THE CORPORATION AND SOCIETY: AN EVOLUTIONARY/INSTITUTIONAL APPROACH

William L. Baldwin*

Over the past two decades, there has been a resurgence of institutional and evolutionary thought throughout the social sciences. A basic feature of the institutional approach to social evolution is the notion that institutions change in response to exogenous changes in their environment or in response to pressures from organizations operating within the existing institutional framework, as well as making conscious efforts to alter features of that environment. In this paper, I discuss one aspect of the not at all original observation that both the corporation and the society are evolving. The corporation continually adapts to the institutional environment in which it operates. Any discussion of corporate behavior must therefore take into account this broader context.

The general framework employed here stems from Thorstein Veblen's pioneering contributions to institutional economics as elaborated on and modified by later institutionalists, particularly Mitchell, North, and Rutherford.[1] Veblen viewed humans as endowed with various instincts, which assume different behavioral forms.[2] These he referred to as "habits."[3] For Veblen, progress is far from inevitable; institutions, for better or worse, are molded by habits and the environment. Wesley Mitchell, who had studied under Veblen, noted that Veblen defined institutions differently in different places and that his definitions were frequently complex.[4] Mitchell proposed the following, which has been widely repeated in subsequent literature, as capturing the core of Veblen's concept: "These habits of thought which prevail in a given period, the

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* John French Professor of Economics Emeritus, Dartmouth College; Ph.D. 1958, Princeton University; M.A. 1953, Princeton University; B.A. summa cum laude 1951, Duke University. This article was originally delivered as a speech at the Vermont Law School's Corporate Responsibility Symposium held on September 27, 2002.

1. *See* THORSTEIN VEBLEN, THE HIGHER LEARNING IN AMERICA (1918); THORSTEIN VEBLEN, THE PLACE OF SCIENCE IN MODERN CIVILISATION AND OTHER ESSAYS (1919); *see also* 2 WESLEY C. MITCHELL, TYPES OF ECONOMIC THEORY: FROM MERCANTILISM TO INSTITUTIONALISM – 699 (Joseph Dorfman ed., 1969) (dissecting Veblen's institutional economic theory); DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990) (predicting economic reactions to institutional change occurring from inconsistent human behavioral patterns); MALCOLM RUTHERFORD, INSTITUTIONS IN ECONOMICS: THE OLD AND THE NEW INSTITUTIONALISM (1994) (examining Veblen's old institutionalism economic theories including problems from social norms).

2. VEBLEN, THE HIGHER LEARNING IN AMERICA, *supra* note 1, at 2–7; MITCHELL, *supra* note 1, at 602–03.

3. VEBLEN, THE HIGHER LEARNING IN AMERICA, *supra* note 1, at 6; MITCHELL, *supra* note 1, at 606.

4. MITCHELL, *supra* note 1, at 607.

widely prevalent habits of thought, Veblen called institutions . . . . Those institutions [are] the current outcome of an age-long accumulation of human experience. Thus the theorist must [treat] problems from the evolutionary viewpoint . . . ."[5]

The concept of the corporation goes back to ancient Rome, i.e., an association of individuals formed to achieve some common purpose of the group but recognized at law as an entity separate and distinct from its flesh-and-blood members.[6] Over centuries, religious societies, municipalities, craftsmen's guilds, charities, and universities, among other groups, have adopted the corporate form. But the direct ancestor of the modern business corporation is without a doubt the joint stock company, or the great overseas trading companies of the 17th and 18th centuries, such as the British East India Company, Hudson's Bay Company, and the South Sea Company. These companies sought charters of incorporation to meet the perceived needs of newly developing forms of large-scale transoceanic trade. Such charters were granted sparingly and, in principle, only as a special privilege where it was deemed to serve a public interest, although both the Tudor and Stuart monarchies found issuance of charters for a fee to be a convenient device for supplementing the royal exchequer.

Before the advent of the joint stock company, groups of "merchant adventurers" had pooled their resources to outfit an overseas merchant ship —or a land caravan—for a single trip and then divided up any trading gains when, or if, the ship or caravan returned. This practice made it extremely difficult to finance permanent investments in multi-voyage "overhead" in distant parts of the globe, such as warehouses, wharfs, shipyards, trading stations and fortifications, along with resident representatives. Investors could not manage the company directly, and a great deal of authority had to be delegated to distant agents ships' captains, supercargoes, trade managers, garrison commanders, and, in some instances, governors of foreign enclaves. The solutions to such problems appeared to lie in the corporate form. Most important was the right to issue transferable shares, thus

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5. *Id.*

6. The following historical analysis is derived from ADOLF A. BERLE, JR., POWER WITHOUT PROPERTY (1959); Adolf A. Berle, Jr. & Gardiner C. Means, *Corporation, in* 4 ENCYCLOPAEDIA OF THE SOCIAL SCIENCES 414 (Edwin R.A. Seligman ed., 1931); ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); JOHN P. DAVIS, CORPORATIONS: A STUDY OF THE ORIGIN AND DEVELOPMENT OF GREAT BUSINESS COMBINATIONS AND OF THEIR RELATION TO THE AUTHORITY OF THE STATE (1905); 1 JOSEPH STANCLIFFE DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS (1917); ARMAND BUDINGTON DUBOIS, THE ENGLISH BUSINESS COMPANY AFTER THE BUBBLE ACT: 1720–1800 (1938); BISHOP CARLETON HUNT, THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND: 1800–1867 (1936); SHAW LIVERMORE, EARLY AMERICAN LAND COMPANIES: THEIR INFLUENCE ON CORPORATE DEVELOPMENT (1939).

obviating the need to dissolve the venture after each voyage. Of almost equal importance was the right of the investors to delegate authority and responsibility to a board or "court" of directors, coupled with limited liability which provided that the proprietors would not be liable for any decision made by the directors or managers above the amount of their investment. The delegation of authority also protected investors by removing any authority from individuals who might acquire shares of stock but might not possess the competence or intelligence to make sound business decisions.

Adam Smith, patron saint of today's free marketers but himself no ideologue, described the British joint stock companies as follows in his great 1776 work, *The Wealth of Nations*:

> The trade of a joint stock company is always managed by a court of directors. The court indeed is frequently subject to the controul of a general court of proprietors. But the greater part of those proprietors seldom pretend to understand any thing of the business of the company; and . . . [typically] give themselves no trouble about it, but receive contentedly such half yearly, or yearly dividend as the directors think proper to make to them . . . . The directors of such companies, . . . being the managers rather of other people's money than of their own, it cannot be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own . . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. It is upon this account that joint stock companies for foreign trade have seldom been able to maintain the competition against private adventurers.[7]

With the dawn of the drastic technological and institutional changes encapsulated in the phrase "industrial revolution," which Adam Smith just missed, existing business owners and entrepreneurial entrants alike throughout Great Britain and the United States responded to the opportunities—or the imperatives of survival—opened up by technical economies of scale and scope in production, communication, and distribution, as distinct from those engaged in the overseas shipping trade. Concurrently, over the nineteenth century the demand grew for a form of business organization that could amass and efficiently manage very large and long-

7. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 741 (Clarendon Press 1979) (1776).

lived capital investments including managerial as well as technical economies of scale and scope.[8] In both this country and Great Britain, society responded by making corporate charters far easier to obtain, doing away with a separate legislative or royal action required for each issuance, and in the United States substituting virtually automatic issuance by the several states.[9] Further, a number of powers and privileges that had previously been controversial were now extended to these corporations as a matter of course—most notably the right to issue transferable shares, which implied a corporate life independent of the lives of any of its owners, the delegation of authority to management, and last but not least, limited liability. By 1929, 48% of the approximately 211,000 manufacturing establishments in the United States were incorporated.[10] These corporations accounted for fully 90% of manufacturing employment and 92% of the value added by manufacture.[11]

Most significant from the perspective of this paper is the delegation of authority, i.e., the election by stockholders of directors who set company policies and hire and fire top management. But by the 1930s, most stockholders held only small fractions of their companies' outstanding shares and typically, like their forebears of 1776, gave themselves "no trouble" about the affairs of their corporations. Instead, these small shareholders far more often than not simply ignored proxies or signed them over to management without giving the matter any thought, thus ceding to management the power to name directors. If small stockholders were dissatisfied, it was much easier for them to sell their shares on one of the organized stock exchanges that had sprung up than to challenge errant management. This situation led a lawyer, Adolf Berle, and an economist, Gardiner Means, to coin the phrase "separation of ownership and control" and to define control as "[lying] in the hands of the individual or group who [has] the actual power to select the board of directors (or its majority) . . . ."[12] Berle and Means found that in approximately two-thirds of the 200 largest industrial firms in 1930, this control lay in the hands of management or a small

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8. *See* ALFRED D. CHANDLER, JR., STRATEGY AND STRUCTURE: CHAPTERS IN THE HISTORY OF THE INDUSTRIAL ENTERPRISE 1–7 (MIT Press 1993) (1962); ALFRED D. CHANDLER, JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 8 (1977).

9. Berle & Means, *Corporation*, *supra* note 6, at 416–18.

10. 1 U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, FIFTEENTH CENSUS OF THE UNITED STATES, MANUFACTURING, 1929, at 95 (1930).

11. *Id.* at 94–95.

12. BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, *supra* note 6, at 69.

portion of owners.[13] A post-World War II investigation found that such managerial control had extended to about 90% of the largest 200 firms.[14]

According to conventional wisdom, this "separation of ownership and control" still describes the governance structure of the typical large "modern" U.S. corporation.[15] But the institutional environment has continued to change since the Second World War and so, in adapting to these changes, the corporation has continued to evolve. To illustrate this point, consider the "paraproprietal society" as described by Father Paul Harbrecht.[16]

One of the outstanding features of the U.S. economy since the Second World War has been the growth of financial institutions old and new, most prominently mutual funds and pension funds, but including bank trust departments, insurance companies, foundations, and college endowments. But, analysis of data collected by the Federal Reserve Board since 1983 shows that the number of families who are direct or indirect claimants on the financial institutions rose rapidly over the past two decades.[17] Now consider Father Harbrecht's question, who owns a corporation's real assets such as trucks, machines and buildings?[18] Not the stockholders—they have given up control of and even access to what annual reports typically refer to as "their company's" physical assets. Nor is it the individual who invests in a fund managed by a financial institution. The shareholders of a mutual fund and most of the beneficiaries of personal trusts receive variable payments based on the portfolio's performance, while pensioners and insurance claimants have contractual claims against the financial institution that are fixed regardless of the portfolio's earnings. In both cases, income paid to the individual recipient no longer depends on the distributions of a single company. The financial institution, which has title to the stock and has voting rights, is not the owner of the stock. It is merely a fiduciary manager of monies provided by some for the benefit of themselves or others. Neither providers nor beneficiaries can be considered owners of the shares of particular corporations in the portfolio of the institution. It may be that there is no answer to the question of who owns the trucks, machines,

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13. *Id.* at 94–114.

14. ROBERT J. LARNER, MANAGEMENT CONTROL AND THE LARGE CORPORATION 16, 19–20 (1970).

15. Berle & Means, *Corporation*, *supra* note 6, at 418.

16. *See* PAUL P. HARBRECHT, PENSION FUNDS AND ECONOMIC POWER 273–89 (1959); PAUL P. HARBRECHT, TOWARD THE PARAPROPRIETAL SOCIETY 37–43 (1959); *see also* BERLE, POWER WITHOUT PROPERTY, *supra* note 6, at 52.

17. James M. Poterba and Andrew A. Samwick, *Taxation and Household Portfolio Composition: U.S. Evidence from the 1980s and 1990s*, 87 J. PUB. ECON. 5, 8–15 (2003).

18. HARBRECHT, TOWARD THE PARAPROPRIETAL SOCIETY, *supra* note 16, at 37–43.

and buildings of a particular corporation or even who owns its shares. This is the conclusion reached by Father Harbrecht, who wrote, "[the] concept of ownership [of the corporation] has reached a dead end and no longer has any functional meaning."[19] In sum, "[a] bare title held by a legal fiction is an inert concept."[20]

Over three decades ago, in commenting on Father Harbrecht's seminal work, I wrote, "[t]he group which predominates in shaping the objectives of giant corporations may prove to be the managers of banks, mutual funds and insurance companies rather than those managing the actual corporate property."[21] If only I had stopped there, I could be congratulating myself even now. But I continued,

> [t]he institutional investors, like other stockholders, should be primarily interested in profits; and unlike many small individual investors, however sophisticated, the institutions should find it a rational allocation of staff and executive time to devote much observation and study to the policies and prospects of firms in which they have invested or may invest.[22]

But nearly four decades later the question must be asked, will the directors and managers of these institutions become the 21st century's equivalent of Adam Smith's shareholders, giving themselves "no trouble" about the quality of their corporations' portfolios above and beyond the next quarterly statement?

There are indications that the financial institutions can affect the behavior of corporations in which they have invested. Hartzell and Starks, in a study of firms in the Standard and Poor's index from 1991 through 1997, found an inverse relationship "between the concentration of institutional ownership and the level of executive compensation"[23]—evidence that while the directors and managers of these institutions do not own the stocks in the portfolios they hold for the ultimate beneficiaries, they can exert an influence on the non-financial corporations in which they invest.[24] But along with power should come recognition of a responsibility

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19. HARBRECHT, PENSION FUNDS AND ECONOMIC POWER, *supra* note 16, at 4.

20. *Id.*

21. William L. Baldwin, *The Motives of Managers, Environmental Restraints, and the Theory of Managerial Enterprise*, 78 Q.J. ECON. 238, 251 (1964).

22. *Id.*

23. Jay C. Hartzell & Laura T. Starks, *Institutional Investors and Executive Compensation* 1, 31 (Jan. 2002) (AIM Investment Center Working Paper), *available at* http://www.bus.utexas.edu/AIMCenter/working%20Papers/Hartzell8.pdf.

24. *See* Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 839–40 (2002).

to society. And to date, such responsibility has not yet become a "widely prevalent habit of thought."[25]

My objective here has not been to prescribe a specific and effective remedy for this particular malfunction: I have none. I would contend, however, that it illustrates a basic point that lies behind Veblen's pessimistic contention that social evolution is not always towards a better and brighter future. We cannot frame an ethical code for directors, prescribe social responsibility of the corporation, or formulate appropriate public policy towards business, and consider our collective responsibility met. The problem of correcting corporate misbehavior will not be solved by reforming individuals or by altering their habits. Rather, reform will also require making changes in economic institutions, as was done in the early 1930s to deal with the impact of the "modern corporation" on the boom and collapse of financial markets in particular, and the economy in general, through the disclosure requirements of the Securities Act of 1933[26] and the reforms and regulations imposed on financial markets a year later by the Securities Exchange Act of 1934.[27]

John Cassidy wrote an article in the September 23, 2002 issue of the *New Yorker* magazine entitled, *The Greed Cycle; How the Financial System Encouraged Corporations to Go Crazy*.[28] Thorstein Veblen would have recognized immediately the course of events Cassidy was describing. Consider his title. Substitute "the acquisitive instinct" for "greed cycle," and "institution" for "system," and you have a title that could serve for this paper.

25. MITCHELL, *supra* note 1, at 607.

26. Securities Act of 1933, 15 U.S.C. §§ 77a–77bbbb (2000).

27. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78mm (2000).

28. John Cassidy, *The Greed Cycle; How the Financial System Encouraged Corporations to Go Crazy*, THE NEW YORKER, Sept. 23, 2002, at 64.