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THE CORPORATION'S SPLIT PERSONALITY

*Herbert Hovenkamp**

THE MULTINATIONAL CHALLENGE TO CORPORATION LAW: THE SEARCH FOR A NEW CORPORATE PERSONALITY. By *Phillip I. Blumberg*. New York: Oxford University Press. 1993. Pp. xx, 316. \$45.

Phillip I. Blumberg¹ is a distinguished treatise scholar of corporate law.² In *The Multinational Challenge to Corporation Law* he makes a normative argument for at least modest revision in the law of corporations mainly to base liability on the enterprise as a whole, rather than to divide the corporation into its distinct legal entities, such as parent and subsidiary.

Blumberg distinguishes between “entity” conceptions and “enterprise” conceptions of corporate law (pp. 21-45). Entity conceptions formalize corporations as legal institutions, emphasizing that they are legal “persons” and that the legal form defines the nature of the entity. Under the entity conception, for example, the law of limited shareholder liability remains sacrosanct, even if the corporation is a subsidiary and its only shareholder — the parent — is also a corporation. Blumberg sees little policy justification for preserving such a principle, and great potential for harm (pp. 52-61). It permits a parent corporation to shield itself from liability for its own wrongs, even when the general principle justifying limited liability — concern for the protection of inactive shareholders — does not apply.

By contrast, enterprise conceptions of the corporation view the corporation as a functional profit-maximizing entity, more or less economically defined. Incorporation of subsidiaries is no more than a technical fact, done mainly for purposes of regulatory compliance, as well as for tax and liability avoidance. With respect to liabilities against strangers such as creditors or tort victims, Blumberg believes such firms should be treated as a single enterprise (p. 253). Thus the parent should be held readily accountable for the injury-causing acts or omissions of its subsidiaries, notwithstanding separate legal personhood and a general doctrine of limited liability.

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2. PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS* (1983-1992 & Supp. 1993) (5 vols.).

Blumberg's approach to the issue of entity versus enterprise conceptions of the corporation is traditional and, in fact, quite conservative. This book contains virtually no economic analysis of the business firm.³ The omission of economic analysis is somewhat unfortunate because economic analysis of the nature of the firm could provide many insights into the kinds of questions that Blumberg considers, such as tort or debtor liability of parents for the acts of wholly owned subsidiaries (pp. 87, 92), the capacity of corporations related by ownership to be "conspiring entities" for the purposes of antitrust law (pp. 98-100), the extent to which a court may obtain judicial jurisdiction over a foreign parent based on the activities of a domestic subsidiary (pp. 116-17, 193-99), and so on. Indeed, much current economic analysis would support Blumberg's substantive position.⁴

Ronald Coase's pathbreaking article, *The Nature of the Firm*,⁵ defined the scope and size of a corporation in terms of profit maximization and the costs of using the market. As a result, law-and-economics scholars have tended to view the internal structure of the firm as driven largely by considerations of profit maximization.⁶ A firm purchases the things it needs from others through market transactions up to the point that the costs of purchasing from others equal the cost of producing those things for itself; at that point the firm switches. Transactions that were formerly part of the market become internal to the firm itself. So, for example, General Motors might purchase automobile bodies from one or more outside firms as long as that option costs no more than producing them in house. As soon as the cost of market transactions makes outside purchase more expensive than inside production, however, General Motors will begin making automobile bodies for itself.

Of course, the economic analysis of the structural determinants of the firm can include many things in addition to the simple transaction costs of using the market. This analysis also includes the costs of regulatory compliance, which in turn includes the costs of complying with corporate law. Just as General Motors must decide whether to buy or make automobile bodies, so too it must decide whether to make them through an unincorporated division or a separately incorporated subsidiary.

The Coaseian analysis of the nature of the firm applies in the same way to the question of incorporation as it does to the basic question about production inside or production outside the firm, although the

3. For such an analysis, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

4. See, e.g., Jonathan R. Macey, *Corporate Law and Corporate Governance: A Contractual Perspective*, 18 J. CORP. L. 185 (1993).

5. Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

6. See, e.g., EASTERBROOK & FISCHEL, *supra* note 3, at 1-39.

relevant factors are different. The firm compares, at the margin, the transaction, tax, and other costs encountered in separate incorporation of subsidiaries against the gains to be realized. Most of the costs and gains in this case are consequences of various aspects of the legal and regulatory system, rather than costs of using the market. If the principal gain from separate incorporation of subsidiaries is reduced parent liability, and if this is nothing more than a mechanism for externalizing a certain cost of doing business by shifting it to others — such as creditors or tort victims — then limited liability for the parents of wholly owned or substantially controlled subsidiaries is very likely inefficient. Limited liability would lead the parent to refrain from investing in efficient, risk-minimizing procedures or to overinvest in areas where social costs are greater than prospective gains, but those social costs could effectively be forced upon others.

Blumberg is not an economist, however, and did not set out to do this kind of analysis. One should not generally criticize his book for failing to do something he never intended, and economics does not provide the only way of looking at the problem. Rather, Blumberg's approach is both historical and comparative. The central thrust of his historical argument is that limited liability was not inherent in the nature of the corporation but was something that developed over time (pp. 10-14). Further, its main purpose was to protect the nonparticipatory shareholder (pp. 10-14). As long as the shareholder of a small firm is also a controlling participant, the case for limited liability is rather weak because such a rule effectively limits the liability of the entrepreneur for his own acts.

As absentee shareholders become increasingly prominent, however, limited liability performs the more salutary function of encouraging investment, by decreasing the extent to which an investor's other assets are at risk. Historically, when liability was not limited, it was joint and several. A single shareholder could effectively be held responsible for the entire judgment against the corporation, although there might be a subsequent right of contribution against the others. Blumberg believes the better rule would be pro rata liability so that each shareholder is liable for a percentage of the total judgment that reflects his percentage ownership in the firm (p. 126). For example, even a moderately large individual shareholder in Exxon, with 1000 shares, would own only .00003034 percent of its 1.813 billion outstanding shares. This liability exposure is significantly less than joint and several liability. Of course, the best rule from the shareholders' perspective is limited liability, which effectively provides that the shareholder's liability for any judgments against the corporation is limited to his investment in shares. That is, the shares may become worthless as the judgment is paid off, and thus the investment may become worthless as well, but the shareholder may not receive a deficiency judgment for what is left over. Limited liability effectively en-

sure the shareholder that he can invest without risking his other assets. The emergence of limited liability was probably necessary to facilitate the emergence of the modern capital market. Importantly, the absentee shareholder is not responsible for the acts of the corporation and is not more than marginally involved in making the decisions that subsequently yield liability.

This historical rationale for limited liability, Blumberg observes, is of little relevance when the shareholder is a parent firm that owns all or perhaps a controlling interest in the subsidiary and sets the subsidiary's policy or perhaps even directs its daily operations (pp. 121-50). In that case, a blanket rule of limited liability can effectively absolve the enterprise from acts for which it is responsible, shifting these costs to others.

Blumberg's historical argument is telescoped and highly generalized. In the process, it necessarily distorts a rather complicated historical picture. The picture is mainly complicated by the fact that the United States has never had a national corporation law. The individual states had their own statutes and did not pursue identical policies. In fact, limited liability was fairly robust in the United States at an earlier stage than Blumberg implies⁷ and well before the rise of the large, publicly owned business firm.⁸ To be sure, Jacksonian corporations could and did have passive shareholders, but they tended to be family members, business acquaintances, or other local people who had at least a modest knowledge of the corporation's activities. The one exception was the railroads, for which stock ownership was spread more widely. Generally, however, limited liability in the United States before 1880 or so was tied to the corporation's paid-in capital. Indeed, under most of the general incorporation acts passed during the Jackson Era (1828-1850) and after, shareholders had limited liability only after the stated capital of the corporation was fully paid in. An absentee shareholder would likely know no more about the extent to which the corporation's capital was paid in than about the extent of the firm's liability-generating business activities.⁹

The rationale tying limited liability to paid-in capital was the distinctly premarginalist view that the paid-in capital established a "fund" for the payment of future corporate obligations and thus served precisely the same purpose as a natural person's assets or estate. That is, in determining whether a corporation was creditworthy, one looked at the amount of capital that had been paid in, not at the cor-

7. See pp. 10-11.

8. See HERBERT HOVENKAMP, *ENTERPRISE AND AMERICAN LAW, 1836-1937*, at 49-55 (1991).

9. See *id.* at 51-52.

poration's earning potential.¹⁰ In this sense, limited liability was nothing other than a consequence of legal personhood. Classical legal theory treated the corporation as a "person" in numerous respects; one way it did so was to conclude that the corporate person's debts were to be paid out of that person's assets.¹¹

Blumberg's argument based on comparative law is more convincing overall than his historical argument and carries stronger policy implications. Some other industrialized nations are significantly ahead of the United States in dealing with problems of corporate liability on an enterprise rather than an entity basis.¹² Here, Blumberg notes, one must separate questions of local regulatory compliance — which may require the use of local incorporation — from liability for the overall activities of the enterprise (pp. 168-201). Even in this area, however, the acceptance of enterprise principles has been incremental rather than revolutionary, and piecemeal rather than global.

This is a readable book, easily accessible to someone who knows little of the law of corporations and, indeed, to those with no legal training at all. It treats the issues in an intelligent, balanced way, which is just what one would expect from a scholar of Blumberg's stature.

10. See Herbert Hovenkamp, *The Marginalist Revolution in Legal Thought*, 46 VAND. L. REV. 305, 346-58 (1993).

11. See HOVENKAMP, *supra* note 8, at 53-55.

12. See pp. 160-61 (New Zealand), 161-63 (Germany), 165-67 (European Community).