Corporate Governance and the Problem of Corruption in the United States

Before the Great Depression

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Warning: This is an incomplete draft based on incomplete research.

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> The promoters . . . had their reasons for celebration. . . . [T]hey had set up the Crédit Mobilier, into whose chest the gains from contracts for the whole Union Pacific building had flowed. . . . The proceeds from government bonds, security sales, and sales of lands and town sites had all been swallowed up in the mounting costs of building or in other ways. For this work the directors of the Union Pacific had ingeniously contracted with themselves at prices which rose from $80,000 to $90,000 and $96,000 a mile, twice the maximum estimates of engineers. . . . Hence the jubilation of the Union Pacific ring. For what profits could they have awaited, if they had confined themselves purely to trafficking in freight or passengers through the empty prairies?
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> —Matthew Josephson[1]

The Crédit Mobilier manipulation, by which directors of the Union Pacific Railroad organized their own construction company and profited from overcharging to build the road, was a spectacular scandal.[2] But the involvement of the federal government, which had granted the Union Pacific extensive tracts of public lands and

[1] Matthew Josephson, *The Robber Barons: The Great American Capitalists, 1861-1901* (New York: Harcourt, Brace & World, 1934), p. 92.

[2] For an alternative view arguing that the "arrangement was meant to be astute, not a steal," see Mark Wahlgren Summers, *The Era of Good Stealings* (New York: Oxford University Press, 1993), pp. 50-54.

also provided loans to finance construction, and the revelation that shares in the construction company had been handed out to influential Congressman, obscured the underlying reality that such conflicts of interest were endemic to corporations at the time.

For the purposes of this paper I am defining corruption to be the use of power by those in positions of control within corporations to further their own personal interests at the expense of those of other members of the firm. I will show that the law evolved during the late nineteenth and early twentieth centuries in ways that made it more difficult to safeguard the interests of minority investors. I will also show that the courts at this time offered minority shareholders protection against only the most egregious instances of corruption and often refused to enforce side contracts that would have mitigated their defenselessness.

Nonetheless, the number of corporations relative to partnerships increased steadily over this period. Comprehensive data on business forms are not available for the nineteenth century, but Jeremy Atack and Fred Bateman used the names of firms enumerated in the Census of Manufactures to estimate that partnerships accounted for nearly 90 percent of multi-owner firms during the period 1850-1870. In 1900, the first year the Census recorded information on organizational form, 67 percent of all manufacturing establishments owned by more than one person were partnerships and 29 percent were corporations, with the remaining 4 percent consisting mainly of cooperatives. Economy-wide counts are not available until after 1916, when the Internal Revenue Service (IRS) began to collect the income tax. In 1920, there were approximately 314,000 corporations in the United States compared to about 241,000 partnerships. These figures likely understate the use of partnerships because all

corporations were required to file tax returns whereas partnerships only had to file if their income exceeded the threshold for the tax.[3]

The large and growing number of business people willing to invest in corporations despite the lack of legal protections poses an intriguing puzzle and suggests that the significance of formal property rights may be overemphasized in the literature. Either the general culture may play an important role in mitigating contracting problems and forestalling corruption, or private enforcement mechanisms may be more significant that hitherto considered.

The Pervasiveness of Conflicts of Interest in Corporations

The vast majority of corporations in the late nineteenth and early twentieth century were enterprises whose stock was closely held. These companies typically were managed by owners who held the majority of their corporation's stock. Because these owners often took some of their compensation in the form of salaries for their managerial duties, conflicts of interest were unavoidable. The amount of compensation they received was determined by the corporation's board, which often consisted of themselves or others of their choosing. [Discuss evidence that this was regarded as normal business practice.] Not surprisingly, however, many suits by minority stockholders complained of excessive salaries paid to owner-managers. For example, a stockholder of the Traveller Newspaper Assocation claimed that majority shareholder Roland Worthington had, among other

[3] Jeremy Atack and Fred Bateman, "Preliminary Data on the Spread of Organizational Forms Among American Manufacturing Firms in the Nineteenth Century," unpublished paper, 1995; U.S., Census Office, *Twelfth Census: Manufacturers* (Washington, DC: U.S. Census Office, 1902), Vol. 7, p. 503; U.S., Internal Revenue Service, *Statistics of Income: 1920* (Washington, DC: Government Printing Office, 1922), pp. 8-10.

things, "improperly received large amounts as his salary as president of the corporation, and as rent for a building owned by him and occupied by it . . . ."[4] [Give other examples.]

Stockholder in corporations often had other business interests related to that of the corporation. Indeed, it was often these interests that induced them to organize corporations in the first place. The earliest textile companies in the U.S., for example, were organized by merchants who had knowledge of the market for cloth and who handled sales of the new firms' products.[5] The resulting synergies were often seen as desirable, but as large numbers of lawsuits attest they could also be perceived as conflicts of interest. [Give examples for both the pro and con.]

Corporations whose stock was sold on the market had all of the same potential for conflicts of interest. In addition, a controlling group of shares might be bought by one or more business people whose interests diverged from those of the other owners, and the resulting conflicts often ended up in court. [give examples] For example, two minority stockholders of the Lowell and Salem Railroad Company filed a bill in equity charging that businessmen owning a majority of the company's shares were also interested in the Lowell and Lawrence Railroad, were running the former in the interest of the latter, and had destroyed the value of the former's shares (*Peabody v. Flint*, 88 Mass. 52 [1863]). [Give other examples and conclude with a general discussion that underscores the widespread nature of the problem.]

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[4] *Dunphy v. Traveller Newspaper Assoc.*, 146 Mass. 495 (1888).

[5] See, for example, Frances W. Gregory, *Nathan Appleton: Merchant and Entrepreneur, 1779-1861* (Charlottesville: University Press of Virginia, 1975), pp. 164-7.

The Powerlessness of Minority Stockholders

Before the spread of general incorporation laws in the middle of the nineteenth century, the grant of a corporate charter required a special legislative act.[6] Not surprisingly, the terms of these early charters varied enormously from one enterprise to the next. As the number of such grants increased, however, legislatures developed standard templates that made the provisions much more uniform. The extent of variation was reduced still further with the passage of general incorporation laws. In the case of governance rules, for example, some early charters allowed stockholders one vote for each share owned, but others specified one vote per share up to some ceiling, and some even gave each stockholder the same vote regardless of his or her holdings. By mid century, however, most general incorporation laws specified one vote per share, majority rule governance.[7]

This standard governance rule weakened the position of minority shareholders and potentially subjected them to exploitation by shareholders controlling a majority of the stock. If the majority followed policies that members of the minority thought were wrongheaded or detrimental to their interests, there was little the latter could do but grin and bear it. Minority shareholders could not force the majority to change their policies.

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[6] This section is based on Naomi R. Lamoreaux, "Partnerships, Corporations, and the Limits on Contractual Freedom in U.S. History: An Essay in Economics, Law, and Culture," in *Crossing Corporate Boundaries: History, Politics, and Culture*, ed. Kenneth Lipartito and David B. Sicilia (New York: Oxford University Press, forthcoming); Lamoreaux, "Business Organization," in *Historical Statistics of the United States, Millennial Edition*, eds. Susan B. Carter, et al. (New York: Cambridge University Press, forthcoming); and Lamoreaux and Jean-Laurent Rosenthal, Legal Regimes and Organizational Choice: A Comparison of France and the United States during the Mid-Nineteenth Century," unpublished paper, 2003.

[7] John J. Wallis, "Market Augmenting Government? The State and the Corporation in Nineteenth-Century America," in *Market Augmenting Government*, eds.Omar Azfar and Charles Cadwell (Ann Arbor: University of Michigan Press, 2003), pp. 223-67; Colleen A. Dunlavy, "From Citizens to Plutocrats: Nineteenth-Century Shareholder Voting Rights and Theories of the Corporation," in *Crossing Corporate Boundaries*, ed. Lipartito and. Sicilia.

They could not compel a dissolution of the firm. Nor could they easily exit by selling their shares. Indeed, in the case of closely held corporations, often the only buyers for their shares were the same majority shareholders with whom they were in conflict—a situation conducive more to extortion than to an equitable resolution of the problem.[8]

Although corporations made most decisions by majority votes, initially any non-trivial change to a corporation's charter required stockholders' unanimous consent. [9] This unanimity rule gave minority shareholders some power to force the majority recognize their interests, but it could also lead to holdup. For this reason, the rule was seriously weakened during the second half of the century as courts permitted firms effectively to liquidate and reorganize in order to bypass recalcitrant shareholders.[10] By the early twentieth century, moreover, the collective effect of changes that states had made to their general incorporation laws was to increase further the power of majority shareholders over the minority. For example, a wave of statutes enacted in the wake of New Jersey's permissive 1888 law typically included provisions that reduced the ability of individual stockholders to block managerial decisions that fundamentally altered the business of the

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[8] J.A.C. Hetherington and Michael P. Dooley, "Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem," *Virginia Law Review*, 63 (Feb. 1977), pp. 1-62; Robert W. Hillman, "The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations," *Minnesota Law Review*, 67 (Oct. 1982), pp. 1-88; Lawrence E. Mitchell, "The Death of Fiduciary Duty in Close Corporations," *University of Pennsylvania Law Review*, 138 (June 1990), pp. 1675-31. Of course, voting rules that limited the power of majority shareholders could also cause problems by giving minority shareholders power to hold up the majority, but it is not obvious that one vote per share, majority rule governance schemes are always superior. Presumably the desirability of alternative schemes would vary from one firm to the next depending, for example, on the role played by minority shareholders in the ongoing success of the enterprise. Where members of the minority contribute critical human capital, it may be important to give them a voice disproportionate to their shareholdings. For further discussion of these issues, see Lamoreaux and Rosenthal, "Legal Regimes and Organizational Choice."

[9] See, for example, *Stevens v. Rutland and Burlington Railroad Company*, 29 Vt. 545 (1851). For discussions of other cases, see Dodd, *American Business Corporations Until 1860*, pp. 134-48; and Victor Morawetz, *A Treatise on the Law of Private Corporations Other than Charitable* (Boston: Little, Brown, and Company, 1882), pp. 47-9.

[10] William J. Carney, "Fundamental Corporate Changes, Minority Shareholders, and Business Purposes," *American Bar Foundation Research Journal*, 1980 (Winter 1980), pp. 69-132.

enterprise. As one writer put it, the result was increasingly to place the individual stockholder "in the position of holding a 'pig-in-a-poke'"—to make him or her "more dependent with each new statute upon the desires of the management and the majority which often is only another name for the management."[11]

Members of corporations sometimes attempted use shareholders' agreements to protect themselves against the potential for tyranny by the majority, but these contracts often turned out to be unenforceable. For example, there was a high probability that the courts would overturn agreements that required shareholders' unanimity (or even a super-majority vote) for corporate decisions.[12] Even worse, shareholders who ignored or altered the standard governance rules in such ways risked being held partners and thus unlimitedly liable for their firms' debts. As New Jersey's Chancellor warned in 1852, if firms operating for all practical purposes as partnerships were allowed to exercise corporate privileges like limited liability, the result would be to perpetrate "a fraud upon the community." In the case at issue, *Vandyke v. Brown*, two shareholders held all of the stock of the New England Manufacturing Company, excepting four shares, "which were put in the names of four other persons, merely for the purpose of having a sufficient number of stockholders to organize the company in the manner directed by the act of incorporation." After incorporation, the two major owners continued to run their business "as before . . . , by and between themselves as individuals, the company not

[11] Wiley B. Rutledge, Jr., "Significant Trends in Modern Incorporation Statutes," *Washington University Law Review*, 22 (April 1937), pp. 305-43. See also E. Merrick Dodd, Jr., "Statutory Developments in Business Corporation Law, 1886-1936," *Harvard Law Review*, 50 (Nov 1936), pp. 27-59.

[12] George D. Hornstein, "Stockholders' Agreements in the Closely Held Corporation," *Yale Law Journal*, 59 (May 1950), pp. 1040-56; Hornstein, "Judicial Tolerance of the Incorporated Partnership," *Law and Contemporary Problems*, 18 (Autumn 1953), pp. 435-50; William L.Cary, "How Illinois Corporations May Enjoy Partnership Advantages: Planning for the Closely Held Firm," *Northwestern University Law Review*, 48 (1953), pp. 427-41; F. Hodge. O'Neal, "Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-Law Provisions," *Law and Contemporary Problems*, 18 (Autumn 1953), pp. 451-72.

acting by its board." In the Chancellor's view, the business was "in reality but an ordinary partnership." Therefore, either the members of the firm "must be held to conduct their business as a corporation, and be governed by the law of corporations," or they "should be liable to debts to the whole amount of their property."[13]

Despite a steady increase in the number of corporations and in the number of cases involving minority oppression, over the next century there was little evolution in the courts' attitude toward stockholders' agreements that altered the standard governance rules. Thus the New Jersey Appeals Court decided a key case in 1910 on much the same principles *Vandyke v. Brown*. At issue was a corporation organized by Walter M. Jackson and Horace E. Hooper to publish and distribute the *Encyclopedia Britannica*. As in the earlier case, the two men had agreed between themselves to run the business effectively as a partnership in which all decisions were to be made by mutual assent. When they had a falling out, Jackson sued in equity to enforce the agreement. The court turned him down, adamantly declaring that partnerships and corporations were different legal forms and that business people could not "Proteus-like" become "at will a co-partnership or a corporation, as the exigencies or purposes of their joint enterprise may from time to time require."

> If the parties have the rights of partners, they have the duties and liabilities imposed by law, and are responsible in solido to all their creditors. If they adopt the corporate form, with the corporate shield extended over them to protect them against personal liability, they cease to be partners, and have only the rights, duties, and obligations of stockholders.[14]

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[13] *Vandyke v. Brown* 4 Halstead 657.
[14] *Jackson v. Hooper*, 76 N.J. Eq. 592.

As late as 1945, the New York Court of Appeals struck down a corporate by-law requiring stockholders' unanimous consent for the election of directors on the grounds that '[t]he State, granting to individuals the privilege of limiting their individual liabilities for business debts by forming themselves into an entity separate and distinct from the persons who own it, demands in turn that the entity take a prescribed form and conduct itself, procedurally, according to fixed rules."[15]

[Add a discussion here of voting trusts, which the courts regarded as permissible. Voting trusts could conceivably mitigate the position of minority shareholders, but if the trustees acted contrary to the wishes of the minority, there was little that could be done about it. Voting trusts could also make situation of minority shareholders worse by allowing shareholders who collectively owned a majority of the stock to consolidate their power.]

The Difficulty of Legal Remedies

Judges recognized that majority-rule, one-vote-per-share governance potentially placed "the property of stockholders in a corporation in a perilous condition"—that it was possible, for example, for "the managers of one corporation to get the control of another by the purchase of a majority of its stock for the purpose, and then to manage its affairs in such subservience to the interests of their own corporation, as to render the stock of the minority worthless, and avail themselves of its value without compensation." But they also believed that the very nature of the corporation precluded stockholders, either individually or collectively, from pursuing common-law remedies against fraudulent or

[15] *Benintendi v. Kenton Hotel*, 294 N.Y. 118.

negligent officers or directors. The corporation at law was a "distinct person" whose property was "legally vested in itself, and not in its stockholders." Its off icers "though chosen by vote of the stockholders, are not their agents, but the agents of the corporation; and they are accountable to it alone."[16]

Lemuel Shaw, Chief Justice of the Massachusetts Supreme Court, laid out the basic principles in a precedent-setting case in 1847.[17] The Phoenix Bank had failed in 1842 after lending large sums to its president and other directors. Joseph Smith, a stockholder in the bank, sued the directors both for misfeasance and for nonfeasance of their official duty. Council for the defense countered that only the corporation, not an individual stockholder, "might maintain an action on the facts alleged in this declaration," and Justice Shaw accepted this argument, declaring that "there is no legal privity, relation, or immediate connexion, between the holders of shares in a bank, in their individual capacity, on the one side, and the directors or a bank on the other.

> The directors are not the bailees, the factors, agents or trustees of such individual stockholders. The bank is a corporation and body politic, having a separate existence as a distinct person in law, in whom the whole stock and property of the bank are vested, and to whom all agents, debtors, officers and servants are responsible for all contracts, express or implied, made in reference to such capital, and for all torts and injuries diminishing or impairing it. . . . The individual members of the corporation, whether they should all join, or each act severally, have no right or power to intermeddle with the property or concerns of the bank,

[16] *Peabody v. Flint*, 88 Mass. 52 (1863), esp. at 55.
[17] *Smith v. Hurd*, 53 Mass. 371.

> or call any officer, agent or servant to account, or discharge them from any liability.[18]

Shaw went on to claim that even if all the stockholders joined together, they could not take action, because "they are not the legal owners of the property, and damage done to such property is not an injury to them." Rather the injured party was the corporation. Thus the appropriate remedy was for the corporation "to obtain redress for injuries done to the common property, by the recovery of damages . . . ."[19]

Shaw admitted that this remedy was "a theoretic one" and that it was "perhaps often inadequate."[20] The problem, of course, was that if majority shareholders were the source of the problem (as they often were), they were unlikely to support any corporate action against themselves. Minority shareholders who found themselves in such difficulties did, however, have an alternative remedy. They could pursue redress in a court of equity, though they had to do so on behalf of the corporation as well as themselves and any settlement had to go to the corporation. As the court pointed out in a subsequent case, "As between the corporation itself and its officers, it was long since held that they were trustees, and that a court of equity would hold them responsible for every breach of trust." Although the stockholders had no standing to maintain an action at law, they could pursue redress in equity. If the corporation "refuses to sue, or is still under the control of those who must be made defendants in the suit, the stockholders who are the real parties in interest may file a bill in their own names, making the corporation a party defendant . . ."—that is, they may file a stockholders' derivative suit.[21]

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[18] *Smith v. Hurd*, 53 Mass. 371 at 384-5.
[19] *Smith v. Hurd*, 53 Mass. 371 at 385, 387.
[20] *Smith v. Hurd*, 53 Mass. 371 at 387.
[21] *Peabody v. Flint*, 88 Mass. 52 at 56.

Although judges claimed that the "courts of eq uity [were] swift to protect helpless minorities of stockholders of corporations from the oppression and fraud of majorities,"[22] in fact minority shareholders faced substantial legal hurdles when pursed this option. Most importantly, the courts still insisted that "the wrong in such a case is done primarily to the corporation" and hence that it was the proper plaintiff. Because stockholders "impliedly agree," when they join a corporation, "to act in the corporate business through officers chosen to represent them, or by vote at meetings of the members regularly called," they are "bound to seek their remedy through corporate channels, first, by application to the officers in charge, and, failing there, secondly, to the corporation itself, at a meeting of its members." Only "if they can obtain justice at the hands of neither, the courts are open for their relief."[23]

The problem was how to make this case that the corporation was wrongly refusing to seek redress. The mere fact that the majority blocked the corporation from taking action was not evidence that the minority shareholders had been victimized for it was quite possible that the refusal had been entirely proper. Because "intelligent and honest men differ upon question of business policy, . . . a corporation, acting by its directors, or by vote of its members, may properly refuse to bring a suit which one of its stockholders believes should be prosecuted."[24] Indeed, equity courts refused on numerous occasions to intervene in corporate disputes that seemed to concern matters of business judgment. One such case involved the famous inventor, Thomas Edison, and the Edison United Phonograph Company, the firm organized to exploit his phonopgraphic inventions. Edison had assigned his patents to the firm in exchange for half of its stock.

[22] *Dunphy v. Traveller Newspaper Assoc.*, 146 Mass. 495 (1888) at 496.
[23] *Dunphy v. Traveller Newspaper Assoc.*, 146 Mass. 495 (1888) at 496.
[24] *Dunphy v. Traveller Newspaper Assoc.*, 146 Mass. 495 (1888) at 497-8.

Later, he found himself in disagreement with the policies pursued by the majority of the firm's directors and was unable to persuade them to change course. Frustrated, he sued in equity to try to force the dissolution of the firm. The grounds included the claim corporation was insolvent or soon would "become so if its directors do not abandon their present method of conducting its business" and the charge that "the directors, by the course of business they are now pursuing, are violating a trust which was imposed upon the corporation when the complainants assigned their inventions."[25] The court refused to intervene. Viewing the case as little more than a disguised attempt "to induce judicial action which shall substitute the judgment of a minority of the directors of this corporation for that of the majority," Vice Chancellor Van Fleet denied the application. "No rule of law is better settled," he opined, "than that which declares that so long as the directors of a corporation keep within the scope of their powers, and act in good faith and with honest motives, their acts are not subject to judicial control or revision."[26]

In order to secure the intervention of a court, minority shareholders had to show that the directors of their company had not acted "in good faith with honest motives" but had in fact behaved fraudulently. The burden of proof resided with them. Moreover, it was not sufficient to demonstrate that directors were profiting from their position of power within a corporation. Courts took the pervasiveness of self-dealing for granted and, indeed, assumed that it normally redounded to the interest of the corporation as well as the directors. For example in *Faulds v. Yates* in 1870, the Illinois Supreme Court saw nothing wrong with an agreement among three of the largest stockholders of the Chicago Carbon and Coal Company to join together in a partnership to determine "the officers and

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[25] *Edison v. Edison United Phonograph Co.*, 29 Atlantic Reporter, 195.
[26] *Edison v. Edison United Phonograph Co.*, 29 Atlantic Reporter, 195 at 197-8.

managers of the company." The Court also saw nothing wrong with that partnership leasing and operating the mining property owned by the company they controlled.

> If one man owned a majority of the stock, he surely had the right to select the agents for its honest management. These three persons had formed a partnership for mining, under the lease of the company. They knew they must make large expenditures of money. Incompetent and unfriendly directors and officers might involve them in much trouble, heavy expense and useless litigation. They had a double interest to protect,—their interests as shareholders, and their interests as lessees. It is strange that a man can not, for honest purposes, unite with others in the protection and security of his property and rights without liability to the charge of fraud and iniquity.

As the court saw it, the interests of these three men "were identical with the interests of the minority shareholders" because "they were desirous of increasing the investment, and making the stock more valuable. . . . If they destroyed the stock of others, they also, by the same act, destroyed their own."[27]

The Illinois Supreme Court sided with the majority because the record "wholly fail[ed] to disclose any injury to the other shareholders—any waste of property."[28] Not on did such injury have to apparent, it had to have been inflicted as a result of fraud. [Discuss examples where minority stockholders were able successfully to make the case for fraud. E.g. *Brewer v. Boston Theatre* 103 Mass. 378 (1870); *Almy v. Almy, Bigelow & Washburn, Inc.*, 235 Mass. 227 (1920).]

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[27] *Faulds v. Yates*, 57 Ill. 416 (1870) at 420-21.
[28] *Faulds v. Yates*, 57 Ill. 416 (1870) at 420.

[Discuss examples where minority stockholders failed in such suits. E.g. *Dunphy v. Traveller Newspaper Assoc.*, 146 Mass. 495 (1888); *Converse v. Hood*, 149 Mass. 471 (1889); *Doherty v. Mercantile Trust Company*, 184 Mass. 590 (1903).]

[Conclude by arguing that minority shareholders could prevail when they were demonstrably the victims of fraud, but there was a large gray area where majority shareholders could pursue their own interests at the expense of the minority without interference from the courts.]

Was Corruption a Serious Problem?

[Discuss evidence that the problem of minority shareholders may have induced more business people to organize their enterprises as partnerships, and thus bear the costs associated with unlimited liability and lack of legal personhood, than would have occurred if they had greater ability to protect their interests from expropriation in corporations. On the other hand, the large number of corporate enterprises that were formed suggests that the problem could not have been that great.]

[Discuss the striking lack of attention paid to the issue of minority stockholders in advice books directed at business people and in the papers of people organizing enterprises. Haven't yet found much evidence of serious attempts to contract around the problem before the mid-twentieth century. Raises the question of what changed.]