REVIEWS

The Rise and Fall of the Classical Corporation

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Enterprise and American Law: 1836-1937. Herbert Hovenkamp. Harvard University Press, 1991. Pp x, 443.

Herbert Hovenkamp's outstanding new book, *Enterprise and American Law*, chronicles what is arguably the most important development in the history of American business law—indeed, one of the most important developments in the history of American law generally: the remarkable changes in economic theory and legal doctrine that attended the rise and fall of the classical business corporation.

Professor Hovenkamp details the ways in which classical and neoclassical economic theory broke down the mercantilist system of state economic regulation that prevailed during the late eighteenth century and opened the American economy to the benefits of entrepreneurship, capitalism, and free markets. In so doing, Professor Hovenkamp supplies a useful corrective to popular misconceptions about the allegedly nefarious effects of the large business corporation's ascendance in the later years of the nineteenth century, and of the free market ideology of *Lochner*[1] and related

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[1] *Lochner v New York*, 198 US 45 (1905).

cases. For a time, that ideology limited the ability of special political interests to hamper the beneficial development of the large corporation.

Despite the remarkable achievement of this book, Professor Hovenkamp fails to fully appreciate the contributions of the classical business corporation. In the face of overwhelming evidence that classical economic theory and the classical business corporation have contributed enormously to the nation's economic welfare, Professor Hovenkamp views the classical corporation as ultimately a failure, swept away by a new species of heavily regulated enterprise in the New Deal and post-New Deal eras. The deep structure of this book is Hegelian: The classical business corporation is born out of the ashes of its failed predecessor, the mercantilist corporation; it grows ever more powerful and successful during the nineteenth century, reaching its apogee in the Gilded Age; but even in the midst of its success it begins to fracture as a result of internal contradictions. It fails to cope adequately with the challenges of the late nineteenth and early twentieth centuries, principally labor combinations, monopolies, and problems of imperfect competition. It then enters a period of decline in which government intervention is increasingly seen as necessary to control its adverse effects; and ultimately it expires in the flames of the New Deal, out of which is born a very different business enterprise, the post-classical business corporation.

This implicit dialectical model lends structure to the book, but it also risks imposing an order which is not necessarily present in the historical record. Professor Hovenkamp's evidence could show equally well that the classical corporation, and the theories of robust markets and freedom of contract that justified it, were lasting triumphs of economic development—triumphs which, while not without adverse consequences, nevertheless greatly benefited the American public.

Moreover, Professor Hovenkamp surely overstates the case when he proclaims the death of the classical corporation and of neoclassical economic theory. Certainly economic theory has changed, but a powerful strain in economic theory today retains the hallmarks of the classical and neoclassical traditions: confidence in the efficacy of market orderings and suspicion of government intrusion into private economic arrangements. Far from having expired in the New Deal, classical theory has in many respects undergone a resurgence over the past few decades.

Furthermore, while the classical corporation—in the sense of a business enterprise operating free of substantial governmental restraints on its activities—is indeed a thing of the past, the essence of American business enterprise remains competitive and market-driven. In a few areas—too few, regrettably—the government has even loosened regulatory constraints. Supporting these experiments in deregulation—the airline, trucking, and securities industries come to mind—is the modern economic theory that sees government interference with market forces as generally adverse to the welfare of the public and as often serving narrow, organized political interests.

This review is organized according to the three stages that Professor Hovenkamp identifies in the life cycle of the classical business corporation and classical and neoclassical economic theory: rise, decline, and fall. First, however, I comment briefly on Professor Hovencamp's historical methodology.

I. METHODOLOGY

If Professor Hovenkamp's historiography can be faulted, it is in the importance which he attributes to economic theory in the development of legal doctrine and public policy during the periods he discusses. Professor Hovenkamp distances himself not only from public choice theorists, but also from "Marxists, conservatives, and even many liberals" who believe that every economic question the law addresses is ultimately answered by interest group politics (pp 5-6). This view, in Professor Hovenkamp's opinion, is "misleading and limited" because "theory has always been an essential part of state policy" (p 6). As an example, Professor Hovenkamp cites the problem of natural monopolies, where simple reference to the political power of the affected interest groups could not explain their regulation. In such cases, "theory was the dog and politics but the tail"; the political considerations were dwarfed by "a simple consideration of accepted theory" (p 6).

Professor Hovenkamp sees the relative power of theory and politics to determine outcomes as a function of the degree to which a particular theory is accepted in the culture. Thus, because the theory of natural monopoly was well-accepted in classical ideology, natural monopolies were regulated even in an era generally committed to laissez-faire. Conversely, "[w]hen economic theory in an area is poorly formulated and no clear consensus has emerged within the community of experts, politics naturally dominates regulatory decision making, for political interests are always present" (p 107).

With due respect to Professor Hovenkamp, I believe he displays an excessive confidence in the efficacy of theory at generating political outcomes. Over the past years, economists and political scientists of the public choice school have argued persuasively that government policy toward business is principally driven by the influence of organized interest groups that reward or punish politicians depending on whether they serve the group's interests or not. Ideology, while not completely unimportant, plays a minor role in the equation.

II. The Rise of the Classical Corporation

At the core of Professor Hovenkamp's account is the contrast between classical economic theory and its predecessor, the mercantilist ideology of the late eighteenth century. Mercantilism, the dominant ideology at the time of the framing of the Constitution, had little faith in the market as a means to stimulate economic growth" (p 11). Instead, mercantilism was based on belief in the efficacy of state regulation: domestic industries should be subsidized, imports restricted, and private entrepreneurial activity channeled and guided by explicit state policy. In short, mercantilism was a form of industrial policy for the eighteenth century.

Consistent with these principles of state intervention in markets, the mercantilist corporation was chartered by special state permission, and enjoyed substantial subsidies, principally in the form of protection against competition. The quid pro quo for the subsidy was that the corporation was to serve a defined state purpose—often the establishment and operation of turnpikes, bridges, banks, and other essential institutions for economic development (p 12). To ensure it did not abuse the corporate privilege, the mercantilist corporation enjoyed very limited powers. Generally, it could exercise only such powers as were explicitly set forth in its charter or that necessarily flowed from its explicit powers (p 59).

As described by Professor Hovenkamp, mercantilism broke down and was gradually replaced by classical economic theory during and after the Jacksonian revolution of the 1830s (p 13). The Jacksonians objected to mercantilism on the ground that it subsidized a few at the expense of many, and that it impaired economic development by intruding the powers of the state into private market orderings (pp 36-41).

Jackson's attack on the Second Bank of the United States should be understood in this light (p 37). Seen in Jacksonian terms, the Bank epitomized the mercantilist corporation: it enjoyed special chartering privileges from the federal government, and its operations arguably impeded entrepreneurial economic development by deterring the creation of new, state-chartered institutions that could compete in a free marketplace for the provision of banking services. In substantial respects, this perception of the Bank may have been misguided, ignoring as it did the Bank's important regulatory and central banking functions. But the basic Jacksonian objection to the Bank should be understood as part of a broader reaction against special corporate privileges.

The most important manifestation of the Jacksonian revolution was the liberalization of incorporation laws at the state level, which eventually resulted in free corporate chartering (pp 37-38, 64). The business corporation lost its status as an engine of state industrial policy, and instead became a private enterprise for the pursuit of profit. Following Adam Smith's adage about the invisible hand, the business corporation would serve the public best by serving the private interests of its owners. Because the corporation served a private purpose, it enjoyed no special privileges or monopoly status from the state: a corporate charter accorded no special rights to be free of competition from others. And because free corporate chartering involved no subsidies, the corporation did not have to be constrained within narrow activity limits. A corporation could engage in any business, provided that its charter spelled out permission (pp 59-64).

Professor Hovenkamp ties these developments to broader movements in the jurisprudential climate of the nineteenth century. He contrasts the two nineteenth century doctrines used to protect economic liberties—the Contracts Clause and the doctrine of substantive due process—in terms of the basic distinction between mercantilist and classical economic theory. The Contracts Clause of the earlier era served mercantilist goals by enforcing the basic contract between the state and the entrepreneur: it bonded the state to its promise to accord special rights or privileges to the entrepreneur, including generous implications of monopoly privileges in corporate charters. The later doctrine of substantive due process, in contrast, served classical goals by according great respect to private contracts while simultaneously restricting the state's ability to interfere in markets and refusing to imply monopoly privileges in corporate charters (pp 17-35). The contrast is nicely drawn and persuasive.

Equally interesting is Professor Hovenkamp's insightful treatment of the development of federalism under classical economic theory. He illustrates how classical theory, in line with its suspicion about the effects of governmental intervention in markets, developed a concept of federalism that contained a built-in bias against regulation. It strictly limited the regulatory powers of both the state and federal governments, and left many pockets of economic activity essentially unregulated by any legislative entity (pp 79-80). In contrast, as Professor Hovenkamp cogently observes, "the much broader interpretations of the commerce clause and of state extra-territorial power that emerged in the twentieth century have turned the federal system into one that chronically overregulates, because so many markets are subject to simultaneous federal and state control" (p 80).

To the extent that interstate commercial regulation existed at all during the classical period, it often took the form of "general" common law under the doctrine of *Swift v Tyson*.[2] Federal courts formulated this general common law for situations likely to involve interests spanning broad geographic areas. Here, again, Professor Hovenkamp's analysis supplies a much-needed corrective to popular misconceptions. Today, *Swift* is often seen as a mistaken and essentially regressive doctrine that unduly intruded the power of federal courts into matters best left to states for the rule of decision. *Erie Railroad Co. v Tompkins*,[3] the case that repudiated *Swift* and established that federal courts sitting in diversity of citizenship cases must apply state law, is often portrayed as administering a much-needed *quietus* to this outlandish regime. In its historical context, however, *Swift v Tyson* served important and beneficial purposes of achieving a modicum of reliability, impartiality, and consistency in the law of commercial transactions involving interstate interests. Thus, as Professor Hovenkamp demonstrates, it facilitated the economic integration of the nation into a single national market (pp 83-89).

Professor Hovenkamp's insights are equally interesting for the period following the Civil War. He offers an intriguing view of the Fourteenth Amendment as essentially a charter of economic freedom, including economic freedom for African Americans. Although the Fourteenth Amendment is a civil rights amendment, the concept of civil rights itself, in historical context, included "a set of distinctly *economic* civil rights, namely, the right to make contracts and the right to own property" (p 94, emphasis in original). The Fourteenth Amendment, as Professor Hovenkamp observes, "was economic by design" (p 94). Extending the trajectory of these observations, in historical context, the Supreme Court's later efforts to develop a doctrine of substantive due process to protect economic liberties against state incursion appeared not to re-

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[2] 41 US (16 Pet) 1 (1842).

[3] 304 US 64 (1938).

present any fundamental distortion of the original purposes of the Fourteenth Amendment, but rather a fulfillment of an important element of the original design (pp 94-96).

By the last quarter of the nineteenth century, the battle between the mercantilist and the classical models of the corporation ended, with the classical model emerging triumphant. In addressing the doctrines developed during this period, Professor Hovenkamp debunks the Progressive critique of the jurisprudence of the times as favoring "big business" over the needs of individuals. Thus, the Supreme Court's determination in *Santa Clara*[4] that a corporation was a "person" entitled to many of the protections that the Fourteenth Amendment accords to natural persons was not, contrary to popular beliefs, a reactionary protection of powerful vested business interests. Rather, the Court, in Professor Hovenkamp's view, vested corporations with constitutional protections under the Fourteenth Amendment as a means for granting corporate shareholders the same protections of free contract and substantive due process that were already available to owners of unincorporated businesses and sole proprietorships. This prevented the Fourteenth Amendment from effectively discriminating against corporations and in favor of other, potentially less efficient, forms of business organization (pp 45-47).

III. The Decline of the Classical Corporation

The triumph of the classical corporation and classical economic theory, in Professor Hovenkamp's view, could not last. If the first half of Professor Hovenkamp's book is an account of the development and eventual victory of classical economic theory and of the classical corporation that the theory inspired, the remainder deals with the difficulties which the classical corporation and classical economic theory encountered in the later nineteenth and early twentieth centuries.

Classical economic theory—like its libertarian successors today[5]—drew its inspiration from faith in the robustness and efficient functioning of private markets. But even as that theory reached its greatest acceptance in the Supreme Court and elsewhere, it came under challenge from a nascent Progressive ideology that viewed markets with much greater skepticism. The panic of

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[4] *Santa Clara County v Southern Pacific Railroad Co.*, 118 US 394 (1886).

[5] See, for example, Richard A. Epstein, *Takings: Private Property and the Power of Eminent Domain* (Harvard, 1985); Bernard H. Siegan, *Economic Liberties and the Constitution* (Chicago, 1980).

1893 and the economic dislocation that ensued eroded faith in markets: if unregulated markets could suffer this kind of catastrophe, then perhaps classical theory needed significant revision. Government regulation and control in fragile markets appeared much more appealing in light of the business failures, unemployment, and labor strife of the 1890s (p 106).

Against this backdrop of renewed suspicion of free markets, Professor Hovenkamp discusses classicism's approach to three major issues of industrial policy: the problems of market failure, labor unions, and monopolization. Addressing these issues, Professor Hovenkamp takes a number of original and provocative positions.

His treatment of the *Slaughter-House Cases*,[6] for example, challenges the prevailing orthodoxy, which views the government action at issue in the case (creating a slaughterhouse monopoly for the City of New Orleans during Reconstruction) as the product of venal and corrupt special interest politics (pp 116-17). Professor Hovenkamp, on the other hand, perhaps engaging in some rhetorical overkill, sees the New Orleans slaughterhouse monopoly as a "work of great genius" (p 117). He argues that the monopoly was a creative legislative response to the problem of excessive pollution of the Mississippi River by unregulated slaughterhouses: the legislature established a central slaughterhouse facility, which all butchers in the town were permitted to use, and regulated it as to price like a public utility (pp 118-21).

Equally interesting is Professor Hovenkamp's treatment of the development of state policy toward railroads as the classic example of industry regulation in the late nineteenth century (pp 131-48). Consistent with his general thesis that economic theory matters in the creation and implementation of state policy, Professor Hovenkamp criticizes both the public-interest and capture theories of railroad rate regulation (pp 132-37). Professor Hovenkamp claims that the failure of policymakers to understand the economics of the railroad industry resulted in inadequate or inappropriate regulation of the industry, yielding prices which were either monopolistic or inadequate to cover costs: the railroads "seemed destined to be either filthy rich or perpetually broke" (p 148). With the development of an adequate understanding of railroad economics, according to Professor Hovenkamp, the regulatory system

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[6] *Slaughter-House Cases*, 83 US (16 Wall) 36 (1873).

was gradually able to develop a more effective strategy of railroad rate regulation (p 164-68).[7]

Professor Hovenkamp faults classical economic theory for its treatment of labor combinations, criticizing as "one of the most embarrassing political failures of classical economics" (p 5) the notion that combinations of capital and labor should be treated the same way. This statement is somewhat mysterious, since Professor Hovenkamp does not offer much evidence about other embarrassing failures. Moreover, his analysis of classical political economy belies the claim that the treatment of labor combinations represents a dramatic failure of classical political economy. Professor Hovenkamp does not dispute the essential validity of the classical analysis, which viewed labor combinations as intended, like business combinations, to raise prices (here, wages) above market-clearing levels. Rather, his objection to the application of the antitrust laws to labor combinations is based on the much narrower ground that the antitrust laws could not apply equally to labor and capital. Labor, especially unskilled labor, is a market characterized by easy entry, making labor combinations in restraint of trade difficult to enforce without coercion because any increase of wages above market-clearing levels will attract new entry—scabs, in the case of strikes (p 227). Corporations, on the other hand, could avoid the reach of the antitrust laws in the late nineteenth century by merging, rather than by engaging in price-fixing cartels, a strategy not available to labor combinations (p 234).

But these claims do not establish classical policy toward labor combinations as a failure in any terms other than political. While it is true that barriers to entry made combinations of capital somewhat easier to enforce than labor combinations, Professor Hovenkamp's own evidence on the railroad industry demonstrates that even in capital-intensive industries cartels were difficult to enforce. Railroad cartels repeatedly broke down as a result of rebating and other price cutting measures by member firms (pp 146-47); conversely, barriers to entry in labor were not always as low as Professor Hovenkamp suggests: skilled labor could not easily be replaced by scabs. As Professor Hovenkamp himself acknowledges, labor actually enjoyed a favorable bargaining position vis-a-vis

[7] Professor Hovenkamp points to the nice irony that railroads, although they may have earned monopoly profits, on the whole may have reduced the extent of monopolistic practices in the United States because they broke down many other local monopolies by opening up broader geographic markets (p 141).

capital during much of the nineteenth century due to the relative scarcity of workers in the rapidly developing country (pp 213-14).

Further, the fact that corporations could avoid the reach of the antitrust laws by merging is not a fatal objection to the application of classical theory to labor combinations. Rather, it is an objection to the limited reach of the Sherman Act, which failed to deal adequately with the issue of monopoly. The problem was with the antitrust laws, not with the application of classical (or, by the late nineteenth century, neoclassical) economic theory, which was aware of the dangers to competition when a single firm controls production.

IV. The Fall

Professor Hovenkamp closes with a picture of the classical business corporation and classical economic theory in its death throes (p 349). He associates these events with parallel intellectual developments in economics and law: the publication of Joan Robinson's *Economics of Imperfect Competition*, Edward Chamberlin's *Theory of Monopolistic Competition* and of Adolphe Berle, Jr., and Gardiner Means's *The Modern Corporation and Private Property* (p 349). The former studies represent, according to Professor Hovenkamp, the culmination of a "great upheaval" in competition theory (p 356). The artificial premises of perfect competition or pure monopoly were replaced by a general economic theory of competition in imperfect markets, in which scale economies, barriers to entry, and product differentiation made perfect competition impossible even in markets characterized by multiple producers. The Great Depression, which appeared to refute in practice many of the premises of classical and neoclassical economic theory, administered the *coup de grace*: "[t]he time seemed ready for a much more regulatory theory of political economy and of state policy toward business" (p 356).

Similarly, the Berle-Means focus on the separation of ownership and control in the large business corporation destroyed the premises of classical enterprise law, by demonstrating that firms cannot be trusted to act in the best interest of their shareholders, or in the public interest.[8] Thus, according to Berle and Means, the corporation should be organized to serve the interests of the public at large[9]—a view entirely antithetical to the classical theory of the

[8] *The Modern Corporation and Private Property* 119-25 (MacMillan, 1933).

[9] Id at vii-viii, 352-57.

corporation, which viewed it as existing for the sole purpose of serving the interest of its owners (pp 357-58).

Professor Hovenkamp leaves his readers with an image of the classical corporation and of classical economic theory in shambles. By the end of the New Deal, he says, "little was left of the classical corporation" (p 362). Regulated today by the federal securities acts, the labor laws, and the antitrust laws (Professor Hovenkamp could have added the workplace safety laws, the civil rights laws, the environmental laws, and a host of other regulations), the post-classical corporation is dramatically different from its classical and neoclassical predecessors. The invisible hand of the market, says Professor Hovenkamp, "had been struck aside by the very visible hand of the state" (p 362).

While this picture of the classical business corporation *in extremis* has an appealing rhetorical ring and effects closure of a satisfying narrative, it is surely grossly overstated. Just as classical economic theory did not die, but merely evolved into a more sophisticated form in neoclassical theory, neoclassical theory itself did not expire with the New Deal. Indeed, after a few decades of decline it has re-emerged over the past decades in the work of economists such as George Stigler, Milton Friedman, Gary Becker, Sam Peltzman, and Ronald Coase. Like their classical and neoclassical predecessors, these economists are united in appreciating the efficacy of markets at achieving beneficial private orderings, and in viewing government attempts to regulate markets skeptically in the absence of significant externalities.

We have not seen a revival of the classical business corporation, but noteworthy efforts have been made to deregulate some industries efforts which draw heavily on the teachings of these newer economists in the classical mold. Moreover, Professor Hovenkamp overstates the contrast between the classical corporation and the post-New Deal business enterprise. Although heavily regulated in some respects, corporations today still pursue private purposes and still respond to the free play of competitive forces. The American public is the beneficiary.

This observation aside, the Hovenkamp book stands as a superlative achievement by an outstanding scholar. It is destined to be a classic, and should be consulted in the future by anyone seriously interested in the history of American business enterprise.