The Four Functions of Corporate Personhood

By Margaret M. Blair

Vanderbilt University Law School

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Introduction

The essence of what happens when a corporation is formed is that the law subsequently recognizes the existence of a legal entity that is separate from the organizers and investors, but that can carry out certain business activities like a “person.”¹ Centuries ago, courts recognized that an institution like a church or university, if it had a charter from the King (or Pope), could hold property, sue and be sued, and enter into contracts in its own name, apart from any of the individuals who were members of, or affiliated with the institution (Angell and Ames, 1832; Canfield, 1917). Importantly, property held by the chartered entity would continue to be held by the entity upon the death or departure of any of the natural persons associated with the entity (Blumberg, 1993). Organizations which had these features were called “corporations,” from the Latin word “corpus,” meaning “body,” because the law recognized that the group of people who formed the corporation could act as one “body” or one “legal person.”

Despite the importance in law of what is often called “corporate personality,” “corporate personhood,” or “entity status,”² scholarly work on corporate law since the 1980s has been dominated by a “contractarian” view of corporations which holds that it is misleading to think of

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¹ “What were the consequences of incorporation? Incorporation involved the creation of a new personality, distinct from that of individual human beings,” according to Harris (2000: 18). Mark (1987) traces the history of how business corporations were “personified” in American law.

² I will use these terms interchangeably in this article, although I think the term “legal entity” is less emotionally and politically charged, and therefore more likely to facilitate clear thinking about legal questions involving corporations.
corporations as separate persons. Instead, they argue, a corporation is nothing more than a “nexus” through which all of the human persons involved in an enterprise arrange to contract with each other (Jensen & Meckling, 1976; Alchian & Demsetz, 1972; Easterbrook & Fischel, 1991; Bratton, 1988-89). The standard contractarian approach is to assume that a corporation is just the “legal fiction” through which shareholders, as “principals”, contract with directors and managers, who are regarded as “agents” of shareholders. Framed this way, the corporation is not seen as having a separate existence, but is simply an aggregate of the interests of shareholders. The logic of contractarianism, as it has been developed by legal academics in the U.S., at least, supports the normative claim that corporations should be run in the interest of shareholders, and that it is inappropriate to believe or claim that a corporation has any interests that are separate or different from those of the shareholders. Moreover, according to this line of argument, the job of managers and directors is to maximize the value of the shares owned by shareholders, and any other social or economic goal for corporations is illegitimate (Friedman, 1962; Jensen & Meckling, 1976; Chen & Hanson, 2004).

In this article I argue that the legal device of treating corporations as separate “persons” serves at least four functions that became important to business organizers during the industrial revolution, and that those functions are still important to most large, publicly-traded corporations. The contractarian model obscures these functions, and thus may lead to misleading policy prescriptions. If corporations are merely nexuses of contracts, what distinguishes them from other collaborative approaches to carrying out business activities, such as partnerships, or

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3 Bratton (1988-89: 424) asserts that the nexus of contracts view was an explicit attempt by theorists to “dispel the tendency to regard organizations as persons.”

4 Grandori (2010: 360) observes that “‘entities’ are themselves founded on contract . . . . The fact that a contract is recognized, stylized, and regulated by law as a juridical form does not nullify its contractual nature.” This suggests that one can understand the entity status or “personhood” of corporations within an overarching contractarian framework.
joint ventures, or just ordinary contracts? And why have business organizers been so eager to use the corporate form rather than one of these other arrangements? Attention to the role played in the law by the concept of corporate personhood, by contrast, illuminates important ways that the use of the corporate form for organizing business activities contributes to economic value, and why this form continues to be the most widely-used organizational form for business activity around the world.

The four functions that legal entity status for corporations serves would be very difficult, if not impossible, to accomplish using only contracts. These are:

1) Providing continuity, and a clear line of succession in the holding of property and the carrying out of contracts. This is because the separate legal entity continues to exist over time (and continues to hold the property, and be liable for performance under its contracts) even if the individual humans involved die or simply withdraw from the enterprise.5

2) It provides a common source of identity that participants in the enterprise recognize, and to which important intangible assets such as franchises or monopoly rights, special knowledge, competencies, reputation, image, and brand can attach. Such intangible assets are sources of substantial value to the participants in corporate enterprises that would be difficult to develop, sustain, and use by a group of people if the only thing holding the group together were contracts or market exchanges.6

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5 The corporate form makes it possible for “a perpetual succession of many persons [to be] considered the same, and [to] act as a single individual,” according to Chief Justice Marshall in Trustees of Dartmouth College v. Woodward, 4 Wheat. (17 U. S.) 518 (1819). See also Mark (1987), at 1450, and Harris (2000), at 19. Other scholars have emphasized the fact that the corporate form permits “perpetual existence,” (Blumberg, 1986: 588) but I argue that the important aspect of this is that the entity can hold the property and be liable under contracts even as the people associated with the entity come and go.

6 Ashforth & Mael (1989) and Akerlof & Kranton (2005) arguing that people form their self-identity in part on the groups to which they belong. Grant (1996) lays out a “knowledge-based” theory of the firm in which he stresses the role of “organizational capabilities.”
3) It provides a mechanism for separating pools of assets according to which assets are dedicated to the business, and which assets are the personal assets of the human persons who are participating in the business. The ability to partition assets in this way makes it easier to commit specialized assets to an enterprise, and lock those assets in so that they remain committed to the enterprise and can realize their full value (Blair, 2003; Hansmann & Kraakman, 2000). This is because assets that are locked in to the corporate entity also help to bond the entity’s commitments to creditors and other stakeholders (Blair, 2003; Hansmann & Kraakman, 1999). Separation of assets also makes it easier for investors and other participants in an enterprise to limit their exposure to losses if the enterprise fails, a feature commonly called “limited liability.”

And 4) it provides a governance structure through which a large group of individuals, some of whom may not even know each other and may never meet, can coordinate their contributions and activities toward a common end, without requiring numerous separate contracts (Blair & Stout, 1999; Radner, 1992). The governance structure prescribed by corporate law is a managerial hierarchy topped by a board of directors that is distinct from shareholders, management, and employees, and that has fiduciary duties to the corporation itself (MBCA §8.01 and §8.30). The fact that a corporation is a separate entity requires that some legal mechanism be adopted to make decisions for the entity, and the logic of team production makes an independent board an attractive solution to the problem.

These four features of corporations, all of which are consequences of corporate personhood, are important sources of value in organizing business activities that involve a substantial number of people using dedicated assets over long periods of time. All four of these functions have been important since the Industrial Revolution, and continue to be important in

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7 Hansmann and Kraakman (1999) observe that “a firm must have at least two attributes. The first is well-defined decision-making authority.” The second, according to these authors, is a pool of assets dedicated to use by the firm.

8 Blair & Stout, 1999.
business activities today. In large corporations with many shareholders and ongoing business activities, the four functions are generally connected to each other. Building and accumulating intangible assets such as a reputation for technological competence, for example, would be difficult if these assets were not linked to a separate entity, and if there were no assurance that the entity would continue in existence, and the assets would not be split up or dissipated if a key individual dies or separates from the firm. The death of Apple Corp. founder Steve Jobs in October, 2011, provides a particularly salient example of this. It is the separateness of Apple, the entity, from Jobs, the person, that provides assurance to Apple customers, employees, and business partners that the firm will continue to exist and continue to produce innovative products. In words posted on Apple’s website after Jobs’ death, “Steve leaves behind a company that only he could have built, . . . [but] his spirit will forever be the foundation of Apple.”

Separating assets used in the enterprise from the personal assets of the entity’s participants is clearly easier if the corporation has a separate legal status. Moreover, administration of the separate entity is easier if creditors of the entity have access only to the assets of the entity to satisfy entity debts (“limited liability”), and if heirs, creditors and even investors in the entity cannot withdraw assets from the firm or compel dissolution (“capital lock-in”).

Moreover, the separateness of the entity also makes it necessary for the law to specify who will have authority to make decisions and take actions for the entity. That legal rule takes

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9 Blair (2004). This is similar to the argument that Ayotte and Hansmann (2009) make that entity status for corporations make it possible to bundle contracts, so that none of the contracts can be transferred without all of the contracts being transferred together. “The counterparties to the firm’s contracts – the firm’s employees, suppliers, creditors and customers – want protection from opportunistic transfers that will reduce the value of the performance they’ve been promised,” they observe (Ayotte & Hansmann, 2009: 1).


11 Blair (2003). The combination of these two features of the corporate form has been called “asset partitioning” by Hansmann & Kraakman who argue that it is one of the central functions of organization law (Hansmann & Kraakman, 2000).
the form of a requirement that corporations are to be governed by a board of directors (MBCA §8.01). Governance by a board of directors is a solution that is particularly useful in solving the inevitable problems that arise in “team production,” in which numerous participants contribute complex inputs and produce a joint output that is more than the sum of the inputs (Blair & Stout, 1999).

While all four functions are valuable for enterprises that involve a large number of individual persons, some corporations are formed to take advantage of only one or two of these purposes. In particular, in corporations whose shares are entirely owned by another corporation, it will often be the case that only one of these functions is particularly useful – the ability to partition assets, especially the “limited liability” feature. Such enterprises already have the benefit of perpetual succession, common identity, and board governance through their parent corporation. Likewise, corporations formed as “special purpose entities” (“SPEs”) to facilitate securitization of financial assets are formed solely to take advantage of limited liability. For such corporations, the contractarian model, which reduces corporations to little more than a bundle of assets that belongs to shareholders, may be an adequate characterization, and legal rules or policy prescriptions based on that model – in particular, that the job of management is solely to maximize share value – are likely to be valid.

But for firms in which corporate personhood is serving all four functions – the largest and most important corporations in our economy today – entity status creates value for numerous participants in addition to shareholders, value which is often at risk in the enterprise just as shareholder capital is at risk. For such firms, there may be many situations in which the interests of corporation as a whole diverge from what is in the best interests of any one set of constituents such as shareholders.
Despite the use of the phrase “corporate personhood” as a summary expression to indicate that a firm has the full package of corporate characteristics, all four characteristics serve to distinguish corporations from human persons, rather than to make them more like human persons. This could have significant implications for the debate over policy questions such as whether corporations should have rights protected by the U.S. Constitution, and if so, which rights. Although it goes beyond the scope of this article to do so, it might be useful, for example, to consider whether a particular right is important to the effectiveness of one or more of the functions. For example, granting corporations the right to due process before property can be taken away is consistent with the function of continuity in property ownership, and thus it makes sense that corporations should receive such rights.

In this essay, I explore these four functions to show why they are important in modern business enterprises, and why they would be difficult to achieve purely through contract. All four, however, are achieved easily when the law recognizes corporations as legal entities separate from any of their participants. Attention to these functions of entity status make it clear that, generally, a corporation should be regarded as more than simply a nexus of contracts.

In Part I below I review the history of the corporate form and the evolution of the concept of corporate legal personality. In Part II I show how the concept of legal personality serves the four functions outlined above, and why it would be difficult to achieve the same results using contracts.

12 The U.S. Supreme Court first recognized corporations as “natural persons” in 1886, in Santa Clara County v.S. Pac. R.R. Co., 118 U.S. 394 (1886). In a controversial decision in early 2010 (Citizens United v. Federal Election Commission 558 U.S. 08-205 (2010)), the U.S. Supreme Court found that Congress may not impose limits on the amount of money that corporations may donate to political campaigns, on the grounds that because corporations are “persons,” they have a Constitutional right to freedom of speech.
In Part III, I argue that corporations in which all four of these functions are important, will, from time to time, have interests that are different from those of their shareholders, interests that sometimes are and should be recognized in various ways by the law. Thus, analysis of the four functions of entity status points to a more nuanced answer to corporate governance questions such as what it means that directors of a corporation have fiduciary duties to act in the best interest of “the corporation.”

I. Historical evolution of “corporate personhood.”

The earliest corporations were not organized for business purposes. Corporate law as we know it today evolved out of laws and practices governing churches and religious institutions in the Middle Ages in Europe.13 Such institutions were often granted charters by the Pope that feudal lords nearly always honored. Charters gave these religious institutions the authority to operate as separate entities for purposes of inheritance, so that the property of the institutions would not be handed down to heirs of individual persons who were members, or who controlled and managed the property on behalf of the institutions (such as bishops or abbots), nor would the property revert to the estate of the lord when those controlling persons died or were replaced (Blumberg, 1993). In other words, the charters granted to religious institutions gave them “the power of perpetual succession” (Mark, 1987, p. 1450).

The idea that a group of people could act together, in law, as a single entity with an indefinite life, at least for the purposes of holding property, was subsequently applied to boroughs, municipalities and guilds. By the sixteenth century, corporations were being used in a

13 Avi-Yonah and Sivan (2007: 155) claim that “the corporation as a legal person separate from its owners is a uniquely Western institution.” Some scholars have argued that there were antecedents to the corporate form in the traditions, practices and law of business people in the Roman Empire and in medieval Italy (Hansmann, Knaakman & Squire; others), but for my purposes in this article, we need not go back beyond the charters granted to religious institutions in Europe in the Middle Ages.
wide range of institutions, including “the King himself, cities and boroughs, guilds, universities and colleges, hospitals and other charitable organizations, bishops, deans and chapters, abbots and convents, and other ecclesiastical bodies” (Harris, 2000: 16-17). Notably absent from this list are business or commercial organizations. The purpose of incorporation, for all of these entities, was primarily perpetual succession, so that a succession of different individuals would be recognized as a single “legal person,” while the property and wealth of that “person” could be accumulated and held over time for the relevant public or quasi-public purposes, and neither revert to the state, nor be subject to division and distribution to heirs upon the death or departure of any of the administrators of the property or members of the corporation.

A few categories of corporations involved only a single individual, such as the King, or a bishop. These corporations were called “sole corporations,” and their purpose was simply to make it clear that the property they held and controlled did not belong to them personally, but to the institution or public function they served, and the contracts they made were not entered into on their personal behalf, but only in their official capacity (Carter, 1919: 14). This would ensure that the property, contract rights, and liabilities would pass to successors in that office if the office-holder died or otherwise vacated the office.

All of the other categories were called “aggregate corporations,” and as to these, another important purpose of the corporate form was self-governance among a group of people. For purposes of their external relations, the incorporated group was able to act as a single individual in buying, selling, or holding property or entering into contracts. Within the group, they had to work out their own mechanisms and rules of governance and resolve their own disputes (Harris, 2000: 23; Gevurtz, 2004). Importantly, decisions about internal governance would not be
subject to interference by the state or sovereign, except perhaps to enforce governance rules that were specified in their charters.14

In the 17th century, in England and on the Continent, charters also came to be issued to trading companies (Harris, 2000). Trading companies were initially organized as “companies,” which are essentially partnerships, a legal category that was recognized as contractual at common law, and that did not require a charter. These partnerships were usually between a merchant sea captain and one or more passive partners who would provide financing for a fleet of ships that would sail to East India to purchase spices or other goods. When the ship returned, merchandise acquired would be sold, the proceeds would be divided, and the partnership dissolved. Successive missions were organized as new partnerships.15 Hence, these organizations did not have the features of perpetual succession, common identity, and asset separation, although such features may not have been needed given the nature of their business model.16

These trade missions were inherently extremely risky, and the risks of shipwreck, piracy and disease were compounded by the risk that if too many ships returned with too much spice, spice prices could collapse and even an otherwise successful venture could lose money (Harris, 2000). So in 1600, Elizabeth I in England granted a charter to a group of merchants organized as the East India Company, along with monopoly rights to control the spice trade on behalf of England. Two years later, the Netherlands did the same thing, chartering the Dutch East India

14 The internal hierarchy and board of directors of a corporation have long been regarded as a “court of last resort” regarding decisions about the management of corporate assets. Courts will not hear a case involving a dispute between two managers of the same corporation over division of a bonus pool, for example. Blair & Stout, 1999 at 284, citing to Oliver Williamson Comparative Economic Organization: The Analysis of Discrete Structural Alternatives, 36 Admin. Sci. Q. 269, 274 (1991) (“courts . . . . refuse to hear disputes between one internal division and another.”)
15 Need cites and sources for this paragraph.
16 Hansmann et. al. have argued that the asset partitioning function on successive voyages was largely carried out by the physical separation of assets loaded onto each ship.
Company. These companies initially were formed for a limited number of years (which suggests that their initial purpose was not perpetual succession in the holding of property, as it was with churches and charitable organizations), but they were reorganized at the end of each term, and eventually, they were granted charters in perpetuity.¹⁷

Because of their origins in partnership law, these early trading companies were generally governed like partnerships, with major decisions made by vote of investors on a one-person, one-vote basis. But trading companies that had received franchises from Parliament or from a monarch were sometimes governed like partnerships, and sometimes governed by councils that may have included individuals appointed by the king.¹⁸

By the end of the 17th century, numerous European chartered trading companies were building, populating, and governing colonies around the world, as well as controlling international trade between the colonies and Europe. For these organizations, the most important purposes of the charter may have been the franchises that came with the charters. Perpetual succession became important after the organizations ceased to be dissolved at the end of each voyage and were given charters in perpetuity.

Just as guilds, towns, and church organizations could have a changing membership over time, so it became useful for trading companies that continued in existence from one trade mission to the next to have different investors over time. This was made possible when the chartered companies issued investment “shares” in exchange for financial capital, and investors began trading these shares among themselves (Werner, 1981: 1631). Such companies were called “joint-stock companies.” Joint-stock companies might have evolved rather quickly into modern corporations in the 18th century after this development, except that English courts

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¹⁷ Cites for this paragraph too.
¹⁸ Cite to Gevurtz, with examples of chartered trading companies being governed by such councils.
considered them to be partnerships. Moreover, the English Parliament and the king began to jealously protect and hoard the special franchises that had come with early charters, issuing them rarely. And in 1719, Parliament passed the so-called “Bubble Act,” which made it illegal to trade in the shares of unincorporated joint-stock companies. From that time until Parliament passed the first general incorporation act in England in 1844, England had a two-tier system of business organizations in which only chartered companies had the primary characteristics we have come to associate with corporations, including entity status (but not necessarily limited liability (Harris, 2000: 23 – 24)), while unchartered joint stock companies could not (legally) have tradable shares, and were treated as partnerships by English courts.

The Joint Stock Companies Act of 1844 gave many more firms access to charters, and the Joint Stock Companies Act of 1856 streamlined the chartering process and served as the basis of modern company law in England. As a result of travelling this path, modern company law in England can be seen as having evolved out of partnership law rather than out of the law governing eleemosynary institutions. Some scholars have argued that this helps explain why corporate law features in Britain are more contractual and partnership-like (Moore, 2010: 25; Dignam and Lowry, 2010: 271) than corporate law is in the U.S.

In the American Colonies, most business activities were carried out either by individual proprietorships, or by partnerships, through the end of the 18th century, but the joint-stock company was a well-known organizational form because such companies had in many cases helped to establish, settle, and govern the colonies. Business people would have encountered the

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19 Cite to those early cases on joint stock companies.
20 From 1700 to 1800 in England, only about a dozen corporate charters were issued, and of these, only six were for manufacturing firms (Blumberg, 1993: 14). So business people used the joint-stock company form, which flourished in England despite confusion over whether partnership law would apply to them, or whether they would be treated as partnerships. Blumberg (1993) observes that “modern English business law . . . developed as company law – or the law applicable to joint stock companies – not as corporation law” (Blumberg, 1993: 15). Blumberg (1986: 579 – 580 (as cited in Mendelson, 2002: 1209) asserts that limited liability was not considered “among the essential attributes of the corporation” in the early 19th century.
corporate form frequently in other contexts too, because it was used by churches, libraries, universities, other eleemosynary institutions, and for some public works projects such as canals, bridges, water works, and turnpikes.  

Most corporate charters in the colonies in the early 18th century had actually been granted by the governors of each colony, which granted charters much more liberally than the king or Parliament in England. So this form was more readily available in the colonies than in England, and its status less ambiguous than that of joint-stock companies (which would probably have been considered partnerships by local courts). After the Revolution, however, when the authority of the English monarch and Parliament were no longer recognized, state legislatures took over the task of issuing charters, and did so with greater frequency, and for more different types of organizations (Blumberg, 1993: 10) than had the King or Parliament. Nonetheless, it was still costly and time consuming to organize a business as a chartered corporation rather than as a partnership or unchartered joint-stock company because each corporate charter required its own special act of the legislature. By 1800, there were only about 335 business corporations existing in all of the states.  

Partnerships and unchartered joint-stock companies, while easier to establish, had a huge drawback for industrial enterprises relative to chartered corporations. Assets accumulated by a business organized as a partnership were subject to being withdrawn at any time if a partner decided to pull out of the business, and if a partner died, the partnership had to be dissolved and reformed after paying out an appropriate share of assets to the heirs of the deceased (Blair, 2003). By contrast, courts recognized that any business organized with a corporate charter obtained from the state was a separate legal “person,” that could hold the property in perpetuity, 

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21 Creighton (1990: 30) reports that prior to the Revolution, only seven corporations were chartered for business purposes (other than public works, banks, and insurance companies) in the American Colonies.

22 And 88 percent of the charters for these business corporations had been issued after 1790. See Davis (1917: 3, 24, tbl.I).
even as a stream of investors and managers came and went in the enterprise. Investors could sell their shares to another investor, but could not demand that their share of the assets be paid out of the corporation to them. Thus, by early in the 19th century, business people began seeking corporate charters for a wider variety of businesses, and especially for any businesses that required a substantial commitment of long-lived capital. As a consequence, the law governing business corporations developed in the U. S. more rapidly than it developed either in England or in other European countries.

Despite the cost and difficulty of obtaining a charter, demand for charters increased rapidly, and by 1850 there were thousands of business corporations in existence, and 14 of the 31 states either had general incorporation statutes, or state constitutional amendments or provisions that provided that any group who met certain requirements and filed the appropriate papers could form a corporation (Creighton, 1990: 151). As many as half of all corporations in existence by then were business enterprises (Creighton, 1990). By 1890, there were 500,000 business corporations in existence in the United States (Votaw, 1965), substantially more than existed in any other country, and almost every state had a general incorporation statute (Hilt, 2008). Incorporation statutes did not always provide for limited liability for corporate shareholders, especially early in the nineteenth century (Blumberg, 1986; Blumberg 1993: 10 – 13; Mendelson, 2002). So while this feature of corporations later

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24 By 1673, France had developed an organizational form called a “Société en commandite”, which was equivalent to a limited partnership (Angell & Ames, 1858, at 40), and this form was also used in many parts of Europe, though not in England. The limited partnership form permitted some participants to be passive partners, protected the passive partners from liability for the business, and permitted the shares of the passive partners to be transferrable.
25 Angell & Ames (1858) observed that “corporations of our own time . . . are those which have been created in different parts of the United States by charters, that impose upon each member a personal responsibility for the company debts, and in that respect, resemble an ordinary copartnership” (Angell & Ames (1858), at 45). Hovenkamp (1988: 1651) asserts that “during the first third of the nineteenth century, American states experienced a general legislative and judicial reaction against limited liability.” Limited liability became a standard feature of
became important, it was not initially the feature that caused so many business people to seek out and adopt this organizational form (Blair, 2003; Creighton, 1990; other cites).

What was compelling and attractive, however, was the legal standing that chartered corporations had as separate entities. In particular, separate legal entity status provided continuity by assuring a clear line of succession in the holding of property and the carrying out of contracts, as it had traditionally done for eleemosynary or public purpose corporations. It also provided a common source of identity for participants in the enterprise to which important intangible assets such as special knowledge, competences, reputation and brand could attach. Such assets emerged as extremely important in the late 19th century to support mass production and mass marketing. And the corporate form provided a mechanism for committing assets to a particular enterprise and protecting those assets from creditors or heirs of the corporation’s participants (as well as protecting investors in the corporation from creditors of the corporation). By the mid-19th century, an emerging body of corporation law provided that the entities created when a charter was issued by a state were to be governed by boards of directors. I discuss each of these purposes in the next section.

II. The four functions

A. Continuity through perpetual succession.

The earliest corporate charters were granted to enable a “perpetual succession of individuals . . . capable of acting for the promotion of a particular object, like one immortal

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26 The legal recognition of corporations as separate entities eventually led courts to absolve shareholders of liability for corporate debts, at least after they had paid in their full initial capital, so limited liability came to be associated with entity status. But entity status preceded limited liability.
being,” as Angell and Ames said in 1832.\textsuperscript{27} The purpose promoted by these institutions was to accumulate property for a specific quasi-public use, such as religious buildings, monasteries, or universities, in a way that would protect the property from division, confiscation or taxation each time it came under the control of a new person. This could not be done under common law contract or property rules because of the “rule against perpetuities.”\textsuperscript{28} This rule was intended to prohibit individuals from putting restrictions on the use of property in their wills that would otherwise bind the court for many years after the death of the person who imposed the restrictions.

The granting of a charter to a corporation, however, had the effect of creating a separate legal entity that would continue in existence over time. It was then the chartered entity that existed in “perpetuity,” not the constraints on the transfer of property. If the entity held the property, then the property could continue to be dedicated to the purpose for which that entity was formed as long as the entity existed.\textsuperscript{29} The ability to commit property in this way was important for assets that would be dedicated to a specialized purpose, a function that became quite valuable in business as the industrial revolution generated scale economies in the 19\textsuperscript{th} century and business people began building railroads, large refineries, mills, and factories that could not be readily redeployed to some other purpose. For reasons I have explored at length elsewhere, business organizers prior to the late 20th century could not achieve perpetual succession for the enterprise through the standard partnership form of organization without, as

\textsuperscript{27} Angell and Ames (1832), at 2.
\textsuperscript{28} cite
\textsuperscript{29} In response to this development, statutes of “mort-main” (from French meaning “dead hand”) were developed to regulate the sale and transfer of land to incorporated entities.
Angell and Ames (1832, 2) put it, “perplexing intricacies, the hazardous and endless necessity of perpetual conveyances for the purpose of transmitting it from hand to hand.”

The ability to commit specialized assets to a common purpose over time is still one of the most important functions of incorporation. Although today it may seem that corporations buy and sell assets and turn their properties over much more readily than they might have in the early 20th century, business corporations continue to be substantial owners of specialized capital, both physical and intangible, that is more valuable if it can be committed to its specific function over a period of time, even though a succession of individuals may have management responsibility over the assets.

Perpetual succession was also important to assure counterparties that contractual obligations would be carried out by the entity, even if the individuals who negotiated and signed the contracts were no longer around. Entity status thus provided continuity that made it feasible for business organizers to enter into long term contracts for supplies of raw materials such as iron ore to feed into a steel mill, for example, or to build communities along the path of a railroad to provide services, supplies, and equipment to the railroad and its passengers and crews.

B. Common identity.

The idea that a corporation could stand in the place of a group of people who wanted to act collectively, so that they could own property, enter into contracts, sue and be sued as if they were a single person, is also fundamental to the corporate form, and its roots are deep in the history of corporate law. A corporation, according to Kyd, is “a collection of many individuals.

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30 See also Blair, 2004, at 421, citing Eyre (1823).
31 We may be more likely today to find assets committed for decades, or even centuries, in entities such as museums, libraries, universities, and churches than in business corporations.
vested by the policy of the law, with a capacity of acting . . . as an individual, particularly of
taking and granting property, contracting obligations, and suing and being sued."  

As corporations came to be used extensively to organize large scale businesses in
manufacturing, transportation, and wholesale and retail trade, business people learned to market
their products to customers across great geographic, social, and economic distances (Chandler,
1977, Ch.7). But this meant that the customer no longer had a personal relationship with the
people who produced the goods. How could she be sure that the product would be well-made, or
that the producer or seller would stand behind the product? One solution to this problem turned
out to be the development of the idea of “branded” goods.  

Firms that produced factory-made machinery in the mid 19th century, such as guns,
sewing machines, and farm equipment, for example, had to convince potential customers that the
manufacturer would stand behind the product, and provide for repairs and maintenance. In the
late 1850s and early 1860s, sewing machine maker I. M. Singer & Co. – originally organized as
a partnership – developed a network of distributors in local communities who were direct
employees of the firm (rather than independent distributors), who could sell the machines, teach
women how to use them, provide financing for households to buy the machines, and repair the
machines if they broke. This network of employees helped to build a reputation for quality,
reliability, and service that made it possible to sell sewing machines to customers who never met
Mr. Isaac M. Singer, the inventor of the machines. The Singer sewing machine thus became one
of the first branded factory-made machines to be used in many households.

32 See 1 Kyd, 13, as cited in Angell and Ames (1832, 1).
33 “Campbell Soup, Coca-Cola, Juicy Fruit gum, Aunt Jemima, and Quaker Oats were among the first products to be
‘branded’, in an effort to increase the consumer’s familiarity with their products. See Wikipedia entry on Brands, at
businesses, their products, and services.
34 Cite to Singer sources. Maybe to Chandler
By 1860, the reputational value that I. M. Singer & Co. (the partnership) built up since its founding in 1851 was vulnerable to the extent that it was tied to Mr. Singer the person, because Singer was growing old, and became increasingly eccentric and flamboyant as he aged. Singer’s partner Mr. Edward Clark intuitively understood that it was crucial to the long run success of the business that it be separated from Singer, the person. So he convinced Singer to reorganize the business as a corporation, the Singer Manufacturing Co. This had the effect of transferring all of the tangible assets of the business into a separate corporate entity, and helped to link the intangible reputational assets to that entity, which could be distinguished from Singer the person, and could continue in existence for more than a century after Singer was gone (Blair, 2003: 445-448).35

Having a corporate entity serve as the bearer of reputational and organizational capital results in a significant change in the relationships among customers and employees of the firm. In a market of individual producers and shops, customers trust the quality of the meat, bread and candles because they trust the competence of the individual butchers, bakers, and candlestick makers. Where corporations make and sell mass produced branded products in many markets, however, the customer often comes to trust the product first, and trusts the competence of individuals involved in making and selling the products without knowing them personally because they are employed by the corporation and identified with its brand.36 In this way, the use of the corporate form of organization makes it possible to extend the reputational value created in the firm across time and space, so that numerous firm employees can share in the

35 In the context of modern business enterprises, Crain (2010, at 1182) observes that “brands allow a firm to separate itself and its reputation from the people who make the products or provide the services . . . .”  
36 Social identity theory, argues that individuals’ define and identify themselves partly in terms of the social groups to which they belong (Taylor & Moghaddam, 1994). Empirical research has shown that most individuals have strong needs to identify with social groups (Ashforth & Mael, 1989). Numerous scholars have studied how employees tend to identify with the firms that employ them, as well as with groups within the firms (Ashforth & Mael, 1989; Akerlof & Kranton, 2005).
reputation of the firm, and so that the reputational value reaches many more possible customers. The brand creates value for these customers by reducing the transactions costs associated with identifying reliable sources for products, and reliable people with whom to do business.

If the brand is attached to the corporate entity rather than to any of the individual investors, managers, board members, or employees this makes it easier for the work force of a firm to identify the firm, and with each other, which in turn creates value because employees who identify with each other and with the firm have been shown to be more productive (Akerlof & Kranton, 2005; Chen & Chen, 2011; Boivie, et. al., 2011).

C. Asset partitioning: capital lock-in and limited liability

The legal recognition of corporations as separate entities makes it much easier to separate pools of assets according to which assets will be available to which heirs or creditors for settlement of debts. Other scholars have written extensively about the benefits to business organizers of one aspect of partitioning assets, “limited liability.” Limited liability means that the corporation itself, and only the corporation, is responsible for debts of the corporation, and equity holders and creditors cannot be held personally liable for the corporation’s debts. Limited liability makes it easier for corporations to raise equity capital from widely dispersed shareholders, or from shareholders who prefer to invest passively, leaving the management of the company to others. Limited liability and separate entity status for corporations may even provide efficiencies for creditors of corporations because they make it much clearer which assets back any loans to the corporation.

37 Hansmann & Kraakman (2001); Blair (2004).
38 Mendelson (2002: 1209, note 14) cites articles and cases dating from 1927 through 2000 for the point that other scholars and jurists have deemed limited liability to be one of the most important corporate characteristics.
39 Courts can “pierce the veil” of the corporation and hold shareholders liable in exceptional circumstances, such as when a controlling shareholder abuses the privilege of limited liability by pulling assets out of the corporation, leaving it unable to pay its debts.
Separate entity status also facilitates “capital lock-in.” Corporate law makes it easier to commit capital to an enterprise because, under corporate law, the assets of the corporation belong to the corporation itself, and may not be pulled out by shareholders without a decision by the board of directors to make a distribution to shareholders. If shareholders want to get out of their investment for any reason, they have no right to have their interest bought out by the corporation individually (as partners would have in a partnership), nor do they have any authority to order a pro-rata distribution to all shareholders. Instead, shareholders are generally entitled to sell or transfer their shares, which gives the purchaser of the shares the rights to any distributions, when and if they are made subsequently.

Moreover, if a shareholder dies, the corporation will not be broken up so that assets can be distributed to the heirs of the deceased shareholders (as would happen in a partnership). Instead, the estate of the deceased is left with shares in the corporation that can be distributed to heirs without changing anything about the financing or management of the corporation. And, similarly, creditors of individual shareholders (or other investors) may not claim corporate assets or compel a distribution of corporate assets to satisfy their claims against the shareholders. Shareholders could, however, transfer their shares to the creditors as payment for the debts.

Hansmann & Kraakman use the phrase “asset partitioning” to refer to the combination of these two functions, limited liability of shareholders for corporate obligations, and the protection of the firm from liability for debts of its shareholders or from having shareholders pull assets out. They argue that it might have been possible to arrange for limited liability for shareholders through contracts, but that it would be difficult or impossible to protect the firm from creditors of the shareholders by contract. Separate entity status for the corporation achieves these results however. Thus they assert that asset partitioning is the quintessential feature of corporations that
distinguishes them from other contractual arrangements, and that can only be achieved through separate entity status.

While asset partitioning is undoubtedly a very important function of separate entity status, in the large corporations that emerged in the 19th century and came to dominate the industrial economy of the 20th century, perpetual succession, common identity, and asset partitioning were all three important, and generally came as a package. Legal recognition of separate entity status neatly and cleanly accomplishes all three functions.

D. Governance structure.

From its earliest days, the corporate form was a mechanism for organizing the affairs of a group of people acting together, either in succession, or contemporaneously, or both. In fact, in the U.S., as states began to pass general incorporation statutes in the first half of the 19th century, these statutes all required that there be at least three, or sometimes five or even seven incorporators or members. The corporate form was not available, as it is today, for use by a single individual (or another corporation) to carve their assets into separate pools, some available for business creditors and others available for personal creditors. The requirement that at least three or more individuals were needed to form a corporation was still in place in nearly all states as late as 1950. This was not considered controversial in the early development of corporate law because one of the main reasons for incorporation was to make it possible for a group of

40 As late as 1960, according to the notation to Model Business Corporation Act, §2.01, “all but nine states specified that the incorporators must be three or more natural persons,” and the comment to the 1960 MBCA stated that the Act “followed] the traditional concept of several individuals combining to form a corporation.” The MBCA was changed in 1962 to permit incorporation by a single person, or by another corporation. (MBCA (2011), at 2-5).

41 Case law going back at least to 1871 suggests that when, on occasion, a single individual came to hold all of the shares of a corporation, courts would still recognize that the corporation was a separate entity from the owner of its shares. See, e.g., Newton Mfg. Co. v. White 42 Ga. 148, 1871 WL 2379 Georgia 1871. But it appears that corporations could not be formed for this purpose prior to the changes in state corporate law that took place in the 1950s and 1960s.

42 Model Business Corporation Act Annotated, 2008: §2.01, Annotation, p. 2-5.
individuals to unite “under a common name, the members of which succeed each other, so that the body continues the same, notwithstanding the change of the individuals who compose it, and which for certain purposes is considered a natural person,” according to Angell and Ames (1832: 1).

With multiple people involved, it becomes necessary that the participants in the enterprise have some method of governing their relations. In firms organized as partnerships, the law views partners as having contractual relationships with each other. These relationships are supposed to be largely self-governed, but if a dispute arises among partners that they cannot resolve themselves, they can turn to a court of law to weigh the equities, consider the contract terms, and determine the appropriate outcome.

Corporate law, by contrast, provides that corporations must have a board of directors, and that the board has sole authority to act for the corporation.43 Although corporations are subject to regulations concerning their business activities and their public disclosures, as to internal questions about such matters as the choice of ventures to pursue, the allocation of resources within the firm to one project or another, or the distribution of wealth created by the firm as between bonuses and dividends, such matters are left to the business judgment of boards of directors, and courts will not second-guess them unless there is evidence that the directors breached their fiduciary duties in some way.44

Although the requirement of having a board appears to have emerged early in the history of corporate law, there has been relatively little scholarship on the origins of this requirement.45 Gevurtz (2004) speculates that chartered associations formed for commercial purposes copied

43 MBCA §8.01 (“each corporation must have a board of directors. (b) All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, or its board of directors. . . . “).
44 Cite articulating business judgment rule
45 Gevurtz (2004) is a significant exception.
the organizational structure of chartered townships, which were governed by town councils, and that, when states were drafting general incorporation statutes, they incorporated this feature, which had become quite a common feature of corporate charters (Gevurtz, 2004: 144-145).46

Corporate law clearly separates the role of directors from that of shareholders. Although this separation of roles makes it easier for investors in corporations to be passive investors, it has also been troubling to legal scholars at least since Berle and Means (1932) documented the extent to which the ownership of shares in corporations had migrated to investors who were almost completely disconnected from corporate management. The concern is that separating “ownership” from “control” in corporations gives management free rein to run the corporation in pursuit of their own personal agenda, rather than to create value for shareholders.

Prof. Stout and I have argued elsewhere, however, that one of the important benefits of the corporate form is precisely that it takes power away from the individual participants, and vests all powers of action in the board, a governance arrangement that helps support “team production.”47 “Team production” refers to productive activity carried out by a group of people who contribute complex inputs that are difficult to measure or specify, and in which the output is a “joint output” in the sense that it is not possible ex ante to determine which portion of the output is attributable to which input provider. Team production requires team members to cooperate, but if inputs are complex and difficult to specify in advance, it can be impossible to write complete contracts that can elicit this kind of cooperation without creating incentives for one or more team members either to shirk, or to attempt to “hold up” the other participants in an effort to extract a larger share of the benefits ex post.48

46 Blair (2003: 435-437) reviews some of the evidence in the historical record that boards of managers or directors were a common feature of early business corporations.
47 Cite to Blair & Stout, 1999.
48 Holmstrom (1985?)
One solution to such a contracting problem is that all of the team members agree to give up control rights over the enterprise and its output to an outside third party who has the authority to hire and fire, as well as to allocate the surplus created by the team (Rajan and Zingales, 1998). Boards of directors play this role in corporations. Since they exercise “all corporate powers” (Model Business Corporation Act, §8.01(b)), all other participants can credibly commit not to use power over corporate assets to hold each other up.

Among some of the earliest corporations, it was clear that board governance helped to balance the competing interests of different participants in the firm. For example, the charter of the Farmers’ and Mechanics’ Bank of Philadelphia (incorporated in 1809) required that “a majority of the directors be farmers, mechanics, or manufacturers actually employed in their respective professions” (Blair, 2003: 436, at note 196). This requirement suggests that the directors of the bank would be expected to represent the interests of the borrowers from the bank as well of investors in the capital stock of the bank. Similarly, investors in early railroads included people who lived along the route of the railroad, who were interested in how the railroad affected their lives, in addition to earning a financial return (Werner, 1981: 1637). In more recent times, a common pattern in high tech firms financed with venture capital is that the boards of such firms consist of a representative or two of the entrepreneur, a representative or two of the venture fund that is providing financing, and several prominent individuals who are involved in and knowledgeable about the industry but have little or no direct investment in the firm (Liebeskind, 2000). This pattern suggests that the board is expected to play a role as neutral mediator among the various interests in the corporation.

While it would be possible to vest control rights in a board without creating a separate legal entity, board governance and entity status complement each other. Board governance
makes it clear who can act for the entity, and entity status provides a mechanism for embodying and expressing any interests of the group as a whole that may conflict with or at least not be shared with the interests of any of a firm’s individual participants. Importantly, both statutory law and case law require that directors act “in the best interest of the corporation,” a requirement that makes much more sense if the corporation is recognized as a separate entity from its shareholders or managers, as well as from the board itself.

III. The Best Interest of the Corporation.

Both statutory and case law of corporations in the U.S. regard a corporation as an entity separate from its managers, employees, creditors and directors, and even from its shareholders. Statutory law provides that corporate directors owe their fiduciary duties to the corporation (MBCA §8.30(a)), and courts often describe the duties of directors as being owed either to the corporation, or to the corporation and its shareholders, clearly implying that the corporation is something different from its shareholders. But advocates of shareholder primacy generally argue that it is dangerous and misleading to treat a corporation as having interests that are different from those of shareholders. They take the position that a corporation should be regarded as just a mechanism for aggregating the interests of shareholders, and that those interests can be succinctly summarized in one metric: the value of the shares.

Analysis of the four functions of separate entity status suggests that each of these intellectual constructs may be valid in some circumstances, and not in others, and offers a way to think about the circumstances in which each approach is appropriate. Perpetual succession in the ownership of assets, providing a common source of identity that is also the bearer of reputational capital and other intangible assets, and locking-in assets to keep them dedicated to a certain

49 Cites to cases.
enterprise, are functions that support building, preserving, and sustaining human institutions. Such institutions likely have a broader purpose than just the enrichment of shareholders, purposes such as providing safe and reliable products, good jobs for employees, new treatments for diseases, investment options for small investors, financing for housing or college, or access to communication networks that link individuals around the globe, make vast amounts of information available to them, and give them an outlet for self-expression. While investors in these institutions will expect, and deserve, to get a return on their investment, profits for shareholders are clearly not the only value being created by such enterprises. In these cases, the “best interest of the corporation” can be interpreted to mean that the corporation is supposed to serve (or at least not harm) these other interests. Governance by a board of directors can be useful in striking a balance that sustains the larger purpose.

But not all corporations have such interests. Since the mid-20th century, business organizers have discovered ways of using the corporate form solely for the purpose of asset partitioning, particularly for the protection of limited liability for the organizers of the corporation. We see this primarily in two contexts: 1) in the creation of corporations in which a single corporation owns all the shares of another corporation; and 2) in the creation of “special purpose entities” (SPEs) by financial firms for the purpose of “securitizing” financial assets. When the shares of corporation A are owned in their entirety by corporation B, the incorporation of A as a separate entity adds little or no further “perpetual succession” or “common identity” benefit that was not already achieved by the incorporation of the parent corporation. Similarly,

50 Bratton (1988-89: 427) makes a similar claim about the role of entity status in building institutions: “The entity idea exists and matters because of a heightened interdependence among the parties participating in corporate ventures and institutions. Their positions demand ongoing cooperation, and the entity reification embodies and strengthens common goals, such as the preservation of the relationship, that enhance cooperation.”

51 Such financing vehicles are also called “special purpose vehicles” (SPVs).

52 There may be benefits from maintaining separate brand identities for different parts of the enterprise – Procter and Gamble sells products under at least 50 different brand names, for example. But there is no compelling identity
little governance purpose is served by A having a separate board of directors. Thus the primary function of the corporate form in the case of a wholly-owned subsidiary of another corporation is to make sure that creditors of the subsidiary corporation do not get access to assets of the parent corporation to settle its debts (Mendelson, 2002; Thompson, 2003). Similarly, special purpose entities formed by financial firms for the purpose of securitizing financial assets are likewise created for the sole purpose of isolating the assets that would be available to pay the claims of purchasers of securities issued by the SPEs, and attempting to protect the parent corporation from liabilities associated with those securities.

When the corporate form is used in these limited and stylized ways, the resulting corporations conform to the model that advocates of the nexus of contracts theory of corporations seem to have in mind, in which corporations are understood to be just a mechanism for holding the property of shareholders. For corporations formed solely for such purposes, it might well be the case that there is no distinction between the interests of shareholders and the interests of the corporation. In such corporations, it is reasonable to believe that the only duty of boards of directors is to maximize share value. But, of course, in corporations that exists solely to separate assets, it seems there would be little purpose in requiring governance by a board of directors.

But in conventional business corporations, where business people use the form to achieve continuity and common identity and to build an institution that lasts beyond the vision of the founder (as is suggested in the quote from Apple Corp.’s website at the beginning of this article), separate identity, longevity, and the accumulation of institutional assets such as

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53 In United States v. Bestfoods, 524 U.S. 51 (1998), the U.S. Supreme Court found that the parent company of a firm that owned and operated a hazardous waste facility would not be held liable for clean up costs associated with the facility unless the parent company itself actually operated the facility.
reputation and brand, are important. Actions needed to protect these sources of value might, from time to time, conflict with actions that might maximize value for shareholders, at least in the short run. Board governance, the fourth function of corporate personhood, provides a mechanism for balancing such competing interests: Faced with such a potential conflict, the legal requirement on boards to act in the “best interest of the corporation” serves to grant them vast discretion to try to build and preserve institutional capital that can create value for all of the corporation’s constituents over time.
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