

Ernst Freund as Precursor of the Rational Study of Corporate Law

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Introduction

It is hard to overstate the influence of the University of Chicago on the development of the social sciences in America since its founding in 1890 at the dawn of the Progressive Era. Chicago played a central role in the formation of what Dorothy Ross (1992) called “progressive social science,” and was pivotal in the constitution in the interwar period of what Malcolm Rutherford (2010) refers to as the “institutionalist movement” in American economics. Since the Second World War, Chicago has earned a remarkable place in the pantheon of Nobel laureates, playing among other things a significant part in the birth of the new institutional economics (Emmett, 2010). With Ronald H. Coase and Richard A. Posner among its faculty, the University of Chicago Law School was at the heart of this development.

This paper focuses on Ernst Freund, a man that Felix Frankfurter referred to as “the father of the Law School” (quoted in Ellsworth, 1977: 36). Best known as a “pioneer of administrative law” (Firmage, 1962), Freund, whose life spans the years between the Civil War and the New Deal, was a key figure of the “new age of legislation” (Allen, 1965a) that was the progressive response to the increasingly

complex social problems produced by rapid industrialization.¹ Like many of his contemporaries, and certainly like the interwar institutionalists, Freund believed in the role of law as a lever of social justice and democracy (Carrington, 1999).

A central concern that runs through his major works – *Police Power* (Freund, 1904), *Standards of American Legislation* (Freund, 1917), *Administrative Powers over Persons and Property* (Freund, 1928) and *Legislative Regulation* (1932) – is “the problem of achieving efficient and effective government while preserving individual rights and volition in an age of widespread legislative regulation” (Allen, 1965a: 5).² This concern was a driving force not just in his writings but also in his role as a legal educator and his appointment in 1908 by the governor of Illinois to the National Conference of Commissioners on Uniform State Laws, a position that he occupied until his death.

¹ Freund (1864-1932) was born in New York while his parents were visiting America, but grew up and was educated in Germany (Kraines, 1974: 2ff). He studied law at the universities of Berlin and Heidelberg. After receiving a doctorate in canon and civil law from Heidelberg in 1884, he migrated to New York, where he practiced law from 1886 to 1894. His academic career began while pursuing graduate work at Columbia in 1892 as an instructor of public law. In 1897 he was awarded a doctorate in political science. By that time he had already joined, in 1894, the faculty of political science at the recently-founded University of Chicago at the invitation of its first president, William Rainey Harper. When the Law School was opened in 1902 Freund was a member of its original faculty, in charge of teaching Roman law, public law and jurisprudence. He played a significant role in the design of school’s distinctive curriculum that emphasized an interdisciplinary approach to legal education (Ellsworth, 1977). He retained a keen interest in political science, and played a major role in the formation in 1903 of the American Political Science Association.

² Although Thomas K. McCraw (1984) does not focus on or even mention Freund he was arguably no less a “prophet of regulation” than Louis D. Brandeis, with whom he co-founded the American Association for Labor Legislation in 1905 (Semonche, 2009).

Despite his Teutonic education, Freund's conception of legal science shared with those who in the later years of his life began describing themselves as "functionalists" and "realists" the belief that in order to be of social utility law must rest upon a solid foundation of fact (Duxbury, 1995; Schlegel, 1995). However, although he was "conscious of the dangers of barren conceptualism," wrote Arthur H. Kent (1933: 147), he did not share the realists' "extreme distrust of general principles." In the words of the noted legal philosopher Morris R. Cohen (1937: 316-317), a former law school student of Freund's, "despite a good deal of natural revulsion against the nebulous speculation that often passes as legal philosophy," Freund "always sought to find a genuinely rational pattern" that might illuminate the "direction in which the law can wisely be pushed."

Indeed, given his keen interest in economics and sociology, and his desire to connect law with the social sciences, Freund "foresaw the path that much modern legal scholarship would be required to follow" (Allen, 1965b: xlv). Although he was not a man of statistics, he was in every other way engaged in what Oliver Wendell Holmes (1897: 1001) famously called the "rational study of law." Freund's commitment to the rational study of law was revealed early on in his Columbia doctoral dissertation, *The Legal Nature of Corporations*, completed in 1897 and published by the University of Chicago Press that same year. This paper argues that this little-known and rarely-cited work is the earliest example of the rational study of corporate law.

The book is a theoretical discussion of the nature of the corporation. Contrary to all other American treatises published throughout the nineteenth century, it contains neither detailed citations of legal opinions going back to Edward Coke,

William Blackstone, Stewart Kyd or John Marshall, nor a countless number of references to court cases and rulings organized thematically by areas of practice. The distinctively analytical approach is in part due to the fact that it was written as a doctoral dissertation in political science. But more fundamentally, it is Freund's perceptive eye, and his taste for "the analysis and nature of legal conceptions" (Freund, 1897: 5) that set the tone.

The paper shows that Freund had the mind of an institutional economist, and engaged, implicitly at least, in what today would be called comparative institutional analysis. Although he ignores some issues, failing for instance to discuss limited liability, his was an approach that compared the costs and benefits of alternative institutional arrangements, albeit not in so many words. Freund identified the conceptual and practical failings of the prevailing corporate theories, and proposed a novel view of the nature of corporations that was as much relevant at the turn of the twentieth century as it is today. In the process, he anticipated among other recent developments the functional analysis of corporate law, specifically Henry Hansmann and Reinier Kraakman's (2000) work on asset partitioning and entity shielding. His work also contains a number of useful insights for the theory of the firm.

Corporate Theory in Nineteenth-Century America

The generally accepted narrative regarding the development of nineteenth-century theories of the corporation in America draws parallels with the transformations of corporate law itself (Hurst, 1970; Hovenkamp, 1991; Horwitz, 1992). Prior to the

widespread liberalization of state incorporation laws in the late nineteenth century, when charters were granted primarily to ventures, such as utilities and banks, deemed to be in the public interest (Evans, 1948), incorporation was viewed as a state-granted privilege or franchise. According to this “concession theory” of the corporation, accepted by luminaries such as James Kent (1827) or Joseph K. Angell and Samuel Ames (1832), and duly upheld by the Supreme Court, corporations were fictitious or artificial persons whose powers were strictly limited by their charters of incorporation.

But as state grants came to be associated with legislative favoritism, a key feature of post-Jacksonian populist reform was to make charters “freely” available, and incorporation a simple administrative matter (Hurst, 1982).³ Any group of incorporators, regardless of the object of their venture, obtained the right to incorporate by simple registration, at a standard fee, provided that a certain set of requirements was met. In the *laissez-faire* context of the Gilded Age, the period that witnessed the emergence of American industrial capitalism, the doctrine that corporations were public concessions gave way to the view that corporations were products of private rights and freedom of contract, in appearance confirming Henry Sumner Maine’s (1861: 170) celebrated observation that advanced societies were driven by a movement “from status to contract.”

³ General incorporation laws had already been adopted some states (1809 in Massachusetts; 1811 in New York; 1837 in Connecticut; 1838 in Florida; 1846 in New Jersey, Ohio and Michigan; 1849 in California). In Europe corresponding laws were passed in 1844 in Britain, 1867 in France, 1870 in Prussia, and 1883 in Italy. By the mid-1880s, general incorporation with limited shareholder liability was the norm in most Western jurisdictions.

In this context, the new corporate theory proposed in *A Treatise on the Law of Private Corporations* by practicing corporate lawyer Victor Morawetz (1882) argued not only that the corporation did not necessarily imply a grant of corporate power by statute but also that the key features of corporateness, namely being “considered as personified entities, acting as a unit, and in one name” (Morawetz, 1882: 24), could be achieved by unincorporated partnerships as well. In fact, a corporation was merely a highly developed partnership, an “association formed by a contract between the members who compose it” (Morawetz, 1882: 420). Mutual consent was essential to the validity of the charter that, when granted by the legislature and accepted by the grantees, constituted a contract between the state and the incorporators that could not later be altered by the state.⁴

The key implication of the partnership analogy was that “the rights and duties of an incorporated association,” particularly as related to property, were “in reality the rights and duties of the persons who compose it, and not of an imaginary being” (Morawetz, 1882: 2). If substance was to be preferred over form, reference to the fictitious person needed to be discarded. As Henry O. Taylor (1884: 14), another corporate lawyer, argued: the corporation should be viewed as nothing

⁴ James Barr Ames, the influential Dean of Harvard Law School best known for his affection for the case-study method of legal education, considered Morawetz’s book, with its reliance on close to 2,000 cases, as “the best treatise on the subject of corporations” available (cited in McClure, 2015: 3). The book was also admired by Andrew Carnegie, who retained its author for a railroad case that Morawetz won, leading him to become the steel magnate’s personal attorney and occupy a number of executive positions in various railroads companies. As J. P. Morgan was among his other key clients, Morawetz played an important role in the formation of U. S. Steel in 1901, then the largest corporation in the world.

more than the shareholders, given that in terms of “physical existences” there was only “a collection of [natural] persons.”⁵ This “aggregate theory” of the corporation, lauded by Edmund B. Seymour (1903: 549) as “the first attempt to put [corporate] law upon a scientific basis,” soon found an echo in the courts. It informed key Supreme Court rulings in the 1880s, most notably *Santa Clara*.⁶

Paradoxically, although *Santa Clara* and the legislative ethos of the 1880s seemed to have legitimized the corporation as a private institution by using the partnership analogy, thereby favoring the emergence of big business, it was precisely the emergence of big business that led to the demise of aggregate theory by the end of the 1890s. The wave of horizontal integration in American industry that began in the mid-1890s after the passage of general incorporation laws for holding companies in New Jersey led to rapid corporate growth and extreme market concentration. Over half of the consolidations undertaken during this “great merger movement” absorbed more than 40% of their industries, and about a third absorbed more than 70% (Lamoreaux, 1985: 2-3).⁷

In this context, as legal historians such as Morton J. Horwitz (1992) have explained, it became difficult to argue that the increasingly large-scale, concentrated manufacturing conglomerates were essentially like partnerships.

⁵ Prominent proponents of this view included Seymour D. Thompson (1895) and William L. Clark (1897). For a particularly clear statement see Benjamin Trapnell (1897).

⁶ *Santa Clara County v. Southern Pacific R. Co.*, 118 U.S. 394 (1886).

⁷ On the rise of modern industrial enterprise see Alfred D. Chandler’s (1990) classic work on scale and scope. For a theoretical discussion see Richard N. Langlois (2007).

Indeed, it became hard to deny the reality of corporate organization, as something distinct from an aggregate of shareholders, when vast economic power lay in the hands of professional managers and “absentee ownership,” to use Thorstein Veblen’s (1923) famous expression, was more often than not the norm. In the 1890s, however, an alternative legal theory of the corporation was unavailable in America.

The need for a new theory of corporations was all the more obvious that the “corporation problem,” as William W. Cook (1891) referred to it, namely the numerous abuses perpetrated by corporate promoters and managers exploiting their oligopolistic positions, was at the center of the public debate, spurred by the revelations of a new generation of muckraker journalists such as Henry Demarest Lloyd (Adelstein, 2012). Under pressure to act, Congress created a federal Interstate Commerce Commission in 1887 to deal with pricing abuses by railroad corporations, and took steps to restrict the use of the trust arrangement as a means of creating combinations of corporations with the Sherman Antitrust Act in 1890 (Sklar, 1988; Hovenkamp, 1991; Berk, 1997).⁸

Like many of their contemporaries, leading economists Henry Carter Adams and Richard T. Ely observed these developments with apprehension. The problem with the emergence of modern corporations, wrote Adams (1891: 16-20), and the “completeness with which they have transformed the industrial structure,” is not simply that they rendered obsolete the “old rules of business conduct” but that they

⁸ Many states had already introduced similar measures.

“interfered with the effective workings of the accepted system of jurisprudence, pertaining to the significance of rights and to the relation between rights and responsibilities.” With limited liability and the separation of ownership and control, Ely (1887: 976) concurred, “the moral element is at its minimum”: everyone involved in a corporation feels that they “cannot be held personality responsible for its immoral conduct.”

That the rise of large corporations meant that what D. H. Robertson (1923) called capitalism’s “golden rule” was violated was not lost on any observer at the time. The transformations of the American economy were so profound that many traditional conceptions, in particular the belief in the virtue of the association of control with risk, a principle that made sense in a world of mostly local competition between small businesses owners, needed to be reconsidered. But the fact that “the nature of corporations ha[d] not yet been fully explained,” observed Ely (1877: 975-977), was an impediment to any serious attempt by scholars and legislators alike to find “some contrivance which will render artificial persons amenable to the moral law” of liability.

The need for a new theory of corporations was likewise manifest in the Congressional debates surrounding the problem of corporate taxation (Joseph, 2004; Bank, 2010). As the wealth held by the rising class of industrialists and bankers was increasingly taking the form of stock ownership, legislatures responding to public perceptions that the holders of this “new wealth” were not bearing their fair share of the tax burden (Bank, 2010: 40), or simply seeking to expand their tax base, were confronted with the question of how to reach this wealth. Since existing tax laws made no mention of corporations, having been

devised when corporations were small and scarce, the only way forward was to assume that the property of both artificial and natural persons was equally liable.

Taxing corporate property, however, was seen as taxing the investors involved, given both the prevailing aggregate theory of the corporation and, as one would expect, the investors' protests that they would be subjected to unfair double taxation. Although double taxation was "not necessarily unjust," argued Edwin R.A. Seligman (1890: 636), clearly the idea of corporate taxation required some justification. As Cook (1891: 102) put it, "how to tax [corporations] fully, yet fairly, is one of the most perplexing problems of the times," particularly now that proposals to tax corporations at the federal level were also being made (Bank, 2010).

A first attempt in this direction was made in the Revenue Act of 1894. The Act was struck down by the Supreme Court in 1895 even though, as the distinguished editor of the *American Law Register and Review*, the country's oldest law journal, George Wharton Pepper (1895: 296) wryly observed, "the nature of the corporation [was] still under discussion," and indeed despite strong differences of opinion regarding this key question among the Justices themselves.⁹ The lack of consensus concerning what constitutes a "taxable entity" (Joseph, 2004: 81ff) was in no small measure the result of the prevailing conceptual confusion about the nature of the corporation.

⁹ The Court later upheld the Corporate Tax Act of 1909 (Bank, 2010). The principle of corporate taxation was firmly established in the Revenue Act of 1913.

From an analytical point of view, while the reconceptualization of the corporation as an evolved partnership was a way to explain what John P. Davis (1897: 280) called the “voluntary inception” of corporations, a salient fact in the context of general incorporation, the rejection of the notion of artificial personality as a metaphysical relic of the past meant that the aggregate theory lacked the ability to explain the “compulsory endurance” of the incorporated group, namely its persistence through time despite changes to its membership. Moreover, proponents of the aggregate view seemed unable to account for the voluntary inception of corporations without reducing the charter to a contract or a “bargain between a state and a group of its citizens” (Davis, 1897: 282).

This idea, as Henry W. Williams (1899: 68) and others commentators observed, was “founded partly upon a misconception of the true nature of corporations, and partly upon the failure to distinguish between ancient and modern charters.” Far from being contractually determined the terms of the “bargain” could be altered neither by the state nor by the shareholders. The rights and duties of shareholders were “fixed and determined ... by law, the fact being that such rights and duties [could not] in any way be affected by any contract among themselves” (Williams, 1899: 74). The position of a shareholder in relation to the corporation, wrote Williams (1899: 74), was “one of status and not of contract.”

Although it is true that, unlike the privilege-conferring charters of old, the new charters were merely records of privately initiated incorporations, in both cases the practical result was the assignment of corporate personality by the state. However much one might dislike the state’s involvement, and whatever the extent

of one's distaste for metaphysical speculation, this point could not be evaded. Indeed, observed Williams (1899: 10), to say that a corporation is an artificial person "is not to deal in metaphysics or in subtle concepts" but is simply to underline a "legal fact of the greatest practical importance."

Unfortunately, as Davis (1897: 275, n.1) could only lament, the notion of artificial personality was the "source of much confusion in legislation and legal decisions relating to corporations," the main difficulty stemming from "the effort to apply to them legal principles elaborated in a system of law founded on individual social units instead of modifying the existing system so as to make its principles applicable to [composite] social units." From this point of view, Davis (1897: 286-287) argued, it was important to acknowledge the fact that an incorporated group acts and is acted upon as a composite unit,¹⁰ and establish a link between this "compulsory unity" and the device of corporate personality.

Freund's Rational Study of Corporate Law

It is in this context that Freund's *The Legal Nature of Corporations* was written and published. It is unclear whether it was Freund's intention to address the glaring gaps in the American understanding of the nature of corporations, or to tackle, indirectly at least, the legislative problems of the day. However, although in the book's preface he claimed that the investigation that followed was "without

¹⁰ "The members of a corporation act not as units, but as parts of a composite unit," Davis (1897: 279, n.1) explained.

immediate ... reference to practical questions” (Freund, 1897: 5), as a practicing lawyer and teacher of public law it is inconceivable that he was unaware of both the conceptual and practical importance of the questions he was devoting himself to. In any case, in his attempt to satisfy the “demands of technical jurisprudence” (Freund, 1897: 83), Freund proposed a novel conceptual system that is well worth examining in some detail.

Freund’s discussion identifies the conceptual weaknesses of Morawetz’s aggregate theory but also what he saw as problematic aspects of the corporate theory proposed in Germany by Otto von Gierke, a towering figure of the German historical school, whose monumental *Das Deutsche Genossenschaftsrecht (The German Law of Fellowship)* led the attack on the state-creation theory of corporations associated with the school’s founder, Friedrich von Savigny.¹¹ Gierke believed that corporations were private creations, but in stark contrast with Morawetz’s views, argued that there was much more to corporations than merely the aggregate of their members: an organized group could acquire the characteristics of “a living organism and a real person, with body and members, and a will of its own” (Maitland, 1900: xxvi).

Everything seems to oppose this “real person” theory of the corporation and the aggregate view, yet Freund understood that both approaches suffered from the same defect. More precisely, he attributed the failure of these “prevailing theories

¹¹ Freund’s *Legal Nature of Corporations* offered the first American discussion of Continental corporate theory. Freund encountered Gierke’s ideas first-hand, well before Frederick W. Maitland’s famous translation of sections of Volume 3 (Gierke, 1900), having no doubt attended Gierke’s lectures at Heidelberg in 1884. [check]

of corporate existence” to the “orthodox view” of the nature of rights, namely that “undivided personal volition [i]s essential to the holding of a right” (Freund, 1897: 49). It is the implicit acceptance of the will theory of rights that led Morawetz, on the one hand, to reduce all corporate rights and duties to the rights and duties of their individual members (Freund, 1897: 12), and its explicit acceptance that led Gierke, on the other hand, to see “every corporate act [a]s the manifestation of corporate will and therefore of corporate personality” (Freund, 1897: 76).

For Freund, a more adequate theory of corporations was one that rejected Gierke’s “strained view of the corporation as a real person” (Freund, 1897: 76). A corporation is not, as he sarcastically put it, “a new and distinct species of humanity” (Freund, 1897: 52). At the same time, the requisite theory needed to account for the undeniable fact that for most, if not all, practical purposes law treats “corporation and member as two absolutely different holders” of rights and duties (Freund, 1897: 41).¹² The challenge is to show that corporate rights and duties are not “abnormal and illogical” (Freund, 1897: 48), and that “the treatment of the corporation as a distinctive legal person” (Freund, 1897: 83) is justified.¹³

¹² There is a tendency among some commentators of American corporate theory to misrepresent Freund as America’s first organicist follower of Gierke. William W. Bratton (1989: 1490), for instance, claims that Freund was the “most prominent exponent” of Gierke’s theory, and observes that “moderate commentators ... tried to establish positions in the debate between the extremes presented by Freund and Morawetz” (Bratton, 1989: 1508). Yet Freund cannot be said to have held an extreme position as he discarded the dubious aspects of Gierke’s theory (Gindis, 2009). The differences between Freund and Gierke were noted by Pepper (1901) in his detailed review of Maitland’s translation in what was the first widely-read discussion of Gierke’s real person theory of the corporation in America.

¹³ For Freund the term “person” referred to nothing more than a “point of imputation of

From Freund's perspective, the fact that this "technical conception ... has grown up in connection with property and not with governmental rights" or privileges (Freund, 1897: 9) becomes clearer once rights are construed, following Rudolf von Jhering, as "legally protected interests," the benefits of which are secured by some "active ... element of control" (Freund, 1897: 15).¹⁴ The advantage of identifying the "two elements of a right, control and interest" (Freund, 1897: 17), is that both their normal coincidence in the same natural person and their frequent separation can be explained within the same framework. The latter case is particularly relevant to the corporate theorist, since corporations are certainly characterized by a "separation of control and interest" (Freund, 1897: 16).

It is the specific form of separation that distinguishes corporations from partnerships and other unincorporated groups, all of which should be distinguished from agency or trust arrangements that involve a separation but lack the "voluntary acts of mutual connection" (Freund, 1897: 22) that are essential to associations. Similarly, with "relations in which a number of people are subject to a common

rights and duties that arise in legal relations" (Gindis, 2016: 508).

¹⁴ From his exposure to German jurisprudence Freund retained above all the teachings of Jhering, whose "most attractive combination of historical and philosophical" (Freund, 1890: 485) considerations he admired. Jhering's theory of rights as legally protected interests, and the resulting conception of the purpose of law as a method to reconciling conflicting interests, inform both *The Legal Nature of Corporations* and his later work as well. Jhering's (1879) jurisprudence was already well known in America (Tamanaha, 2006), perhaps due to its conceptual proximity with John Stuart Mill's utilitarian discussion of rights. In *The Common Law*, Holmes (1881: 208) had referred to Jhering as "a man of genius." Roscoe Pound (1911) later viewed Jhering's conception of law as a cornerstone of sociological jurisprudence.

authority without having joined each other by voluntary acts of mutual connection” there is also “strictly speaking no association, but a sum of individual contractual relations entered into by one person with a number of persons acting separately, and affecting them alike” (Freund, 1897: 22).

It is important to understand, Freund (1897: 19) explained, that in any association based on a “combination of resources,” the purpose of which is to “bring returns to each party far in excess of what he would procure by the separate and independent employment of his own means,” a key issue that arises is whether the associates must act in concert to pursue their common interests. Given that disagreements over the proper course of action may arise, and in fact often do, particularly when the number of joint parties is large, the obstacle of “concurrent action” (Freund, 1897: 23) needs to be overcome.

A common solution to this problem is the adoption of a decision-making procedure such as a majority rule (Freund, 1897: 24ff), and this implies, according to Freund, a form of separation of control and interest: when associates agree to the “principle of representative action” (Freund, 1897: 47), each associate accepts the possibility that the representatives of the majority in control of the common interests may initiate actions that they may not individually desire. It follows that the associates’ commitment to the association, despite this possibility, is of central importance. Without it, the unity and the continuity of the association over time are uncertain.

Indicative of the level of commitment is the associates’ choice of legal form. In fact, without legal form, an association will not only be “legally irrelevant” (Freund, 1897: 71) but also unable to exercise any “binding power over its

members” (Freund, 1897: 21) since the undivided control over the association’s affairs will not be legally secured. It follows that an association of this kind will be constantly subject to the possibility of breakup and dissolution. On the other hand, depending on the chosen legal form, “security both against outsiders and against defection on the part of the members” (Freund, 1897: 22) can be more or less successfully achieved.

Freund’s argument is that incident to the adoption of a particular legal form is the legally binding separation between control and interest, and that this institutionalization of the principle of representative action is what provides the associates with the requisite security. The greater the degree of separation recognized by law or the courts, the greater the security, and the more “the idea of the unity of the association as a holder of rights is justified” (Freund, 1897: 77).

In Freund’s (1897: 24ff) terminology, the operation of the principle of representative action that is an incident of, or originates with, the legal form itself is “original representation.” Original representation is fundamentally different from “representative action under express delegation, by which joint rights are commonly exercised” based on the law of agency (Freund, 1897: 23). Indeed, the main problem with “the relation between agent and principal” is that it “does not solve entirely the difficulties of concurrent action” (Freund, 1897: 23-24).

American courts, Freund observed, effectively recognize a form of original representation in partnerships. Courts have repeatedly upheld the business convention that “each partner is the representative of the firm” (Freund, 1897: 26) based on the reasoning that a partnership may outwardly “appear as a unit” (Freund, 1897: 30), that this “outward unity is expressed by a collective name and

title” (Freund, 1897: 40), and that in ordinary business dealings this implies that partnerships contract their own debts secured by the property held in common.¹⁵

With partnerships, however, the recognition of the separation is imperfect. While in some respects “the undivided control of partnership affairs may be strengthened by contractual stipulations,” Freund (1897: 27) clarified, partnerships lack an absolute protection against “express dissent” and “an unqualified recognition of majority rule” (Freund, 1897: 28). It follows that “the principle of original representation fails in transactions beyond the ordinary course of business” (Freund, 1897: 27), where acquired reputations tend to be insufficient.¹⁶

By contrast, Freund (1897: 81) argued, original representation that comes with corporate status means that “corporations constitute distinctive parties to legal relations” irrespective of the scope of business, reputation or other factors that affect the unincorporated partnership, and ultimately condemn it to relatively small sizes. A fundamental advantage of the corporate form is that undivided control over corporate assets lies in the hands of a “governing body,” that is, a board of directors, whose position is “different from that of mere agents” because its binding powers cannot be revoked at any time, even “by majority [shareholder] resolutions” (Freund, 1897: 59). Although specific members of the governing body may be under some conditions replaced, the undivided control over corporate

¹⁵ As Morawetz and other commentators at the time, including Pepper (1898), had likewise noted.

¹⁶ A notable exception to this rule was the way in which Carnegie managed to retain control over multiple limited partnership arrangements up until the incorporation of Carnegie Steel in 1892.

affairs by a governing body is an incident of the corporate form itself.

The separation of control and interest is accordingly complete, with the implications that “the rights held by a corporation are not the rights of any physical person, that its members are not the part owners of the corporate property, nor part creditors or debtors of the corporate claims and obligations” (Freund, 1897: 9-10). An incorporated association, one to which the legal system has assigned the status of a corporate person, becomes a genuine “property-holding body” (Freund, 1897: 9) that can survive changes in membership, and this is what provides the ultimate security both against outsiders and against defection on the part of the members.

The upshot is that the three “salient features of the body corporate,” namely “its unity, its distinctiveness, and its identity in succession” (Freund (1897: 47), all of which are properties of corporate personality, justify the treatment of the corporation as a “human agency devoted to distinct purposes” rather than merely as a “number of individuals” (Freund, 1897: 81). Of course, a qualified departure from the principle of individual rights is necessary in order to make sense of the idea of corporate rights and duties. But the justification for such a departure becomes clearer, according to Freund (1897: 77-78), thanks to the “analogy of composite things”:

If we treat a house, a ship, a forest, or a mine, as one thing, we do not deny that this thing is composed of many separate or severable parts, each of which may be a thing by itself. But in so far as the connection is operative, the part has no legal existence except as a part, and does not form an object of separate legal disposition; it shares the legal status of the composite thing, while as soon as the nexus is broken or only

disregarded, it becomes a subject of independent treatment in law. In like manner we treat the [corporation] as one, disregarding the separate existence of its members as individuals, in so far as their recognition as such would make the protection of joint interests an impossibility, i.e., in so far as it would disturb the conditions of undivided control.

When Morawetz and others claim that the corporation is “in strict logic a fiction,” they fail to see that “fictions based upon the neglect of the irrelevant are very different from fictions which mean the substitution of an imaginary conception for a substantial nonentity” (Freund, 1897: 78).¹⁷ The dogmatic belief in the “axiomatic proposition that the aggregate is nothing but the sum of its parts” (Freund, 1897: 11) accordingly leads them to “unwarranted and fallacious conclusions” that any theory of corporate existence, corporate acts or corporate rights and duties, deals with “undemonstrable entities” (Freund, 1897: 52).

This contrasts with Freund’s own approach that proves that it is possible to satisfy the demands of technical jurisprudence “without having recourse to a fictitious entity” (Freund, 1897: 83), or to the more dubious ideas associated with Gierke. At no point does Freund deny that the corporation “becomes visible and active in and through individuals only” (Freund, 1897: 77). On the contrary, Freund’s theory is built on the fact that, far from being speculative, the idea of “corporate acting capacity” (Freund, 1897: 55) is directly derived from acts by

¹⁷ Freund’s distinction between difference kinds of legal fictions owes much to Jhering. See Fuller (1967) for a detailed discussion of different kinds of fictions to be found in jurisprudence and language more generally.

individuals in appropriate corporate positions.

As Freund (1897: 52) explained, “when we speak of an act or an attribute as corporate, it is not corporate in the psychologically collective sense, but merely representative, and imputed to the corporation for reasons of policy and convenience.” Indeed, “when we speak of corporate acts, or corporate tort ... we mean ... representative acts [or] tort” (Freund, 1897: 75). As an “instrument of legal reasoning,” the objective of which is to “determine the incidence of the effects of legal acts done in the corporate name” (Freund, 1897: 82), there is nothing objectionable in the “idea of vicarious performance,” Freund (1897: 56) concluded. Such is the true nature of corporate agency.

Relevance of Freund’s Corporate Theory: Then and Now

Despite an early endorsement by no less a figure than Pepper (1897), whose review of Clark’s treatise based on the aggregate theory invited readers to study the more satisfying work by Freund, *Legal Nature of Corporations* received little immediate attention. Some attention came after Maitland’s translation, and more specifically after Pepper’s (1901) review that underlined the superiority of Freund’s representation theory over Gierke’s organicist position, but Freund’s book was not widely cited.¹⁸ Nearly a decade passed before the first serious discussion of

¹⁸ It was not even mentioned in Davis’s (1905) otherwise perceptive study. Freund himself never cited it in subsequent work. The book had not received any reviews in law or political science journals, and this may have led him to lose interest in the topic as his efforts turned to more important matters.

Freund's ideas was published. Its author, George F. Deiser, devoted several pages to Freund's representation theory in a series of articles explicitly attempting to outline a corporate theory without "spectral attributes" that could provide "a working basis for the solution of corporate problems" (Deiser, 1909: 314).¹⁹

From a similar perspective, Harvard's widely respected John Chipman Gray (1909: 54) argued that Jhering's conception of rights as legally protected interests could be mobilized to explain the issue of corporate liability without the "dogmatic speculations" associated with Gierke: legal duties were imposed on corporations "to protect the rights of other persons, including the rights of individual members of the corporation." Freund would have wholeheartedly agreed. Indeed, this was the focus of *Police Power: Public Policy and Constitutional Rights*, his first major work published in 1904 that explored the constitutional questions involved in the regulation of the relations between private interests and public welfare.

In this respect, it was important to acknowledge, wrote Freund (1907: 70), that:

Organization and combination have increased social and business efficiency for evil as well as for good ... Familiar commercial abuses will appeal to the popular sense of wrong more strongly if manifested in a strong organization; more than that, the powerful organization will be measured by standards of commercial morality never applied to the individual merchant. There will, in consequence, arise a demand for the legislative control of

¹⁹ See Mark H. Hager's (1989) detailed discussion of Deiser's views on how regulators might put the new corporate theory to use.

relations which were formerly deemed purely private, and the demand will increase with the power to be regulated. There will be greater watchfulness as to the operation, the observance, and the enforcement of such legislation on the part of the public, and greater resistance and power of resistance on the part of the regulated interests. Under these circumstances a very much higher degree of care in framing legislation will be required than under the old conditions.

Freund devoted much of the remainder of his career to the framing of the kind of “intelligent legislation” that he felt was not only needed but also lacking in the United States given, first, the absence of a tradition of administrative law and, second, the “striking ... lack of uniformity” (Freund, 1900: 27) between state laws on all manner of important legal issues. In his most important work, *Standards of American Legislation*, Freund was well aware of the fact that the “advance of legislation to new fields of control” (Freund, 1917: 144) implied experimentation at the local level, and understood that “attempt[s] to secure absolute uniformity of local legislation” were often unsuccessful (Freund, 1917: 157), particularly “as regards corporate organization, powers, relations, and liabilities” (Freund, 1917: 169). But he firmly believed in the virtues of standardization, at least as an “ideal in legislation” (Freund, 1917: 248).²⁰

These considerations played an important role not just in the general establishment of what Daniel R. Ernst (2014) called the “administrative state,” but also in the vivid debates surrounding the legal status of unincorporated

²⁰ It seems that Freund was not as enthusiastic as Brandeis would become about the value of states acting as laboratories of democracy.

associations such as partnerships.²¹ While the judicial recognition of the mercantile view of partnerships as *de facto* legal persons was widespread (Cowles, 1903; Brennan, 1904; Burdick, 1909), it was not uniform, and this created some uncertainty, particularly in matters of interstate commerce. For Freund (1912: 107) this situation called for a uniform partnership law that would recognize the “firm as formal holder of rights” but stopped short of recognizing full “corporate capacity.”

The drafters of the Uniform Partnership of 1914 attempted to agree, as its chief drafter William Draper Lewis (1911: 100) explained, on “such fundamental matters as the legal nature of a partnership, the rights of the members in partnership property, or even their relation to third persons,” but failed to do so, Scott Rowley (1916) and other observers pointed out, in a logically coherent manner. As one outspoken critic put it, by refusing to formally define the partnership a legal person, the drafters not only fell short of their stated objective, namely to link varied business practices to a single statutory form, but also failed to achieve consistency with existing legislation, most notably the Bankruptcy Act

²¹ The issue of the legal status of trade unions was also of particular importance. Brandeis (1903: 13) believed that unions should incorporate, becoming legally responsible for the actions of their members, as this would enhance the unions’ legitimacy in the eyes of employers, thereby reducing the “bitter antagonism” between capital and labor. Like their British counterparts in the aftermath of *Taft Vale Railway Co. v. Amalgamated Society of Railway Servants*, UKHL 1 (1901), Samuel Gompers and other American labor leaders rejected this idea (Meltzer, 1998). Freund’s view on the matter is unclear, although his corporate theory would have logically led him to agree with Brandeis. See Morton Keller’s (1990) detailed discussion of the debates surrounding labor regulation.

of 1898 (Crane, 1916: 842).

The Bankruptcy Act clearly construed partnerships as falling under the category of “persons” alongside corporations (Anon, 1908: 391). The text of the Uniform Partnership Act was highly ambiguous in this respect, since it recognized that partnerships as such could hold property but at the same time that partners were co-owners of this property. As Joseph H. Drake (1917: 626) put it, the statute recognized “the composite entity of the group and not the unit entity of an extrinsic juristic person.” It would take eighty years for this anomaly to be settled in a manner that Freund would have approved of: the formal definition of the partnership as “an entity distinct from its partners” was enshrined in the Revised Uniform Partnership Act of 1997 (§201a).²²

Among other things the new statute provides: that the partnership property is owned by the legal entity rather than by the partners, meaning that partners are no longer co-owners of this property; that this property is protected from both the partners and their creditors; and that the partnership is not dissolved in the event of partner dissociation. In other words, to use Freund’s terminology, the statute enhanced quite considerably the separation of control and interest, making “its unity, its distinctiveness, and its identity in succession” (Freund, 1897: 47) very similar to the original representation characteristic of the corporate form. Yet differences remain.

²² The comment on §201 clarifies that it is in light of the ambivalence of the 1914 Act that the Revised Act embraces the entity theory of partnership. See http://www.uniformlaws.org/shared/docs/partnership/upa_final_97.pdf.

Most notably, from Freund's perspective, the new partnership form does not provide for the "undivided control of partnership affairs" (Freund, 1897: 27): there is no mandatory presence of a "governing body" whose binding powers cannot be revoked (Freund, 1897: 59). Whereas corporate law is expressed mainly in mandatory terms, as Larry E. Ribstein (2010), Eric W. Orts (2013) and others have explained, partnership law remains fairly contractual in the sense that it is couched in terms of default or enabling rules, modifiable by mutual agreement. In partnerships the partners may resolve to form a board, but also to remove it. The separation of control and interest emphasized by Freund is accordingly incomplete.

Freund's corporate theory provides a useful lens through which the transformations of American partnership law over the past century can be understood. More interestingly, Freund's discussion contains some of the central elements of the functional analysis of corporate law developed recently by Hansmann, Kraakman and their colleagues (Kraakman *et al.*, 2009). Like Freund, this approach places a great deal of emphasis on the essential role played by law's assignment of legal personality to various organizational forms, and more specifically on the various types of "asset partitioning" (Hansmann and Kraakman, 2000: 393) that this involves.

Of course, the modern discussion is more sophisticated in terms of legal detail, more informed by efficiency considerations, and broader in terms of the variety of organizational forms considered. But the spirit is strikingly similar. Where Freund focused on the degree of separation between control and interest to compare partnerships and corporations, the comparative institutional analysis developed by Hansmann *et al.* revolves around the stronger and weaker forms of

partitioning available. Arguably, there is a sense in which the claim that partnerships benefit from “weak entity shielding” and corporations from “strong entity shielding” (Hansmann, Kraakman and Squire, 2006: 1337-1388) can be traced back over a century earlier to Freund’s *Legal Theory of Corporations*.

But the book does more than explain in functional terms the features, strengths and weaknesses of alternative legal forms. It also contains insights for the theory of the firm. In effect, Freund proposed an economic rationale for the choice of the corporate form that anticipated the way in which Margaret Blair and Lynn Stout (1999) introduced corporate law into Armen A. Alchian and Harold Demsetz’s (1972) classic team production theory of the firm. Freund’s point of departure was very similar to Alchian and Demsetz’s. In modern terminology, he assumed that an association of resource owners would only exist if it was possible to generate a super-additive surplus (Freund, 1897: 19), and focused on some of the collective action problems involved.

The failure of cooperation due to the “defection on the part of the members” (Freund, 1897: 22) was a real possibility, particularly in associations of resource owners in which control is jointly exercised and concurrent action is necessary. Even when joint control and concurrent action were no longer strictly necessary because delegation and majority decision rules had been adopted, he reasoned, the problem of preventing defection on the part of the members remained. Some sort of credible commitment mechanism, as new institutional economists would put it, was needed. Contrary to the new institutionalists’ account, however, for Freund contractual stipulations alone were generally insufficient.

To truly prevent internal defection associations had to exercise “binding

power over their members” (Freund, 1897: 21), and the best way to achieve this was to hold common property in a manner that ensured the “continuity of the tie binding remaining and incoming members together” (Freund, 1897: 46).

Paraphrasing Oliver Hart (1995), to avoid the constant threat of break-up or dissolution, associations need some sort of glue to hold them together despite changes in their membership. It is the legal form, Freund argued, that fulfilled this role more or less successfully, the most credible commitment of all being incorporation.

By incorporating the association, the members agreed to transfer their property to the legal entity that is, first and foremost, a “property-holding body” (Freund, 1897: 9), and accepted the implication that undivided control over the corporate property would now rest with the board of directors (Freund, 1897: 59). Blair and Stout’s (1999) discussion of the centrality of the board is based on very similar considerations.²³ The upshot is that by “locking in” the committed capital, as Blair (2003) put it, the corporate form not only protects the association from the defection on the part of its members but also constitutes a credible commitment in dealings with third parties, and this helps ensure its economic viability over time.

Coase’s (1937) view that the contractual centralization of decision-making authority captures the nature of the firm is accordingly insufficient. As Freund (1897: 22) pointed out, when “a number of people are subject to a common

²³ Gregory A. Mark (1987: 1474) described “Freund’s brilliant exposition of the notion of undivided control over property within a corporation” as the “intellectual foundation” of managerialism.

authority without having joined each other by voluntary acts of mutual connection,” as would be the case, for instance, between workmen in a factory, there are, in effect, only “individual contractual relations entered into by one person with a number of persons acting separately.” The workmen and their boss cannot enter into contracts or hold property in the group’s name. As a group they are legally irrelevant, constantly subject to the possibility of break-up and dissolution. Arguably, a theory of the firm that fails to take this into account falls short of its stated objective.

Conclusions

Freund’s *Legal Nature of Corporations* was published at a time of great upheavals in American society. Questions raised by the profound transformations brought about by the proliferation of the corporate form and the rise of the large corporation found few satisfactory answers in existing treatises on corporations, the authors of which were content with merely quoting older treatises and judicial opinions. Freund’s book did not purport to provide satisfactory answers to all the pressing problems of the day, but it was the first attempt to engage in a proper theoretical discussion. This was a significant intellectual achievement on its own.

Freund proposed the first rational study of corporate law, to paraphrase Holmes. *Legal Nature of Corporations* involves a sustained attempt to construct a logically consistent conceptual system on the basis of a clear understanding of the nature of rights, having considered alternative theories and discarded them based on that same understanding of rights. Thinking like an institutional economist,

Freund successfully used the same conceptual system to conduct a comparative institutional analysis, rudimentary though it may be, of the two main legal forms available at that time. In the process, he anticipated some of today's best work linking the theory of the firm and corporate law scholarship. This, again, is a significant intellectual achievement.

Although there is a chapter on corporations in *Police Power* Freund never returned to the development of corporate theory, and it seems never encouraged students or colleagues to delve deeper into the topic. One can only wonder what course the literature might have taken had he devoted himself to fine-tuning his theory, or criticizing others' ideas. One also wonders what Freund thought of Walton H. Hamilton, John R. Commons, and other institutional economists who were a generation younger than his own, but whose conceptual and regulatory concerns he shared and must have been familiar with. The answer to this question will need to be the focus of future research. A visit to the University of Chicago Library that holds the Freund papers archive is no doubt overdue.

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