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Is the Corporation a Free-Market Institution?

by Frank van Dun

Is the modern large publicly traded business corporation compatible with a truly free market?

The question itself may seem strange, even silly. Corporations are primary actors in what the media refer to as "the market economy." Also, when the media refer to "the market," they as often as not mean the stock exchange, which is the place where the shares of large corporations are traded. Moreover, during the age of socialist ascendancy, many defenders of the free market have felt themselves moved to defend the corporation against socialist or "liberal" attacks.

Many genuine advocates of the free market even appear willing to make the stronger claim that a defense of the free market requires a defense of the corporation. In their view, defending the corporate form of business organization is an essential part of the argument for the free market. Prima facie, there seems to be a strong case for saying that the large publicly traded corporation is compatible with the requirements of the free market.

Nevertheless, I believe classical liberals and libertarians have good reasons to question that view. First, what the media say is not always accurate even on the count of reporting facts, which supposedly is their core business. Conceptual analysis is not their forte. They do not have much consideration for the theoretical contexts from which terms such as "free market" derive their significance or for the requirements of consistency in their use of such "theory laden" terms. The stock exchange is a market of sorts, but it is not "the market." In any case, the stock exchanges with which the media are familiar are not really free but rather heavily regulated markets.

Second, socialist critiques of the corporation often were presented as critiques of free-market capitalism and merited a vigorous response from the latter's defenders. Sometimes, however, that response merely consisted in conceding that there were problems with the form of the corporation *in its present environment*. The gist of that response was to draw attention to legal and regulatory requirements imposed on the corporation. The argument was that such regulations set up "perverse incentives" that lead corporations to engage in behavior that the socialist critics adduce as evidence for the evils of capitalism. However, defending the corporate form of business organization against socialist attacks is not the same as proving its consistency with the principles of the free market.

Obviously, with merely impressionistic evidence and without a workable definition of its central terms, we cannot hope fruitfully to address the question that concerns us here. Let us therefore try to frame the question

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within a meaningful theoretical context. As a philosopher of law, I am particularly interested in the study of markets and corporations from the perspective of law. That perspective delimits the scope of the following observations. For reasons of space, I must leave other—historical, sociological, or economic—perspectives for another occasion.

Order of Natural Persons

Let us begin with a clarification of the idea of the free market. From the point of view of classical-liberal, or libertarian, political philosophy, the free market is the economic aspect of a particular order of human affairs. To be more specific, it is the result of adherence to the principle of individual sovereignty in the production and exchange of tradable goods and services. That principle is that a person's natural rights are respectable per se. One's natural rights are one's

- life (in the biological sense);
- freedom (one's life in the sense of one's activity as a thinking, speaking, acting, and working person);
- natural property (one's body, which is the physical seat of one's life and freedom).

All other rights are respectable if and only if they are established in a manner that does not violate anyone's already established respectable rights (be they natural or established). This is the case specifically for a person's works, that is, those things that he produces by his own actions. As John Locke conveniently summed it up: his life, his freedom, and his property (his body and his works) are a person's rights under the law of nature, which reason declares to be respectable.

The law of nature, properly speaking, is the order of natural persons.[1] It is a condition without disorder or confusion in human affairs, without a trace of war among natural persons. Human affairs are in order when there is no confusion about who said, did, or produced something. Then people can base their actions, words, and works on a correct ascription of authorship. Nobody gets away with blaming, praising, or holding responsible one person for what another said, did, or produced. Nobody gets away with treating the respectable property of another as his own.

Respect for person, property, and personal responsibility, and liability for one's words, actions, and works, are the basic rules of law of the natural order—the basic rules of the natural law. Disorder emerges when people do not heed those rules in every particular instance of human interaction. Then people start treating a person as if he were somebody else, or as if he were not a person at all, which is the epitome of injustice.

Deviations from the basic rules are possible but only with the free consent of those whose respectable rights otherwise would be violated. Thus consensual undertakings, giving rise to contractually established rights, can be compatible with the natural law. In short, they can be lawful—unless, of course, they involve infringements or violations of already established respectable rights.

Those propositions apply to all human affairs. They apply in particular to the production and exchange of tradable goods and services. Thus whether or not there is a free market depends on the degree to which people respect the rule of natural law in their economic activities.

Natural Persons and Corporations

It is beyond dispute that people can agree to form corporations within the boundaries of what is lawful on a free market. A corporation, indeed, need be no more than a consensual undertaking. However, our question concerns the large publicly traded corporation, not just any conceivable corporate formation.

We can rephrase our question by asking whether such a corporation could lawfully arise on a free market. An affirmative answer to that question invariably stresses the consensual or contractual nature of the corporation. For example, we often read that a corporation is a "network" or "nexus" of contractual relationships.[2] However, that is far from sufficient to prove the lawfulness of such corporations. Not all con-

tracts are lawful; not all contracts are such that their execution does not involve infringement or violation of the respectable rights of others. A and B may contract to murder C. That is a contract but not a lawful one. Moreover, even if a corporation is to some extent a network or nexus of contractual relations, it still may derive some of its characteristics from other sources, for example, legal or royal privilege. In the natural order of human affairs, there are no such privileges.

The large publicly traded corporation enjoys at least one legal privilege: its "legal personality," which it shares with the granter of the privilege, the state. Let me stress at the outset that the partners in a lawful consensual undertaking may well decide to endow their organization with an "artificial personality." There is nothing intrinsically unlawful about that. It is merely a convenience for ordering their relations and interactions within the organization. It does not bind or obligate any third parties.

However, being binding on third parties is the primary function of that other type of artificial personality, "legal personality." As John Marshall opined, a "corporation is an artificial being, invisible, intangible, and existing only in contemplation of the law." The crucial phrase is "in contemplation of the law." The "law" in question obviously is neither the natural law nor the law established by the contract that founds the corporation. The phrase here means "in the contemplation of the officials and agents of the existing legal order."

Artificial Systems Derive from Rulers' Commands

Now a legal order just may happen to conform to the requirements and rules of the natural order of human affairs, but usually it does not. Specifically, when artificial persons such as the state or other corporations are given equal standing with natural persons in an order, it is not a natural but an artificial order. That is even clearer when their status is superior to that of natural persons. The patterns of order ("laws") of an artificial system do not derive from the law of natural persons but from the general commands of its rulers. What is most distinctive about it is that it also reduces the standing of natural persons to that of "legal persons." All the fallacies of the positivistic legal ideology follow from that premise. For example, the individual person—and only natural persons are individual or indivisible—is said to be a "creature of the legal system," whose "rights and duties" are defined by the rules of the proper legal authorities.

A corporation that is compatible with natural law is no more than an association of natural persons, who agree to recognize the association as an artificial person "in its own right." However, as far as other persons are concerned, the existence of the association and its recognition by the partners as an independent artificial person in no way diminish the responsibility or the liability of the partners. How the partners assign responsibilities and liabilities among themselves is their business, but they lawfully cannot agree to deflect them to the artificial corporate person that they created. The partners own the corporation, and, as owners, they are fully responsible and liable for what "it" does. I cannot give lawful personality to my dog or my car and tell others that, when an accident happens, they should sue the dog or the car and leave me alone. In natural law, a corporation is just as much a means of human action as a dog, a car, or any other tool might be.

The privilege of "legal personality," however, consists precisely in the dilution of the responsibilities and liabilities of ownership. For those who receive the privilege, it is both an immunity and an empowerment. For others, the privilege is a dilution of their respectable rights. That is obvious in the case of the corporate form of political dominion. That construction, a.k.a. the state, implies incorporation of natural persons into a corporate body. The rulers stipulate that their subjects (a.k.a. "citizens") are legally liable for the debts incurred by the rulers. At the same time, they deny that the subjects are owners of shares of the corporation. To say that the state legally owns the

subjects is more accurate than to say that the subjects own the state.

However, the corporate veil of the state also obfuscates the fact that the rulers make the decisions. It forbids saying that the rulers own the state. Historically, that is even a defining characteristic of the state. When the kings of yore failed to establish proprietary title over their political realm, they created the corporate entity now known as the state. Unable to make the realm the property of the king, they made kingship a property of the realm. Kingship became a function within an artificial, invisible, intangible person, the corporate legal system that exists only "in the contemplation of the legal system itself."

The English philosopher Thomas Hobbes put the seal of his redoubtable intellect on the new invention. He declared that the political sovereign (the king) is but the representative actor whose subjects own his every word and action. What he does to them, they do to themselves. Hence, as Hobbes shrewdly pointed out, the sovereign cannot do his subjects an injustice. Their legally presumed prior consent absolves the ruler of every responsibility and liability. The state, an entity owned by no one, exists outside the law.

Liability of Shareholders

In the world of business, the shareholders own the private or closed corporation. They are fully liable for its debts, whatever the nature or the cause of those debts. They may agree to a regime of limited liability. However, that merely means that they instruct the officers and managers of the corporation to restrict the obligations of the corporation to the sum invested in it. When the obligations of the corporation exceed that sum, it has to be determined who has to bear the excess liability. Will it be the managers for having failed to fulfill their assignment, or the shareholders for having failed to supervise their corporate property? The corporate veil cannot serve as a pretext to dupe outsiders. In particular, the shareholders face the risk of full liability just as much as would any owners of another type of property. (Obviously, the attitude of the courts and the legal rules they apply vary widely from one country to the next.)

However, the large publicly traded corporation is different from the private corporation. In its pure form, its shareholders merely supply capital to the corporation. It is pointless to say that they have "limited liability," when in fact they have no liability at all. It is true that the value of their investment may fall to zero, but that is a risk all investors run. The shareholders are not liable for the debts of the corporation. They own the shares, which entitle them to dividends (if the corporation decides to pay out dividends) and perhaps also to attend, speak at, and even vote at certain meetings of the corporation's members. However, they are not the owners of the corporation. They do not have any of the responsibilities and liabilities of an owner. Nor is it the case that they have contracted away the burdens of ownership to willing parties. The only persons that would fit that role are the managers, but they too are not owners. Their liability is limited by their status as employees of the corporation.

From the perspective of natural law, the original or first owner of the corporation is the entrepreneur who founds it, but the legal form of the corporation obfuscates that fact. The founder sells shares, invests the proceeds in the corporation, and hires managers to run it. Typically, he becomes a shareholder or a manager. According to the legal definitions of those positions, he no longer is an owner in the full sense of the natural law. Like the state, the large publicly traded corporation is an entity owned by no one.

Of course, the business corporation is in many respects unlike the state. It cannot shift liability for its debts to the shareholders in the way a state can shift liability to its subjects. It cannot prevent its shareholders from selling their shares in the way that states can prevent their subjects from selling their legal liabilities or benefits.

The corporation, in the Anglo-Saxon world and to some extent elsewhere, operates on a number of competitive markets—

factor markets, product markets, and markets for corporate control. Moreover, official courts, which are organs of the state, tend to have less scruple in lifting the corporate veil when business corporations are in the dock than they have when the state is involved. They are likely to go after the natural persons (shareholders, but more likely managers) who actually made the wrong business decisions. They are not so likely to go after voters, legislators, or ministers who made the wrong political decisions. Because of that competitive environment and the attitude of the courts, there are more or less efficient ways for disciplining the actions of a business corporation. State actions may be notoriously inefficient and still elicit no more than an annoying question in parliament or an occasional repudiation at the polls.

However, our question was not whether large publicly traded corporations are more or less efficient than the state. It was whether such corporations are compatible with the free market. The argument presented here appears to lead to the conclusion that they are not. Without the grant of the privilege of "legal personality," the partners who make up the corporation would remain fully liable for the actions of their corporate tool. Every diminution of respect for lawful property weakens the free market and the natural law of human affairs. Diluting the burdens of ownership for a particular type of property is but one way to undermine the regime of property that defines the free market.

Risks of the Corporate System

Business corporations are significant players in the modern economy, but that is an economy in which they are policy-makers almost as often as policy-takers. Perhaps there are moments when the advocates of freedom can rejoice in the existence of Big Business as an effective counterweight to Big Government (or vice versa). But there are also times when the two of them weigh heavily on the freedom of non-artificial persons. Both are social organizations, very much interested in eliminating "the human factor," in "socializing" human beings into corporate creatures, docile citizens, and ditto workers. Both are enticing us to trade in our natural rights—and the burdens of responsibility and liability that go with those rights—for a limitless right to the satisfaction of our needs and desires. Both rest their claim for legitimacy on the purported fact that they can satisfy our needs better than we can ourselves.

Leave aside the catastrophic losses of wealth and life that the failings of the corporate system of business organization and politics have inflicted on several occasions during the past century. Let us admit that the corporate form of business organization has proven itself an immensely successful tool for mobilizing capital and labor. Let us also admit that it often has led to great achievements. In that respect, too, business corporations are like their political counterparts, the states, which have a similarly impressive record of mobilizing men and means and achieving great things. However, let us not forget the downside of those successes. It shows in the loss of freedom, our natural right to be the master of our own lives, albeit at the price of taking full responsibility for them. □

1. For details about this nonmetaphysical conception of the law of nature and about the fact that reason cannot but find the natural law a respectable order—one that rational beings ought to respect—see my book (in Dutch) *The Fundamental Principle of Law* (Antwerp: Kluwer-Rechtswetenschappen, 1983).

2. See for example, Robert Hessen, *In Defense of the Corporation* (Stanford, Cal.: Hoover Institution, 1979) and Norman Barry, *Business Ethics* (London: Macmillan, 1998).