corporation Nation: How Corporations Are Taking Over Our Lives and What We Can Do About It* (New York, 2000); David C. Korten, *When Corporations Rule the World*, 2nd ed. (Bloomfield, Conn., 2001); Thom Hartmann, *Unequal Protection: The Rise of Corporate Dominance and the Theft of Human Rights* (New York, 2002); Ted Nace, *Gangs of America: The Rise of Corporate Power and the Disabling of Democracy* (San Francisco, 2003); see also Reuven S. Avi-Yonah, "Corporations, Society, and the State: A Defense of the Corporate Tax," *Virginia Law Review* 90 (Sept. 2004): 1193–255. For other justifications for intervention, see the articles in the special issue, "Regulation, Risk and Corporate Crime in a 'Globalized' Era," *Risk Management* 5, no. 2 (2003).

<sup>76</sup>On this point, see also Eric Hilt, "When Did Ownership Separate from Control? Corporate Governance in the Early Nineteenth Century," *Journal of Economic History* 68 (Sept. 2008): 645–85; Aldo Musacchio, *Experiments in Financial Democracy: Corporate Governance and Financial Development in Brazil, 1882–1950* (New York, forthcoming); and Gonzalo Andres Islas Rojas, "Essays on Corporate Ownership and Governance" (unpublished Ph.D. diss., University of California, Los Angeles, 2007). For the recent period, see Holmstrom and Kaplan, "The State of U.S. Corporate Governance." The outcry over Google's corporate-governance structure at the time of its initial public offering is a good indication of the extent to which U.S. firms voluntarily adopt rules that are more protective of minority investors than the law requires.

competition and thus typically inflicts considerable damage on the economy over the long run.<sup>77</sup>

The main additional costs of internal, or Type I, problems of corporate governance are the ruined fortunes and lives of the victims and the corrosive cynicism to which scandals like Enron, WorldCom, Vivendi, and Parmalat give rise. But Type II problems also have victims. They are not so visible perhaps, because they are dispersed throughout society, but they are very real nonetheless. Moreover, Type II problems produce a cynicism that, because it extends to government officials as well as business leaders, can be even more socially corrosive, undermining faith in democratic political institutions at the same time as it inhibits economic growth.

The middle way is to attempt to navigate a course between the two corporate-governance monsters by relying upon a third-party enforcer, such as the SEC. European countries have moved in this direction in recent years, and all the members of the European Union now have SEC-type regulatory agencies.<sup>78</sup> As in the case of the Islamic clerics of early modern times, there is always the danger of laxness and corruption (capture), on the one hand, or rigidity and excessive regulation, on the other. The scandals and financial crises of the early-twenty-first century are an indication that the SEC became too lax and drifted toward the monster Scylla. A correction of course is clearly needed, but it is important not to steer too close to the other monster. As Odysseus once upon a time calculated, it is better to suffer some losses than to risk the entire ship.

<sup>77</sup>See Rajan and Zingales, "Great Reversals"; Stephen Haber, Amando Razo, and Noel Maurer, *The Politics of Property Rights: Political Instability, Credible Commitments, and Economic Growth in Mexico, 1876–1929* (New York, 2003); North, Wallis, and Weingast, *Violence and Social Orders*. In the United States in the early nineteenth century, state governments often took equity positions in the corporations they chartered. The political revolt against corporate privileges led to the passage in many states of constitutional prohibitions against such investments. See Frederic Jesup Stimson, *American Statute Law*, Volume 2: *An Analytical and Compared Digest of the Statutes of all the States and Territories Relating to General and Business and Private Corporations* (Boston, 1892).

<sup>78</sup>See Prentice, "Inevitability of a Strong SEC."