INCORPORATION BY THE STATES.

Assume, for a moment, that all of the State statutes dealing peculiarly with corporations had, on January 1, 1905, been repealed.

Assume, also, that there had then been appointed a competent body of men, familiar with the present financial, commercial and social conditions, and with the general common and statutory law, but wholly unaware of the previous existence of the mass of "corporation law" so repealed; and that upon this body of men there had been conferred the power of making a system of "corporation law" for the United States.

Considering the matter in this light it is highly improbable that the new corporation law thus produced would be in any way similar in its general framework to the present so-called "State system" of incorporation and corporate regulation.

In other words, our present system of corporation law is explainable only by reference to the history of its growth, not by reference to present conditions or to any justifiable modern theory.

I. General Legal Theory of Corporation Law.

The legal theory of corporation law can be most accurately understood by considering such law as consisting of:

(*a*) A number of peculiar *powers* granted to individuals (granted by the legislature and peculiar in the sense that the same are in derogation of the common law).

(*b*) *Limitations* placed upon the exercise of these powers.

(*c*) Means provided for the *enforcement* of such limitations.

A concrete illustration will serve to show the application of the above classification. A given state grants to a body of individuals the powers of corporate existence and identity, succession, limited liability, establishment of a representative form of government, means of voluntary dissolution, etc.

Upon each of these powers there are placed one or more limitations, as, for instance, a given state limits the power of corporate existence to fifty years; the power of representative

government to a specified number of directors elected in a specified way; the power of voluntary dissolution to a public and specified form of procedure, with proper guaranties of the protection of the rights of third persons.

These limitations, again, are enforced by various means, the most common method being the provision for reports or returns to be made by the corporation to specified state officials. Incorporators are by a given state required to show in their certificate of organization that they have not exceeded the maximum period of allowed succession or duration; that the prescribed number of directors have been chosen, etc. A criminal penalty, fine or imprisonment, may be provided for failure of officers to keep proper books; creditors are given private rights of action against stockholders who accept dividends which render a corporation insolvent, etc.

In brief, it is seen that a corporation is a bundle of powers, conferred upon a given number of individuals, subject to certain limitations, which limitations are enforced by specified means.

Powers Granted.

That these powers are in derogation of the common law appears from the statement of them. The power of succession or legal immortality is possessed by no individual as such. The power of limited liability is substantially an exemption of certain individuals from the ordinary full liability for debts which is imposed by the common law. The power of representative government is a material modification of the common-law form of agency which appears in partnership.

In like manner it will be seen that the other powers peculiar to corporations are in derogation or in modification of the ordinary common law. This fact of derogation of common law is the basis for the peculiar regulative power of the state over corporations. When individuals are given powers which do not exist under the common law, it is necessary that in their corporate capacity they should be subject to regulations to a corresponding extent in order to prevent the misuse of such powers.

Limitations upon Powers.

Upon the power of representative organization and government are imposed the limitations necessary to protect the ordinary stockholders and to safeguard the rights of the minority. The general principle of limitation upon this power is quite analogous to constitutional limitations imposed upon

the legislative and executive branches of state and federal governments. Similarly, the limitations upon the powers of internal and external management are intended for the safeguarding of the rights of stockholders and of third parties doing business with the corporation in the capacity of creditors, employees and consumers. Similar limitations are also placed upon the powers of doing business so that a certain amount of publicity must be maintained for the information of the state and of third parties.

Enforcement of Limitations.

In order to make these limitations efficient, various machinery of enforcement is provided, mainly in the nature of publicity through reports to state officials, and also by placing certain penalties, either in the nature of criminal penalties or in the nature of the right of damages in third parties, against officers and stockholders overstepping such limitations.

The foregoing outline is of course only illustrative of the features of corporation law. It will be seen that all the features above cited are peculiar to corporation law, and to that extent are not known to the common law. The state creates corporations and grants to them certain powers, as above indicated, not within the reach of the individual engaged in business. These powers are so great and so permanent that they would be subject to abuse unless restrained, and the state therefore places limitations upon them and sees that these limitations are enforced.

The aggregate of legislation under these general principles is what is known as corporation law.

II. Economic Theory of Corporation Law.

Corporation law, as an economic product, is primarily the result of concentration of capital. For the purposes of this discussion it is practically necessary only to consider economic phenomena of this nature that have appeared in the last fifty years.

Previous to that period the individual or partnership form of transacting business was a sufficiently satisfactory instrument for carrying on business. The ordinary business of that time was small in extent, required a comparatively small amount of capital, and this necessary amount of capital could usually be furnished by at most three or four men, and all those engaged in the undertaking could give the business their personal supervision.

But then arose the striking and peculiar series of phenomena that have characterized the economic history of the country in the latter half of the last century.

The proper development of the business resources of the country at the opening of this period began to require that very large enterprises should be undertaken, enterprises involving millions of money, a considerable period of time for development, and the highest business and technical skill available. Under no other conditions could the necessary work of commerce be performed. What is known among economists as the "minimum unit of efficiency" had greatly increased; in other words, the minimum amount of capital with which certain kinds of businesses could be carried on profitably became very much larger than before.

It thus became apparent that the individual or partnership form of business would be wholly inadequate. It was, of course, absurd to contemplate the construction of a transcontinental railroad, for instance, or any business of similar magnitude, by individuals or by a partnership. There became apparent the imperative economic need for some form of doing business by means of which the surplus capital of numerous individuals might be combined and directed upon a single enterprise. The application of this mass of capital must, for business efficiency, be centered in a few hands. The many small investors, necessarily thus deprived of personal control and supervision over the use of their individual contributions, must in equity also be relieved of personal responsibility for mismanagement. Safeguards must be provided against the abuse of the powers concentrated in such few hands so as to protect both the mass of stockholders, the minority interests, third parties, and the state. Hence the corporate form, with its massing of a large number of small units of capital, through divisibility of its stock interests, its control, vested through a representative form of government, in a few men constituting its board of directors, its correlative release of the ordinary stockholders from personal responsibility, through the medium of the legal feature of limited liability, and the necessary limitations imposed upon these powers in favor of stockholders, creditors and the state.

The obvious appropriateness, availability and economic necessity of the corporate form became at once apparent with the development of the commercial and economic phenomena above outlined.

III. Basic Legal Factors.

State System of Incorporation.

The "State system" so called, is the most important single factor in our present corporation law.

The development of this state system could hardly have been avoided in view of this historical development of the United States. The earliest local sovereignties in this country were the colonies or the states. The creation of corporations, being an act of sovereignty, and in many respects in derogation of the common law, necessarily lay with these states. Prior to the adoption of the Federal Constitution, there was no other legal sovereignty. It may be added, also, that at the time when the seed of our present corporation system was sown and until the plan had attained considerable growth, the colonies or states were not only legal sovereignties, but were also distinct entities in commerce and finance, and the state boundary lines had a definite commercial meaning.

Regulation by the States.

Regulation of corporations by the states followed as a necessary corollary from the incorporation by states. The power which created must also regulate, there being then no other or superior power to do so.

State Comity.

When one considers, in the light of general principles, the well-known theory of the comity of states as regards corporations, this theory assumes the position of a very interesting and peculiar phenomenon. The substance of this theory is to the effect that a corporation, chartered in one state, may exist, do business, sue and be sued in other states, subject to such regulations as such other states may choose to impose. In other words, while the laws of one state have no effect outside the territory of that state, nevertheless a corporation of one state, which is wholly the artificial creature of the laws of that state, has definite existence, identity, and powers beyond the limits of the creating state.

So far as is known, the abstract theory at the basis of this position has not been clearly laid down. It would seem, for the purposes of state comity, that the corporation laws of one state are not only recognized, but are, to some extent, tacitly reënacted in the laws of the other states. A corporation is practically an artificial creature of statute law and has no existence, identity or powers beyond the statute of its crea-

tion. The statutes of a given state stop at that state's line. And yet the principle of state comity, as universally applied in our present corporation system, allows of the existence in one state of the corporate entities created by another, and the exercise there by them of certain powers. All this without any express legislative permission on the part of the foreign state; but as statutory action of some sort is theoretically necessary to the existence of a corporation, the theory of state comity must assume a tacit action on the part of the foreign state which is tantamount to a reënacting of the laws of the incorporating state. In practice, of course, a foreign state almost always adds some few express restrictive requirements on its own account as to foreign corporations, but, subject to this qualification, it may be roughly said in theory that the corporation law operative within any one state of the Union is made up of one part express statutory law passed by its own legislature, and of forty-four parts implied statutes passed by the legislatures of other states; in other words, the corporation law of a given state is an aggregation of all the laws of all the states, regardless of the manner in which they may conflict, vary or modify each other.

So much for the abstract theory at the basis of state comity—a matter of pure theory, inasmuch as no decision can now be cited going into the theory of the matter comprehensively and generally.

As to the practice, state comity is, as said above, more of an economic necessity than a legal theory. In practice, it may be roughly said that it amounts to an extra-constitutional federation of the states on the single point of corporations as citizens.

The Corporation as Such.

For the legal theory of the corporation we are indebted largely to the Roman law, which, with the strict logic of that law, laid stress upon the wholly artificial nature of the corporate entity regardless of the natural individuals composing its membership. This tendency in the treatment of the corporation was naturally predominant at the time when our corporate system was formed, at which time the corporation was more important as a theory than as a fact. Our courts accordingly developed the corporation on theoretical lines. Logic demanded that the relation of the individual stockholder to the corporation, and as a part of the corporation, be minimized, and the result was that when, in the latter half of the last century,

the economic forces began to operate upon our corporate system, the corporation known to our law was a highly artificial entity.

IV. Recent Forced Growth of Corporation Law.

In the latter half of the last century the corporation suddenly leaped from the position of a legal phenomenon to that of an economic necessity, urged by the forces of commercial development above indicated. When this great economic change took place, it found the framework of a corporation system already prepared, having, as above stated, certain predominant features:

(*a*) The development of the corporation as a strictly artificial legal phenomenon.

(*b*) The practically exclusive control of corporate creation by the states under the state system.

(*c*) Regulation of corporations by the states.

(*d*) State comity, and the peculiar relations dependent thereon.

Then came the swift progress of the country towards material prosperity, the accumulation in the hands of many individuals of small surpluses of capital, the development of great enterprises, the increase of the minimum "unit of efficiency" in given businesses, and the accompanying concentration of capital in a few hands.

To meet these conditions the legal form of doing business known as the corporation was required, and into the old artificial framework of corporation law already constructed was turned the rush of these great economic forces, and the over-predominance of legal theory gave way to a corresponding over-predominance of practical necessity, until our present corporation system, in its distorted and disproportionate outline, shows the effect of these forces, as a geological formation shows the effect of overwhelming forces of disturbances.

With these forces pressing upon the legislatures, the modern history of our corporate system opens. The results reflect the motive forces. Regardless of theory or consistency or permanence, or the proper and proportionate protection of the interests involved, legislation yielded to the new pressures, and a structure was built up which is a marvel and a monument of opportunist make-shift.

At first, it is true, the states held back, retaining the old notion of the semi-sacredness of the corporate franchise as a special privilege and grant of sovereignty. Then the comity of

the states began its logical work; the more accommodating states got the larger share of the revenue-bringing incorporation. The conservative states gained only empty credit for their caution, and their own citizens journeyed to other states for easy incorporation, and returned home a foreign corporation, paying taxes and owing allegiance elsewhere, but, through the comity of states, doing business freely in the practically helpless conservative state.

Then as the century closed, the use of the corporation as a mere stock-jobbing tool became suddenly important. This process is as yet only partially complete, but what the final product will be under existing conditions is obvious now. What does it avail that forty-four states have good corporation laws, if the forty-fifth, through the principle of comity, can offer a lax law, and practically thereby nullify the virtuous aims of the others, and in addition, be rewarded for such laxness by an inrush of remunerative incorporation? How long will the more conservative states stand up against the logic of such circumstances, when such conservatism hurts them, and does no one else good? The making of corporation laws must degenerate, as it already largely has, into a bidding of state against state for corporate patronage through increased grants of power and decreased regulation. The final result under the present system, if carried to its logical and inevitable conclusion, will be a reduction of all our corporation law to the lowest level of laxity, and the disproportionate favoring of the strictly "promoting" interests, the original organizers, as against the other interests properly concerned in corporation law, to wit, stockholders, creditors, consumers and the state. And it must always be remembered that those who "promote," or organize a corporation have no necessary interest in its permanent success as a business machine. They are frequently concerned only in the "flotation" of its securities.

V. Actual Statutory Result.

A comparison with the various corporation laws of the states in force to-day will illustrate what has already been said. It is not necessary to make a complete summary of all the state laws for this purpose, nor would it be justifiable to do so within the limits of this article. It is sufficient for illustration to take certain powers or certain limitations thereon in states selected at random and compare them, and with this in view, it is to

be remembered that the following statements are not intended to be comprehensive, but merely by way of illustration, and taken from varying numbers of states selected wholly at random.

Take, for example, the power of *corporate succession*, to wit, the duration of the existence of corporations. Out of seven states so selected, five allow perpetual existence unless otherwise specified; one limits the duration of such existence to fifty years, and one to twenty years.

Minimum number of incorporators. Out of five states, three states require at least four, and two at least five.

As to the very important power of *making by-laws*, four states out of eight allow the stockholders to confer this power upon the directors; one confers it directly upon the directors, and the rest leave it in the hands of the stockholders only.

Scope of by-laws. The powers granted in this direction vary from "any by-laws not inconsistent with law," to a detailed and specified statement covering half a printed page, very few corporation laws being alike on this point.

Place of meeting. No uniformity is observable here, some states allowing meetings of directors or stockholders to be held in or out of the state, some restricting stockholders to meetings in the state and others making various combinations of these two factors.

Voting. By way of exception to emphasize the general rule of diversity, nearly all the states forbid a corporation to vote its own stock. Various provisions are made allowing bondholders in certain cases to vote.

Number of directors. In seven states, four require three or more; one, five or more; one, three to eleven; and one, three to fifteen. Some of these states require that a majority of these shall be resident; others require only one resident, and three out of seven have no requirement as to residence.

Executive committee. This very important feature is allowed in three states out of seven, and in the other four states is not provided for.

Character of business. This power varies in the restrictions placed upon it. Most states allow "any lawful business except"—and these exceptions are varied in proportion to the number of states.

Amount of capital. In a number of selected states, the minimum varies from zero to $2,000, and the maximum from $250,000 upward indefinitely.

Consideration for stock subscriptions. This important question is treated in a great variety of ways. It is impossible to specify or classify satisfactorily the provisions on this subject, some states allowing substantially anything with no restrictions as to value, other states requiring that stock should be paid for in cash or property, with a certain amount in cash, and others allowing cash, property or services at actual valuation.

Enough has been said, it is believed, to indicate the diversity of legal conditions now existing. It is to be remembered that the number of variations presented above in legal conditions is to be multiplied many times, as previously indicated, by the addition of the feature of state comity, and it is to be further noted that this feature of state comity adds the further peculiar legal condition that any corporation doing business in a foreign state under the theory of state comity is transacting business as a foreign corporation, with the peculiar legal conditions that attach to this relationship.

To finally cap the pyramid of diversity, additional varying statutory conditions are placed by such foreign states on the right of corporations of other states to do business therein.

It will be seen from the above that no attempt in this connection has been made to make a complete summary of the legal conditions under which corporations are now doing business. Obviously, no such attempt can properly be made within the limits of this magazine. It is merely desired to demonstrate, as forcibly as may be, the extreme diversity and complexity of the legal corporate relations that have arisen through the development of the "State system," based upon a theoretic rather than a practical view of a corporate entity, and made commercially available through the doctrine of state comity. The basic reasons for this state of affairs have already been outlined. It is probable that the so-called "State system," to wit, the incorporation by states, is the most important feature contributing to this situation. Given that feature, and the results above noted are almost inevitable. Under the state system, the theory of the comity of states was an economic necessity, and given forty-five state legislatures, annually or biennially creating or revising their respective corporation laws, each influenced by the local habit of thought and local prejudices, and each having in mind local conditions and interests, it is obvious that no better or more complete means could have been devised for creating a legal mosaic of the highest diversity and complexity.

VI. Economic and Financial Results of the System.

It may perhaps be fairly said that this corporation system can be best comprehended by regarding it as an imperfect attempt to attain, under great restrictions, and in the face of great difficulties, a crude federal system for corporate business. And if corporations were as unimportant as they were a hundred years ago, this system would be an extremely interesting legal phenomenon, but would have no vital bearing on the industry of to-day. Unfortunately, this is not the case. The vast majority of business is now carried on under the corporate form. Probably the vast majority of our population stands in close relation to corporate business. The paramount problems of the present and of the future are those of industry. These are the problems which engage the ablest men of the present. No consideration of our present commercial system would be in any way complete if it did not take into account the singular legal conditions under which it is being carried on.

As to Corporations Themselves.

Since the earliest historic times, our race has been engaged in a continuous struggle to establish the liberty of the individual, and the one continuous method for this end, and the one toward which our struggles have been consciously or unconsciously directed, has been the defining, with ever-increasing clearness, of the outlines and boundaries of this liberty, until to-day a citizen knows, with reasonable certainty, his personal rights, duties and privileges.

But in the last fifty years there have come into existence a large number of artificial entities—*i. e.*, corporations—which, by virtue of their character, have no inherent or original rights or duties. Their status depends substantially upon statute. The welfare of the country and the welfare of the vast majority of the citizens of the country are intimately connected with these artificial entities. Uncertainty as to their rights, privileges and duties is uncertainty as to the essential things that go to make up the happiness of the individual citizen, and yet uncertainty is the one overshadowing fact that can be predicated of the status of the corporation of to-day. It is hardly necessary to develop this idea further or to go into the details of the present diversity and practical anarchy that prevails as to corporate relations. The foregoing statements of general principles are sufficient to indicate the peculiar foundation upon which our industrial system largely rests.

As to the Public.

The public stands toward the corporation in the diverse relations of creditor, stockholder, consumer and voter. The legal uncertainty above mentioned permeates all these relations, and in the most important one, to wit, that of the voter, the evil effects of this uncertainty are great. Public opinion is the strongest single force in the United States. It is slow of growth; it is the basis of all our law; our law is merely a crystallization of public opinion; and recognizing its importance, it has been the uniform policy of the country so to educate the people that this public opinion shall be in the end correct. If it is not, our political system must fail.

No means could be better adopted to prevent the growth of an intelligent public opinion on the industrial issues of to-day than our present corporation system. How can the average citizen, the unit of public opinion, gain the most rudimentary basis for intelligent views on the present forms of industry? When forty-five different jurisdictions are continually creating or modifying as many forms of corporation law, when a dual system of courts, federal and state, is differing in construction of these laws, when no trained lawyer will undertake to give an opinion as to the fundamentals of the corporation law outside his own state without prolonged examination of the most recent statutes, how can the average citizen act or think intelligently or justly in this matter?

The ignorance of the many has always been the profit of the few. In the relations of stockholders, creditors and consumers, our present system has been abused by men who have made a specialty of such abuse. The system is a standing invitation to such abuse, and the invitation has been widely accepted. The results have been the defrauding of the ignorant public as stockholders and as creditors, the lowering of the tone of public standards of integrity, and the degradation of certain great classes of American securities in the markets of the world.

As to the States.

Corollary to the above, have been the results on the states themselves. The great economic forces being thus obliged to deal with state legislatures, and having before them this invitation of uncertainty and diversity, have brought about political effects and established political standards that are inconsistent with the ideals upon which our country was founded. The

present large corporation is commercially a national affair. Commercially, it knows nothing of state lines, and it operates without regard to them. Legally, it is the creature of one state. In all other states it is a foreign corporation. Doing business throughout the nation, it is doing it under conditions imposed by single comparatively small parts of the nation, and when the two forces meet, to wit, the corporation that desires grants of power and the legislature that should withhold, the forces are unevenly balanced and the contest is unequal.

Briefly, the legal conditions of our business systems do not correspond to the commercial conditions. National businesses are being carried on under state forms.

VII. Viewed as Experiments.

It can at least be said for our present system of incorporation that it gives room for experiment. Probably nearly every conceivable form or modification of corporation law has at one time or other been enacted by the states. This of itself is of course an advantage from a strictly scientific standpoint, however unfortunate may be the results commercially. Probably a comparative study of the corporation laws of the states would be one of the most instructive aids to the formulation of a satisfactory system. This study would show not only the different features of the laws themselves, but also their respective merits, their respective enforceability, and the varied forces working upon the legislatures through which these laws are introduced. It is believed that if there is to be any uniform and rational system of corporation law established in the United States, either by federal incorporation or the federal license plan, as suggested in the recent report of the Commissioner of Corporations, an important part of the work will be done when a thorough comparative study has been made of the corporation laws of the various states, with the varying legal efficiency thereof, the diverse effects upon business and the relations of the states as law-making powers to such systems of law.

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