Zach Boyle
David Ciepley
PLSC 2650
March 7, 2018

Incorporation Without Obligation

Even though disagreements would inevitably form over their success in doing so, almost all Americans would agree that it is the government's explicit role to serve at the behest of the people. Such is the nature of an effective democracy. Corporations however, who wield such power and influence in 21st century America, have managed to curtail this responsibility. The question of to whom they're beholden remains inconclusive. The prevailing theory promoted by many intellectuals and economists in America over the past few decades has been that corporations are predominantly beholden to their shareholders. This theory is easily disputable, both from a historical context and in a contemporary sense. This essay will use both of these points to argue that the modern corporation should primarily serve the public interest, as it once did. I will examine how the corporation has managed to pare down its social responsibility, before conceding that to reconcile the modern profit-driven corporation with this new purpose of serving the public would require a drastic shift in consumer awareness and behavior.

Any piece that strives to refine the modern corporation should first consider the original purpose of the earliest modern corporations and whom their foremost iterations served. Both the Dutch and British East India Company's original charters can provide worthy insight. The 1601 charter of the British East India Company (EIC) strongly implies that the corporation, above all else, should serve the Crown. Page 5 of the charter contains the line: "Know ye therefore, that we tendering the Advancement of the Nation… for the Increase of our Navigation, and the

Advancement of lawful Traffick, to the Benefit of our Common Wealth…" (EIC 1601, 5). This makes explicitly clear that the EIC served a number of purposes for the State beyond simple economic enterprise. It served navigational purposes as the British Empire endeavored to expand their presence in far-reaching parts of the world. It enlarged the Crown's militaristic appearance. These benefits to the British Empire would have been seen as justification for the public privileges that the EIC received. Without the obvious implication that the EIC would be subservient to the State it's fair to infer that such a charter would never have been issued.

The original charter issued to the Dutch East India Company (VOC) consists of similar themes. The impetus for the formation of a Corporation came from both the State and the *bewindhebbers,* who were the owners of the precompanies. The State encouraged the formation of a united company as the Netherlands was at war with Spain and Portugal. The Dutch government understood that a united front, coupled with the potential economic gains of forming a monopoly in the East Indies would be highly beneficial to the Dutch Empire. The *bewindhebbers* on the other hand were likely more compelled to join forces for business reasons. They understood that their competing against each other in trade only served to reduce profits for all of them, and the security of monopoly would stand to benefit all parties (Steensgard 1977, 240-41). The key factor to note with both the British and Dutch East India Companies is that they were deferential to the state in both cases. That above all else, the corporation served the state, and by proxy the public good.

Something else that becomes evidently clear when looking closely at the way the VOC was run during its early years is that the shareholders were not at all a priority for those in control of the Corporation. Now operating a monopoly, the priorities for the *bewindhebbers* changed. A divergence had formed between the interests of the shareholders and the *bewindhebbers.* Steensgard described how the division of interests was formed between the two groups: "Their remuneration by provision made it their interest to maximize the turnover of the company, even at terms that were not advantageous to the participants" (Steensgard 1977, 243). Revisions would be made to the charter in 1623 and 1647 that somewhat mitigated the control of the *bewindhebbers* and granted minor concessions to the shareholders. The *bewindhebbers* would be subject to re-election every three years and the shareholders were granted minor influence over the nomination process. It's important to note however, that the bewindhebbers continued to be perceived as a managerial group, not representatives of the shareholders (Steensgard 1977, 244). During the early years of the corporation, shareholders did not play a large role at all.

These practices far from ended with the British and Dutch East India Companies. Up until the mid 19th century in the United States, the vast majority of corporations were chartered by the state in order to accomplish tasks in service of the public. The corporate form was utilized to provide incentive for businessmen to do tasks that would otherwise have been considered too risky or unprofitable to embark on. The corporate form enabled individual responsibility to be severely diluted, but it required compromise. William Roy explained the obligation placed upon corporations in order to gain a charter: "In order to have the privilege of limited liability, gain access to the bountiful supply of Wall Street capital, and achieve the right to act as legal individuals, the incorporating individuals had to pledge fealty to the state" (Roy 1997, 45). If a company failed to prove that it would be serving a public need, then it would not be issued a charter. It's worth noting that this custom didn't end because it was found that it was too inefficient or was preventative of growth. Instead Roy surmises that it came to an end due to a series of contingent factors including the rise of railroads as a preference over canals, a global financial depression, and Andrew Jackson’s populist antistate ideology. The public perception was that the privileges of incorporation were reserved for only the wealthy that were thus able to obtain monopolies. New Jersey was the first state to adopt general incorporation laws, Roy wrote of the state’s decision, “The forces for accountability lost to the forces of accommodation.” (Roy 1997, 70). By the turn of the century, becoming incorporated in the United States and benefitting from the privileges of the corporate form was a right available to all – with no requirement to prove a purpose of societal good (McBride 2011, 4).

This movement of lesser social responsibility for the corporation was pounced upon during the 20th century as profits became the sole motivation for many corporations. While shareholder primacy thinking existed previously, it wasn’t until the 1970s when Milton Friedman and the Chicago School of Economics rose to prominence that shareholder primacy became the norm. Friedman argued in a New York Times essay that because shareholders “own” the corporation, it is socially responsible for a corporation to prioritize the maximization of profits (Stout 2012, 18). This line of thinking caught on, and by the turn of the millennium shareholder primacy had become gospel in corporate circles. Leading corporate scholars Reinier Kraakman and Henry Hansmann wrote in 2001 that, “ultimate control over the corporation should rest with the shareholder class,” and that, “managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders” (Stout 2012, 21-22).

This prevailing thought has been increasingly challenged in the past decade, on a number of different grounds. For starters, there is no legal obligation upon the directors of corporations to maximize shareholder wealth – a myth that has been propagated by those in favor of shareholder primacy for decades now. The reality is that the law does not make clear what the purpose of the corporation is or to whom it should serve. “The overwhelming majority of corporate charters simply state that the corporation’s purpose is to do anything “lawful”” (Stout 2012, 28). Furthermore, shareholder primacy thinking is not at all consistent with the economic structure of corporation. Shareholders own nothing more than shares of stock which grant them only limited rights within a corporation – the right to vote, the right to sue, and the right to sell their stock (Stout 2012, 42). Even these rights become severely diminished when stock ownership is widely dispersed. The end result being that if those in control of the corporation - being management and the board of directors - failed to prioritize shareholder value then there is little that shareholders can do to quickly and effectively prevent them. The recent failures of major corporations that embraced shareholder primacy only provides empirical backing to the argument that corporations should not serve at the behest of shareholders. Pressure to produce strong quarterly figures that increase shareholder value led to hugely fraudulent corporations like Enron and HealthSouth as well as cost-cutting measures on safety procedures that led to BP’s *Deepwater Horizon* oil spill (Stout 2012, 5).

Despite backlash toward the aforementioned corporations for their brazen practices, it was the embrace of general incorporation laws that condemned the government to impotence in preventing large corporations from harming society through their actions. Prior to their adoption corporations had a genuine obligation to serve the public, but so long as they're in place there is little that can be done by government to enforce social responsibility for corporations – their rights are simply too extensive in the eyes of the law. As history has proven, once rights and privileges have been given, they are very difficult to strip away. The onus has been placed on consumers to hold corporations accountable for their actions. America's embrace of free market ideology has taken this burden of regulating corporations away from government and given it to the consumer. Fortunately, in the modern age this doesn't have to be an exceedingly difficult task. Being informed has never been easier. Shareholders especially have a responsibility to invest with a conscience, and use the influence that they carry to promote ethical practices from the corporation they're investing in. Recognition from the general public that the corporate form carries privileges that can only be checked by the consumer is vital. Just as citizens of a democracy are obligated to hold their representatives answerable to their actions, citizens of this corporate world are just as obligated to hold corporations accountable.

Bibliography

English East India Company. 1601. “Charter Granted By Queen Elizabeth, To The East-India Company.”

McBride, David. 2011. “General Corporation Laws: History and Economics.” *Law and Contemporary Problems* 74 (1): 1-18. Duke Journals.

Roy, William. G. 1997. “The Corporation as Public and Private Enterprise.” *Socializing Capital.* 41-76. Princeton: Princeton University Press

Steensgaard, Niels. 1977. “The Dutch East India Company as an institutional innovation.” *Dutch Capitalism and world capitalism.* 235-257. Paris: Cambridge University Press.

Stout, Lynn. 2012. *The Shareholder Value Myth.* San Francisco: Berrett-Koehler Publishers.