

A FUNCTIONAL APPROACH TO THE LAW OF BUSINESS ASSOCIATIONS

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I

The law of business associations has crystallized for the most part under the classifications of corporations, partnership and agency. Into one or more of those categories has been thrown the substantial part of the law of all of the business units—the individual proprietorship, the partnership, the limited partnership, the limited partnership association, the joint stock company, the corporation, and the business trust. The reasons for making such categories are not hard to divine. The main vehicles of business since the industrial revolution have been the corporation and the partnership. The joint stock company and the individual proprietorship were relatively eclipsed long ago. A large body of law grew up carrying the labels of partnership and corporations. In one sense it was logical that such groupings took place. Cases carrying labels are not difficult to classify; the importance of the *form* of the unit is apt to make the regulation of that *form* the focal point; the ancient stress on details of organization emphasizes *form*; the increasing importance of certain businesses is likely to bring into consciousness *devices* which are being used by business and the habit grows of thinking of the social regulation of business in terms of the regulation of the *device* used. It need hardly be mentioned that habit pyramids; that what is done soon becomes tradition; that tradition is a strong directive force.

At the same time came the crystallization of agency law. It is interesting to note that this classification did not follow the others. In relation to the others it was cross sectional. It sampled

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a bit in each form of unit and in each type of business. The reasons for such divergent classification are well known. No matter what business unit was employed the person using it found it convenient to appoint some one else to perform some of the acts for him. The agent as the *tool* for expediting business became indispensable. Case law multiplied. The universal use and need raised the cross-sectional problem to the level of major importance. Whatever business the future lawyer would advise would employ agents. So out of the other fields agency was taken. Analogous relational problems were drawn from familial law and the agency field was fashioned. Likewise grew master and servant. Thus side by side grew four major fields of law—two based on *form* of organization; two on *tools* for expediting business. The latter only rarely reached higher in the management structure than the salesman and truck driver. No common chord running through other cross sections was emphasized. Comparable problems pertaining to those to whom wider discretion had been allocated—the executive officer, the managing partner, the director—were omitted for the most part. The reasons for the omission were at best arbitrary. But this divergence in agency and in master and servant, though arbitrary, was a step towards a synthesis that looked more to substance than to form.

Such evolution, however, is not nearly so significant and interesting as are its effects. The focal point of study being the *form* of business unit it was not difficult to predict the emphasis of classroom discussion, lawyers' argument and courts' opinions. The kind of organization, its nature, its quality, its limitations, were analyzed. The analysis took the form of rules; the rules became the theology. The analysis, the rules, the theology emphasized the business unit. It was this. It was not that. It could do this. It could not do that. It was different from this but similar to that. It—and its qualities and its characteristics—were the keystone of the law of business associations. The habit of thought crystallized. The theology obscured thinking. It instituted an endless process of refinement. It continued by its own momentum. The theology complete in itself left no room for growth. Postulates became firmly fixed. The flexibility required for adaptation to an ever-changing economic order was lacking. Creation of new postulates in the light of new facts became increasingly difficult. A theology not fashioned in concepts which earmarked it as part of a specific economic and social order soon

knew no industrial society for its forbears and readily adjusted itself to no economic and social order as its inheritance. The consequence was that the unit instead of being visualized as a device adjustable to a changing order and as a vehicle for the accomplishment of certain specific business functions was apt to be pictured as static. What the functions were was obscured. What vital processes were involved was concealed.

Defects were soon apparent. The phenomena of a changing order emphasized the deficiencies. A new articulation was in demand. It was undertaken. The analysis was directed to the basic factors at issue. The economic and social forces at play were examined. The emphasis began to shift from the *vehicle* employed to the *function* performed; from the form of unit to empirical facts; from a static theology to postulates stated in terms of human behavior. This is legal history. Legal literature abounds in examples.¹ Today it is more common to find class discussion, briefs and opinions flavored with such analyses. Those are the dynamics of law.

One has to read, however, but a small fraction of the representative literature in the field to realize what short progress has been made. The analysis has been so conceptualized that the attention is too frequently focused on the device used rather than on the function which the device is intended to perform. Though courts and lawyers and students have come closer than ever during the last twenty-five years to an analytical consideration of the social and economic forces working in and through the guise of legal concepts and labels the continued use of the old categories and classifications tends to confuse thought. The labels deter clear thinking because of the tendency to misplaced emphasis. So long as the quest is for the economic and social forces involved in the cases it would seem that a set of categories which would focus attention on such forces would be more desirable. That would lead rather to a consideration of the phenomena observed in the organization and operation of a business than of the mere form itself of business. That would result in observations of the things men attempt to do and are found doing when engaging in business. That would lead to the emphasis being placed on the end sought. That would translate present

1. Cook "Scientific Method and the Law" (1927) 13 Amer. Bar Assn. Jour. 303, is perhaps the best expression of the approach indicated above. The present discussion is an application of the general theme to a narrow segment of legal and non-legal material.

institutionalized patterns of agency, partnership, corporations, etc., into patterns portraying the functions which the phenomena of modern business reveal. That would shift the emphasis from forms of business units to the uses to which the units are put. That would discard at one sweep the theological refinements of the concepts. Instead of having his mind cluttered up with many analytical distinctions (oftimes metaphysical) the student would start with considerations more fundamental. The process would be concerned almost solely with the incidents of economic, social, and business problems; with a consideration of the social controls over such economic, social, and business forces; with the results of such controls. Around such incidents would the legal and non-legal material be grouped. To such controls would the focal points shift. With a measurement of such results would the process be concerned.

Several such approaches are possible. The following is merely one that has been tried and sampled in part and has produced amazing results. It focuses on three basic processes concerned with the organization of business. It centers on those three functions as functions common to all business. The treatment is concerned with the methods by which these functions are performed. Such performance being effectuated by the instrumentality of the various business units the treatment is vitally concerned with the law of such units. The legal material realigns itself with non-legal material under three headings.

II

The assembly of resources is the first. The process of assembling goods and funds is common to each form of unit. The devices and mechanisms for effecting the assembly vary. The variation exists not only in respect to the type of business unit employed but the type of business undertaken. Yet common to all business is the process of assembling capital, initially or at a time when the business needs more capital for expansion, or new capital for resuscitation, or additional capital for operation. It is unknown to none. It is common to all. This process is seen to have two main phases—(1) long-term financing; and (2) short-term financing. Both deal with the devices and mechanisms for assembling funds and goods. The legal and non-legal material reveal the following processes. Long term funds are in part raised by the various kinds of bonds and the ever-increasing types of stock, and in part by partners'

capital contributions. If the financing is public the mechanisms through which the stocks and bonds are marketed are the promoters, the brokers, the syndicate and the stock market. In absence of public financing there is the direct contact between the person needing the money and the supply. The other phase of long-term financing is the acquisition of goods. Goods are assembled for such purpose by the use of the lease, the merger, the consolidation and the subsidiary corporation, in addition to the use of corporate stocks and capital contributions of partners. Here we are observing related human behavior directed towards one end. The devices for effecting the result vary from business to business and from business cycle to business cycle. But whichever device is being used, an objective study of the business phenomena would reveal one phase of the function of assembly of capital being performed—long-term financing.

The other phase of the assembly of resources is short-term financing. Short-term funds are assembled largely by the promissory note and mortgage. The common mechanism is the commercial bank. Goods are assembled by the use of the many types of security devices known to modern business. When they are used, how they are used and their limitations are relevant inquiries. The variables from business to business are great. But the common process justifies drawing the various devices together for a unified treatment.

For practical purposes long-term financing might be treated separately from short-term financing. But again, since they are related functionally, a correlated treatment might seem preferable. There would thus be thrown together for study all of those devices and mechanisms which are performing the same function—the assembly of resources. The focal point of analysis and study being this function the emphasis would turn to (1) what are the socially sanctioned ways in which this activity can be conducted? and (2) what social regulations of such activity are necessary in order to protect the investor, to safeguard those with whom the business will come into contact and to make the undertaking of business not too burdensome? Such emphasis would result in the treatment of functionally related problems together. It would take business phenomena as it found them and translate them into social regulatory rules and social regulatory rules into them. Isolated, separate treatment of various phases of such process with consequent emphasis on labels and concepts would disappear.

With such disappearance would appear a new vitality. Case law and business practice would be inseparably intermingled.

III

The "control" or "direction" of the business enterprise is the second. This group of material embraces the various mechanisms involved in the performance of the function of allocation of "control." Stated as baldly as that, an element of vagueness enters. "Control" is an all inclusive term. It means so much it means nothing. It has neither length nor breadth as do goods. It cannot be handled as can funds. It is indefinite. It lacks specific quantity and quality. But an analysis of the fact situation is reassuring.

The X Company is a corporation. Who "controls" it? The owners? Who owns it? That person who has legal title? It is absurd, when the various incidents of ownership are considered. If "control" or "direction" be taken to mean the legal and non-legal devices for forcing certain members of the group to act in certain ways and for effecting certain policies, it will be at once observed that practically no business unit today exists in which the phenomenon of allocation of "control" among labor, creditors, employees, investors and the state is not present. The right to determine prices may be impaired by the state. The complete "control" of all regulations of working conditions, working hours and working wages is denied on the one hand by employees, on the other by the state. And such denials influence conduct. Part of the discretion which a single entrepreneur has appears in the lower stratum of employees and a part in the upper stratum. Practically none of the discretion is in the investors. The "control" of the stockholders—the so-called entrepreneurs—is residual. It is a truism that though there is a legal check the factor of absentee ownership has denied it factual strength. Where it has gone is difficult to generalize. Perhaps one man on the board of directors actually formulates the policies; perhaps the executive committee; perhaps a strong financial interest not on the board; perhaps employees; perhaps creditors. Who runs the business is difficult to answer. Where is the actual management is difficult to indicate with an arrow. Titular management can be identified. But actual "control" is more ephemeral. Such being the business phenomena it would be more realistic to correlate the study of the law to the facts. In the long run of business cases the "control" (as defined

above) appears allocated among all members of the business group. The allocation takes place whatever the type of business, whatever the type of business unit. Such being the *facts* the study of the law growing out of such allocation process takes on greater vitality and more dynamics if it is visualized as a part of the allocation process and if it is observed as a strong social force stepping in at times to re-allocate "control" which has been allocated in such a way as to put a premium on mismanagement and fraud, or which results in a non-social operation of the business. The checks on discretion which the law sustains; the rights to withdraw powers allocated; the right to exercise powers bestowed; the right to assert powers assigned or waived; the right to resume the exercise of powers on certain contingencies; the right to deny to some the exercise of powers because of the injuries to others; the positions of labor, of creditors and investors in respect to the acquisition of or retention of a voice in policy formulation—all these tie up with and become an integral part of formulating and executing business policies, of supervising the formulation and execution of business policies—in short, of managing and carrying on a business. They constitute administration of a business. They represent the complexities resulting from the evolution of business under modern industrial society. They add meaning and flavor to the concept of "control." They create a concept out of the business phenomena observed. The concept is defined in terms of human behavior. The resulting emphasis shifts, however, from static rules to such dynamic behavior.

IV

The absorption of losses is the third. The material deals with the mechanisms involved in the performance of the function of allocation of losses. If the X Company is considered as a group composed of all employees, all creditors, all investors and the state, it will be at once observed that each such member of the group normally has an economic interest at stake in the business. One person sold coal, the other steel; one contributed labor, another professional skill; one contributed property, another money. All of these contributions make possible the operation of the industrial unit. In a sense more realistic than fictional each is a member of the economic unit. To what claims is the contribution or interest of each subjected? The classical entrepreneur by well known rules has subjected his original \$10,000 to a series of well

known claims. Nor are the claims necessarily restricted to the \$10,000. Theoretically there may be no restriction. A limitation may be attempted through various devices. Whether the limitation is effective is frequently put in issue. The insulation of limited liability is often attempted to be broken down. That focuses the question, should the particular items of loss be allocated to the so-called entrepreneur?

Concurrently with such problems is the question, should the same allocation be made to those who are different from the classical entrepreneurs in that they share only in profits, or only in control? These problems are raised graphically either when the business is a going concern, is being liquidated or is being reorganized. It appears most dramatically when there is not enough in the common fund to pay every one who has a claim. It appears as realistically, however, on solvent dissolution when the *form* of the investors' repayment may vitally effect its value. The fact that the parties to the controversy are members of the same class does not change the essential characteristic of the controversy.

None of these problems is really inseparable from the larger problem—as between each class of claimants and each other class of claimants how should the loss be allocated? Secured as against unsecured trade creditors, labor as against trade creditors, labor as against the state, labor as against the investors, trade creditors as against the state—and so on. Who shall suffer most; who least? The man giving his labor, the seller his coal, the stockholder his property, the bondholder his funds, have each contributed to the operation of the industrial unit. Such contribution takes place whatever the business, whatever the unit. To what extent can each get out the value of that which he contributes? These are problems in allocation of loss. As such they should be treated together. To hide them under the guise of what is a partnership or what is a corporation is to fail to focus on the social regulatory function which the judicial process is performing through these various legal devices. The failure to focus on that function again changes the emphasis from substance to form. The effect is to lose sight of the under currents of case law which are giving mobility and direction to the judicial process. Attention to the function being performed will obviate this. Rules of law will be studied not as ends in themselves but as a part of the allocation process. They will be observed to re-allocate incidents of loss which had been allocated by the parties. They will be seen to be factors

bearing on the risks to which the joint adventure must be subjected and must be taken into consideration in any appraisal of those risks. They will be observed to create new items affecting the costs of doing business. They will be seen to realign claims in the order of their seniorities and to define the seniorities. Such will follow from the new alignment of legal and non-legal material. Such will be the result of changing the emphasis from a static system to a functional approach.

V

With such functional approach there is room for growth. Flexibility necessary for adaptation to a changing order is present. Though new postulates are created, they are fashioned so entirely out of the phenomena with which they deal that they are not so apt to persist when new phenomena replace them. The plasticity required of any social science is at hand. The organization attracts non-legal material rather than repels it. Correlation to such material is almost necessary. The correlation having been effected, a dynamic treatment has been realized.

The organization of material under these new headings is not without difficulty. Under this approach business is pictured largely as a series of acts involved in the performance of one of the three functions just discussed. One isolated act may have only one incident. Frequently, however, it has several incidents. The banker will agree to the financing if he can be assured that certain policies will be effected. Control over the formulation of policies is effectively secured to him by the voting trust or non-voting stock. Allocation of control as the consideration for the assembly of funds! Management and finance! But there appears to be no disadvantage in treating one fact set up from two different angles. And it is not an unusual phenomenon to have one device performing two functions or several devices one function. Though such overlapping causes some difficulty, on the whole the demarcation is sufficiently clear to permit either a single or double grouping.

Specific arrangement of materials within the several groups is not deemed so important. Any number of possibilities exist. Whether the right to remove an employee should be treated alongside of the right to remove a director is unimportant. Whether a part of that material treated commonly under labor law should be drawn in is immaterial. Different minds will react in different ways on many matters of arrangement. There is no rule for

symmetry. The clay is yet so plastic that it is surmised that it would be better craftsmanship to set no hard and fast lines at present. To keep it in the plastic stage for a relatively long period of time will prevent a recrystallization into concepts as devitalized as those being displaced. To keep it in the state of flux will allow time to gather the facts pertaining to the business phenomena so that when the crystallization takes place the new alignment will be correlated to and coordinated with the facts of business practice. Such crystallization can be predicted due to man's inherent weakness for theology. It is not to be deprecated so long as the realignment allows room for growth and development in the directions in which the social and economic phenomena are moving. It should not be prevented so long as it allows the focal points to be the functions which are being performed. That the approach here suggested makes such allowances is its chief virtue.