The Passing of the Corporation in Business

R.J. Powell
THE PASSING OF THE CORPORATION IN BUSINESS

In this period of upheaval, nothing is more marked in the business world than the growing conviction that the corporation as a business instrumentality for ordinary enterprises must soon be abandoned. Revolutions in business affairs seem to be as inevitable as revolutions in politics. As soon as a business method is established there seems to spring up an antagonistic force which eventually compels its abandonment or modification. The history of the law abounds in instances substantiating this proposition, and in the history of the corporation in business we are finding its truth again presented.

The corporation, while not an American invention, nevertheless was developed as a business instrumentality to its present high state of efficiency by American genius. Its wonderful growth has been ascribed to the effect of the Dartmouth College case, but the writer is rather inclined to think that it was due more to the broadening effect of the development of the railroad, with the subsequent introduction of the telegraph and the telephone, than it was to this famous case.

We will consider the business reasons which have led to the adoption and development of the corporation, then we will discuss in a general way the causes which are tending to destroy the usefulness of the corporation in business, after which we will

1 (1819) 4 Wheat. (U. S.) 518, 4 L. Ed. 629.
point out what seems to us to be an available method as a substitute.

The individual in business finds his activities limited by the extent of his capital and his capacity for getting things done through others. He is also operating under the shadow of loss through his sickness and inability to look after his business, and must always face the certainty that at some time his death will necessitate the liquidation of his affairs. In addition to these disadvantages, his liability is, in a sense, unlimited.

The partnership combines the capital of several, and may multiply its business activity by the number of its partners. To that extent it possesses a much wider scope than the individual in business. Its disadvantages, however, are well known and fully appreciated. There is unlimited personal liability; the absence of perpetual succession; and the possibility that a readjustment of the business may be rendered necessary by the death or bankruptcy of one of the members, or by the withdrawal of some one from the firm.

The idea of the corporation was seized upon by the business world when rapid development, rapid transportation and rapid communication made it possible for business men to combine large interests, scattered over an extensive territory, and in time the corporation became, as we all know, the common method for combining the funds of several in a common enterprise. While the corporation was known in business in England prior to the creation of the American government, its development into the common form of business activity has taken place in this country within less than one hundred years. In fact, it may be safely stated that the enormous growth of the corporation in business, and of corporation law as applied to its business operations, has taken place within the last sixty years.

The advantages of the corporation are well known and fully appreciated. It makes possible the combination of the funds of a large number of individuals, by which there may be created a powerful organization with sufficient capital to accomplish any reasonable purpose. The business is secured against frequent reorganizations by the perpetual succession in the membership and the treatment of the corporation as a separate legal entity. To the lawyer, all of these advantages are commonplace, and as compared to a partnership, the corporation is obviously preferable, so far as all of these things are concerned, but, being a
creature of the law and easily within the reach of all of those political elements which are unfriendly to successful business, it has been made the object of burdensome and adverse legislation for a great many years.

Soon after the civil war, the spirit of antagonism to the corporation began to manifest itself. Unscrupulous individuals had used the corporation as a shield, and it also had been made the instrumentality through which transactions had been carried on, which were questionable and clearly against public welfare. It is not the writer's purpose in this paper to attempt to analyze all of these factors,—it is enough for present purposes to remark that on the one side the privileges of the corporation had been abused, while on the other side was the growing determination to eradicate the abuse by practically killing the instrumentality. Legislation in congress forbade the co-operation or pooling of competing lines of railroad instead of following the wiser and more constructive method of encouraging pooling under public control. The Sherman Act, aimed at illegal combinations in restraint of trade, operated principally to discourage strong business combinations, which, in our present predicament, are found to be the very things which we should, under proper public control, have developed and encouraged. Year by year we have seen statutes passed, not only by congress but by the legislatures of the several states, each one imposing some additional duty or burden upon the corporations. The very common requirements in the statutes of most of the states, compelling every foreign corporation to file a copy of its charter in every state in which it desires to do business, and to become subject to the laws of that state, and to pay taxes upon the percentage of its capital engaged in that state, while perfectly proper from the standpoint of the state, become extremely burdensome to business interests endeavoring to carry on enterprises of an extended character over a large territory. As a further instance, we may note the enactment of the so-called "Blue Sky" laws. These laws express the benign purpose on the part of the states to protect their citizens from their own cupidity, although the purpose of these laws is generally expressed in another way. It is an instance of paternalism, and the various commissions appointed under these Blue Sky laws assume not only to pass upon the value of the assets of a corporation whose securities may be offered for sale, but to determine the feasibility of the plan of the corporation or the prob-
ability of the success of its business venture. This attitude on the part of the states in that respect is cited merely as an instance of the increasing difficulties which are being thrown around the organization and conduct of a business in a corporate form.

Following all of these troubles, with which every corporation lawyer and manager is familiar, we find ourselves confronted with the federal income tax. One of the advantages of the corporation is the facility with which several persons are enabled to combine their individual funds in a common enterprise having perpetual succession, and in which the individual interest of each is transferrable without involving a readjustment of the business. This very feature of combination, however, now operates to the disadvantage of the individuals associated in the corporation, because their combined earnings through the corporation become subject to the increasingly heavy excess profits tax. Thus, if a corporation having ten stockholders, each owning an equal amount of stock, were to make a profit of $50,000.00, it is obvious that the probability of an excess profits tax falling upon that fund is much greater than if the stockholders as individuals had each earned one-tenth as much.

It would be presumption for any writer to undertake to discuss in other than the most general terms the probable operation of the surtax and excess profits tax provisions of the federal income tax law, and, as applied to the present discussion, it will be wholly unprofitable, because every corporation lawyer, as well as every one connected with the management of corporations in the United States at the present time, knows from bitter experience the perplexities involved in an attempt to make out an income tax return for a corporation. Some optimistic individuals may be indulging the vain hope that when this war is over we shall see the repeal of these income tax provisions which so largely increase the difficulties of corporate management. The writer is not by nature pessimistic, but he ventures the prophecy that no person now in business will ever live to see the corporation relieved entirely from these income tax laws. What the future may bring forth in added burdens, duties and requirements, we cannot now imagine, but it is safe to assume from our past experience that the path of the corporation will not be made any easier to follow in the future than it is at the present time.

But, if the corporation must go, is there any method by which business interests may be combined in effect without encountering
all of the obstacles and difficulties to which the corporation in
business is now subject? For some kinds of business the corpor-
ation may be the only method by which a large number of indi-
viduals can be combined for a common purpose. Some lines of
business must be carried on through the medium of corporations,
as for instance, banks and trust companies. Eleemosynary insti-
tutions and public or quasi public business enterprises must un-
questionably continue to be carried on through corporations. But
the writer is of the opinion that a method can be worked out
through the ancient law of uses and trusts, by which the advan-
tages of the corporation, or some of them, can be retained, and at
the same time the interests and the income of the individuals
interested in the enterprise be kept distinct for purposes of taxa-
tion. In fact, such a method is in process of development at the
present time.

In Massachusetts the plan suggested in this paper has been
in vogue to a certain extent for a number of years, although,
according to the writer's present information, the business of such
trusts has been confined largely to real estate and investments.
This plan has also been a favored one for carrying on the business
of estates which a testator has seen fit to tie up for a long term of
years. It naturally occurs to a lawyer, when the subject has been
carefully considered, that there is no very good reason why the
estate of a person cannot be managed by a trustee in his lifetime,
if it can be managed for a term of years by a trustee after his
decease. The pertinent inquiry also presents itself whether, if a
trustee can be appointed to wind up a business and distribute its
assets, one cannot likewise be appointed to continue the business
and distribute the profits. On principle, it must also follow that
if one man can create a trust of his own property, with power in
the trustee to continue the business indefinitely, subject to the
right of the beneficiary to terminate the trust agreement on notice
and take the business back again, two or more men can turn their
property, or a portion of it, over to a trustee, with power to
combine the funds for a common purpose, so long as such purpose
is lawful. It follows also that a man likewise can divide his
property among several trustees, empowering each of them to
conduct a different sort of business. It does not require the in-
vention of any new legal principles in order to effectuate this
general design.
The trust principle seems to have originated in the Roman law. The idea was invented or adopted for the purpose of enabling a testator to avoid the rigorous provisions of Roman law which forbade the distribution of property to certain classes of heirs or legatees. By devising property to a third person, who was capable of taking under the law, with a request or direction that the property so devised be used for the benefit of the real person intended as heir or legatee, the general law was complied with, and at the same time circumvented. The request to the trustee was in time treated by the Roman magistrates as a command, imposing an obligation on the conscience or good faith of the trustee, which the courts would enforce, and there grew up in the Roman law those testamentary trusts known as fidei commissa.

The idea of using a trustee to accomplish purposes which could not be carried out directly was again resorted to when the statutes of mortmain in England forbade the granting of lands to the monasteries and religious houses. The Roman plan was revived, and lands were granted to natural persons for the use or benefit of the monasteries or religious houses. The chancellors, following the principle of the Roman law, and imposing the sanction of the court upon the consciences of these third parties, held them to be trustees and bound to regard the terms of the trust. Without pausing to discuss the growth and development of this idea, it is enough to say that for the past six hundred years it has been known and applied in English and American law, and under no head of jurisprudence is the law better established than under that relating to trusts and trustees. It is interesting to note that lawyers seem to turn instinctively to the trust principle, whenever laws or legal rules become harsh or irksome; while at the same time the courts resort to the trust principle to enforce the dictates of conscience and good faith, whenever a case is presented wherein the law, by reason of its universality, fails to furnish an adequate remedy.

We have, then, the law and the machinery all established and at hand, and the interesting question is whether or not ordinary business can be successfully conducted through the medium of such trusts. And why not? Everybody knows that a trustee can be designated and empowered to control, manage, or wind up estates of decedents, bankrupts or incompetents; to administer charities; and to perform all sorts of similar functions. It is
settled that a man can create a trust for his own benefit, and, to a certain extent, under his own control. It seems just as clear that a man can create a trust for himself, and direct the trustee to combine his funds with similar funds of others for a common purpose.

While the practice has not been extended very generally outside of Massachusetts, it is well established there, (and the principles under which the practice there has developed are as well recognized elsewhere), that individuals may create a fund in the hands of a trustee, or trustees, and direct the trustees to embark in a certain line, or lines, of business for such period as will not violate the rule against perpetuities, and such business organizations are not only held to be valid, but they are considered meritorious, and the legislature of Massachusetts was advised that to attack such organizations "would be an unwarranted interference with the right of contract, and would raise serious constitutional questions." Let us consider briefly some of the questions which will naturally occur to a lawyer investigating this plan.

(1) The Trustee. In considering whether the trustee shall be a public trust company or a private individual, and whether a single trustee, or several trustees, shall be nominated, the statutes of the state in which the contract is made must be carefully observed, particularly as to the provisions relation to perpetuities. The statute of Minnesota relating to this subject provides:2

"that the trust shall not continue for a period longer than the life, or lives of specified persons in being at the time of its creation, and for twenty-one years after the death of the survivor of them, and that the free alienation of the legal estate by the trustee is not suspended for a period exceeding the limit prescribed in Chapter 59."

Inasmuch as the sort of trusts we are discussing would not suspend the power of alienation of real estate at all, we need pay no attention to the limitation referred to in the foregoing quotation. For some purposes a public trust company would be preferable, while in other enterprises it would be more satisfactory, perhaps, to have private trustees. In either case, however, the period of duration of the trust should be made with due regard for the statutes we have just mentioned, subject of course, to the right of the beneficiaries to terminate the trust by notice, or voluntary agreement, as may be provided for in the deed of trust.

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2 Minn. G. S. 1913 Sec. 6710.
can create either a trust company, under the general statutes relating to the creation of such companies, or they, doubtless, under the statutes of some of the states, can create a holding company, with power to act as a trustee. In the case of large business interests, where the number of persons interested in business is comparatively small and the holdings are compact, arrangements can be made to have some of the business associates named as trustees, for there is no doubt but that, under the authority of proper terms incorporated in the trust agreement, such members of a business organization can be both trustees and beneficiaries.

(2) The Trust. Care must be taken to make the trust an active one, and not a dry or passive trust in which the trustee has nothing to do but hold the title to the property engaged in the business. Under the statutes of many of the states a dry or passive use or trust would be executed, and the entire title legal and equitable, as to real property certainly, and quite likely as to the personality, would be cast upon the beneficiary, or beneficiaries, as the case might be. Another reason why the dry or passive trust should be avoided is that the beneficiaries would probably be held to be subject to a partnership liability, if they were given entire control of the enterprise.

(3) Transferability of Shares or Interests. The common practice in Massachusetts is to make the beneficiaries practically an unincorporated association, transacting business through the trustees, and the interest of each beneficiary is represented by a transferable certificate representing his proportionate share in the enterprise. The certificate gives the member no voice in the direction or management of the business and is intended more as evidence of the extent of his interest and the basis upon which he is entitled to a proportion of the profits. The writer is of the opinion that the relation as between the trustee and the beneficiary should be made more direct and intimate. In other words, instead of creating the association first, and then nominating the trustees, as trustees for the association, the contract between the trustees and each member should, if possible, be made direct and personal, although the object which the trustees may be directed to pursue is a common one. While the trustees would be guided, of course, by the wishes of the beneficiaries, expressed either severally or collectively, and would be removable for malfeasance, and the trust would be liable to termination in accordance with the provisions of the trust deed, nevertheless it is apparent from a con-
sideration of the authorities, that the less the beneficiaries have to do with the actual conduct of the business, the more remote will be the probability that they can be held personally liable in any manner for any of the debts contracted in the conduct of the business. This brings us to the question of liability.

(4) The Trustee's Liability. We will pass over without discussion the question of a trustee's liability for torts or malfeasance, and consider only the trustee's liability to creditors for debts contracted in the conduct of a going business. In this respect the law is well settled and cannot be stated more clearly than by quoting from the opinion of Mr. Justice Woods in the case of Taylor v. Davis:3

"A trustee is not an agent. An agent represents and acts for his principal, who may be either a natural or artificial person. A trustee may be defined generally as a person in whom some estate, interest or power in or affecting property is vested for the benefit of another. When an agent contracts in the name of his principal, the principal contracts and is bound, but the agent is not. When a trustee contracts as such, unless he is bound no one is bound, for he has no principal. The trust estate cannot promise; the contract is, therefore, the personal undertaking of the trustee. As a trustee holds the estate, although only with the power and for the purpose of managing it, he is personally bound by the contracts he makes as trustee, even when designating himself as such. The mere use by the promisor of the name of trustee or any other name of office or employment will not discharge him. Of course when a trustee acts in good faith for the benefit of the trust, he is entitled to indemnify himself for his engagements out of the estate in his hands, and for this purpose a credit for his expenditures will be allowed in his accounts by the court having jurisdiction thereof.

"If a trustee, contracting for the benefit of a trust, wants to protect himself from individual liability on the contract, he must stipulate that he is not to be personally responsible, but that the other party is to look solely to the trust estate."

From this it will be seen that the question of the liability of the trustee should be carefully provided for in the trust agreement, and pains should be taken to see to it that every creditor dealing with the business has notice of the limitation of the trustee's liability.

(5) The Liability of the Beneficiaries. The question of the liability of the beneficiaries is the one to which the legal mind immediately turns whenever this plan of doing business is sug-

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3 (1883) 110 U. S. 330 (334), 28 L. Ed. 163, 4 S. C. R. 147.
gested. The beneficiaries of such a trust business are certainly free from all of the provisions relating to stockholders of a corporation, and they cannot be held to be subject to the liability of stockholders. The legal title to the entire property has passed to the trustee and the equitable interest remaining in each investor is a right to share in the profits of the business conducted by the trustee, and to share proportionately in the distribution of the property remaining, if any, in case the trust is dissolved. As we have just seen, the trustee is in no sense an agent, and it is just as clear that there is no such thing as the relation of agency existing as between the beneficiaries, if the trust has been properly organized. So far as the authorities have gone in considering cases involving the principles applicable to this question, two propositions may be safely considered as reasonably established: First, it may be assumed that where the trust is an active one and the trustee is given entire and unlimited control and management of the business, the beneficiaries are subject to no liability whatever on account of any indebtedness or obligation incurred by the trustee in the conduct of such business. Second, where the trust is a dry or passive trust, and the business is managed, controlled and conducted by the beneficiaries, they will be held to be partners and subject to a partnership liability. Between these two established propositions, however, there lies a variety of undetermined questions, the principal one of which being as to how far, or to what extent the beneficiaries may direct the management of the business, either in the original instrument creating the trust, or by subsequent vote of the beneficiaries without incurring a partnership liability. It is hard to see how a partnership liability would be created by a provision in the trust agreement giving the trustee full control of the business, but suggesting the employment of one or more of the beneficiaries in the conduct of the business, and permitting the beneficiaries, or a majority of them, to terminate the trust, in case the management of the trustee was unsatisfactory. The basic principle of partnership liability is mutual agency, but it is clear that in the trust arrangement nothing like the relation of principal and agent exists as between the trustee and the beneficiaries. In fact, as the writer has previously suggested, it seems that it would not be a very difficult or cumbersome undertaking to create such a trust in which there would be no mutuality whatever as between the beneficiaries. Here again the question of notice becomes important. It is a fundamental
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proposition that where creditors have been led to deal with an organization on the faith of representations, actual or implied, the members of such organization will be compelled to make such representations good whenever it is necessary to do so for the protection of such creditors. This is the principle which lies at the root of the so-called trust fund theory of the liability of stockholders for unpaid subscriptions. The same principle would apply in cases of the sort we are now discussing. But if the trust agreement explicitly limits the liability of the trustee to the funds placed in his hands, and declares that the beneficiaries shall not be liable in any case for any of the debts contracted by the trustee in the conduct of the business, and the terms of the trust agreement in that respect are brought home to the notice of creditors dealing with the trustee before their debts are contracted, it is difficult to see how the creditors could claim that they had been misled, or how they could escape being bound by such notice.

(6) Business Credits. At first, doubtless, the banks will be inclined to scrutinize such organizations with a great deal of care; but it can readily be observed that, since, the entire property of the trust must necessarily be pledged to the payment of its debts, and since that entire property is in the control of a trustee, the credit of such a business ought to be as sound, if not more so, than if the same organization were incorporated. Such, probably, will be the final verdict among the bankers.

(7) Taxation. The tangible property in the hands of the trustee will be subject to taxation, exactly the same as though held by the individual owner. The trustee should be required to keep his accounts in such a way as to show the individual share of each investor, and the plan should be organized so as to keep the interests of the several beneficiaries as separate and distinct as possible. The income of each investor, therefore, would be subject to the provisions of the income tax law relating to the income of individuals. The profits, if any, which the trustee may have made in the conduct of the business would not be aggregate or joint profits, but the several profits of each investor, and ought to be taxed accordingly. In determining the place of taxation the courts of Massachusetts have treated associations of beneficiaries as partners, but not so as relating to their liability.

(8) Comparative Advantages and Disadvantages as between such a Trust and a Corporation. One of the prominent advantages of the corporation has been the fact that it was an entity
which survives for the stated period, regardless of the continued existence of the incorporators. The same effect can be achieved by a trust such as we have outlined. The death of one of the beneficiaries would pass his equitable interest in the trust to his personal representatives, but it would not dissolve the trust in any way, and the business would continue just the same. This equitable interest can be devised, sold, levied upon and transferred by operation of law. It can be divided among different purchasers or devisees exactly as the interest of a stockholder in a corporation may be divided, without affecting the trust in any way or interfering with the continuance of the business. Through the medium of incorporation large funds may be accumulated for the conduct of an extensive business, and hundreds of persons may become interested in the corporate business as shareholders. There is no reason why the same cannot be done through the medium of the trust. The corporation, being a creature of the law, cannot operate outside of the state of its domicile, except upon such terms as other states may see fit to impose, but a trustee, especially if he be an individual, has all the rights of a natural person and a citizen of the United States, and he can transact business with the trust funds in any or every state of the union, and any attempt to place a limitation upon his right to extend his business from one state to another would fall within the constitutional prohibitions. The business would escape entirely from all of the statutory limitations or requirements relating to corporations. There would be no reports to make, such as are required from corporations, either to home or foreign governments, and as we have pointed out, there would be no capital stock to tax, and the objects of taxation would be simplified to the mere question of tangible property and individual income. The expense of such an organization is much less than the expense of organizing a corporation, and the only fees required to be paid would be the fees of the register of deeds for recording the trust agreement, in case real property were involved. If private trustees are used there will be no reports or records of a public character, and the taxing authorities are the only ones who would have any authority to examine the books of the business, other than the interested parties themselves.

(9) Some Suggestions as to the form of such a Trust Agreement. The practicing lawyer would not think of organizing a business along the lines herein outlined without giving the subject
considerable study, and in doing so he would, from the various authorities, readily perceive what the general provisions of such a trust agreement should be. There are a few matters in that connection, however, which may be properly suggested in this paper. The trust agreement should, of course, designate the trustees, and cover with sufficient detail the purposes for which the trust is formed, and contain such general directions to the trustee as the special circumstances may seem to require. The agreement should provide for the period during which the trust is to continue. It should also provide for the manner in which the trust may be terminated; the time, place and manner in which the funds shall be turned over to the trust company; the manner in which the business shall be managed and the manager selected. It should also provide for the issuance of trust receipts or certificates to each investor, showing the proportionate amount of his investment in the trust, and stating that such interest is transferable. By its terms each individual investor should be treated as a separate, independent owner of a proportionate part of the trust property, determined by the proportion of his investment to the total fund, and should require that all accounts as to earnings be kept by the trustee with each individual investor. In other words, while the general purpose which the trustee may be required to carry out is a common one, the investment should not be made a joint investment any more than a common ownership of income paying real property is a joint investment. Special features, not contrary to law, that may occur to the parties at the time of the organization of such a trust, should, of course, be incorporated in the trust agreement. In selecting a name under which the business is to be carried on, those should be avoided which may suggest either a corporation or a partnership, and the words "company" or "association" should not be used. Preferably, the word "trust" should be adopted, and such names as the "Home Building Trust," or the "Paul Lumber Trust" should be applied to the business. It may appear objectionable to make use of the word "trust" because of the prejudice existing against trusts, but undoubtedly the way to get rid of the prejudice in the public mind is to use the term to designate every sort of commonplace business.

(10) **Summary and Conclusion.** The foregoing is a hastily prepared and rather crude attempt to stimulate interest in what appears to the writer to be a most promising development of a
Continued prosperity and development require that business be as free and untrammeled as possible, and while this general plan is yet in its experimental stage, it would seem that its general adoption in business may well be considered. Some objections may be suggested, and such a method, of course, cannot always be resorted to, even in cases where a corporation may be undesirable, but in the light of twenty years' experience as a practicing lawyer, constantly dealing with corporations in business, the writer has reached the conclusion that a development of the general plan herein hastily outlined will enable the great majority of business enterprises to be carried on with greater freedom, more certainty and less annoyance than is possible by corporations under existing law and the present state of the public mind toward such organizations. Those who may become interested in this subject will find it very ably discussed in a volume entitled "Trust Estates as Business Companies," by Mr. John H. Sears. Mr. S. R. Wrightington also has collected the authorities and treated many phases of the subject in an accurate and exhaustive manner in a volume entitled "Unincorporated Associations." The writer has thought best not to obscure the discussion with the citation of authorities other than those just mentioned, for the law on the subject, aside from the general principles of trusts, which are well established, is in its formative period, and the authorities are not very numerous.

R. J. Powell.

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