“Public Corporation as Private Constitution”

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Covegno
“Le Societa per Azioni Nel Mercato Globale: Evoluzione dei Modelli”
Fondazione “CESIFIN - Alberto Predieri”
Rivista Diritto Societario
Florence, Italy

March 17, 2008

Abstract: The large publicly-traded corporation in the United States derives its essential structure and metaphoric language from the republican form of government laid out in the US Constitution. Public shareholders elect a decision-making body that formulates and supervises an executive bureaucracy, subject to review by a judiciary (typically, in Delaware) that balances shareholder interests and management prerogatives. The analogy to the republican government structure found in the federal Constitution and replicated in all 50 states is unavoidable. Both “specialized hierarchies” create a principal-agent model of separated powers that contains similar sets of voting rights, nearly identical standards of judicial review, and generally parallel recognition of exit opportunities. Thus, an understanding of US corporate governance inevitably compels an understanding and appreciation of the structures of US political governance. Metaphorically, the public corporation is private constitution.

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“It may be that universal history is the history of a handful of metaphors.”

Jorge Luis Borges
"The Fearful Sphere of Pascal" in Labyrinths (1962)

Human society depends on human institutions. In fact, human institutions are at the root of civilization. Our institutional instincts may be genetic, deeply rooted as we are in human hierarchies. Even casual observation of primate societies reveals our attachment to specialized structures. No doubt some of our hierarchies are also learned. Human organizations vary from society to society, and within society.

My inquiry is simple to state: how and why is our US Constitution (political governance) similar to our large business organizations (corporate governance)? At a superficial level, the analogies have long been recognized. In the eighteenth century Blackstone
observed in his *Commentaries on the Law of England* that the corporation is a “little republic.” He described -- as generations of corporate commentators have since – the their formation, powers and privileges, the composition and decision-making prerogatives of their governing board, their answerability to interested persons, and ultimately their dissolution.

At a rhetorical level, corporate governance borrows freely from political governance – and, to some extent, vice versa. Consider a handful of linguistic counterparts from constitutional and corporate court decisions: (1) “One person, one vote” becomes “one share, one vote.” (2) “Government serves the will of the people” finds its analogy in “the Board cannot impose its will on the stockholders.” (3) The “rational basis test” (judicial deference to legislative policy)” is mirrored in the “business judgment rule” (judicial deference to board decisions). (4) The dictum that political “voting is clearly a fundamental right” is echoed in the dictum that the “stockholder’s vote is a fundamental right of owning stock.” And (5) “the people are masters and all officials of the state are servants of the people” takes wing with “Directors are agents of shareholders, not their Platonic masters.”

Beyond rhetoric, the texts and structures of our Constitution and corporate statutes bear remarkable similarities – powerfully suggesting a common source. The US Constitution begins with a preamble declaring prerogatives of the people and the formation of a new nation, followed by specification of the powers of the legislature, the responsibilities of the executive, and the jurisdiction of the judiciary, and concluding with provisions specifying rights of citizenship, expansion into new territories, and the process of amendment. Of course, personal liberties are guaranteed in the first set of amendments – the Bill of Rights.

The typical US corporate statute follows a similar schematic. It first describes the process for formation of the corporation, followed by a statement of corporate powers, the powers and operation of the board of directors, the titles and duties of officers, the various rights and prerogatives of shareholders (particularly voting rights), and concluding with the processes for corporate expansion through merger, for corporate change through amendment of the articles, and for corporate death through dissolution. Implicit (and sometimes explicit) is judicial oversight of the corporate structure.

Noticing these similarities Albert Hirschman – more than 35 years ago – pointed out that organizational answerability and thus legitimacy is achieved through a confluence of voice, exit and loyalty – in many human organizational spheres, including the corporate and the political. But my inquiry, I believe, involves more than reciting and specifying Hirschman’s insight. For example, partnerships and families can be usefully compared – offering an interesting and fruitful line of inquiry. Or imperial CEOs could well be compared to imperial political rulers. My thesis is that our notions of republican government (and its democratic ideals and practices) inform our notions of corporate governance. And thus to understand the modern public corporation – and to set its agenda -- compels us to understand and dissect its republican impetus.
As we consider the calls for governance reform of public corporations, the dramatic and recent arrival of institutional investors in their governance, the internationalization of corporate ownership and thus governance, it is useful to bear in mind the Japanese proverb, “Vision without action is a daydream; action without vision is a nightmare.” To contemplate the public corporation merely as an economic phenomenon or as a set of historical financial adventures fails to see its essentially borrowed and political character, to see its animating metaphors. And just as republican government shows its inherent limitations – the Arrow Theorem perhaps only grazing the surface – we cannot afford not to regard the political constitutional underpinnings, both rhetorical and theoretical, of the modern corporation.

That we have borrowed from the political sphere to structure the private/economic sphere is not new. The constitutional/corporate borrowing is a relative newcomer to a long history of human reference and reliance on one organizational mode to inform another. We operate on analogies, on metaphors. Consider how the business partnership draws its egalitarian principles from the family structure – and how family precepts and vocabulary in turn dominate that of the partnership. Consider how the patriarchal business model draws from its imperial counterpart – for example, the Roman economic unit is cast from the same mold as the Roman political empire.

The US Constitution precedes the modern public corporation, and thus the structuring vocabulary and doctrinal formulas flow from the political to the economic. Nonetheless, each offers us a wealth of lessons about how we have constituted (and should constitute) the other. And each presents a host of open questions for which answers, theoretical and practical, can be found in the literature and scholarship of each. That this dialogue across disciplines has not been formalized is perhaps evidence of how deep the distrust government has had of the corporation, and the corporation of government. Or how little constitutional (political scientists) and corporate law scholars (economists) mix.

I begin my inquiry by sketching the emergence of the corporation as the dominant social institution in modern society. I then draw the obvious parallels between the US constitutional structure (focusing on the federal level, which is replicated in every state) and the US public corporation (looking at the Delaware phenomenon, which is largely duplicated in all other states). I then turn to consider the essential protective prerogatives of citizens and shareholders – voice, loyalty, and exit – the techniques identified by Hirschman to oversee and discipline wayward governance.

If nothing else, this exercise suggests that an understanding of the US public corporation depends on an understanding of the US constitutional structure – our corporate metaphor. And any argument that the modern corporation has a manifest global destiny fails to confront and acknowledge the variety of constitutional notions that still inhabit the globe. That is, metaphorical variations may well supply different visions for the corporation.
1. The emergence of the public corporation

Significant to my thesis is the modern movement, well underway, from a US society dominated by political institutions and public norms (republican government) to one dominated by private institutions and private norms (public corporations). The transformation in the United States has received much attention – both from an adoring right and from an appalled left.

Consider the most obvious measure of any society’s most important institution: its tallest structures. The pyramids of Ancient Egypt; the Parthenon of Ancient Greece; the Towers of Babel; the Temple in Jerusalem; the Gothic churches and looming castles of medieval Europe; the Mayan temples; the majestic legislative houses of the Nineteenth Century; and the Twin Towers. The exceptions – like the Capitol in Washington, DC or the Duomo in Florence – prove the rule.

Or consider for a moment the power of the modern corporation in our private lives. The essential elements of human existence (food, shelter, movement, belonging, sex) are lately functions assumed or, at least, fomented by the corporation. What (no longer “who”) supplies our livelihood? our food? our agriculture? our transportation? our acquaintances? our energy? our communication? our health care? Nearly compartmentalized in a public sphere – at least in the United States -- are our collective defense, our education, our water supply.

In fact, when one looks at the most important public concerns in the United States as revealed in contemporary public surveys (the following from recent Gallup polls), the problems and thus the solutions rest nearly as much with public government as with the public corporation.

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Curiously, some of the problems (such as the Iraq war, the immigration dilemma, and global warming) are popularly perceived as more the brainchild of the corporation than of government. And political depravity and corporate perfidy vie for top public vilification. Whether the perceptions have substance, the collective perception becomes reality. Whether assumed or imposed, the public corporation’s economic, social and political roles are not about to go away.
So my inquiry becomes as much a window into two overlapping legal regimes as one into US society and our allocation of power. It is at once a study of the history and jurisprudence of the US Constitution, and a study of the history and jurisprudence of the public corporation. It is a story of political powers and individual rights, of corporate powers and shareholder rights. Ultimately, it sketches our shared conception of what a “specialized hierarchy” should look like.

Curiously, it was this inquiry that animated the ground-breaking study of the modern US corporation by Adolf Berle, a Wall Street lawyer and law professor whose data was collected by an economist colleague Gardiner Means. Berle and Means decried that the modern US corporation had assumed so much power in American life, without adequate systems of answerability. They identified the separation of ownership and control essentially as a political one, borrowing from the logic and rhetoric of political discourse. That Berle and Means are now identified with identifying an economic problem – the agency costs in the public corporation -- is a testament of how effectively the government/corporate parallelism is (or has been) hidden from view.
2. The parallels – two specialized hierarchies

The principals in the US Constitution are “the people,” and in the US corporation “the shareholders.” Both are described as masters and owners of their collective hierarchical enterprise. Both are described as the principal beneficiaries of their enterprise – all men to enjoy inalienable rights of life, liberty and the pursuit of happiness, and the common equity shareholders to have their wealth maximized.

Of course, in both organizations, deep and ongoing questions exist about the contours of membership. Does membership extend to other constituencies, such as black men and women and immigrants, or creditors and employees and communities? The failure of the political constitution to adequately resolve these questions has resulted in a history of regular and continuing episodes of violence. The ability of the economic sphere to adequately define the corporation’s boundaries will test its legitimacy.

Both principals, though dispersed and suffering from collective action deficits, have the power to elect the organization’s law-making bodies. The citizens vote for congressional representatives to the Congress for fixed terms; the shareholders vote for the board of directors, also for fixed terms. The Congress (a decision-making body) has the power of making laws, sharing it in only limited circumstances with the executive and judiciary. The board (required to act as a body) has the power of directing all corporate business and affairs, sharing it in only limited circumstances with shareholders.

The delegation of power to the executive is the hallmark (and a controversial one) of the modern US government and the modern US corporation. In theory, the executive branch in each case operates only with respect to delegated power, except in the special carveouts. In practice, the executive branch operates with significant prerogatives, given its numerical superiority, the power to spend, the power to set the organizational agenda, the power over information. The label “imperial presidency” and “imperial CEO” are rhetorical devices used to bemoan the lack of oversight, on the one hand by the Congress and the other by the board of directors.

The executive – at least in the United States -- is chosen through different mechanisms under the Constitution and in the public corporation. The US President, sometimes called the “chief executive,” is chosen by citizens through a bizarre intermediated process (the Electoral College) meant to provide a buffer against popular willfulness. The cabinet and other senior executive officers then must be vetted by the legislature (specifically, the consent of the Senate). The corporate CEO, formerly called the “corporate president,” is selected (along with the other executive officers) by the board, despite calls for a direct shareholder vote on executive pay, if not more.

Removal of government/corporate officials also turns out to be difficult in both organizational structures. Under the US Constitution, to remove the president or any federal judge, the official must be charged by the House of Representatives, and tried and convicted by the Senate, subject to a super-majority vote. No US president has ever been formally removed from office; judges have fared nearly as well. The removal of directors
by shareholders follows a similar pattern – with charges, a chance to defend, and a vote whose expense is borne in most cases by the complaining shareholder. By comparison, the CEO can be removed by the board at will, though this has been a rare occurrence.

The judiciary, which oversees the exercise of organizational power for the protection of the principals, is constituted in similar ways. Federal judges serve for life; Delaware judges for renewable 12-year terms. Judicial appointment is supposed to be non-political: federal judges by practice and law are prevented from political activities; Delaware judges are appointed to maintain a political balance on the state’s bench, and must be scrupulously independent of corporate officials. In fact, Delaware courts (especially the Court of Chancery) can be seen as a system of alternative dispute resolution that is part of the overall organizational package offered to corporations that choose a Delaware incorporation.

Central to the judicial function under both regimes is respect for re-composition of the structure. Amendments to the corporate articles and bylaws receive special judicial attention and deference. Amendments to the US Constitution, as well as changed societal conceptions over time, constitute the bulk of the Supreme Court’s agenda. In addition, both regimes pay special attention to process, sometimes over substance. Harsh administrative rules are acceptable if procedurally sound; harsh corporate decisions are acceptable if vetted by informed, independent directors.

One curiosity of these two parallel “specialized hierarchies” has been how each contemplates the other. The constitutional structure has long viewed with a jaundiced (even fearful) eye the corporate structure. Corporations were originally permitted by legislative grant only for limited purposes, with limited capital, with limited duration. For the past century, corporations have been specifically forbidden to participate in political elections – though their money, like water flowing downstream, has found its way. Lobbying and commercial/investment speech by corporations is tolerated, but subject to sometimes heavy regulation.

And just as corporations are not to cross into government, government in the United States is forbidden from owning private corporations. In fact, to ensure broad ownership (and thus to guard against concentrated ownership) institutional shareholders such as mutual funds and insurance companies are prohibited from owning more than 5-10 percent of any corporation’s voting power. Likewise, US banks are prevented from the role assumed in other countries of holding voting corporate securities for their own account.
3. Protective devices in specialized hierarchies

   a. Voice

Hirschman identifies voice as an effective, and socially desirable, way of avoiding decline in an organization. Rather than exiting in disgust or loyally standing by in the face of organizational inattention, members express their views and thus foment change.

In the US Constitution, voice is enshrined as the fundamental right to vote. Voting in political elections receives special recognition in many ways. Regular voting is specified. The state cannot interfere with each citizen’s right to vote. Discrimination is prohibited on a variety of grounds – both the usual (race, gender, national origin) and the unusual (economic, place of residence, party affiliation). Thus, while taxes on virtually all other activities are permitted, poll taxes are not. Access to the ballot is limited, typically requiring party nomination or not insubstantial signatures.

In the public corporation, voting is also viewed as fundamental. Although voting is not inherent, shareholders subject its absence to a heavy discount. For voting shareholders, voting for directors (as well as on fundamental corporate transactions and shareholder resolutions) is treated as mandatory and non-waivable. Regular director elections are specified; judicial intervention, often on an expedited basis, applies in cases of voting irregularities. Discrimination (through such devices as high-voting and non-voting shares) is permitted, but viewed with disfavor. Access to the ballot, though theoretically open, is limited in practice by the proxy mechanism.

In the political sphere, votes cannot be sold – though money can be spent lavishly to educate, convince, and cajole the voters. Public funding of candidate campaigns is seen with favor, though disregarded in practice. In the corporate sphere, votes can be sold, but only under limited circumstances. The political rhetoric against vote-selling permeates (and once permeated even more) corporate doctrine on the subject. While shareholders have nearly unlimited freedom to slice and dice their economic rights, their attempts to treat voting rights as they do cash-flow rights have met stolid resistance.

Curiously, political voting did not originally contemplate that citizens would vote beyond electing Representatives, with the President and the Senate buffered from direct elections. At most, the Constitution contemplated the possibility of amendments through a vague convention process, which has never been exercised. Nonetheless, the tendency has been toward more direct voting. The Senate came to be elected directly in 1913, Western states added voter-initiated referenda to their constitutions, and primary voting became the norm after Watergate.

Similarly, voting in US public corporations traditionally has expected that shareholders would elect a board slate selected by the incumbent board or would vote on board-initiated mergers and article amendments. Rubber-stamping was the norm. Lately, with the emergence of institutional shareholders, voting in the corporation has taken new directions. The shareholder’s dormant power to initiate bylaw amendments has found
new life; the potency of shareholder-initiated resolutions has been proved; and shareholders have even sought to have access to the corporation-funded nomination process. At each step, shareholder activists – both self-styled and derided as a political movement -- have borrowed the forms and rhetoric of political activism. Whether shareholder activism “works” has led to debates that pit reformers against traditionalists.

The US Constitution contemplates that political voting will be supported by information rights – the First Amendment enshrining the freedom of speech (especially political speech), the freedom of the press (especially when covering political matters and persons), and the right to assemble (particularly for political purposes). Although electoral fraud is not regulated – candidates can say and promise what they please – it is often punished politically. Beyond these freedoms, which protect against government interference, citizens have access to internal government information under the Freedom of Information Act – a stated purpose for which was to facilitate informed voting.

In like manner, the public corporation since its christening in the New Deal also carries information rights that support corporate suffrage. In particular, federal securities laws require that shareholders receive specified information when they vote (proxy statements), regulated ballots (proxy cards), and updates on the corporation (annual reports). Proxy fraud is heavily regulated, both at the federal and state level. And for information that is not made available through the proxy process, state law has its own FOIA in the form of inspection rights – with voting specifically recognized as a “proper purpose” for shareholder information requests.

Voting follows wealth in both systems. Although money is not supposed to buy political elections, the recognized truth is that a federal campaign (whether to Congress or for the Presidency) requires the support of wealth. And the Supreme Court has enshrined the ability of candidates to spend as they choose. Likewise, attempts to limit corporate voting rights on a “per shareholder” basis have failed. Although some institutional shareholders face statutory (populist) caps on the voting power they may hold, many do not. For example, takeover firms and hedge funds exercise unrestricted corporate voting rights – sometimes through naked vote buying – and are celebrated and denounced.

In a departure (though with historic antecedents) from political voting, corporate voting contemplates that intermediaries will vote on behalf of the ultimate beneficial shareholders. Institutional shareholding, with its recent ascendance and with similarities to old-time voting along party lines, creates a new voting dynamic that the metaphorical tools borrowed from political voting are ill-suited given the new face of corporate governance. For example, it remains unclear whether institutional investors (whose portfolio turnover is legion) should have voting rights, at all. Possible reforms include broader voting transparency, requirements to survey beneficial owners, duties of care and loyalty akin to corporate managers. As to these issues, the regulatory apparatus that molds the corporation, particularly judicial review, will have to forge new metaphors.
b. Loyalty

Hirschman understands “loyalty” as the adherence of members to the organization. The more loyalty, the less often are voice and exit necessary as disciplining strategies. But loyalty, like trust, is earned. For purposes of thinking about the overlap between political and corporate governance, I regard loyalty as the rights that social members have to demand respect for their organizational position – that is, the judicially-enforceable norms that inhere in the organizational structure.

Under the US Constitution, the loyalty owed by the government is reflected in the Bill of Rights (and its extension to the states through the Fourteenth Amendment). These rights, particularly as measured against legislative prerogatives, have led to classifications that guide judicial review. Similarly, the officials of public corporations owe fiduciary duties – classified as loyalty and care -- to shareholders, with the shades of judicial review varying according to the extent of conflicts between shareholder and manager interests. Remarkably, the levels of review in each context – and their justifications – are nearly identical in wording and substance.

Legislative action is subject to minimal review (“rational basis”) when the legislature is not seen as intruding on personal liberties, such as in the area of commercial regulation; in these areas, the political process, with voting as its backstop, is seen as sufficiently protective. Legislative action that touches on categories that the political process is seen as defective – race, national origin, religion – are subject to intrusive review (“strict scrutiny”) because of the danger of majority tyranny. In between, legislative action that raises questions about majority overreaching, subject to some political pressure – such as gender -- is subject to balanced review (“intermediate scrutiny”).

Board decisions are subject to essentially the same three tiers of review, each varying according to the perceived level of conflict between managerial (whether the board or the majority shareholder) and non-managerial owner interests. Board decisions dealing with corporate operations are presumed to be consonant with general corporate interests and receive minimal review (“duty of care” and “business judgment rule”). Board decisions that involve clear financial conflicts between decision-makers and shareholder interests – director self-dealing transactions, squeeze-out mergers, and manipulation of shareholder voting – receive extensive and intrusive review (“duty of loyalty”). Board decisions that combine elements of business as usual and managerial self-interest are subject to a careful balancing (“proportionate review”).

In looking at these review standards, courts and academic observers sometimes characterize the approach as “abstention” – that is, when matters are either “too political” or “too business” for judicial competence. Similarly, notions of standing – complex topics both in Delaware and before the US Supreme Court – define the limits of judicial involvement. Whether a shareholder or citizen can claim rights, and thus a day in court, tends in both cases to turn on the directness of his pecuniary injury. Standing doctrine, which measures individual injury against collective harm, follows the money both under the US Constitution and in the corporation.
While political governance has long sought space for human rights, as reflected in venerable doctrines such as due process, free expression, right to privacy, even human integrity, corporate governance is only lately called upon to identify and act upon that space. Although (cynical) non-shareholder constituency statutes purport to abjure judicial interference when boards act on behalf of creditors, employees, suppliers, customers and communities, the “corporate social responsibility” movement has largely been one carried on outside of the judicial sphere. That is, the powerful political metaphors of respecting other’s humanity increasingly find expression in director surveys, corporate codes of conduct and as a marketing device – though not yet fully in the legal structure of the corporation.

While corporate organization has as one of its main attributes the externalization of risk (both through limited-liability rules against flow-through of corporate liability to participants and through “separate entity” rules against flow-back of participant liability to the corporation), the externalities of government action are less studied – as such. Corporate law has developed elaborate rules for internalizing risk in limited circumstances under the “piercing the corporate veil” doctrine. But, by and large, corporate externalization of risk is one of its great and catastrophic characteristics.

Political organization under the US Constitution recognizes the dangers of externalization in some contexts. The Contract Clause prevents the government from reneging on its debt obligations; the Third Amendment prohibits the forced quartering of soldiers; the Fifth Amendment requires payment of just compensation in cases of government property takings. Curiously, the morphing of the US Constitution into the vessel for a modern social state has meant that the government’s taxing and regulatory powers have assumed a broad scope. That is, externalities have come to be viewed as the price we citizens pay.
c. Exit

Hirschman sees exit as the option of last resort for disaffected social members. The rise of stock markets in the corporation and the disciplining effect that mass exit (selling, followed by hostile takeovers) has on corporate governance is now orthodoxy. The tension between voice and exit in this context has been much debated, with voice seeming to be currently more popular (and available) in the public corporation.

Public corporations are built on, and defined by, exit rights. The availability of liquidity through stock markets distinguishes the public corporation and the privately-held one. Exit rights (as share liquidity) are jealously guarded under corporate law. For example, shareholders in a public corporation can sell without restriction; although management has latitude to discourage hostile bids by adopting poison pills, it cannot formally squelch the shareholders’ right to sell.

In the process, the stock markets facilitate (and perhaps necessitate) the specialized structure of the public corporation. An iterative loop pushes corporation governance to adopt modalities to conform to stock market expectations, and market expectations are then molded by governance structures. Exit (and entry) becomes the clearest form of expression of shareholder interests; and governance mechanisms compel executives (through stock-based compensation) to become fluent in the market’s language.

The US Constitution recognizes exit, though more subtly. The brilliance of the US federal system, it is often said, resides in the ability for migration from state to state. Each state serves as a social laboratory, whose failings and successes are tested through the protected exit and entry rights of the country’s citizenry. In fact, the Privileges and Immunities Clause can be seen as essentially designed to ensure free and unimpaired exercise of the ability to exit one state and enter another.

Not surprisingly, the US Constitution does not formally recognize a right of exit. This proved costly. A bloody civil war was fought over the nature and extent of the exit rights of states from the Union. Nonetheless, exit rights have been assumed. While immigration is regulated (even cruelly), emigration is not. Moreover, loyalty oaths are no longer permitted, while flag burning is. In fact, violent exit from the constitutional structure, if it were to go awry, is specifically preserved in the Second Amendment and its right of militias (and perhaps citizens) to bear arms. The notion that the right to bear arms constitutes an exit right is deeply held by many.

Moreover, free trade – a matter left in the US Constitution to the political process – serves as a sort of exit right. If US laws and regulations become too burdensome, or if US government services become too inadequate, it is possible to take umbrage elsewhere. Exit to avoid heavy environmental regulation, labor standards, taxation, even substandard health care lately animate a central part of the political dialogue. That is, just as corporate exit communicates about the viability of corporate management, political exit communicates about the viability of government competence.
Conclusion

Perhaps this game of analogies is trite, revealing little insight. Maybe it is overdrawn, failing to recognize the inherent differences between political and economic activity. Or perhaps, when the details are flattened and the edges softened, it reveals an ineluctable common conceptual source for republican government and the public corporation. Their genetic makeup establishes their co-fraternity.

Thus, the language of private choice, contract and markets (still in vogue) may actually mislead us about the true nature of the corporation. For example, contemplations about what the corporation would be if contractual, drafted from scratch, fails to appreciate that there is no *tabla rasa*. The private corporation is an iteration, built on a set of metaphors, of the public constitution. In fact, when corporations have been drafted as contracts – whether 17th Century British deeds of settlement or 19th Century Sardinian banks – their specialized hierarchy has been that of republican constitution.

The constitutional form – with specialization built into its separation of powers, with group decision-making to foster wisdom, with voting to ensure its legitimacy, with judicial supervision as a necessary protection, and with exit always available – has enjoyed a powerful place in the American mind. And today, just as important as these republican notions and their metaphors are to our body politic, they are essential to understanding the public corporation and molding it to our collective will.