Are Corporations Creatures of the State?

Ralph Nader shares the widely held belief that every corporation, through its charter, receives special privileges from the government and thus is a creature of the state. He has made this claim in print on at least seven different occasions, but his only proof consists of naming three corporate features—entity status, perpetual life, and limited liability—which he regards as state-created privileges.[1] Before challenging his claim, it will be useful to supply the explanations he does not provide.

One could make a case to support the idea that corporations receive special privileges from government only by showing that corporations possess features that other types of business organizations (such as partnerships) do not possess and that these features cannot be acquired by contractual agreement.

Nader and other critics believe that entity status is one such privilege. A corporation can sue and be sued in its own name, but a partnership cannot; unless authorized by law, a partnership can sue only in the name of its individual owners. The reason for this difference is that a partnership, in Anglo-American legal theory, is considered to be an *aggregate*, an association of individuals acting together to pursue a common business objective. In contrast, a corporation is held to be something entirely different: an *entity*, a fictitious legal person, an artificial legal being, which exists independently of its individual owners. The legal right of a corporation to sue in its own name is an immense convenience resulting from the fact that the law views a corporation as a distinct entity. Presumably, this point supports Nader's belief that entity status is a state-created privilege.

Perpetual life has also been suggested as a special privilege. A partnership is automatically dissolved whenever one of the general partners dies, goes bankrupt, becomes insane, is expelled, or wishes to withdraw. Terms like transient, ephemeral, and short-lived are often used to describe partnerships. In contrast, a corporation is called immortal or eternal because, as a distinct entity, it continues to exist despite changes in the ranks of its owners and because the law permits the founders of a corporation to specify perpetual duration in the articles of incorporation. Thus, immortality also seems to be a privilege conferred by the state.

Limited liability has also been claimed as a special privilege of corporations. Partners (like sole proprietors) incur unlimited personal liability for business debts. If the assets of the partnership are insufficient to settle the claims of creditors, then the total personal property of each partner is subject to seizure for the benefit of creditors. But the shareholders of a corporation possess *limited* liability, and if a corporation cannot meet its debt obligations to outside creditors, the shareholders cannot be assessed to make up the deficit. A shareholder incurs no liability beyond the amount that he has chosen to invest because the law holds that a corporation is an entity distinct from the shareholders and that it contracts debts in its own name. Hence, by law, the owners are not responsible for the corporation's debts.[2]

These three fundamental differences between partnerships and corporations appear to prove that a corporation is a recipient of special privileges bestowed by government. And in exchange, say corporate critics like Nader, corporations should be subject to special restrictions and controls. If the special privileges theory is invalid, then so is Nader's corollary.

Corporate Features by Contract

Can entity status, perpetual duration, and limited liability be explained by the inherence theory, that is, as being contractual?

Entity status merely means that a corporation can sue (and be sued) as a unit, instead of having to specify the name of every shareholder. It also means that a corporation can hold legal title to property despite changes in the ranks of its shareholders. If a privilege means a favor or immunity bestowed by law on one party at the expense of another, then entity status cannot be classified as a privilege. Professor Adolf A. Berle wrote: "More accurately, the associates are granted a legal convenience, in that they may use the courts without writing the name of every shareholder into their papers." If this convenience is considered a privilege, then it is neutralized, for as Berle noted, "The reverse process—that of liability to be sued under a single name, is manifestly not advantageous to them, but is rather a measure of fairness to their opponents."[3]

Moreover, entity status is an optional feature available to all unincorporated businesses, including partnerships, limited partnerships, and trusts. Owners can designate trustees to represent them in lawsuits and to accept or convey title to property on their behalf. Being a legal entity, then, is clearly not a feature unique to corporations, or a one-sided advantage, or a state-created privilege.

Nor is it accurate to call perpetual duration a special privilege conferred by government. Perpetual duration simply means that the articles of incorporation need not be renewed, unless the founders originally specified that the enterprise was to exist only for a fixed period of time. The privilege of perpetuity certainly does not guarantee that a corporation will continue in business forever; more than half of all corporate ventures fail and cease to exist within five years of their inception. On the other hand, although partnerships are not automatically immortal, many firms—of attorneys, accountants, architects, and stockbrokers, to mention a few—have been in continuous existence for a century or more.

If they choose to do so, partners can make their enterprise immortal by adopting a continuity agreement specifying that the firm will not be liquidated when one of the general partners dies or withdraws. After outlining a variety of means by which partners can assure the continuity of their enterprise, Professor Alan R. Bromberg, a leading authority on partnership law, writes: "By skillful use of agreements, partnerships can be given virtually any desired degree of continuity."[4] The idea that government makes corporations immortal while partnerships cannot achieve a permanent, on-going existence is an illusion.

Limited liability is the most controversial and least understood corporate feature. How can it be explained except as a state-created privilege?

Limited liability actually is the result of an implied contract between the corporate owners and their creditors. As Professor Berle observed: "A clause could be put in every contract by which the apposite party [i.e., the creditor] limited his right of recovery to the common fund: the incorporation act may fairly be construed as legislating into all corporate contracts an implied clause to that effect."[5]

Contrary to popular belief, limited liability does not discriminate against creditors to the benefit of shareholders. Creditors cannot be compelled to accept a limited liability arrangement. They can, and often do, insist that one or more of the shareholders become personal guarantors or sureties for the debt. This fact explains why limited liability is often an illusory feature for a new or unstable corporate enterprise.[6] When creditors do accept limited liability, they do so, as Professor Berle noted, by means of an implied contract. Because creditors have a choice in the matter, limited liability cannot be viewed as a state-created privilege that benefits the corporation at the expense of the creditor.

Limited Liability for Torts

Thus far, the inherence theory—the idea that corporate features are created by contract—has been applied to entity status, perpetual duration, and limited liability for debts. But how can limited liability for torts be explained by a contractual theory, since tort victims do not consent to limit their claims to the assets of the corporation? Surely, limited liability for torts would seem to be a state-created privilege.

A tort is a wrong or injury (except breach of contract) for which the law awards compensation to the victim. Broadly, there are two major classifications: torts which are intentional—acts which are committed with deliberate malice, such as assault—and torts which are negligent or unintentional—acts which are accidental and unforeseen, resulting from oversight, carelessness, or failure to take adequate precautions. Most torts involving business firms are negligent rather than intentional. A classic example is an injury to a pedestrian caused by a vehicle owned by a business firm and operated by its employee or agent. In terms of liability, there is a crucial difference between a corporation and a partnership.

In legal language, the liability of partners for torts is joint and several. A tort victim may bring suit against the assets of the partnership, or against any one or combination of the partners, or against the firm and its members simultaneously, at his option.[7] A partner is liable to the extent of his *total* wealth, not merely the amount he has invested in the partnership, for claims by tort victims. If only one of the partners is sued, he must pay the full amount of the settlement (unless, of course, it exceeds his total wealth), and then he can try to recover the amount from the assets of the partnership or from the other partners personally.

In contrast, a shareholder's liability for torts is limited to his investment in the corporation, and he cannot be singled out to pay the whole amount (unless, of course, he personally committed the tortious act). If a vehicle owned by a corporation and operated by one of its employees or agents injures a pedestrian and if the damages exceed the assets of that corporation, then shareholders are not personally liable, either individually or collectively, and they cannot be assessed to make up the deficit.

The customary rationale for this rule is that a corporation is an entity distinct from its shareholders so "they" are not responsible for the torts committed by "it" or its agents and employees. Thus, it seems that shareholders' limited liability for torts is a privilege, shielding them from liability, conferred by government and never created by contract.

How, if at all, can limited liability for torts be integrated into a *contractual* theory of corporations? The answer is that it can't—and it needn't be. The question poses a false alternative: either limited liability for torts is a state-created privilege or it is contractual (which it obviously is not). In fact, there is a third possibility.

The rules of tort liability orginated many centuries ago in England when courts established the doctrine of *respondeat superior*—let the master be answerable for the acts of his servant. This principle of vicarious liability is based on the premise that the servant commits the tort while engaged in some activity on behalf of the master (for example, he injures a pedestrian while driving the master's carriage) and that the servant is personally hired, instructed, and supervised by the master. By holding a master fully liable for the torts committed by his servants, the courts gave the tort victim someone solvent ("a deep pocket") to sue for damages. But, equally important, the courts were serving notice upon masters that they must carefully choose and closely supervise their servants or else bear the financial consequences of their neglect to do so.[8]

Subsequently, application of the principle of vicarious liability was extended to sole proprietors and to general partners on the premise that they personally select and monitor their employees and agents. This extension is reasonable, but it does not automatically follow that the same principle should be extended to corporate shareholders. Vicarious liability should only apply to those shareholders who play an active role in managing an enterprise or in selecting and supervising its employees and agents. The tort liability of inactive shareholders should be the same as that of limited partners—that is, limited to the amount invested—and for the same reason; namely, inactive shareholders and limited partners contribute capital but do not participate actively in management and control.

The proper principle of liability should be that whoever controls a business, *regardless of its legal form*, should be personally liable for the torts of agents and employees. Thus, in partnerships, vicarious liability would fall upon the general partners only, while in corporations, the officers would be liable (whether they are owner-investors or hired managers). The safeguards open to general partners and corporate officers would include more careful selection and closer supervision of personnel and the purchase of larger amounts of liability insurance.

The current rule that shareholders are not personally liable for corporate torts because "it" is an entity distinct from "them" has permitted and condoned an injustice: the use of the so-called one-man corporation and the close corporation. Instead of buying enough liability insurance to cover potential tort claims, a sole proprietor forms a one-man corporation, and then it (deliberately undercapitalized and underinsured) rather than he, the active decision-maker, is liable to tort victims for the acts of its employees and agents. Similarly, the entity doctrine enables general partners to limit their tort liability by forming a close corporation and then by mutual consent to discard nearly every other corporate feature. The use of one-man and close corporations has unfairly thrust the burden of accidents and injuries upon the hapless victims. It is an abuse long-noted and vigorously condemned in legal literature, but one which is inevitable and ineradicable as long as the idea persists that a corporation is legally a distinct entity.

Two qualifications should be noted. First, tort victims do not necessarily benefit from the rule that general partners bear unlimited liability. In fact, there is no guarantee that a tort victim will collect anything—that depends on whether the partnership carries liability insurance and whether the partners possess any assets. If the net assets of the partners (individually or collectively) are meager or nonexistent, there is no one to pay the tort victim's claim for damages.

Second, the rule that each partner bears unlimited liability for torts may actually produce an effect opposite of that intended. The source of the problem is that, by law, tort liability is joint and several—one partner may be singled out to pay the whole amount. A partner who may be willing to pay his *proportional* share may, understandably, be unwilling to pay the whole amount. And he may feel that the courts should distinguish between intentional and unintentional torts. Liability for an intentional tort should be imposed only on the individual partner who committed or authorized the act, while liability for unintentional torts should be joint only; that is, it should fall proportionally on all partners. But American judges not only view debt liability and tort liability identically, they also refuse to differentiate between intentional and unintentional torts. Thus, this judicial tradition may be detrimental to tort victims because it encourages individuals with substantial assets to form close corporations in order to limit their liability for torts.

Regardless of one's view about limited liability for torts, the whole issue is irrelevant to giant corporations, which either carry substantial liability insurance or possess sizable net assets from which claims can be paid.

The Entity Idea

In America the source of the idea that a corporation is a distinct entity was Chief Justice John Marshall's 1819 dictum that "a corporation is an artificial being, invisible, intangible, and existing only in contemplation of law."[9] His statement still serves as the leading definition of a corporation and is widely quoted in judicial opinions. Nonetheless, Marshall's definition is defective because it fails to differentiate a corporation from a partnership. And it is confusing because it is metaphorical, not literal (as a definition should be); it makes a corporation sound like a hallucination—a legal pink elephant. But Ralph Nader believes that John Marshall's definition cannot be improved because it "still best expresses the idea that corporations are not endowed by their creator [i.e., government] with any inalienable rights."[10]

Other writers who do not share Nader's animus against corporations have attempted to reformulate Marshall's definition into nonmetaphorical language. One recent attempt states: "A corporation . . . is a fictitious legal person . . . In the eyes of the law, therefore, the group has an existence which is independent of its individual members."[11] Another scholar, after surveying numerous attempts to revise Marshall's definition, reports that they all are "pervaded by the notion of a 'body' or an 'entity' or an 'artificial legal creation,' the continuance of which does not depend on that of the component persons, and the being or existence of which is owed to an act of state."[12]

But the entity concept serves no valid purpose. Like the idea that corporations are creatures of the state, it is a vestige of medieval mentality and should be discarded. The proper alternative is the inherence theory of corporations—the idea that men have a natural right to form a corporation by contract for their own benefit, welfare, and mutual self-interest. It is the only theory of corporations that is faithful to the facts and philosophically consistent with the moral and legal principles of a free society.