CHAPTER I

THE CONCEPT OF CORPORATION

The concept of corporation is not one, but many in one. Though in general a corporation implies an association of shareholders or stockholders, it is described from different angles by different writers. This has given rise to a number of approaches to the concept of corporation. For instance, there are two broad approaches to the concept of corporation. One approach is to define a corporation in terms of those features of corporation which distinguish it from other forms of business organisation. The second approach is to explain corporation in relation to the functions it undertakes in the modern business world.

Besides these two approaches to the concept of corporation, there are two theories of corporation. These two theories, namely, "Contract theory" and "Sovereignty theory" throw ample light on the concept of corporation.

Also there is another way of explaining corporation— corporation as a human effort and corporation as a socio-economic institution. This approach may be termed as the "Socio-economist's approach".

It can be said that the above mentioned approaches can be safely categorised into three broad schools of thought on the concept of corporation. It would be quite interesting to discuss them one by one in the pages to follow.

As it is already mentioned, that the first school of thought has two approaches. The first approach was adopted first by John Marshall, Chief Justice of the U.S.Supreme Court from 1801 to 1835, who defined a corporation as,"an artificial being, intangible, and existing in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence.------- Among the most important are immortality, and -------individuality; properties by which a perpetual succession of many persons are considered as the same, and may act as a single individual".(1)

This definition of corporation refers to the special features which a corporation possesses as a legal entity. These features relate to legal status, immortality, individuality and such other properties on the basis of which a corporation is generally distinguished from other forms of business organisation.

Elaborating the features of a corporation, it can be said that a corporation is an artificial person. Since a corporation is a creation of law, the prevailing view is

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(1) "Corporate Finance",1949, by Milo Kimball, page 9.

that at least all the important forms of business organisation termed as corporations are legal entities distinct and quite separate from their participants, say, members or stockholders. It can be further said that a corporation is not only distinct from its stockholders but also from its officers and employees.

A corporation, as a separate legal entity, has certain legal rights and legal obligations. The rights generally include those of a corporate name, of holding and conveying title to property, of making contracts and making use of legal means of enforcing them, of sueing and of making rules and by-laws governing its own behaviour within the law. On the other hand, a corporation may be sued and most necessarily comply with the legal requirements--including special taxation in many countries---applying solely to the corporation. It can, therefore, be said that the life of the corporation is quite distinct from the life of its shareholders, officers or employees.

The shares of ownership in the corporation are generally transferable without restriction; and these shares accord the shareholders the privilege of limited liability for the financial obligations of the corporation. In view of the rights and privileges accorded, the corporation and the shareholders who invest in the corporation, together with the legally separate identities of the corporation and its shareholders, two noteworthy developments have taken

place. First, the corporate form of business organisation has been widely adopted by the modern business enterprises; and second, special taxes have been devised for corporations and their shareholders.

From the above-mentioned implications of John Marshall's definition of corporation, it becomes obvious that there are certain features peculiar to the corporate form of business organisation. Firstly, corporation is a legal or artificial person. This type of status gives a corporation an actual existence with rights and duties of its own. A corporation has a name apart from that of its members and may further simplify its identity by use of a seal. Like most of the individual persons, a corporation has a residence.

Secondly, the concept of a corporate entity connotes permanency of life. Since it has an existence quite distinct from its members, it enjoys succession within the limits set by its charter and the laws of the State which created it. In practice, charters of most of the corporations provide for a permanent existence for a corporation. But, some provide for a limited period of years for their existence. Whereas, some corporations have existence for a period limited by statute. Therefore, the dissolution of the corporate entity can be effected only by cancellation or expiration of the charter, by voluntary or judicial decisions. Otherwise, a corporation will persist as a legal

entity, irrespective of whether any or all of its stockholders stay or change.

Thirdly, it is a noteworthy feature that in a business corporation, for its entrepreneurial activities, it can collect capital funds by securing subscriptions to its capital. All those who subscribe to the capital fund are generally called stockholders or shareholders. These shareholders are given certificates which represent their rights and privileges. Such certificates are transferable. The liability of the shareholders is limited to the amounts of their subscription to the share capital of a corporation. Thus, the shareholders are not responsible for the actions of a corporation nor for its debts. Since a corporation has a separate existence, no shareholder would lose more than what he has subscribed to the capital fund. This is the most important characteristic of a corporation that has enabled this form of business organisation to collect or attract large funds.

The second approach under the first school of thought is to deseribe a corporation in terms of its functions. The proponents of this approach have gone to the extent of stating that the legal relationship established by a corporation,"is incidental to the main reasons for the prevalence of the corporate form of conducting business operations".(2)

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(2) "Corporation Finance",1947, by H.E.Hoagland, page 62.

According to them, it is because of the specific economic functions performed by a corporation that it is given a distinct legal status.

According to this approach, a corporation should be described in terms of its economic functions such as financing, producing etc. A corporation, in this sense, can be termed as a financial institution and/or a producer. As regards the economic functions performed by a corporation, reference may be made to the principal activities of industrial or manufacturing corporations, banks, trust companies, insurance companies, loan associations incorporated under the companies Acts, and public utility companies. Modern economic production is carried on in units on such large scales that it would be impossible to finance them from personal or family resources. So, corporations are regarded as the best means of collecting the subscribed capital from a large number of shareholders. The degree of risk of assets has also been reduced to the extent of the subscribed share capital by the principle of limited liability.

After having discussed the two approaches of the first school of thought, a question may be raised whether or not these two approaches are really two separate approaches or whether both are interdependent or complementary. One approach emphasises the legal aspect and the second one emphasises the economic aspect of a corporation. These two aspects are interrelated. Therefore, it may be argued that the two

approaches are the two possible ways of treating the problems of a corporation. Only when both these approaches are happily combined that a theoretically and practically acceptable concept of corporation can be arrived at.

However in actual practice, it quite often happens that the economic aspect of a corporation gets more importance than the legal aspect. Eventhough, legally a sharp distinction can be drawn between a corporation, its shareholders and its bondholders, in practice the economic considerations have led to a substantial modification in this distinction between a corporation, its shareholders and its bondholders. Of course, the legal status and legal rights of shareholders and bondholders can be sharply differentiated. But, for economic purposes, these two groups of persons and also the funds that they supply are much the same. In practice, neither has any significant control over management in the large corporations and each supplies its funds in the expectations of a given rate of return——a fixed rate of interest in the case of bonds and a dividend return in the case of stock or shares, usually distinct from the actual rate of earnings of a corporation in either case. On the other hand, in small corporations, the practical operation and the actual process of decision making are much like that of a partnership or a sole proprietorship; and the legal distinction assumes importance only in decisions outside the direct functions

of the business enterprise, namely, in decisions concerned with financial liability. The fact that the economic characteristics of a corporation merge with those of other business firms for most purposes is a consideration that is of great importance in assessing the consequences of taxation or other Government policy directed specifically towards corporations.

Coming to the second school of thought, there are two theories to explain the concept of corporation. The "contract theory" of corporation states that the simplest view of corporation is to regard it as a contractual arrangement between certain persons for the pursuit of common ends. As a matter of convenience, the State may insist that such contracts be filed and open to inspection at a designated place. Also, the State may refuse to recognise certain contracts if they are not in harmony with public interest. Therefore, the State does not "create" a corporation in any sense. In fact, it merely recognises it or alternatively refuses to recognise it. In this sense, the notion of corporate personality is merely a convenient shorthand expression. When one refers to corporation as a person, one merely designates certain characteristic features of the association in a brief word.

Against the "contract theory" of corporation, the "sovereignty theory" states that it is wrong to believe that

a corporation is a mere piece of contract paper recognised by the State. According to this theory, a corporation is something more than a mere piece of contract paper. As a separate person, distinguished from its shareholders, it enjoys certain special privileges and benefits conferred by the State, as a sovereign power. Therefore, F.W.Maitland states that,"a corporation is a right-and-duty bearing unit."(3)

The above discussion shows that these two theories come in conflict in regard to the legal status of a corporation. So, both the theories are one sided in the sense that they take into account only the legal aspect of corporation, ignoring altogether the economic aspect of a corporation. Of course, in actual practice, the "sovereignty theory" enjoys greater support, both from the point of view of taxation and the functions of the State.

The third school of thought, which represents a socio-economist's point of view, explains corporation in terms of human effort, its relation to the society and

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(3) F.W.Maitland's lecture on "Moral Personality and Legal personality", in selected Essays, Cambridge, Eng.,1936, page 13.

its economic activities. This line of thinking has been developed by Peter.F.Drucker who states that a corporation is a social institution organising human efforts to a common end. Thus, he emphasises the essence and the purpose of corporation not mainly in its economic performance or in its formal rules, but in the human relationships both between the members of a corporation and between a corporation and the people outside of it.

Mr.Drucker believes that corporation is an instrument for the organisation of human efforts to a common end. This common end is not the same as the sum total of the individual ends of human beings organised in a corporation. It is a common but not joint end. "Though in legal and political practice, the old crude fiction still lingers on which regards the corporation as nothing but the sum of the property rights of the individual shareholders..... the essence of the corporation is social, that is human organisation".(4) Thus, according to the third school of thought, a corporation is above all a social institution, that is, a human organisation and not just a complex of inanimate machines; that is based on a concept of order

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(4) Concept of corporation, 1946, P.F.Drucker, pages 20-21.

rather than on gadgets, and that all persons, as consumers, as workers, as savers and as citizens have an equal stake in its prosperity.

This approach does not define a corporation in terms of its features or functions. It defines a corporation in terms of its social purpose and human relations in the modern industrial society. In a sense, this seems to be a narrow concept of corporation, since it mostly includes only those corporations which plan "production for use and not for profit".

So far, three schools of thought on the concept of corporation have been discussed. These approaches point out that there are different ways of defining or describing a corporation. None of them is perfectly satisfactory. Therefore, in actual practice, the concept of corporation has undergone a number of operations to suit the needs of the country concerned. For instance, originally the U.K. treated corporation or a company as an association of shareholders on whose behalf the company had to pay the tax. At present; the U.K. follows a modified concept of corporation according to which only a part of the taxes on a company is credited to the shareholders. The profit tax is not refundable. The original or traditional British principle is still applied in countries like Ghana, Nigeria and Malaya which were in the past British colonies.

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But, in recent years, it has been widely accepted that a company has an independent capacity to bear taxes. Accordingly, the tax systems of the U.S.A.,Australia and some other Western countries have been chalked out. In the U.S.A., in recent years some writers such as W.B.Taylor (in Financial Policies of Business Enterprise,1956,page 14) and others have tried to draw a line of distinction between a corporation and a joint stock company. They argue that historically and legally, a joint stock company lies midway between a partnership and a coporation. It has been loosely defined as a partnership with transferable shares, and as a corporation with unlimited liability. This type of distinction is far fetched. It may fit in, in the business world of America where special tax laws and combinations laws exist to facilitate such a distinction. But, in most of the other countries including India, this type of distinction between a joint stock company and a corporation as tax paying entities is not feasible.

Not that a country's tax system is influenced by one factor alone, namely, the concept of corporation. It is also influenced by a number of economic, legal and political factors. But, the examples of the old and the present tax systems of some of the Western countries mentioned above indicate that a country's corporate tax system is certainly influenced by the approach on the

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concept of corporation.

This also shows that the theoretical interpretation of the concept of corporation is one thing; and the modified concept of coporation to suit the economic conditions and revenue needs of a country is another thing. To understand this point, it would be quite interesting to know the evolution of the definition of a company in India.

In India, upto 1959, for tax purposes, the British version of corporation was in vague and accordingly tax credit was allowed to the shareholders. After 1959, under the new system of company taxation (which is discussed in chapter VI), no tax credit is granted to the shareholders, since a company is regarded as an entity separate from its shareholders. Hence, the system of "grossing up" the dividend is abolished. In other words, the "dividend-received-credit" approach to corporate taxation in India is done away with after 1959. In the same way, the meaning given to a "company" in the Income Tax Act for the purposes of taxation has undergone rapid changes in the past two decades. In the process of evolution of corporate taxation to suit the everchanging economic and political conditions of the country, the definition of company in the Income Tax Act had to be revised from time to time so as to fit in the general policy of the State in regard to taxation and the national economy at large.

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Summing up the discussion on the concept of corporation, it may be pointed out that though there are different approaches to the concept of corporation, they do not create any conflict. Because, the first school of thought emphasises the legal and the economic aspects of a corporation. The second school of thought explains corporation more or less from the point of view of the position or status of a corporation vis-a-vis the State. The last approach is a socio-economist's approach emphasising the human element in the purpose and organisation of a corporation.

But, in practice, a number of legal, economic and political factors influence the concept of corporation. This becomes obvious from the examples of the countries mentioned above. Therefore, it is quite just to say that there is not one single concept of corporation. Only when different approaches are put together, one can fully explain the whole concept of corporation.