

LEGAL CHANGE IN AN INTEREST-GROUP PERSPECTIVE: THE  
DEMISE OF SPECIAL CORPORATE CHARTERS

by

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CHAPTER I  
INTRODUCTION

Reductions in direct and specific government involvement with the organization of individual business associations are not common. Yet, in both the United States and England, legislative bodies relinquished their strict control over the availability of the corporate form. American general incorporation laws and the English Companies Acts of the nineteenth century were the culmination of the evolution of a legal institution which originated as an exclusive privilege and ended as a privilege open to all. That a change in method of incorporation from special charters or special legislative acts to general incorporation through a simple procedure represents a major change in the structure of property rights. This dissertation presents a legal-economic history of the decline and fall of the special charter in both England and the United States. Thus, this historical study, which takes nothing as autonomous or the result of historical accident, explains the timing of the emergence of general incorporation laws -- the replacements of the system of special corporate charters.

The first section of this introductory chapter establishes the value of the corporate charter by comparing the legal and economic advantages of the corporate form with those of alternative forms of business organization. In the second section, the model of legal-institutional change utilized in this dissertation is developed, and apparent inconsistencies between legislative behavior suggested by

the model and the actual behavior of legislators with respect to their relinquishment of their direct control over incorporation procedure are pointed out. The purpose of this dissertation is to explore these apparent inconsistencies. Finally, the last section provides a summary of the organization of the dissertation.

#### A. Legal and Economic Advantages of the Corporate Contract

The earlier special acts of incorporation in both the U.S. and England were valuable because they granted either a monopoly privilege, such as an exclusive franchise, or the use of the police power of the state, such as the power of eminent domain, or both.<sup>1</sup> While these acts played an important role in the development of the corporate form, they are of minor importance in this section, which is concerned with establishing the value of the usual corporate privileges (i.e., those privileges which were made available at lower costs through general incorporation laws) and, thus, the value of the special-interest legislation that conferred corporate privileges. These privileges were also granted by special acts of incorporation, which did not confer any monopoly rights or special privileges other than the right to do business as a corporation.

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<sup>1</sup>See Joseph E. Davis, Essays in the Earlier History of American Corporations (Cambridge: Harvard University Press, 1917), Samuel Williston, "History of the Law of Business Corporations Before 1800," Harvard Law Review, II (1888): 105, and E. Merrick Dodd, American Business Corporation Until 1860: With Special Reference to Massachusetts (Cambridge: Harvard University Press, 1954) for descriptions of earlier American corporations, and A.B. DuBois, The English Business Company After the Bubble Act (New York: The Commonwealth Fund, 1938) for the British history. Also, see subsections III.A and IV.A.3, *infra*.

An acceptance of the concession theory of the corporation, which views corporations as coming into existence only as a result of a special concession or grant made by the government, should not be inferred from these opening statements. To the contrary, most of the historical evidence supports the inherence theory of the corporation, which perceives the corporation as the product of market forces and purely private contract.<sup>2</sup> The primary focus of this dissertation is incorporation associated with a simple, inexpensive procedure. The advantages of such incorporation, except for limited liability with respect to involuntary (tort) creditors, are available through private contractual arrangements which evidently involve higher transactions costs than the simple incorporation procedures. The fact that these corporate advantages often accompanied monopoly grants does not imply that the corporate form by itself necessarily represents a grant of special privileges from the government.

Many of the legal benefits of organizing as a corporation are related to the so called "entity" and "aggregate" theories. The corporation, which obtains an artificial personality granted by the state, is regarded by the law as an entity--a thing separate and apart from its owners, the shareholders. On the other hand, the law

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<sup>2</sup>See Shaw Livermore, Early American Land Companies: Their Influence on Corporate Development (New York: The Commonwealth Fund, 1939); Hugh Sowards and James Mofsky, "Factors Affecting the Development of Corporation Law," University of Miami Law Review, 23 (Winter/Spring, 1969), pp. 467-94; and Robert Hessen, In Defense of the Corporation (Stanford: Hoover Institution Press, 1979).

regards the partnership as an aggregate of persons; there is no separate entity.

The legal benefits of organizing as a corporation usually include the following: (1) the ability to acquire and dispose of property as a unit; (2) ability to sue and be sued by outsiders; (3) ability of the body to sue and be sued by its members; (4) perpetual succession; (5) free transferability of interests; (6) concentration of powers by management; and (7) the limitation of liability.<sup>3</sup> When compared with the major alternative forms of legal organization available in the mid-nineteenth century--partnership, business trust, or joint stock association--these legal privileges probably represented considerable net-cost savings when there was a large number of members in a business association.<sup>4</sup>

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<sup>3</sup>Edward H. Warren, Corporate Advantages Without Incorporation (New York: Baker, Voorhis & Co., 1929): 1728. This is a complete treatise on the extent to which courts do and should permit advantages commonly considered as corporate to be obtained without incorporation.

"In a survey covering over eight hundred pages, he has as his primary purpose the demonstration that if courts admit even a single exception to the rule forbidding them, in the absence of legislative authorization, to view an association as a legal unit or juristic person, they convict themselves of the threefold error of usurping legislative power, disregarding unduly the dogma of stare decisis, and throwing the law into needless confusion."

E. Merrick Dodd, "Dogma and Practice in the Law of Associations," Harvard Law Review, 42 (June, 1929): 977-1014, 977-78.

<sup>4</sup>The federal corporate income tax, which was not imposed until 1909, is not considered in this dissertation. It must be mentioned, however, that one of the main reasons for incorporation today is the ability of the corporation to accumulate business or investment

The inadequacy of partnership law,<sup>5</sup> when there was a large number of partners, was particularly noticeable with respect to the first five items. Items (1), (2), and (3) were troublesome because of the requirement that all partners must be parties to a legal action by or against the partnership. The legal requirement that the partnership was automatically dissolved upon the death or resignation of a partner (because there is no separate entity which survives) is illustrative of the inadequacy of the law of partnership with respect to the perpetual succession of the association. The liquidity of a corporate shareholder's interest, as evidenced by the fact that a shareholder may transfer his interest to anyone at any time, is much greater than the liquidity of a partnership interest because partnership interests may not be transferred except with the consent of all the partners. Also, the partners in a partnership were jointly and severally liable for the activities of the association.

Many of the inadequacies of the partnership with respect to conducting business collectively in the early nineteenth century

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income while deferring the shareholder's personal income taxes. Respect for the principle of freedom of contract allows shareholders in closely held corporations to achieve the benefits of corporate tax status while contracting to have the firm managed in a manner similar to a partnership. For thorough development of these points, see Boris I. Bittker and James E. Eustice, Federal Income Taxation of Corporations and Shareholders, Fourth Edition (Boston: Warren, Gorham and Lamont, 1979) and William H. Painter, Business Planning (St. Paul: West Publishing Co., 1975).

<sup>5</sup>No attempt is made here to make more than a cursory comparison of partnership law and corporation law. See Alan R. Bromberg, Crane and Bromberg on Partnership (St. Paul: West Publishing Co., 1968) for a detailed treatment of partnerships and limited partnerships.

could be overcome through the use of business trusts and joint-stock associations,<sup>6</sup> both of which made extensive use of the law of trusts. In both types of organizations, the management of the business was vested in a central body of trustees who held title to the property contributed by the shareholders and who alone could make valid contracts for the association. The "articles of association" or "declaration of trust", under which the joint-stock association or the business trust were formed and governed, respectively, provided for continuity of the enterprise beyond the lives of the shareholders and for free transferability of their evidence of ownership. The major distinction between these types of organizations and the corporation was the question of limited liability. In the joint-stock association, the shareholders had the ultimate control of the business and they were jointly and severally liable for the activities of the association. The liability of the members of a business trust (i.e., the beneficiaries of the trust) was limited to the extent of their contribution provided the trustees held title to the property and had ultimate control of the business. In the early 1800's, a major obstacle to the use of these devices was the uncertainty of their status under the common law.

Economic reasons for the development and widespread use of the corporate form (including limited liability) are related to the value of freely transferable shares and the control of certain transactions

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<sup>6</sup>See Warren; Dodd, "Dogma and Practice"; and Livermore, Early American Land Companies.

costs which are associated with transferable shares.<sup>7</sup> The traditional view is that transferable shares evolved in response to an exogenous increase in the demand for capital by early foreign trading companies. That is, a major economic advantage of the corporation is the ability to raise large sums of capital from the sale of various kinds of securities. A recent contribution of Ekelund and Tollison<sup>8</sup> suggests that transferable shares were developed to guarantee perpetual succession in order to sustain the monopoly privileges obtained from the Crown at great expense as cartel owner-managers retired or desired to leave the partnership for other reasons. This complementary, supply-side explanation views the development of transferable property rights, as manifest in the English joint stock company, as a means by which to promote efficiency and enhance profitability in the market for management of state-chartered monopoly rights. Thus, we have an economic rationale

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<sup>7</sup>The discussion of the economic advantages has drawn on the following sources in addition to sources cited: Armen A. Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization," American Economic Review, LXII (December, 1965): 777-95; and M.C. Jensen and W.H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," Journal of Financial Economics, 3 (1976): 305-60. Closely related to this topic are the literature on the internal organization of firms -- see Oliver E. Williamson, "The Modern Corporation: Origins, Evolution, Attributes," Journal of Economic Literature, XIX (December, 1981): 1537-68 for a survey article -- and the literature on the development of the corporation as an institution -- the seminal work is Adolf A. Berle and Gardiner C. Means, The Modern Corporation and Private Property, revised edition (New York: Harcourt, Brace and World, Inc., 1967).

<sup>8</sup>Robert B. Ekelund and Robert D. Tollison, "Mercantilist Origins of the Corporation," Bell Journal of Economics, 11 (Autumn, 1980): 715-20.

for the development of freely transferable shares and the corresponding perpetual succession. As we shall see, many "good" results have sprung from the "bad" intentions of the early cartel owner-managers. Regardless of its origin, the use of freely transferable shares has several other important and beneficial roles.

A major benefit of freely transferable property rights is that they allow specialization by owners and managers. This is particularly important where there are many shareholders or partners. If all of the shareholders participated in day-to-day managerial decisions, many shareholders would shirk the task of becoming well-informed because of the high cost of the relevant information when contrasted with the minute expected payoff from being well-informed on any particular decision. That is, specialization by management and ownership avoids potential problems related to decision-making by shareholders who are rationally ignorant.

Another benefit of the corporate form is that transferable shares provide an external system of discipline for company managers.<sup>9</sup> The right of shareholders to sell their corporate shares without the approval of any other stockholder, as opposed to partnership law which required the approval of all partners before a partner could transfer his interest, provides a more acceptable escape to each shareholder from continued policies with which he disagrees. That

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<sup>9</sup>See Henry G. Manne, "Some Theoretical Aspects of Share Voting," Columbia Law Review, 64 (December, 1964): 1427-45; and Henry G. Manne, "Mergers and the Market for Corporate Control," Journal of Political Economy, 73 (April, 1965): 110-120.

is, rather than try to control the decisions of the management through the structure of the organization, which would become increasingly difficult as the number of shareholders or partners increased, it is easier for a shareholder to sell his shares and invest in a firm which he thinks is maximizing profit. Furthermore, since the decisions of many shareholders concerning the correctness of the management's decision are capitalized into the price of the shares, there are potentially large capital gains which may be captured by replacing incompetent management with a new group of profit maximizing managers. That is, managerial shirking is policed by across-market competition from new groups of managers as well as competition from members within the firm who seek to displace the existing management. Of course, an efficient capital market is a necessary condition for the realization of this beneficial function of transferable shares.

Manager's proclivity towards shirking can be reduced even further by the use of stock options and stock bonus plans, which would not be available in the absence of freely transferable shares. This is so because the manager's time horizon for his managerial decisions can be made to extend beyond his period of employment and to encompass the entire period for which he owns stock in his present employer. In other words, the use of freely transferable can solve some of the agency problems associated with specialization by owners and managers. Principals can compensate their agents in a manner that tends to reduce the extent of divergence between the interests of the agent and

principals because the shareholders' agent becomes a principal (i.e., a shareholder).

The legal institution of limited liability has been defended as being of considerable value from an economic point of view. Demsetz and others<sup>10</sup> have recognized that limited liability may economize on certain transaction costs. For example, the shared liability of partners under the law of partnership gives each partner the incentives to invest considerable time in monitoring the behavior of managers and the wealth position of other partners. Under the rule of limited liability, the shareholders do not have as much at stake and they do not spend as much time monitoring. Rather than bear the costs of monitoring, shareholders pay a higher rate of interest to their creditors under limited liability.

Manne<sup>11</sup> explains that the rule facilitates diversification of risk (not elimination of risk) by shareholders, and promotes efficiency because it is less costly for creditors of corporations to assess the risks of investment than it is for many small shareholders. Manne concludes that a contrary rule would be expected to generate undesirable anticompetitive results because the lack of limited liability would make it more costly to exchange shares and

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<sup>10</sup>Harold Demsetz, "Toward a Theory of Property Rights," American Economic Review, LVII (May, 1967): 347-59; M.C. Jensen and W.H. Meckling, "Theory of the Firm"; Henry G. Manne, "Our Two Corporation Systems: Law and Economics," Virginia Law Review, 53 (March, 1967): 259-284; and Richard A. Posner, "The Rights of Creditors of Affiliated Corporations," Chicago Law Review, 43 (1976): 499-526.

<sup>11</sup>Manne, "Our Two Corporation Systems."

lead to the concentration of ownership, which would defeat the discipline of the capital market and lead to longer tenure for inefficient management.

Meiners, Mofsky, and Tollison<sup>12</sup> argue that limited liability makes little difference in the allocative market for loanable funds and they discount the importance of it in the areas mentioned above. (e.g., they present arguments to the effect that limited liability does not reduce transactions costs for corporate investors). They also address the problems of limited liability that are purported to occur in connection with involuntary (tort) creditors. The usual view is that the major problem in such situations is the "undercapitalization" of one-man or closely-held corporations by which entrepreneurs, who would normally be subject to full responsibility as a sole proprietor or a partner, are able to protect their assets from tort victims by incorporating. Consequently, the costs of doing business are shifted to potential tort victims, and this often leads to inequitable results. Meiners, et al., reject this view and argue that limited liability does not arbitrarily impose unwarranted costs on involuntary creditors. They argue that the real issue is not one of "undercapitalization" but rather one of "underinsurance" -- which they define as a situation in which a tort claim arises that cannot be satisfied by the assets of the corporation, whether the corporation self-insures or purchases

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<sup>12</sup>Roger E. Meiners, James S. Mofsky and Robert D. Tollison, "Piercing the Veil of Limited Liability," Delaware Journal of Corporate Law, 4 (1979): 351-67.

insurance coverage from an insurance carrier. That is, they claim that the argument that firms may be "undercapitalized" reduces logically to a question of whether producers purchase formal contracts of insurance against tort contingencies and reflect the extra costs in higher prices, or whether consumers bear the tort risk themselves and pay lower prices as a result. Their main point in this regard is that insurance is not free in either case. Thus, while limited liability may have produced a particular institutional structure for the way in which insurance is provided, it has not led to less real insurance than would exist under another rule. Thus, having downplayed the importance of limited liability, they conclude that it is not the primary reason for the existence of the corporate form.

In this section, the legal and economic advantages of the corporate form have been discussed. Despite some disagreement over the importance of limited liability, an overwhelming conclusion is that for purposes of conducting a business with many co-owners the corporate form is superior to the partnership. Also, despite the fact that joint-stock associations and business trusts offered most of the usual corporate advantages, it must be concluded that those inconvenient devices whose legality was not always certain were inferior to the corporate form which was governed by statute. The major value of the corporate form can be seen in the cost savings that arise from freely transferable property rights, and the ability to obtain standing as a legal entity (i.e., reduction in legal transaction costs). As mentioned earlier, the legislatures

maintained strict control over the access to these valuable corporate privileges until the middle of the nineteenth century.

#### B. Legal Change and the Interest-Group Theory of Government

The framework for this dissertation is that utilized by Lawrence Friedman in A History of American Law.<sup>13</sup> Specifically, the law and legal institutions at any one time should not be viewed as an historical accident or the outcome of autonomous evolution, but rather the result of political and economic forces as manifest in competition between interest groups for favorable legislation. In this view, it is possible for the actions of the state to have good results in terms of economic efficiency; however, it must be noted, that these "good" results can, and often do, spring from "bad" intentions.<sup>14</sup> That is, politicians and legislators are not interested

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<sup>13</sup>See Lawrence M. Friedman, A History of American Law (New York: Simon and Schuster, 1973): 10-14 for an outline of the framework.

<sup>14</sup>A brief example of "good results springing from bad intentions" in Friedman's framework is given by Robert B. Ekelund and Robert D. Tollison, "Economic Regulation in Mercantile England: Hecksher Revisited," Economic Inquiry, XVIII (October, 1980): 567-99. They explain both the rise and fall of English mercantilism by utilizing the Landes-Posner theory of the independent judiciary (William M. Landes and Richard A. Posner, "The Independent Judiciary in an Interest-Group Perspective," Journal of Law and Economics, 18 (December, 1975): 875-901). The important institutional change that motivates their interpretation was the gradual takeover by Parliament of the power to supply regulation.

Regulation in mercantile England reached its peak while the monarchy had complete control of the power to supply regulation. The traditional interpretation claims that the king tried to avoid the free-trading emphasis of the common law courts (and their allies in Parliament) by establishing a royal court system centered in the Privy Council (Court of Star Chamber), and that this court system gave the crown the administrative elasticity to enforce grants of national or regional monopoly.

in economic efficiency or social welfare per se, and no implications for increased economic efficiency or social welfare are implicit in this framework. Government activity, according to this view of legal-institutional change, is basically a negative sum redistributive game -- primarily because of the costs of rent seeking, and the transaction costs and enforcement costs of the political contracts.<sup>15</sup>

The economists' version of the interest-group theory of government,<sup>16</sup> which also suggests that legislation is supplied to

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Ekelund and Tollison reject Hecksher's contention that the common law jurists were the heroes of the rise of free trade (Eli Hecksher, Mercantilism (London: George Alen and Unwin Ltd., 1934, 1931), translated by Mendal Shapiro). Essentially, according to Ekelund and Tollison, the common law courts and their allies in Parliament competed with the monarchy and its court system in the promotion of national monopoly rights. Monopoly founded on custom or by Parliament was legitimate under the common law, while those founded by royal grant were not. Applying the Landes-Posner model, Ekelund and Tollison explain the demise of the regulation as the result of this uncertainty over the durability of a monopoly right and the corresponding decline in the returns from seeking national monopoly through the state. Although Parliament won the battle to supply legislation, it was unable to consolidate this power in a systematic way so as to be able to continue to operate a vast rent-seeking economy. Ekelund and Tollison conclude that Parliament's inability to consolidate the power to pass and to enforce special interest legislation resides primarily in the higher costs of democratic relative to monarchical decision-making in this respect.

<sup>15</sup>The seminal works on rent-seeking activity are Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies, and Theft," Western Economic Journal, 5 (June, 1967): 224-32; and Anne O. Krueger, "The Political Economy of the Rent-Seeking Society," American Economic Review, 64 (June, 1974): 291-303.

<sup>16</sup>See George J. Stigler, "The Theory of Economic Regulation," Bell Journal of Economics, 2 (Spring, 1971): 3-21; Richard A. Posner, "Theories of Economic Regulation," Bell Journal of Economics, 5 (Autumn, 1974): 335-58; and S. Peltzman, "Toward a More General Theory of Economic Regulation," Journal of Law and Economics, 19 (August, 1976): 211-40.

groups or coalitions that outbid rival seekers of favorable legislation is complementary to Friedman's approach to legal-institutional change. In the market for special-interest legislation, legislation is "sold" by the legislature and "bought" by the winning coalitions that outbid rival seekers of favorable legislation.<sup>17</sup> Accordingly, this approach to government would suggest that the major winners and losers under a given government program should be identified before attempting to explain the program's emergence.

In the absence of any politically effective, clear-cut winners on the demand side of the market for legislation, it may be necessary to examine the supply side,<sup>18</sup> where the legislature has monopoly power

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<sup>17</sup>See Robert McCormick and Robert D. Tollison, Politicians, Legislation, and the Economy: An Inquiry Into the Interest-Group Theory of Government (Boston: Martinus Nijhoff Publishers, 1981) for theoretical formulation and empirical tests of this view using cross-sectional data on state governments in the U.S. Note, in particular, the chapter entitled "The Outside Earnings of Politicians" for an explanation of how legislators are legally compensated for selling special-interest legislation. Briefly, they argue that lawyers predominate among legislators because, even though they have high opportunity costs to serving, they also have a unique ability to internalize through their law practice the outside returns from passing laws.

<sup>18</sup>In the context of this paper, the "supply side" means the actions by the legislatures, and should not be confused with the supply-side approach which envisions a political process in which the bureaucracy plays an active and oftentimes decisive role. It should be noted, however, that the theories are complementary. The seminal works applying economic theory to bureaucracy and bureaucratic behavior are Gordon Tullock, The Politics of Bureaucracy (Washington, D.C.: Public Affairs Press, 1965); Anthony Downs, Inside Bureaucracy (Boston: Little, Brown and Co., 1967); Ludwig von Mises, Bureaucracy (New Rochelle: Arlington House, 1969); and William A. Niskanen, Bureaucracy and Representative Government (New York: Aldine Atherton, 1971).

over the production and supply of legislation, including corporate charters, within its jurisdiction. However, the legislature is not a classical monopoly because it has to contend with two sources of competitive pressures. First, the monopoly power is controlled by the majority political party, which is always faced with internal competition for the right to control legislative output. In this regard, it is useful to view political parties as maximizing firms that are confronted by competitive market forces within the legislature as they attempt to gain control of the monopoly power (i.e., gain control of the supply side of the market for legislation).<sup>19</sup> Second, the legislature's monopoly position may also suffer from foreign competition if the political boundaries delineating the legislature's jurisdiction are not effective entry barriers against intrusion by other legislatures.<sup>20</sup> Within these bounds, it is descriptively accurate and useful for predictive purposes to view legislatures as the possessors of monopoly power within their respective jurisdictions.<sup>21</sup>

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<sup>19</sup>The majority party faces many production and organizational problems common to conventional firms -- it must estimate the demand for legislation, organize the legislature so as to supply laws at least cost, and it must select leaders to monitor the performance of these activities. See W. Mark Crain and Robert D. Tollison, "The Sizes of Majorities," Southern Economic Journal, 46 (April, 1980): 726-34.

<sup>20</sup>See Barry D. Baysinger, "A Theory of the Efficiency of Jurisdictional Choice: The Case of Corporate Federalism," unpublished Ph.D. dissertation, VPI&SU, 1978.

<sup>21</sup>In many instances, the legislature's monopoly position is constrained by the availability through private contracting of close substitutions for laws. Thus, high transactions costs and other problems associated with cartel management usually make legislation the least cost, but not the exclusive, method of creating and capturing monopoly rents. In other words, the monopolists-legislators are faced with a downward sloping demand function for their product.

In this perspective, the passage of general incorporation laws was a voluntary reduction in monopoly power by the legislatures. In the absence of any politically effective coalitions to "buy" the passage of general incorporation laws, this voluntary reduction in monopoly power appears to be incompatible with the competing interest-group theory of government in that it may be evidence that the firms (i.e., political parties) were not maximizing profits. The major purpose of this dissertation, therefore, is to explain why the legislatures surrendered their monopoly power over such an important legal institution.

Friedman's approach to legal institutional change should be distinguished from the framework developed by Harold Demsetz, by Davis and North in Institutional Change and American Economic Growth, and by North and Thomas in The Rise of the Western World.<sup>22</sup> Demsetz's thesis is that "the emergence of new property rights takes place in response to the desires of the interacting persons for adjustment to new benefit-cost possibilities."<sup>23</sup> Similarly, the Davis-North and North-Thomas models are based on the hypothesis that institutions develop in response to changing private needs or profit potentials, and that new institutional arrangements will not be set up unless the private benefits of their creation exceeds the costs: "It is the possibility of profits that cannot be captured within the existing

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<sup>22</sup>Harold Demsetz, "Toward a Theory of Property Rights;" Lance E. Davis and Douglas C. North, Institutional Change and American Economic Growth (Cambridge: Cambridge University Press, 1971); and Douglas C. North and Robert P. Thomas, The Rise of the Western World: A New Economic History (Cambridge: Cambridge University Press, 1973).

<sup>23</sup>Demsetz, "Toward a Theory of Property Rights," p. 350.

arrangemental structure that leads to the formation of new (or the mutation of old) institutional arrangements."<sup>24</sup> Accordingly, the major characteristic of the methodology of these net-benefit, property-rights models is an emphasis on the identification of exogenous changes in order to explain why property rights which cannot profitably be established at one point in time will later be economically justified. Implicit in these models, and also their major conflict with the Friedman (competing interest-group) theory, is the notion that as legal institutions change, they are groping towards the economically efficient property-rights structure -- as if led by an "invisible hand."

The efficiency implications of the Demsetz, Davis-North, and North-Thomas models of institutional change are open to criticism from several viewpoints. First, the prisoner's dilemma in modern game theory suggests that in many market and non-market instances all Pareto relevant externalities will not be internalized, and thus the efficient or "best" outcome will not be realized, because many of the actors will have the incentives to not reveal their true preferences.<sup>25</sup> That is, the efficiency implication does not necessarily follow if the possibility of strategic behavior by individually rational actors is present. Second, institutional changes which appear to be efficient

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<sup>24</sup>Davis and North, p. 39.

<sup>25</sup>For development of this point, see James M. Buchanan, The Limits of Liberty: Between Anarchy and Leviathan (Chicago: University of Chicago Press, 1975).

when viewed in isolation (in the small) might not be efficient when presented in a general equilibrium framework (in the large). For example, the change in method of incorporation evidently led to more efficient organizing of business associations, but it is not clear that the long-term effects of this change were efficient. More specifically, if the passage of general incorporation laws led to the formation of more "efficient" rent-seeking coalitions, which then led to an increase in government transfers of wealth,<sup>26</sup> then it is not clear that the institutional change was an efficient move. Third, these models do not suggest any way in which the preferences of the general public, which presumably under their model would reflect the total net benefits of all individuals, are transformed into legislative action. That is, there is no voting model to explain the legislators' incentives to move towards the economically efficient property rights structure.<sup>27</sup>

Despite these problems with the efficiency implications of the Demsetz, Davis-North and North-Thomas models, their methodology is still applicable to the framework of this dissertation. The interest-group approach can utilize their methodology to help explain the timing

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<sup>26</sup>For the development of a model that has these implications, see Henry N. Butler, "General Incorporation Laws in an Interest-Group Perspective," manuscript, University of Miami Law and Economics Center, August, 1980, presented at Liberty Fund Conference on Law and Political Economy, Chicago, September, 1980.

<sup>27</sup>The seminal works on voting models are Anthony Downs, An Economic Theory of Democracy (New York: Harper and Row, 1957); Duncan Black, Theory of Committees and Elections (Cambridge: Cambridge University Press, 1958); and James M. Buchanan and Gordon Tullock, The Calculus of Consent (Ann Arbor: University of Michigan Press, 1962).

of legislative actions by identifying changes in exogenous economic variables which would alter the costs and benefits of the existing property rights structure and thus encourage interest groups to seek favorable legislative changes in the law. In this view, the ultimately-important benefits and costs are those of the legislators, who are seen as reacting to the pressures of competing interest groups. This view of legal-institutional change does not include the implication that legislated changes necessarily tend towards the economically efficient property rights structure.

A similar combination of the interest-group approach and the Demsetz, Davis-North and North-Thomas methodology was utilized by Libecap,<sup>28</sup> who explained the changes in Nevada's mineral rights law by identifying changes in exogenous economic variables which would alter the costs and benefits of the existing property rights structure to the major owners of mineral rights and thus give them the incentives to seek legislative changes in the law. However, in the final analysis, Libecap abandoned the interest-group aspect of his model in favor of the efficiency explanations. He did this because he concluded that the efficiency gains were more important than the equity (transfer) effects of the changes in the law. From the perspective of this dissertation, the efficiency results of the changes in the law were the by-products of special-interest legislation. Libecap's rejection of the interest-group explanation was the result of a fundamental mistake --

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<sup>28</sup>Gary D. Libecap, "Economic Variables and the Development of the Law: The Case of Western Mineral Rights," Journal of Economic History, 38 (June, 1978): 338-62.

failure to recognize that "good results can and often do spring from bad intentions." He observed the "good" results (i.e., improved economic efficiency) and concluded that they must have been the intended results of, and the reasons for the passage of, the changes in the property rights structure. This fundamental mistake in interpretation will not be repeated in this dissertation.

Thus, in spite of his bias towards the efficiency interpretation, Libecap's use of the net-benefit property-rights models demonstrates their utility in a interest-group perspective, and their methodology will be utilized to help explain why the method of incorporation was changed at a particular point in history. For example, in order to determine the incentives legislators would have for changing the method of incorporation from special charters to general incorporation laws, it is convenient to view the legislative bodies as suppliers in a market for corporate charters. In this framework, the law will not change unless the legislators perceive the possibility of net gains from changing the law. That is, legislators are maximizers who make trade-offs at the margin which determine the nature of the law at any given time. In applying the net-benefit methodology, it is not necessary to measure directly the legislators' net gains from changes in the law in order to understand the incentive for legal change. Instead, one can follow exogenous economic and legal events which would tend to alter the legislators' costs and benefits, and then determine if the predicted changes occurred.

In summary, the model of legal institutional change used in this dissertation employs the interest-group perspective to explain why the

method of incorporation was changed, and the Davis-North, North-Thomas, and Demsetz methodology to help explain when it was changed.

### C. Prospectus

In Chapter II, a review of hypotheses suggested in the literature and hypotheses consistent with other theories of legal-institutional change that are applicable to, but have not been extended to, the issue to be investigated by this dissertation, are presented. A conclusion of this discussion is that the efficiency explanations for the emergence of legal institutions fail to provide a satisfactory model of legislative behavior. Also, in Chapter II, it is suggested that the major reason for the decline and fall of the special chartering system was that the rates of return to the legislators from the production of special charters was lowered by exogenous legal and economic changes. This thesis is supported by the two following chapters, Chapters III and IV, which present an historical-institutional study of the change in method of incorporation in England and the United States, respectively. The reason for examining both countries is that England may be viewed as a closed economy, in which all government activity is endogenous, and the individual states in the United States may be viewed as open economies affected by both exogenous and endogenous government activity. That is, there is the possibility of jurisdictional competition in the United States but not in England. Finally, some conclusions and implications of the analysis comments are offered in Chapter V.

## CHAPTER II

### EXPLANATIONS OF THE EMERGENCE OF GENERAL INCORPORATION LAWS

While the history of the passage of general incorporation laws has received considerable attention in both the legal and economic literature,<sup>1</sup> explanations for their passage have been few and far between. Because of this, the alternative hypotheses presented in this chapter are extensions of existing economic theories of legislative and governmental behavior which are applicable to, but heretofore have not been applied to, the issue investigated in this dissertation. These hypotheses are summarized, and then evaluated in terms of the competing interest-group theory. Finally, an hypothesis consistent with the tradition of Friedman and Ekelund-Tollison is presented.

#### A. Efficiency Hypotheses

##### 1. The Supply-Side Efficiency Hypotheses - Shannon and Friedman

Two legal scholars who have addressed this question, H.A. Shannon and Lawrence Friedman<sup>2</sup> concerning England and the United States, respectively, have suggested that the major reason for the change in the method of incorporation was that the passage, and subsequent amendments, of special acts of incorporation took up too much of the legislatures' time. This supply-side explanation can be characterized as an efficiency hypothesis because it implies that production of

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<sup>1</sup>See Chapters III and IV, *infra*, for citations.

<sup>2</sup>H.A. Shannon, "The Coming of General Limited Liability," Economic History, II (1931): 6; reprinted in E.M. Carus-Wilson, ed., Essays in Economic History, I (London: Edward Arnold Ltd., 1962): 358-79; and Friedman, pp. 172 and 447.

special charters was halted in order to divert legislative resources to higher valued uses; for example, to the passage of different types of legislation which had a higher net rates of return or to some use not related to legislation.

The Shannon-Friedman hypothesis is not satisfactory from an interest-group perspective because it fails to explain why the legislatures did not behave as monopolists and increase the price of the special acts in order to reduce the volume of legislative time devoted to them. That is, the legislatures could have chosen to produce a mixture of legislation that included at least some special acts of incorporation, which would have been "sold" at higher bids than previously, rather than totally abandoning the market for corporate charters. Thus, is an interest-group perspective, they seem to be claiming that general corporate privileges were not important, that there were no rents to be captured from the marketing of special corporate charters, and that there were no rents to be captured from making corporate privileges available to all.

Since all of the early prohibitions against the passage of special charters in the United States were the result of provisions adopted at state constitutional conventions and approved by the electorate,<sup>3</sup> however, it appears that the Shannon-Friedman hypothesis might help explain this phenomenon at the constitutional stage. In other words, the general public's objections to the waste of legislative time and money associated with the special-chartering system might have been

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<sup>3</sup>See subsection IV.C.1, *infra*.

better articulated at the constitutional level than in the electoral process. In this regard, another factor affecting the constitutional-contracting process would have been the realization by large segments of the body politic that they could be, or in fact were, "losers" in the competitive rent-seeking process associated with special chartering.<sup>4</sup> For example, as the potential gains from the special charters increased, there would have been more "losers" in the rent-seeking process. These "losers" could have been competing businesses that were placed at a competitive disadvantage or other segments of the population that felt that their interests were being neglected as the legislature devoted their time to special-chartering activity. Throughout the American history of the special charter, legislators were able to resist the political pressures for divesting themselves of chartering activity. This behavior, of course, is consistent with the interest-group approach. No legislature, prior to the exogenous changes identified in this dissertation, voluntarily relinquished its control over the special charter;<sup>5</sup> in several states, however, the power was taken from the legislatures when the states revised their constitutions. Thus, the Friedman hypothesis might be consistent with this partial explanation of the decline of the special charter.

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<sup>4</sup>For the contractarian theory of constitutions, see James M. Buchanan, The Limits of Liberty: Between Anarchy and Leviathan (Chicago: University of Chicago Press, 1975). Also, see John A. Rawls, A Theory of Justice (Cambridge: Harvard University Press, 1971) for development of a theory of individual's demands for constitutional protections when behind the pre-contractual "veil of ignorance."

<sup>5</sup>See section IV.C, *infra*.

2. The Demand-Side Efficiency Hypothesis - Coase, et al.

The Demsetz, North-Davis and North-Thomas models of insitutional change suggest that as legal institutions change, they are groping towards the economically-efficient property rights structure.<sup>6</sup> Similarly, Posner and others<sup>7</sup> have argued that the common law method tends to lead to the economically-efficient legal rule. Both of these observations are concerned with spontaneous changes in property rights structures that evolve through individual interaction rather than calculated legislative action -- such as the passage of general incorporation laws. The framework utilized in this dissertation emphasizes that there is no inherent reason why legislated property rights should reflect the economically-efficient property rights structure either at the time of passage or in the future. However, Coase and others<sup>8</sup> might argue that the legislature is also driven towards the passage of economically-efficient laws; that is, that there is some type of "invisible hand" mechanism that guides legislative decisions.

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<sup>6</sup>See section I.B, supra.

<sup>7</sup>Richard A. Posner, Economic Analysis of Law, 2nd edition (Boston: Little, Brown and Co., 1972). Also see Paul H. Rubin, "Why is the Common Law Efficient?" Journal of Legal Studies, 6 (January, 1977): 51-64; George L. Priest, "The Common Law Process and the Selection of Efficient Rules," Journal of Legal Studies, 6 (January, 1977): 65-82; John C. Goodman, "An Economic Theory of the Evolution of the Common Law," Journal of Legal Studies, 7 (June, 1978): 393-406; and William M. Landes and Richard A. Posner, "Adjudication as a Private Good," Journal of Legal Studies, 8 (March, 1979): 235-84.

<sup>8</sup>Ronald H. Coase, "The Problem of Social Cost," Journal of Law and Economics, 3 (October, 1960): 1-44; Posner, Economic Analysis of Law.

In the Coasian framework, a general incorporation law would be viewed as a quasi-public good intended to reduce transactions costs and promote general economic activity by providing a more efficient way of organizing business associations. The major difficulty with this explanation concerns the underlying theory of what motivates the legislators to make the economically-efficient decisions. Implicit in this framework is the notion that the legislators are responsive to broad-based demands that produce the highest total bids for changes in the law which will allow resources to flow to their highest valued uses. However, public choice theory predicts that it is the distribution of the bids, not just their total size, that determines the passage of legislation. In other words, the major difficulty with this explanation, when viewed from an interest-group perspective, is related to the free-rider problems associated with all goods for which there are broad-based citizen's demands. These types of demands are not likely to be made effective in the political market because of the costly nature of political participation and the publicness of their benefits. That is, the likely result is that the broad-based demands would be overwhelmed by the more intense and narrowly based demands of special interest groups.

#### B. The Simple Revenue-Generating Model -- Ames

Another explanation would be to view general incorporation laws as revenue measures designed to capitalize on the increased demand for larger firms that developed with the Industrial Revolution. This model is suggested by Edward Ames' interpretation of why the method of

conveying governmentally-owned land to private individuals changed from individual charter to selling at a uniform price to all willing and able buyers.<sup>9</sup> In this scenario, the revenues of a state derived from the business of incorporating firms would increase as the state changed from a high-price, high mark-up, low-volume business into a low-price, low mark-up, high-volume business.

Even if state revenues from corporate taxes and fees did increase after this change in the law, this alternative theory by itself does not appear to be consistent with the competing interest-group theory. Special acts of incorporation were special-interest legislation in the purest sense, and in the interest-group perspective the legislators would capture a portion of the monopoly rents created by these special acts. In contrast, under the general incorporation acts, the increased state revenues go directly to the state treasury and there is little opportunity for the legislators to capture the revenues. Although it may be argued that the legislators benefit from having more revenues at their disposal, the interest-group perspective suggests that the maximizing legislator would be better off by creating rents through special acts and then directly capturing their share of the rents in the market for legislation. However, as is argued in Section D of this chapter, this explanation has some merit in an interest-group perspective if for some reason the legislator could no longer create rents by passing special charters.

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<sup>9</sup>This change took place in the United States in the late 1780's and Ames claims tht it was motivated by merely fiscal considerations. See Edward Ames, "Public Land Offices as an Institutional Innovation," presentation at the Public Choice Seminar, VPI&SU, July, 1981.

### C. The Budget-Maximizing Bureaucracy Model -- Niskanen

While it is not clear that the legislators would have been net gainers of the change in the method of incorporation because of the increased revenues at their disposal, the bureaucratic theory of government, as exemplified by Niskanen,<sup>10</sup> can be interpreted to suggest that the bureaucracy could have been the major beneficiaries of the increased revenues generated by the general incorporation laws. According to this view, the growth and proliferation of government are the by-product of an endeavor by supply-side agents to use the powers of the state to maximize their own "wealth", which is linked to the growth rate of their bureau's budget. Accordingly, this supply-side approach predicts that bureaucrats would have been in favor of the passage of the general incorporation laws because of the increased revenues from which to maximize their budgets.

This economic approach to government, in which the evolution of government programs is no longer simply a response to changing citizen demands or the unfolding of a bargain struck between the legislature and some special-interest group, does not appear to be applicable to the change in general incorporation laws for two reasons. First, the bureaucratic theory is usually associated with the passage of a program which requires additional government funding for the growth of bureaucracy. The passage of general incorporation laws produced the additional funding, but there is no historical evidence indicating that the enactments of the laws were accompanied by

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<sup>10</sup>William A. Niskanen, Bureaucracy and Representative Government (New York: Aldine Atherton, 1971).

any other major pieces of legislation. Second, at the time of the change in the law, the bureaucracy was still quite small and, probably, ineffective compared to the bureaucracy envisioned by the modern theory. Thus, while it is possible to mold the bureaucratic theory of government into a thesis explaining the change in method of incorporation, it appears that this adaption has little explanatory power when placed in the proper historical context.

#### D. The Interest-Group Perspective<sup>11</sup>

The thesis of this dissertation, stated briefly, is that legislators abandoned the market for special charters because events beyond their control made it difficult or impossible for them to continue to create and capture rents through the passage of special charters. In other words, this competing interest-group explanation argues that exogenous changes decreased the legislators' rates of return from the supplying of special charters to the point where it was no longer profitable for legislators to produce them. In order to support this thesis, it is necessary to identify the exogenous economic and legal events which would tend to alter the legislators' costs and benefits, and then determine if the predicted changes occurred.

In both the United States and England, the major exogenous changes affecting the legislators' net rate of return from the passage of special charters were produced by the court systems and

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<sup>11</sup>See section I.B, supra.

the economic growth associated with the Industrial Revolution. In England, the common law courts eventually allowed unchartered joint-stock companies to have rights very similar to corporate privileges. That is, the courts recognized a substitute for the special charter; as predicted, Parliament responded to these exogenous changes. Similarly, in the United States, an important Supreme Court decision allowed a major substitute for the intrastate corporation -- the foreign (or interstate) corporation -- to be produced. The growth of an interstate railroad network, the accompanying growth of interstate commerce, and a Supreme Court decision forbidding states to exclude corporations chartered in other states and engaged in interstate commerce, resulted in a national "free market" for corporate privileges. Consequently, localized monopolies over corporate privileges were destroyed, and the special-chartering system came to an end.

The exogenous changes explain the timing of the end of the special charter; however, in the United States they do not provide a basis for predicting which states would be most likely to abandon the special-chartering system in favor of revenue-generating general incorporation laws. One explanation, which was rejected as an independent explanation for the end of the special chartering system, would view general incorporation laws as revenue measures. This explanation for the passage of general incorporation laws is consistent with the interest-group perspective provided the rates of return from the passage of special charters had already been reduced to an unprofitable level vis-a-vis other special interest legislation.

That is, the link between tax receipts and legislators' wealth may be more direct, and thus have more explanatory power, when the passage of a revenue-generating law does not require a trade-off of other forms of special-interest legislation. For example, Stigler<sup>12</sup> presents a patronage or spoils system argument which suggests that larger budgets may offer expanded opportunities for hiring campaign workers or for "paying-off" old election favors. Furthermore, Landes and Posner<sup>13</sup> suggest that legislators might prefer new revenue sources because they provide them with more autonomy.

Of particular interest with regards to the open jurisdictions in the United States is the possibility that the legislatures of some states could have used general incorporation laws to raise revenue from outside their state. That is, some legislatures could have passed politically-controversial laws because the out-of-state revenues generated by the laws would have lowered the public outcry against the laws.<sup>14</sup> If a liberal general incorporation law would generate a fixed amount of revenue regardless of the size of the state passing the law, then the law would most likely raise a larger proportion of total state revenues for smaller states vis-a-vis

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<sup>12</sup>George J. Stigler, "The Theory of Economic Regulation," Bell Journal of Economics 2 (Spring, 1971): 3-21.

<sup>13</sup>William Landes and Richard Posner, "The Independent Judiciary in an Interest-Group Perspective," Journal of Law and Economics, XVIII (December, 1975): 875-901.

<sup>14</sup>See Michael Maloney, Robert McCormick, and Robert Tollison, "Exporting Economic Regulation," unpublished manuscript, Emory University (July, 1981), for a similar point with respect to a public choice explanation of the structure of economic regulations across states.

larger states. This would greatly reduce the political costs to legislators in smaller states, and, at the same time, provide them with a relatively larger benefit.<sup>15</sup> Thus, the revenue-generating model is helpful in explaining why liberal general incorporation laws were passed and, also, why smaller states tended to pass the more liberal laws.

#### E. Conclusion

This chapter has considered the merits of four alternative explanations for the decline and fall of the special chartering system. The bureaucratic theory is not applicable to the historical issue addressed by this dissertation. Although the two efficiency hypothesis are at least plausible, it was suggested that the change in method of incorporation can be explained in a manner more consistent with the competing interest-group theory of government. The revenue-generating model by itself was found to be inadequate as an explanation for the decline of the special charter, but it was found to be helpful in explaining why smaller states would have passed the first liberal general incorporation laws. The next two chapters support the interest-group thesis that the special charter became extinct because the availability of inexpensive substitutes made the production of special charters unprofitable.

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<sup>15</sup>See W. Mark Crain and Robert E. McCormick, "Regulators as an Interest Group," unpublished manuscript, University of Rochester, February, 1981, for theoretical formulation and empirical testing of a model of regulator/legislator behavior that trades-off political support for direct pecuniary gains.

### CHAPTER III

#### EVOLUTION OF ENGLISH CORPORATION LAW

England, for our purposes, may be viewed as a closed economy in which all legislative and administrative lawmaking activities are endogenous to Parliament. This is so because beginning in the late seventeenth century, Parliament became increasingly dominant of the Crown. Thus, in an interest-group perspective, all actions by either the Crown or Parliament which affected the rates of return on special-interest legislation must be viewed as consistent with the desires of Parliament at that time. Parliament could also control judicial lawmaking by passing statutes contrary to judicial decisions. Nevertheless, it is proper to view legal changes through the courts as exogenous to Parliament because the judiciary is independent of Parliament. As will be shown, developments in the common law courts explain the timing of many of legislative changes in England's evolution towards a general incorporation law. In this chapter, the changes in the laws relating to the acquisition of corporate privileges are described. Exogenous changes that would have altered Parliament's rate of return in the market for corporate privileges are identified and shown to be reliable predictors of the changes in corporation law.

## A. Background - English Companies Prior to 1720<sup>1</sup>

Incorporation was a recognized concept of medieval law. At first, incorporation was used only in connection with ecclestical and public bodies --such as monasteries and boroughs --which had corporate personality conferred upon them by a charter from the Crown. The use of the corporate form in the commercial sphere had its origins in the Guilds of Merchants. These medieval associations, which were similar to trade associations, had few attributes in common with modern companies. Because obtaining a charter from the Crown was the most effective method of obtaining for their members a monopoly of any particular commodity or branch of trade, many of these guilds eventually incorporated. Unlike what is now a major function of the corporation as a form of business organization, however, incorporation of the guilds was not used as a convenient method of distinguishing the rights and liabilities of the association from those of its members: each member of the guild traded on his own account subject only to obedience to the regulations of the guild. Thus, it would not be proper to identify the guilds as the source of the use of the corporation as a business organization.

A class of merchant adventurers developed with the expansion of foreign trade and settlement in the sixteenth century. Groups of merchant adventurers organized as companies in order to obtain royal charters conferring not only monopolies of trade to specific

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<sup>1</sup>Only a brief summary of this era is warranted. For a more thorough summary, complete with bibliography, see L.C.B. Gower, Principles of Modern Company Law, 4th edition (London: Stevens and Sons, 1979): 23-30.

territories but also governmental power over the territories by the privilege company. At first, these "regulated companies" were organized in the same manner as the guilds. However, beginning in the seventeenth century, the partnership principle of trading on joint account became popular and the regulated companies became joint commercial enterprises with transferable shares as opposed to groups of individual merchants held together by trade associations.<sup>2</sup> The transition from guild-like trade association to use of the corporate form as a business organization can be traced in the development of the famous East India Company.<sup>3</sup> That Company received its first

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<sup>2</sup>As mentioned earlier (section I.A, supra), the conventional wisdom is that the corporate form with freely transferable shares developed as the result of an exogenous increase in the demand for capital by the early foreign trading companies. An alternative, or complementary, explanation has been offered by Robert B. Ekelund and Robert D. Tollison, "Mercantilist Origins of the Corporation," The Bell Journal of Economics 11 (Autumn, 1980): 715-20. They see the development of transferable property rights, as manifest in the chartered joint-stock company, as a means by which to promote efficiency and enhance profitability in the market for management of state-chartered monopoly rights. That is, the joint-stock form was needed to sustain the economic organization, and the privileges it had been granted, over time as cartel owner-managers retired or otherwise sought to leave the organization. Nevertheless, the real purpose of this dissertation is not to explain the evolution of the corporate form, but rather to explain the evolution of the availability of the corporate form once it was used for more than just the organization of companies that had been granted state-chartered monopoly privileges.

<sup>3</sup>W.R. Scott, The Constitution and Finance of English, Scottish, and Irish Joint-Stock Companies to 1720, 3 vols. (Cambridge, 1910-12), reprint (New York: Peter Smith, 1951): V.II, 89-206. Also see Gary Anderson, Robert E. McCormick, and Robert D. Tollison, "East India Company as a Multi-Divisional Enterprise," unpublished manuscript, VPI&SU, 1981.

charter in 1600, granting it a monopoly of trade with the Indies, but it was not until 1692 that private trading by members was finally forbidden and the organization had completed its evolution to the corporation as it is known in the twentieth century.

These earlier companies obtained their corporate status either by royal charter granted under the common law, or by royal charter granted under statute, or by Special Act of Parliament. These corporations were defined under the common law, and they had all of the privileges that are normally associated with modern corporations. As might be expected, these privileges were restricted to a favored few and could be obtained only through "formal application for an act or charter, a method expensive, cumbersome in procedure and uncertain of success."<sup>4</sup>

The method of allocating monopoly privileges via the corporate charter was altered after the Revolution of 1688. The Crown's prerogative to grant a monopoly for the regulation of foreign trade had not been impaired by the Case of Monopolies<sup>5</sup> in 1602 and the Statute of Monopolies in 1623. Although the courts were beginning to place limitations on the extent of the Crown's power as early as 1668,<sup>6</sup> the Crown's power was upheld by the House of Lords in 1684 in

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<sup>4</sup>H.A. Shannon, "The Coming of General Limited Liability," Economic History, II (1931): 6; reprinted in E.M. Carus-Wilson, ed., Essays in Economic History, I (London: Edward Arnold Ltd., 1962): 358-79.

<sup>5</sup>Case of Monopolies, 11 Co. Rep. 84b (1602).

<sup>6</sup>See, e.g., *Horne vs. Ivy*, 1 Ventr. 47 (1668).

East India Co. vs. Sandys.<sup>7</sup> Nevertheless, at the same time Parliament had become increasingly influential in the administering of monopoly privileges in domestic trade. After 1688, this trend towards Parliamentary control spread to the regulation of foreign trade: "And after the revolution of 1688 it seems to have been tacitly assumed that the Crown's prerogative was limited to the right to grant a charter of incorporation, and that any monopolistic or other special powers should be conferred by statute."<sup>8</sup>

Also, after the "Glorious Revolution" of 1688, and under the influence of Dutch traders who had migrated to England, the unincorporated joint-stock company became a popular form of business association. As indicated by their unincorporated status, these companies were not used in conjunction with state-conferred monopoly privileges. These companies and trading associations remained simple partnerships in the eyes of the law until 1843.

#### B. The Bubble Act, 1720

The use of the corporate form at the beginning of the eighteenth century was closely related to the financial needs of the British government. In particular, there developed the practice of corporations loaning to the government in exchange for commercial privileges.<sup>9</sup> This idea was first exploited by the incorporation of

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<sup>7</sup>East India Co. vs. Sandys, 10 St. Tr. 371 (1684).

<sup>8</sup>Gower, pp. 26-27.

<sup>9</sup>See Kenneth K. Luce, "Trends in Modern Corporation Legislation," Michigan Law Review, 50 (1952): 1291-1322, 1291-3 for a brief description of this practice.

the Bank of England in 1894, and the South Sea Company was incorporated on this principle in 1711 and granted the monopoly of trade to the coast of South America (the South Sea).<sup>10</sup> The passage of the Bubble Act of 1720,<sup>11</sup> which prohibited unincorporated joint-stock enterprises under threat of very heavy penalties, was closely related to the South Sea Company's debt retirement services for the British government.

The South Sea Company's charter was amended in 1719 to authorize it to increase its capital so as to provide funds for the redemption of certain public debts. The company carried out an aggressive marketing scheme that is credited with triggering a period of wild speculation in all joint stock company shares. This so-called South Sea Bubble, which burst in 1720, however, aroused the jealousies of the South Sea directors who felt that they were not receiving their fair share of the rising market for which they were responsible.<sup>12</sup> The political influence of the South Sea Company in this regard is illustrated by the following description of the events leading to the passage of the Bubble Act:

The relation of this Act to the South Sea Company was peculiar. Certain members of the Government were involved in the South Sea directors' bull market notably John Aislabie,

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<sup>10</sup>E.H. Warrer, Corporate Advantages Without Incorporation (New York: Baker, Voorhis and Company, 1919): 329.

<sup>11</sup>6 Geo. 1, c.18 (1720).

<sup>12</sup>See Warren, P. 329. The literature on the Bubble crisis is immense; the best treatment appears to be that of Scott, V.I, Chapters XXI and XXII.

Chancellor of the Exchequer. Many members of Parliament were also involved. Now the essence of the South Sea Scheme of 1719 concerned the irredeemable portion of the National Debt. The company had taken over part of the Debt, amounting to £31,000,000, of which nearly half was in irredeemable annuities. This debt was to be exchanged, the holders of it receiving South Sea Stock, and this exchange was to take place at market prices, that is, the holders (particularly of the irredeemable annuities) were to be tempted to make an exchange. The higher the value of South Sea Stock on the market the more tempting would the exchange become and the less it would cost the company. A man who held an annuity worth £5000 received five units of £100 per stock priced on the market at £1000 in place of fifty units at par.

This was the genesis of the great bull market. But it was discovered that all shares followed the South Sea stock up the price ladder. And people began to manufacture shares just for the purpose of getting into the rising market. This did not suit the South Sea Board at all; the South Sea directors wanted all buying concentrated on their stock. And since they had corrupted both Government and Parliament it is not surprising that there should appear, at the bottom of a portmanteau Act of Parliament, a prohibition of new competition. The Act was passed on June 11, 1720, and the price of South Sea Stock reached its highest recorded price on June 24th. This price was 1050 for the original stock; on June 18th the Company opened subscription books for its third subscription of £4,000,000 at 1000. So much did the elimination of competition do for the South Sea Company, that on August 26th it open a further subscription (the fourth) of £1,250,000 at 1000. The crash came in September after the Lords of Justices had granted writs of Scire Facias against a number of purported companies. Under this writ the companies had to show that their activities conformed to a grant of incorporation, and where this could not be proved the company came to an end. Several companies were thus killed off, their stock became valueless and the unfortunate holders were left with not only valueless stock, but in many cases with loans raised on that stock. Other stocks came on the market to meet this indebtedness and a general wave of selling to realize followed.<sup>13</sup>

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<sup>13</sup>C.A. Cooke, Corporation, Trust, and Company (Cambridge: Harvard University Press, 1951): 82-3.

Other commentators have also suggested that the Bubble Act was passed at the instigation of the South Sea Company.<sup>14</sup>

Shannon, however, offers a public-interest explanation for the passage of the Bubble Act:

In the speculative mania of that time, "the pernicious art of stock jobbing" had been largely practiced at the public's expense. Government misdeeds, financial and moral, added to the public's distress. To allay the popular clamour and to divert the public's attention, the Government passed the famous Bubble Act....The disasters of the time probably checked of themselves any tendency of the company form to spread generally and were a practical demonstration of its possible defects.<sup>15</sup>

Regardless of the public interest or political rationale and rhetoric surrounding the passage of the Bubble Act, the true purpose of the legislation should be deduced from the actual effects. In economic terms, the Bubble Act was an entry barrier designed to put out of business (or hinder development of) all businesses associations which were competing with state charters. In fact, at the time of its passage, Parliament would have been justified from a public-interest perspective in passing enabling-type legislation aimed at having the exact opposite effect as the Bubble Act:

It is at this point that the origin of present day corporate legislation might have been anticipated by almost two hundred years. Parliament might have provided for free incorporation of business organization through a general law, supplemented by affirmative regulation through a general law, supplemented by affirmative regulation of promotion and security flotation to safeguard the interests of investors and creditors. Instead parliament seized upon

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<sup>14</sup>See Warren, P. 329, and John Collyer, On Partnerships, 1st American Edition (Springfield Mass.: G & C Merriam, 1839): 619.

<sup>15</sup>Shannon, "The Coming of General Limited Liability," p. 399.

the free and unregulated company organization which had existed for a generation...and passed the Bubble Act of 1720, a turn in the opposite direction...<sup>16</sup>

As evidence that the Bubble Act was effective in increasing the demand for, and value of, state charters, the difficulties of setting up a large joint-stock enterprise under the law of partnership were set out as the leading reasons for desiring a charter in all petitions for incorporation.<sup>17</sup>

Under the Bubble Act, unincorporated enterprises desiring to issue shares of stock had to operate under the law of partnership which meant that each member of the partnership (i.e., each shareholder) was faced with unlimited liability and, also, that each member had to be joined in a cause of action whenever the partnership sued or was sued. This later aspect of the law of partnership made it virtually impossible to secure standing. In this light, it seems reasonable to conclude that the real purpose of the Bubble Act was to solidify the government's control of the use of a business form that was to become increasingly popular--and valuable:

In fact, the history of the business corporation or joint-stock company in England during the one hundred and fifty years following the statute of 1720 is the story of economic necessity forcing its way slowly and painfully to legal recognition against strong commercial prejudice in

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<sup>16</sup>Luce, p. 1293. Also, see William S. Holdsworth, A History of English Law, 3rd edition, 9 volumes (London: Methuen, 1922-26): VIII, 219-20.

<sup>17</sup>Ibid., p. 361.

favor of "individual" enterprise, and in the face of determined attempts of both the legislature and the courts to deny it.<sup>18</sup>

### C. Special Private Acts for Suing Powers

The joint-stock company became popular later in the eighteenth century despite the Bubble Act, which was not being enforced at that time.<sup>19</sup> Both the common law and the statute law were inadequate to deal with this business form, and this created an opportunity for entrepreneurial behavior on the part of Parliament. The result was, beginning in 1801, the passage of Special Private Acts granting suing powers. These enabled joint-stock companies (i.e., partnerships with perhaps several hundred members) to sue and be sued in the name of a principal officer. The Special Private Acts did not replace the charters as the only method of granting corporate privileges; charters were still needed to confer monopoly privileges and full corporate privileges. The import of these Special Private Acts is that they created a legal entity between a partnership and a corporation.

Shannon claimed that these Acts were important because they involved an increased absorption of Parliamentary time which led to the passage of the Act of 1844.<sup>20</sup> However, this does not seem to be of particular importance in view of the fact that only approximately one

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<sup>18</sup>Bishop C. Hunt, The Development of the Business Corporation in England (New York: Russell and Russell, 1936), p. 13.

<sup>19</sup>See Armand B. Dubois, The English Business Company After the Bubble Act (New York: The Commonwealth Fund, 1938).

<sup>20</sup>Shannon, "The Coming of General Limited Liability," p. 365.

hundred Special Private Acts (conferring suing powers on unincorporated joint-stock companies) were passed between 1801 and 1844,<sup>21</sup> and the rate of less than two and one half per year does not seem burdensome.

Since some of these Special Private Acts were passed before the repeal of the Bubble Act in 1825, the special suing powers must also have conferred some degree of legality on the fortunate unincorporated joint-stock companies. This is important from the perspective of this dissertation because it indicates an additional value of these pieces of special-interest legislation. In fact, there is considerable evidence of this dual characteristic of the acts even after 1825, when the legality of joint-stock companies was left to the common law, which did not clarify their legality until 1843. Consider the following statement by Hunt:

The legislation of 1720 was, in fact, to exercise a deterrent psychological effect upon company promotions even after its repeal under the pressure of a rising industrialism a century later. Before it disappeared from the statute book, it was to be resurrected from near oblivion by the law officers of the Crown again to attack alleged usurpers of corporate privileges and interlopers in "private trading".<sup>22</sup>

Enforcement of the Bubble Act began anew in 1808 with the case of Rex v. Dodd.<sup>23</sup> The Attorney General suggested: "The only reason why

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<sup>21</sup>Ibid.

<sup>22</sup>Hunt, p. 9 (emphasis added). The same point is emphasized by Gower, p. 31.

<sup>23</sup>Rex v. Dodd, 9 East 516 (1808).

this branch of the Statute had not been acted upon for so long was because it had corrected an evil it was intended to suppress, till now of late when it had shown itself again, it was necessary to put this wholesome law into force." In the Court of King's Bench, Lord Ellenborough refused to bring the full force of the law into action, but warned that no person in the future could pretend that the statute was obsolete. This case was followed by several successful prosecutions under the Bubble Act, and the result was great confusion concerning what was legal under the Act. This confusing litigation was one of the major causes of difficulty in using the joint stock form even after the repeal of the Bubble Act.<sup>24</sup> It is also further evidence of the long-term effectiveness of the Bubble Act as an entry barrier.

Further evidence of the aura of legality conferred by the Special Private Acts for suing powers is found in dicta from opinions written by Lord Chancellor Eldon, an arch enemy of unincorporated joint-stock companies. In Davis v. Fisk (1823),<sup>25</sup> Eldon said, "The policy of the Acts of Parliament, in such cases, was to render facility to justice by making one person to represent a mass, which would itself be immovable." That is, an otherwise illegal joint-stock company was

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<sup>24</sup>See Hunt, pp. 15-21, Warren, pp. 329-332, and Gower, pp. 36-7, for the confused state of the legality of joint-stock companies under the Bubble Act.

<sup>25</sup>Not reported. Quoted from Hunt, p. 27.

allowed access to the courts because of the Special Act. Contrast that position with the position taken in Van Sandau v. P. Moore, et al, (1825),<sup>26</sup> a suit involving a concern with several hundred partners and no Special Act conferring suing powers, where the Lord Chancellor suggested that the very impossibility of effective suit under such circumstances was a strong argument to prove the company illegal. Note that these were common-law decisions which were still applicable after the repeal of the Bubble Act. Thus, because of its influence in the common-law courts, the Bubble Act was still an effective entry barrier even after its repeal.

#### D. The Repeal of the Bubble Act, 1825

The years 1824-1825 witnessed a veritable avalanche of company promotions and general speculation. The time was ripe for speculation. The economy had recovered from the post-Napoleonic Wars depression, deflation had run its course; capital was abundant and rapidly increasing, no longer heavily taxed and absorbed by war; and interest rates were low.<sup>27</sup> During this boom company promoters flocked to Parliament with applications for corporate privileges, in some instances suing powers and, in others, for full corporate privileges. Many of the companies were formed in expectation of receiving charters, and Lord Eldon continuously denounced that practice. Petitions for

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<sup>26</sup>Van Sandau v. P. Moore, 1 Russell 572 (1825).

<sup>27</sup>See Hunt, pp. 29-31, for a general discussion of the state of the economy in 1824-25.

companies formed for "public utilities" were much more successful than those for commercial purposes, as indicated by the following figures for 1825: 73 of 104 petitions for corporate privileges for companies engaged in the improvement of towns (waterworks, gas, etc.) were passed; 108 of 146 petitions by companies engaged in internal communications (roads, canals, railroads) were passed; and only 11 of 47 petitions for other purposes were passed.<sup>28</sup> However, this was a boom year, and the proliferation of company promotions continued without the benefit of Parliament.

There was a lot of public pressure for the repeal of the Bubble Act; of course, given the popularity of the shares of these unincorporated, illegal companies it is not surprising that there was considerable pressure for changing the law. In other words, the political economy of 1825 leads to a prediction of strong pressures for change. In fact, the bill that repealed the Bubble Act was introduced by P. Moore, a company promoter in Parliament, who had been a part to the case of Van Sandau v. P. Moore, et al, (1825),<sup>29</sup> which was referred to earlier. An examination of the Parliamentary debates on the repeal of the Bubble Act has revealed that Moore made no attempt to hid his role as a company promoter; in fact, he insisted that the companies with which he was associated were as stable and trustworthy as the Bank of

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<sup>28</sup>Ibid., pp. 50-51.

<sup>29</sup>Van Sandau v. P. Moore, et al., 1 Russell 472(1825)

England.<sup>30</sup> Moore also claimed that his companies were legal, given a proper construction and application of the Bubble Act, yet threatened operation of the Act hindered their activities.<sup>31</sup> The general tone of the debates indicates that there was a widespread belief that the Bubble Act was unnecessarily disruptive.

The Repealing Act of 1825<sup>32</sup> removed the statutory prohibition against partnerships with transferable shares; these joint-stock associations were now legal under the statutory law, but there remained the question of their legality under the common law, where Lord Chancellor Eldon had indicated that they were illegal. That is, the aura of legality conferred by the Special Acts granting suing powers was still a valuable and important attribute of those acts because of the hostility of the common law courts. And of course, the suing powers themselves were still an important privilege for the larger partnerships. Thus, it appears that the repeal of the Bubble Act may not have had as large an initial impact on the market for corporate privileges as one would have expected.

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<sup>30</sup>T.C. Hansard, Parliamentary Debates (London, 1800-1875): Vol. XII (March 29, 1825), p. 1282.

<sup>31</sup>Ibid., p. 1284. Moore also threw in a revenue-generating argument in favor of repeal: Since every transfer of stock was liable to a heavy stamp duty, coupled with the expectation that repeal would increase the transfer of shares, then the Companies could be used to raise a "good deal of revenue." Ibid., p. 1280.

<sup>32</sup>6 Geo. IV, c. 91.

The Repealing Act also conferred greater discretionary power on the Crown in the granting of corporate privileges. As mentioned earlier, royal charters were granted either under the common law or under statute. Under the common law, limited liability was an inseparable incident of corporate status. However, beginning in 1825, the Crown was empowered by the Repealing Act to prescribe to any extent the degree of shareholders' responsibility. That is, there must have been instances where limited liability was not the preferred form of shareholders' liability, possibly because limited liability cost more than some firms could afford and Parliament was able to price discriminate. Thus, Parliament authorized the production of this differentiated product. The Crown could now grant charters which were more similar, in practical effect, to the Special Private Acts granting suing powers than to a royal charter granted under the common law.

Since Parliament was dominant by this time, the granting of these additional powers to the Crown should not be viewed as a relinquishment by Parliament of some of its control over the market for corporate privileges, but rather as an improvement in the management of the production of those privileges. Parliament's time was conserved, but it still maintained at least indirect control over the dispersal of corporate privileges. An any rate, "the grant of charters continued to be very jealously guarded."<sup>33</sup> Between 1825 and 1834, partial corporation privileges were granted by the Crown in only six cases, and

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<sup>33</sup>Hunt, p. 41.

full privileges in only one case, out of a total of approximately thirty applications to the Crown.<sup>34</sup>

E. The Acts of 1834 and 1837

The Trading Companies Bill of 1834<sup>35</sup> reiterated the power of the Crown to confer some of the corporate privileges incident to royal charters. The purpose of the act was "to enable his Majesty to invest trading and other companies with the powers necessary for the due conduct of their affairs and for the security of the rights and interests of their creditors." That is, the stated goal of this act was to allow the Crown to confer essentially the same privileges as those being granted by Parliament in the Special Private Acts for suing powers. As a result of this act, the Crown could then, on special application and approval, create an association that at common law was neither a partnership nor a corporation. The Crown, through the Board of Trade, handed out very few of these privileges during the 1834 to 1837 period; only three or four of some twenty-five applications were approved. But, the courts construed the grants very strictly and the act was found to be ineffective by 1837.<sup>36</sup> Once again, it is important that we view the operation of these acts as being under the direction of Parliament; that is, Parliament was the dominant force in the state's production of corporate privileges. Thus, application to

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<sup>34</sup>Ibid., p. 58.

<sup>35</sup>4/5 Wm. IV, c. 94.

<sup>36</sup>Hunt, p. 60.

Parliament for statutory incorporation fared better than those to the Board of Trade.<sup>37</sup> The demand for special charters had been stimulated by the boom in railroad promotions, but it appears that their expense was prohibitive except for the largest concerns. For example, two railroad special charters were reported to have cost their incorporators £72,868 and £40,588.<sup>38</sup> Even the fees paid directly to Parliament amounted to at least £502 for the passage of a special corporate charter.<sup>39</sup>

The English law of partnership was specifically reported on in 1837 "with regard to the difficulties which exist in suing and being sued where partners are numerous," and "whether it would be expedient to introduce a law authorizing persons to become partners with a limited liability." The Report on the Law of Partnership<sup>40</sup> identified three principal evils of the existing partnership law: (1) those arising from the difficulties of suing and being sued; (2) those arising in legal proceedings within the partnership; and (3) those arising from the rule that any person taking an interest in the profits became liable as a partner (i.e., the difficulties of determining the partnership itself). The Report considered the expediency of

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<sup>37</sup>Gower, p. 309.

<sup>38</sup>Hunt, p. 82.

<sup>39</sup>Ibid.

<sup>40</sup>H. Bellenden Ker, "Report on the Law of Partnership," Parliamentary Papers, XLIV (1937-38).

introducing the limited trading partnership, but recommended against it. The major proposal of the Report was to make illegal all partnerships of more than fifteen members unless formed by a deed of settlement (which constitutes trustees of the partnership property, directors, etc.) and to prohibit the sale of shares by any company not so registered: "Perhaps all the public can require is that they know who are the partners liable and have easy means of suing them."

In his discussion of the Report, Shannon identified six factors which he felt combined to check the correction of this "unsuitable body of law": (1) the conservatism of the legal profession; (2) the example of a great Lord Chancellor (Eldon); (3) the lingering presence of the Bubble Act and its suggestion of common law prohibition; (4) the indifference of the legislature; (5) the relative novelty of the economic changes; and (6) the small number of companies in existence.<sup>41</sup> The most important of these factors from the point of view of this dissertation is the fourth; the legislature was not really indifferent to the inadequacies of the law. Parliament was producing special-interest legislation that corrected many of the inadequacies of the law. The indifference of the legislature was to the passage of a general act, which would, of course, reduce to zero the value of the Special Private Acts for suing powers. Also, as noted earlier, the lingering effects of the Bubble Act helped maintain the value of these Special Acts.

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<sup>41</sup>Shannon, "The Coming of General Limited Liability," pp. 366-67.

Actually, the first three factors could be combined under the following heading: conservatism of the common law process. This aspect of the common law is very important from an interest-group perspective: the value of special-interest legislation will be enhanced in a regimen where the legal and economic institutions, which create the opportunity for entrepreneurial behavior on the part of legislators, are not subject to rapid change. In other words, the greater the certainty that the institutions providing the framework for the special-interest legislation will not change, then the higher the expected present value of the legislation (because of the increase in the expected durability), and thus, the higher the bids for the legislation. In this instance, the conservatism of the common law--as manifest in its reluctance to recognize the joint-stock form as a legal entity between the partnership and the corporation had helped maintain an inadequate property-rights structure, which the legislators exploited through special-interest legislation (corporate charters and Special Private Acts).

As we shall see, gradual changes in the common law, and the flexibility of the equity courts, led to the downfall of this particular form of legislation. These changes by the courts are viewed as exogenous to Parliament. However, we must identify other exogenous changes that might explain why Parliament failed to counteract the changes that developed through the courts. But before identifying the changes that developed through the courts, we turn to the last major piece of legislation affecting unincorporated joint-stock companies prior to the Registration Act of 1844.

"An act for better enabling Her Majesty to confer certain Powers and Immunities on Trading and other Companies" was passed in 1837 in response to the Report on the Law of Partnership.<sup>42</sup> However, the Act did not enact the recommendations of the report. It did confer more discretionary power on the Crown with respect to the limitation of liabilities. Companies granted Letters Patent could receive any, or all, of the privileges of a corporation under the common law. Limited liability, or any other rule concerning shareholders' responsibility, could be granted at the discretion of the Board of Trade. The Act, known as the Chartered Companies Act, included one major improvement over the Act of 1834: the liability of a member ceased upon his transfer of shares.

Shannon's description of the Crown's policy after the Chartered Companies Act of 1837 is illuminating:

It was then possible for the President of the Board of Trade to open or shut the floodgates of general limited liability. A charter still required special application and a discretionary judgment. Practice varied under different Presidents, but consent was never too freely given. Charters conferring suing powers were difficult to obtain, and charters conferring limited liability were seldom granted at all. The Board of Trade in 1834 had declared that the new powers, even the suing powers, would not be conferred indiscriminately so long at least as the partnership remained unchanged, for unfair competition might ensue. They might be conferred where the nature and objects of the company justified their grant on grounds of public policy. The examples given were: first, where the object was hazardous and deterrent to small partnerships, as in mining; second, where the capital was beyond the resources of a few individuals, as in railways; third, where extended

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<sup>42</sup>1 Vict., c. 73.

responsibility was desirable, as in insurance; and where a numerous membership was necessary, as in literary societies. These general principles still applied in 1850 and later. The expense of obtaining a charter remained quite high.<sup>43</sup>

Only fifty companies were allowed to form under the Chartered Companies Act of 1837 in the seventeen years it was in effect.<sup>44</sup> This policy was definitely consistent with the maintenance of Parliament's monopoly position, or at least indicates monopolistic behavior, in the granting of corporate privileges.

The next major statute was the Registration Act of 1844,<sup>45</sup> which granted companies the right to suing powers by mere registration, but first two developments relevant to that radical change in the law must be discussed. The first is the growth in popularity of a major, although not perfect, substitute of the chartered companies: the business trust; the second is the recognition in 1843 of the legality of unincorporated joint-stock companies and freely transferable shares under the common law. As mentioned earlier, the changes that developed through the courts are viewed as exogenous even though they could be counteracted by Parliament. These changes through the courts could be viewed as major determinants of Parliament's decisions to reduce its monopoly power over the use of corporate privileges; and, it will be argued that they were at least catalysts for Parliament's relinquishment of control.

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<sup>43</sup>Shannon, "The Coming of General Limited Liability," pp. 368-69 (emphasis added).

<sup>44</sup>Gower, p. 40.

<sup>45</sup>7/6 Vict., c. 110.

## F. Trusts

Eighteenth century lawyers were somewhat successful in securing the advantages of formal incorporation for the unincorporated company. The substitutes employed were more cumbersome or unweildly than the corporation, and it appears that they were not foolproof.<sup>46</sup> DuBois' description of the methods employed by these unincorporated associations is adequate for our purposes:

Instead of a charter or act of incorporation, the basis of the unincorporated organization has to be found in the articles of association which were, as a rule, in the form of a deed of settlement signed by those participating in the society. This instrument would make provision for the management of the business through a committee of management and an assembly of the subscribers. The articles of association stand as the constitution of the unincorporated society, and it was clearly understood in the eighteenth century that protests from members would be in order if committeemen sought to depart from its provisions....The fact that the unincorporated association in this period was a step-child of the law meant that there were serious difficulties to surmount. If the rules of law that had evolved in connection with the partnership of a small number of participants were to be applied without modification to the larger organization, it would mean that each and every member must join in the conveyance of the society's property and in the bringing and defending of actions, and that the death of a member would necessitate a reorganization of the enterprise....The trustee device was the means most frequently used to circumvent these difficulties. The organization's real and personal property would be placed in the names of trustees, and trustees selected by the subscribers would be authorized in certain instances to act in the society's behalf....Although the trustee device was as a rule an effective method of dealing with the problem of holding the property of an unincorporated association, more difficulty was experienced in regard to the bringing and defending of actions and suits. The secretary or other officer of an unincorporated society might be designated to

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<sup>46</sup>See A.B. DuBois, The English Business Company After The Bubble Act (New York: The Commonwealth Fund, 1938): 219, for an example where the trusteeship was ineffective in meeting the problems of holding property by an unincorporated society.

defend or bring actions, or the trustees who were holding the company's property might be selected. The privilege of so bringing an action was subject to attacks in the courts of law. In Chancery, during this period, representative suits by directors or officers were as a rule permitted, although permission was subject to restriction in the Chancellor's discretion....The difficulties of the unincorporated organization in making use of the courts of law and equity were to some extent lessened in importance by the use of arbitration....The businessman was prejudiced against "the law's delay" and eagerly made use of the service of arbitrators....The trustee device thus served effectively to give the unincorporated association at least some of the ease and effectiveness in dealing with property and court procedure that were the characteristics of the corporation. Indeed, extremely rare was the eighteenth century unincorporated association that did not make at least some use of trustees. Still, the forms involved were complicated, the responsibilities of the trustees great, their rewards small, and the question of succession of trustees bothersome. In most cases it would have been a relief to turn to the simplicity of the corporation.<sup>47</sup>

As we have seen, "the simplicity of the corporation" was not easy to acquire. Also, as a result of the Bubble Act, it was difficult to organize a trust so that the shares were freely transferable. A major difficulty with this was that fluctuation of membership in the society raised questions concerning the authority of the trustees to conduct the business for the new members of the association. An important case concerning this problem was decided in 1810.

In Metcalf v. Bruin<sup>48</sup> it was held that the trustees of a joint stock company could sue on a bond made to them as such, notwithstanding a change in the company; the court reasoned that the obligor, knowing the fluctuating nature of the company must have intended that the

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<sup>47</sup>Ibid., pp. 217-22.

<sup>48</sup>Metcalf v. Bruin, 12 East 405 (1810).

trustees would represent the company in all disputes. Lord Ellenborough, in the Court of King's Bench, stated:

We could not indeed invert the rules of law to enable persons to sue as a body or company who are under no difficulty of suing upon it in their own names. The persons constituting this company laboured under an imperfection to contract, from the fluctuating nature of their body, and therefore, they constituted seven persons to be trustees for them; and whether those seven persons were members of the body or not is for this purpose indifferent.<sup>49</sup>

Thus, the court had yielded to the commercial pressures of the time.

However, it is important to note that the company involved in Metcalf v. Bruin had been conferred suing powers by a Special Act of

Parliament; and thus, as discussed earlier, there was an aura of legality concerning its joint-stock status, which was still illegal under the Bubble Act. That is, the importance of this case for our purposes is that it increased the general utility of the trust device as it relates to suing powers when shares were transferred. However, the legality of the transfer of shares of joint-stock associations that had not received sanction from the state through the Special Private Acts remained in doubt until 1843; thus, the charters and acts of Parliament still conferred valuable privileges.

#### G. The Legality of Unincorporated Joint-Stock Associations

Lord Chancellor Eldon was responsible for a provision in the Repealing Act (1825) to the effect that notwithstanding the repeal of the Bubble Act of 1720 "the several undertakings shall be adjusted and

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<sup>49</sup>Ibid., pp. 405-406.

dealt with according to common law."<sup>50</sup> As shown earlier, the courts, under Eldon's influence, had become increasingly hostile towards unincorporated joint-stock associations prior to the repeal of the Bubble Act. And, as shown below, the influence of Eldon and the Bubble Act continued to place a cloud over the legality of these associations until 1843.<sup>51</sup>

In Duvergier v. Fellows (1828),<sup>52</sup> Chief Justice Best expressed Eldon's view on the legality of the unincorporated joint-stock company when he stated: "Persons who without sanction of the legislature, presume to act as a corporation are guilty of a contempt of the King." However, in Walburn v. Ingelby (1833),<sup>53</sup> the court expressed a more progressive view concerning the legality of joint stock companies. Counsel had urged that although the Bubble Act was repealed, it had been declaratory only, and that therefore the company under litigation was illegal at common law and should not be assisted by a court of equity. The Lord Chancellor (Brougham) rejected this argument and said that:

"To hold such a company illegal would be to say that every joint-stock company, not incorporated by Charter or Act of Parliament is indictable as a nuisance, and (would be) to decide this for the first time, no authority for a decided case being produced for such a doctrine."

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<sup>50</sup>Hunt, p. 41.

<sup>51</sup>See Ibid., pp. 41-45, and Edward H. Warren, Corporate Advantages Without Incorporation (New York: Baker, Voorhis and Co., 1929): 330-32, for more thorough discussions of the transition in judicial thought concerning the legality of the unincorporated joint-stock company under the common law. Also, see Gower, p. 39.

<sup>52</sup>Duvergier v. Fellows, 5 Bingham 267 (1828).

<sup>53</sup>Walburn v. Ingelby, Mylne and K. 61 (1833).

Yet, in Blundell v. Windsor (1835),<sup>54</sup> the judge returned to Eldon's view when he held a company illegal because "it [trenched] upon the prerogative of the King, by attempting to create a body not having the protection of the King's charter." Finally, however, in the following cases decided in 1843, the judges took a more liberal position. In Garrard v. Hardy,<sup>55</sup> Chief Justice Tindal held that:

....the raising and transferring of stock in a company cannot be held in itself an offense at common law: such species of property was altogether unknown in ancient times....the plea states no illegal mode or means by which they pretended to act as a corporation, as by usurping a common seal, or the like; nothing more is stated than their assuming the style and form of a company.

And in Harrison v. Heathorn:<sup>56</sup>

....the raising of transferable shares of the stock of a company can hardly be said to be of itself a nuisance and grievance at common law; no instance of an indictment at common law for such an offense can be shown, the raising of stocks with transferable shares being indeed a modern proceeding; and their very great particularity with which it is described by the statute (Bubble Act) seems to show that it was an offense created by statute....

Thus, at last, the value to Parliament of the Bubble Act as an entry barrier had been reduced to zero.

The value of the Special Private Acts conferring suing powers, and the charters that did not confer limited liability, was twofold prior to 1843. The first attribute of the acts which made them desirable was that they conferred suing powers. The second attribute, we have argued, was that they conferred an aura of legality on these

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<sup>54</sup>Blundell v. Windsor, 8 Sim. 601 (1835).

<sup>55</sup>Garrard v. Hardy, 5 Man. and Gr. 471 (1843).

<sup>56</sup>Harrison v. Heathorn, 6 Man. and Gr. 81 (1843).

unincorporated associations that were issuing transferable shares. As a result of the 1843 cases, which left no doubt as to the legality of those joint-stock associations, the value of the second attribute of the Special Private Acts was reduced to zero. Furthermore, the value of the suing powers conferred by these acts was greatly diminished because the 1843 cases, when coupled with the decision in Metcalf v. Bruin,<sup>57</sup> had increased the utility of a major substitute: the business trust with freely transferable shares was legal and could sue in the name of its trustees.

The interest-group interpretation of these exogenous changes in the common-law courts is that they greatly reduced the demand for, and value of, special-interest legislation. The model of legal-institutional change utilized in this dissertation does not predict that there definitely would be a reaction by Parliament designed to counteract the change in the courts, but it does suggest that a change in the law should not be totally unexpected. As it turned out, the following year saw the passage of a major piece of legislation concerning the legal nature of joint-stock companies.

#### H. The Registration Act of 1844 (or Companies Act of 1844)

Under Gladstone's direction the Board of Trade, in 1844, concluded an investigation into the feasibility of the regulation of joint-stock companies in general.<sup>58</sup> The Committee conducting the investigation was

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<sup>57</sup>Metcalf v. Bruin, 12 East 405 (1810).

<sup>58</sup>"Report of the Select Committee on Joint Stock Companies," Parliamentary Papers, VII (1844), #119. The evidence was taken in 1841 and 1843, and the minutes of the evidence covers more than 300 pages.

concerned primarily with preventing "the use of Joint Stock Companies as mere instruments of share jobbing."<sup>59</sup> The workings of a typical share-jobbing scheme were revealed in the Report and are as follows. Promoters would organize concerns with outwardly-legitimate goals as joint stock companies. In order to signal the legitimacy of their company, the promoters would, without authorization, list the names of distinguished and respected persons as the directors and promoters of the company in the company's prospectuses and advertisements. Using the same and similar fraudulent practices, the promoters would enlist respectable agents throughout the country to sell the shares. The use of respectable agents increased the marketability of shares to persons of limited means, and the Committee found this to be particularly distressing.<sup>60</sup> After selling the shares, the promoters would waste away the joint-stock company's assets and then dissolve the firm:

"The mode of distributing the plunder varies. Sometimes it is taken by one of the leaders, and shared among the others; sometimes it assumes the form of a high fixed payment, disproportionate to the service of the individual and to the means of the Company."<sup>61</sup>

The investors were left with worthless shares, and the partnership status of the joint stock company rendered the shareholders remediless.<sup>62</sup> Accordingly, the Committee was concerned with

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<sup>59</sup>Ibid., p. vi.

<sup>60</sup>Ibid., p. xi.

<sup>61</sup>Ibid.

<sup>62</sup>Ibid.

protecting shareholders. The firms were usually not in debt when dissolved and thus the Report did not address the advisability of either the limited partnership or the limited-liability joint-stock company.<sup>63</sup>

Gladstone's committee concentrated its efforts on "a few remarkable cases of miscarriage or fraud, with a view to practical remedies to be specifically directed to such cases."<sup>64</sup> Accordingly, the witnesses were questioned about the specific activities of only ten bubble companies -- "Seven Insurance, Annuity and Loan Companies; Three Mining and General Companies."<sup>65</sup> Evidence was gathered from lawyers, accountants, merchants, bankers, and a locksmith.<sup>66</sup> The large majority of witnesses were lawyers and accountants associated with established and reputable joint stock companies. The witnesses testified of their contacts with the so-called bubble companies and offered recommendations on how to control the fraudulent companies. In its Report the committee concluded that the great remedy for the evils of share-jobbing was to insure that the public had adequate information about the shares they purchased. In sum, the Committee recommended the establishment of means to insure: (1) sound regulations for the constitutions of the companies at promotion, including the basic

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<sup>63</sup>The "Report on the Law of Partnership," in 1837 dealt specifically with the advisability of limited liability.

<sup>64</sup>Ibid., p. iii.

<sup>65</sup>Ibid., o. vii.

<sup>66</sup>For the list of witnesses, by occupation, see Ibid., p. 1.

requirement of regular shareholder meetings; and (2) publicity throughout the whole course of the proceedings.<sup>67</sup>

At Gladstone's insistence, Parliament responded to the committee's report by passing "an Act for the registration, incorporation and regulation of joint-stock companies," -- the Registration Act or Joint Stock Companies Act of 1844.<sup>68</sup> A joint-stock company was defined as a commercial partnership with more than twenty-five members or with a capital divided into freely transferable shares. The major benefit conferred on the companies by the act was the privilege of corporate suing capacity. Members had the unlimited liability of a simple partnership, and liability continued for three years after a transfer of shares.<sup>69</sup> In the words of Hunt:

What it could not suppress, Parliament now, in the public interest, proceeded to subject "to general inspection and regulation." In testimony before the Committee it had been argued that: "Inasmuch as transferable shares have become in a measure part of the circulation of the courts, and as there will always be an extensive class of buyers and sellers of shares thus made publicly vendible by sanction of law, many of which buyers and sellers will be....inexperienced persons, it is the duty of the legislature to keep some degree of control over the birth and course of life of joint-stock companies, having reference to the different objects for which they may be formed."<sup>70</sup>

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<sup>67</sup>For a complete list of the resolutions see *Ibid.*, pp. xii-xv. For a discussion, see Hunt, p. 94.

<sup>68</sup>7/8 Vict., c. 110.

<sup>69</sup>Shannon, "The Coming of General Limited Liability," pp. 370-71. Thus with respect to limited liability, the "only advance was the recognition that the company itself was primarily liable and that its bankruptcy did not necessarily involve bankruptcy of its members." Gower, p. 42.

<sup>70</sup>Hunt, pp. 95-6.

The registration requirements, and the restrictions on the financial operations of the firm after incorporation, were similar to the provisions of modern American securities laws, which are primarily disclosure and anti-fraud laws.<sup>71</sup> As part of the registration process, a prospectus identifying the promoters and their interests in the firm had to be filed. The financial information contained in the prospectus was required to be kept current, and the directors were required to keep books of accounts and balance sheets. The Act required that the financial reports be audited by someone other than the director (or their clerks),<sup>72</sup> and provided a right of inspection to the shareholder. The Act even included guidelines for the content of the provisions regulating the internal affairs of the firm that should be included in the deed of settlement, a document which performs the same functions as the charter, articles of incorporation and by-laws. The Registrar had the power to reject any deeds which were incomplete or repugnant to the Act or the law generally. Of this, Shannon said: "This is not laissez-faire but administrative or quasi-administrative law, and all in 1844."<sup>73</sup> Finally, there were restrictions on insider trading.<sup>74</sup>

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<sup>71</sup>For a survey of American securities laws see David L. Ratner, Securities Regulation (St. Paul: West Publishing Co., 1975).

<sup>72</sup>See Ross L. Watts and Jerold L. Zimmerman, "The Markets for Independence and Independent Auditors," manuscript, University of Rochester (July, 1979), for a thorough discussion of the development of the use of independent auditors.

<sup>73</sup>Shannon, "The Coming of General Limited Liability," p. 370.

<sup>74</sup>Ibid., p. 371

A major problem with the disclosure provisions of the Registration Act was the inadequacy of its penal provisions. The Act provided that failure to make the required disclosure was punishable by fine; false statements in the prospectus and other documents were misdemeanors, but the act failed to provide whose duty it was to prosecute.<sup>75</sup> The courts at that time did not recognize an implied private right of action from the statute. Thus, in the absence of common law fraud, failure to comply with registration requirements could not be corrected by the courts. As a result of this defect, most companies took advantage of the benefits of the Act (i.e., the suing capacity of the corporation) while frequently ignoring the registration process.<sup>76</sup>

The Registration Act could have taken many forms, and from a public-interest point of view the reforms were called for as early as the Report on the Law of Partnership<sup>77</sup> in 1837. The 1843 cases, it seems clear served as a catalyst for the emergence of the general availability of all of the usual corporate privileges, except limited liability. However, the major query at this juncture is why Parliament chose to pass an act like the Registration Act instead of an act similar to the Bubble Act, which would have been designed to maintain the value of their monopoly power over corporate privileges in the face of the endogenous changes by the courts. To answer this question

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<sup>75</sup>Ibid.

<sup>76</sup>Ibid.

<sup>77</sup>Parliamentary Papers, XLIV (1837) #530.

economic and political developments in England since the repeal of the Bubble Act in 1825 must be considered.<sup>78</sup>

The major exogenous change affecting this era was the Industrial Revolution. The Industrial Revolution was not just an economic change, it was also a catalyst for political and social changes. In the course of seven decades -- between the early 1780's when the steam engine, the new textile machinery and Cort's puddling process were being introduced, and the late 1840's when the railway construction boom was at its height -- the Industrial Revolution transformed a predominately rural, family-based economy into an urban, industrial economy. By the time of the passage of the Registration Act of 1844, England had developed a thriving middle class and, for the first time, the working class was earning more than a subsistence wage.

The Industrial Revolution led to a major transformation of the political economy of England. The Reform Bill of 1832 signifies the beginning of the transfer of political power away from the landed aristocracy and towards the inhabitants of industrial cities. In Parliament, there was a fundamental change in the relationship between voting rights and landed property rights. Earlier MP's wealth had been

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<sup>78</sup>The following historical background is a synthesis and condensation of information obtained from the following sources: Asa Briggs, The Making of Modern England, 1783-1867: The Age of Improvement (New York: Harper and Row, 1959): 184-325; Sir James Butler, A History of England, 1815-1939 (London: Oxford University Press, 1973): 45-95. E. Lipson, The Growth of English Society - A Short Economic History (London: Adam and Charles Black, 1949): 300-24, 362-94.

vested in land, but after 1832 Parliament was made up of less landed aristocracy -- the MP's now held their wealth in forms other than land (e.g., stock or other securities).<sup>79</sup> Thus, the change in the make-up of Parliament might help explain why Parliament failed to reassert its monopoly power that had been eroded by changes through the courts. For example, the MP's would have accepted the changes in the law because the changes could have increased the wealth the MP's by giving them more investment opportunities.

Another explanation for Parliament's response to the changes in the common-law courts is related to broad-based demands for low-risk investment opportunities. The Industrial Revolution's economic and political developments had created a franchised middle class and a working class earning above subsistence wages. Because of these developments, "The rate of investment [for the entire British economy] increased rather suddenly, perhaps by as much as two percent of national income in the 1830's and 40's..."<sup>80</sup> By the 1840's there had been a large increase in the number of depositors and the amount of deposits in savings banks.<sup>81</sup> In part, this was due to the fact that

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<sup>79</sup>Of course, prior to 1832 MP's held some of their wealth in securities. Recall that the MP who introduced the Repealing Act in 1825 was a company promoter; see section III.D, supra.

<sup>80</sup>Phyllis Deane and W.A. Cole, British Economic Growth: 1688-1959, Second edition (Cambridge, England: University Press, 1969): 263-64.

<sup>81</sup>Leone Levi, The History of British Commerce and of the Economic Progress of the British Nation: 1763-1880, Second Edition (London, 1880; reprint: Shannon, Ireland, 1971): 341, and Hunt, p. 341.

the middle and working classes did not have many opportunities for investing their growing wealth. The only safe investments for small passive capitalists were canals and railways, which were Special Charter, limited liability companies. The investment in land or landed securities was not available to most of these parties because of the high risks and transactions costs associated with the uncertainty and complexity of titles.<sup>82</sup> Furthermore, the riskiness of stock in unincorporated joint-stock companies with unlimited liability was greater than the small investor was willing to bear.<sup>83</sup> Thus, it appears that there was a broad-based need and demand for more investment opportunities for small investors. As mentioned above, the Report of 1844 indicated that the disclosure and anti-fraud provisions of the Registration Act were enacted in order to reduce directors' and promoters' opportunities for fraudulent behavior at the expense of investors of limited means.<sup>84</sup> This indicates that the passage of the Registration Act might have been Parliament's response to the broad-based demand of small investors. Although the perspective of this dissertation suggests that broad-based demands will usually be overcome in the legislative process by the narrow-based demands of special-interest groups, the passage of the Registration Act does not appear to contradict this view because the Act's legislative history

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<sup>82</sup>Of course, prior to 1832 MP's held some of their wealth in securities. Recall that the MP who introduced the Repealing Act in 1825 was a company promoter; see section III.D, supra.

<sup>83</sup>Levi, p. 341.

<sup>84</sup>"Report of 1844," p. xi.

fails to reveal any opposition to it and because of the possibility that the MP's themselves were in favor of its passage.

The legislative history of the Act does not explain why the Act was enabling, as opposed to restrictive, in nature. On the other hand, the legislative history does not present any evidence to suggest a reason for the timing of the passage of the Act. The evidence collected is consistent with the thesis that Parliament's action was in direct response to the developments in the common-law courts.

After the passage of the Registration Act of 1844 there were three types of commercial associations: (1) chartered and statutory companies which were incorporated and the members of which were normally free from liability or had their liability limited to a prescribed sum per share; (2) companies formed or registered under the 1844 Act which were incorporated but without limited liability; and (3) private partnerships of not more than 25 persons, and quasi-partnerships of unlimited dimensions formed before 1844 which had not registered under the Act -- these were unincorporated and the liability of the members was necessarily unlimited. Legally all registered-company shareholders were subject to unlimited liability, but there was de facto limited liability for many shareholders because of the cumbersome nature of the law. Because they had to pursue each shareholder in an individual action, the creditors of an insolvent company tended to pursue the richest and best known shareholders for satisfaction of their claims. In effect, the small anonymous

shareholders had limited liability because the creditors never attacked them, and the richer shareholders had no legal resource against the poorer shareholders. A depression from 1845 to 1848 emphasized the need for widespread availability of limited liability and "...it is clear that public opinion began to harden in favor of the extension of limited liability..."<sup>85</sup> Yet the general availability of limited liability was not achieved until the occurrence of another shock to the market for corporate privileges.

#### I. The Achievement of General Limited Liability

The Registration Act of 1844 proved to be inadequate for its stated purposes: the prevention of fraud and the increased availability of secure investment opportunities for small investors. As mentioned earlier, the publication requirements were frequently ignored and there were no enforcement procedures to force compliance by companies that took advantage of the suing capacity granted by the Act. The ending of de facto limited liability for small investors made their investments in joint-stock ventures ever more risky (in terms of the likelihood of liability beyond their initial subscription) and less

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<sup>85</sup>Gower, p. 43. The Joint-Stock Companies Winding-up Act of 1848 (11 and 12 Vict.C.45) marked the complete end of de facto limited liability. Under the 1848 Act, a "Master" was appointed by the court to oversee the liquidation of the insolvent, or solvent, company. The Master had full judicial and administrative powers to distribute the debts of the company among the shareholders in any manner he deemed appropriate. Since he often saw fit to distribute them either proportionately by shareowner or by shares owned, the de facto limitation on liability enjoyed by "small" shareholders was thus eliminated. See Christine E. Amsler, Robin L. Bartlett, and Craig J. Bolton, "Thoughts of Some British Economists on Early Limited Liability and Corporate Legislation," History of Political Economy (forthcoming).

attractive than they were prior to the enactment of the anti-fraud provision. In effect, this change in the realities of unlimited liability increased the attractiveness of these investments to risk averse investors because it reduced their maximum conceivable liability by the amount of debts that would be collected from the smaller investors. In the late 1840's, only the largest firms and the larger, or least risk averse, investors were enjoying the advantages conferred by the Registration Act.<sup>86</sup>

Several members of Parliament were quick to recognize that the major defect of the 1844 Act was the unlimited liability of small, passive investors. However, in 1847, Parliament rejected a plan for en commandite (limited) partnership -- a legal arrangement where the active members of the partnership are subject to unlimited liability as in a simple partnership, while the passive partners' (investors') liability is limited to their subscribed capital.<sup>87</sup> The issue of the general availability of limited liability was hotly contested in the early 1850's. The clash of opinions and statements of facts, including

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<sup>86</sup>The major practical problems of the Registration Act are presented in "Report of the Select Committee on Investments for the Savings of the Middle and Working Classes," Parliamentary Papers, XIX (1850) #508. Also, see Shannon, "The Coming of General Limited Liability," p. 376.

<sup>87</sup>The limited partnership did not receive favorable action from Parliament until 1907; see Gower, pp. 50-1, 102.

conflicting testimony by the leading economists of the day,<sup>88</sup> ran on ad nauseam through the Parliamentary debates of 1850, 1851 and 1854.<sup>89</sup> Finally, in 1855, the Registration Act of 1844 was amended by the Limited Liability Act to provide for limited liability for Registered Companies. In this section, changes in the status of limited liability under the common law are shown to have been the catalysts for legislated changes in the availability of limited liability.

English law had no inherent objection to limited liability itself, and the common law's emphasis on the freedom of contract led to efforts to contract out of unlimited liability. One method of attempting to limit liability was to insert into deeds of association a clause stating that the shareholders should be liable for only the amount of their subscriptions. The creditors of the association were assumed to have due notice. However, this avenue of escape from unlimited liability was blocked by the courts as repugnant to partnership law.<sup>90</sup>

Another method of evasion was more successful in the courts. As Maitland has written:

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<sup>88</sup>See Amsler, Bartlett, and Bolton, "Thoughts of Some British Economists on Early Limited Liability and Corporate Legislation."

<sup>89</sup>See, for example, "Report of Select Committee on Investments for the Savings of the Middle and Working Classes," Parliamentary Papers, XIX (1850) #508; "Report of Select Committee on the Law of Partnership," *Ibid.*, XVII (1851) #1091; and "First Report, Mercantile Law Commission," *Ibid.*, XXVII (1854) #1791. Also, see Hunt, pp. 116-44.

<sup>90</sup>See Shannon, "The Coming of General Limited Liability," p. 372 for general discussion, and Hunt, p. 99 for cases.

If a man sells goods and says in so many words that he will hold no one personally liable for the price, but will look only to a subscribed fund, must we not hold him to his bargain? Our courts were very unwilling to believe that men had done anything so foolish, but they had to admit that personal liability could be excluded by sufficiently explicit words.<sup>91</sup>

Hunt explains this method of evasion as follows:

In some trading companies, we find that directors actually did put a clause in all of their contracts which stipulated that all parties "should look for payment to the capital stock of the company only, and not to the shareholders or directors." Moreover, in the policies of the non-chartered insurance companies, such a clause was "inserted universally." In 1852, such contracts were held good "in the very teeth of the government and the legislature."<sup>92</sup>

The 1852 case, Hallett v. Dowdall,<sup>93</sup> is the major change in the common law that explains the timing of the emergence of the general availability of limited liability in England. In addressing the question of unlimited liability and the changes in the common law, Maitland stated: "The enemy was within the citadel, if the state had not given away, (England would have had) joint-stock companies, unincorporated, but contracting with limited liability."<sup>94</sup> In fact, when limited liability became available through a general incorporation law in 1855 the Economist discounted the importance of the Act because of

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<sup>91</sup>Frederick W. Maitland, "Trust and Corporation," Collected Papers, (Cambridge, 1911): Vol. III, p. 392.

<sup>92</sup>Hunt, p. 100.

<sup>93</sup>Hallett v. Dowdall, XXI, L.J.Q.B. 98, (1852).

<sup>94</sup>Maitland, p. 392.

the availability of limited liability through private contracting.<sup>95</sup> It seems clear, however, that limited liability could never have been attained in a satisfactory, clear-cut fashion -- especially with respect to involuntary creditors -- without legislative intervention, and "...it was this intervention which finally established companies as the major instrument of economic development."<sup>96</sup>

Prior to the developments in the common law, unlimited liability served to restrict to the wealthy or the influential the availability of the more profitable investment opportunities:

The conservatism of successful big businessmen in their vested interests, proud of their triumphs in life and of their ability to bear the honourable burden of unlimited liability, or of lawyers to whom all change was distasteful, was not found so universally among members of a free-trade Parliament. To most of these the law of unlimited liability was a species of protection either through actual wealth and active management or through the high expense of avoiding it by expensive charters or Acts conceded on no clear principle.<sup>97</sup>

After 1852, the availability of limited liability through private contracting decreased the values of the charters or Acts and lowered the protective barrier of the wealthy. Thus, while the decision in Hallett v. Dowdall (1852) did not render valueless the special charters and Acts conferring limited liability because of the high transaction costs associated with private contracting, it did shift Parliament's marginal trade-off in favor of the passage of other pieces of legislation. Because of this change, our methodology predicts the passage of an act

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<sup>95</sup>Economist, Vol. XII (1955), p. 698, cited in Gower, p. 49.

<sup>96</sup>Gower, p. 49.

<sup>97</sup>Shannon, "The Coming of General Limited Liability," p. 376.

dealing with the general availability of limited liability. In 1854, Parliament took the first step by passing a motion which stopped the granting of special charters.<sup>98</sup> Thus, Parliament's reaction was as predicted. The next step was the passage of an amendment to the Registration Act of 1844 providing for the general availability of limited liability.

The question of limited liability came up for debate in 1851,<sup>99</sup> 1852<sup>100</sup> and 1854.<sup>101</sup> Shannon's description (1931) is illuminating:

The debate in 1851 was influenced by the 1850 Report on Savings. The law of partnership was an obstacle to philanthropy and an irritant in social and industrial relations, checking local improvements, e.g., in housing, and the attempts at workers' co-operation of the new 1848 French type. In the debate of 1852, following the 1851 Report on Partnership, the same line of argument was more prominently in the forefront. The need of safe investments for small capitalists was being felt, and "the very intelligent people of the other side of Temple Bar" could look after themselves in active partnerships. The big debate in 1854 swung over to more general lines. Most of the conflicting arguments found in the reports reappeared, but Parliament took a wider view of national requirements than the business men had done. The anomalies of the law were all too patent: private Acts, charters, and special contract terms conferred every day the "protection" of limited liability on some companies; the Registration Act, with its common law unlimited liability, denied it to all others. Such differentiation was inconsistent with "the spirit of recent laws". There had been

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<sup>98</sup>Ibid., p. 377.

<sup>99</sup>T.C. Hansard, Parliamentary Debates (London, 1800-1875): CXIV (1851), 842, et seq.

<sup>100</sup>Ibid., CXIX (1852), 688 et seq.

<sup>101</sup>Ibid., CXXXIV (1854), 752 et seq.

an artificial diversion of natural resources sources into the protected companies or even into foreign countries which had limited liability. This bounty of limited liability had been a cause, if not the cause, of the manias in railway and foreign investments. But limited liability was good. The only safe investments for small passive capitalists had been the canals and railways. The latter were almost completed and would afford no further outlet, but limited liability would open the general field of industry to such investments and further national prosperity would result.<sup>102</sup>

Although most of the debate had related to limited partnerships and not to incorporated companies, coupled with the House of Commons' passage in 1854 of a motion favoring only limited partnerships,<sup>103</sup> the Government introduced a bill to provide for limited liability for companies registered under the 1844 Act.<sup>104</sup> The House of Commons approved the Government's bill without dissent,<sup>105</sup> the House of Lords took exception to several sections of the bill, but the Commons accepted the Lord's amendments. The Bill was given Royal Assent in August 1855.<sup>106</sup> In 1855, the Registration Act of 1844 was amended by the Limited Liability Act<sup>107</sup> to grant limited liability to any company that complied with the registration requirements, claimed limited liability, met

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<sup>102</sup>Ibid., p. 376-377.

<sup>103</sup>Hansard, CXXXIV (1854), 752 et seq.

<sup>104</sup>The government also introduced a limited-partnership bill, but it was not acted on by Parliament. Gower, p. 46.

<sup>105</sup>Hansard, CXXXIX, 310 et seq.

<sup>106</sup>Gower, pp. 46-7.

<sup>107</sup>18/19 Vict., c. 133.

certain tests for financial soundness, and added "Limited" to their name.<sup>108</sup>

Parliament could have acted to counteract the developments in the common law by declaring illegal any efforts to contract out of limited liability, however, it chose to limit the liability of debtors to not only voluntary creditors, but also involuntary creditors. In reality, the political atmosphere of the time probably made it impossible to legislate against the freedom of contract:

The middle of the century marked the high tide of laissez-faire, and at its crest this alternation in the law was sought and granted in the name of "perfect freedom" after a struggle that forms one of the most interesting episodes in the history of the joint-stock company in England. "Limitation of responsibility" became the subject of repeated and voluminous legislative inquiry and heated debate, a topic of widespread discussion in commercial circles, an object of professional investigation, and the solicitous concern of the social reformer. Reinforced by the pressure of rapidly accumulating capital, more and more widely diffused and seeking investment, dogged persistence in Parliament combined with the spirit of the age to secure full liberty of incorporation. Liability of the shareholder to the extent of his last shilling and last acre, in Eldon's phrase, was finally swept away. England thus, in contemporary words, took the crowning step in removing the fetters from human industry, by removing from her code the last of those enactments which [could] impede a free development of her industrial resources.<sup>109</sup>

The Registration Act had already proved unworkable, and the addition of the Limited Liability Act did not improve matters:

Some forty-six companies had been registered under it when it was repealed in 1856. Lowe had become President of the Board

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<sup>108</sup>Gower, p. 47.

<sup>109</sup>Hunt, pp. 116-17.

of Trade, and he was an ardent advocate of limited liability. The 1855 Act was based on the Registration Act and this Act had been shown by the Committee on Assurance Associations to be highly defective. Lowe was convinced that the law relating to companies needed revision. In introducing his own Bill, he traced the evolution of the law as from prohibition to privilege and then to right, and brought out all the defects of the Act of 1844, and the great uncertainty of law that existed between provisional and complete registration. Roundly denying the power, or even the desirability, of Government of attempting to supply mankind with common-sense and contending that 100 honest companies should not be regulated to prevent the 101<sup>st</sup> from perpetrating fraud, he proposed the substantial removal of all restrictions, except a measure of publicity. There was no debate--there could hardly be any after his speech--and the Bill passed easily.<sup>110</sup>

The resulting Joint-Stock Companies Act of 1856,<sup>111</sup> which repealed the Registration Act and its amendments, while considerably simplifying the procedures for registration of a firm, did not provide for any of the old financial safeguards.<sup>112</sup> Also, the Act failed to provide any clear cut grounds upon which the Registrar could deny an incomplete or too general memorandum or one filed for clearly fraudulent purposes. By this Act, any seven or more persons could become a limited liability corporation by registering a "memorandum of association."<sup>113</sup>

The Joint-Stock Companies Act of 1862<sup>114</sup> consolidated the provisions of the earlier Companies Acts and did not make any

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<sup>110</sup>Shannon, "The Coming of General Limited Liability," p. 378.

<sup>111</sup>19/20 Vict., c. 47.

<sup>112</sup>Gower, p. 48, contends this action was a further manifestation of the prevailing laissez-faire philosophy.

<sup>113</sup>Shannon, "The Coming of General Limited Liability," p. 378.

<sup>114</sup>25/26 Vict., c.89.

substantial changes in the 1856 Act.<sup>115</sup> Thus, the general availability of limited liability, which was hotly contested when first provided for in 1855, was firmly entrenched in English law by 1862. By the early 1860's a legal structure existed which made big business possible.<sup>116</sup>

#### J. Responses to the General Availability of Limited Liability

The English economy reacted to the general availability of limited liability in a variety of ways which, for convenience, may be divided into two broad analytical categories. First, responses related to the use of limited liability as a substitute for insurance for undercapitalized companies. Included in this category are the incorporation of small family business and the use of one-ship shipping companies. Second, the responses related to the problems created by inexperienced investors and underdeveloped capital markets. The increase in fraudulent practices and the continuing dominance of partnership principles in conjunction with use of the corporate form are included in the second category. In this section, these responses are discussed in the same order as presented in this paragraph.

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<sup>115</sup>See Frank Evans, "The Evolution of the English Joint Stock Limited Trading Companies," Columbia Law Review, VIII (May, 1908): 340-60, 461-80, 469-73 for a discussion of the specific provisions of the 1862 Act.

<sup>116</sup>The main feature of the subsequent history of English corporation law has been a movement away from the complete freedom allowed by the 1856 and 1862 Acts and the imposition of greater controls and increased provisions for publicity -- in general, a reversion to the basic policy of Gladstone's Act of 1844. See Gower, pp. 49-57, for a summary of these developments.

The response to the 1856 Act sheds some light on the value of limited liability in England at that time. Only forty percent of the companies that registered under the provisions of the Registration Act of 1844 re-registered as Limited Companies under the Act of 1856; the other registered companies also had to re-register but opted to stick with unlimited liability. However, almost all of the firms registering for the first time took advantage of the opportunity to limit liability.<sup>117</sup> These figures should not be interpreted as evidence that the limitation of liability was worth more to firms in their infancy than to established firms because many of the newly registered firms were established closely-held firms (which were able to take advantage of limited liability for the first time when the number of persons required for registration was lowered from twenty-five to seven) and, as discussed later in this section, many of the newly formed firms that registered for the limitation of liability did not in fact take advantage of it.

The increase in small companies registering to take advantage of limited liability was especially noticeable. Many of these new registrants, which had previously operated as partnerships, were

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<sup>117</sup>Geoffrey Todd, "Some Aspects of Joint Stock Companies, 1844-1900," Economic History Review, 4 (January, 1932): 46-71, 54-55.

family owned and managed businesses with low capitalization: "There are small companies with capitals as low, I believe, even as £500, to carry on the business of brewers, bakers, farmers, agricultural steam-engine proprietors and the like."<sup>118</sup> This development of closely held or private corporations apparently caught some MP's by surprise:

In contrast with the expectations of the statesmen responsible for the early Company Acts, there developed the private company (legally unrecognized until 1907). Since many of the concerns adopting this form of organization had previously existed as partnerships or joint-stock companies, the object of private registration was to obtain limited liability while retaining the original management and maintaining the privacy of the past. Further growth was made possible, but only to the extent of the capital of the shareholders named in the Articles of Association, and the introduction of new entrepreneurial talent to the board was inhibited. The private limited liability company represented a typical British compromise. A step had been taken towards big, or at least bigger, business, but it was very fearful and hesitant.<sup>119</sup>

In this context, "legally unrecognized" means that they did not develop a separate body of law for private corporations until 1907.<sup>120</sup>

The use of limited liability by closely held firms probably had its greatest impact in the firms' relationships with involuntary

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<sup>118</sup>Parliamentary Papers, 1867, X (329), Q.1555, quoted in Todd, p. 62, note 5.

<sup>119</sup>P.L. Payne, "The Emergence of the Large-scale Company in Great Britain," Economic History Review, 20 (1967): 519-42, 520.

<sup>120</sup>See Henry Manne, "Our Two Corporation Systems: Law and Economics," Virginia Law Review 53 (March, 1967): 259 - 84. For a discussion on problems in American corporation law that developed when close coporations operated under a statute designed for public corporations.

creditors (e.g., tort victims) as opposed to its dealings with voluntary creditors (e.g., suppliers of goods, or banks). This would have been so because the voluntary creditors would have been able to bargain for either personal guarantees or higher prices in order to maintain their same relative position after the imposition of limited liability. Whereas, the involuntary creditors, by definition, did not have any chance to negotiate (i.e., their position was made worse by the change to limited liability). In cases where the claims of involuntary creditors were large enough to bankrupt the firm (usually when the firm was undercapitalized), limited liability acted as a form of insurance in that it allowed a family owned and managed firm to insulate some of the family's wealth from the claims of involuntary creditors.

Similarly, many shipping companies were formed with small denomination shares and large numbers of shareholders for the purpose of owning and operating one ship. The use of limited liability by these one-ship companies was alleged to have disrupted the shipping industry by causing excessive competition, and this contention was considered by the Royal Commission on the Depression of Trade and Industry in 1886. The testimony of Sir T. Farrer, a former Secretary of the Board of Trade, correctly stated that the "subject is so mixed up with the question of insurance" that it cannot be concluded that limited liability itself gave the one-ship companies a competitive

advantage.<sup>121</sup> It appears that Farrer recognized that the merchants and traders who shipped their goods with the one-ship companies realized that they were bearing the risk of the loss of their goods if something happened to the ship (which was the company's only large asset), and that therefore they would demand (and receive) lower rates. Presumably, the more risk-averse merchants and traders would have been willing to pay higher rates to the larger established shipping companies in exchange for assurances that their claims would be covered by the company or its insurer in the event of loss. Thus, the use of one-ship companies did not result in "excessive competition," but instead resulted in the availability of additional alternatives for customers of the shipping companies.

It has been suggested that the earlier Companies Acts (1855 and earlier) were aimed at the protection of the creditor supplying goods to the company and that the later Acts (1880's and later) were particularly concerned with the protection of the shareholders from the directors.<sup>122</sup> To the extent that statutory provisions could protect the various parties, it appears that they provided little if any protection from fraud for anyone in the interim period, immediately following the 1856-62 changes in the law. In this regard, it is important to note the changes in the quality of the companies formed after the introduction of limited liability. For example, it is clear that some promoters of shares never intended for the companies

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<sup>121</sup>Todd, pp. 64-65.

<sup>122</sup>Ibid., p. 67.

they promoted to come into existence; or, if they were formed, they would be wound up at once without ever operating, so that the promoters would make additional profits out of the winding-up process:

For the benefit of promoters and their professional allies, the lawyers and accountants, many companies were deliberately set up in order that after a short fictitious existence they might pass into the winding-up process, with birth and burial expenses accruing to their creators. It would be arranged that the first charge on the capital received from investors should be the preliminary promoting and vendor charges, which satisfied the first of the trio, and a preferential charge on the assets in winding up was (and is) the legal expenses, which satisfied the other two. Companies, it must be remembered, were then free from having to state either promoting expenses or vendor contracts or to state the minimum capital on which business could be commenced; therefore, when capital sufficient to pay the above expenses had been collected, the company would pretend to start business, fulfil its promoting agreements--and fail, or with an inauspicious future, wind up voluntarily or compulsorily.<sup>123</sup>

Thus, it appears that in the early years of limited liability transfers of wealth were made from the investing class to promoters, accountants, and lawyers as a result of loopholes in the Companies Acts. Whether or not these loopholes were intended to benefit those groups is not clear, but it is clear that they closed themselves as the business community learned to handle the corporate form.

In 1867 and in response to the prevalence of fraudulent practices, a Parliamentary commission conducted an official inquiry "into the operation of the Limited Liability Acts".<sup>124</sup> However,

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<sup>123</sup>H.A. Shannon, "The First Five Thousand Limited Companies and Their Duration," Economic History (A Supplement to the Economic Journal), II (1933): 396-419, 415.

<sup>124</sup>Ibid., p. 418.

instead of recommending more control and regulation of the limited companies, the laissez-faire dominated committee recommended additional privileges for the limited companies, including the power to reduce capital which was the only important alteration made by the Companies Act of 1867.<sup>125</sup> "To laissez-faire doctrinaires, people were either wise or quick learners; to promoters, they were neither."<sup>126</sup> That is, the problem of fraud can be traced to the inexperience of the investors.

Actually, the problem of fraud cured itself within the next ten years for two reasons. First, the investing public eventually improved its judgment and its ability to evaluate risks. Thus, the laissez-faire doctrinaires position was legitimate, but "this effective diffusion of knowledge probably took longer than most economists, over-intellectualising human nature, would then (and now) admit."<sup>127</sup> Second, as discussed below, the limitation of liability did not in fact become effective until some considerable time after 1862, but when it did it spurred the growth of a better and more efficient class of entrepreneurs.<sup>128</sup>

In earlier sections of this chapter it has been suggested that the MP's would have had strong reasons to expect that a general

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<sup>125</sup>Evans, p. 474.

<sup>126</sup>Shannon, "First Five Thousand Limited Companies," p. 418.

<sup>127</sup>Ibid., p. 419.

<sup>128</sup>Todd, p. 68.

incorporation law would lead to economic growth and increased industrial concentration. However, these expectations were not realized:

One thing is certain. The joint-stock and limited-liability legislation of the eighteen years from 1844 to 1862 removed an "important limitation on the growth and ultimate size of the business firm when it destroyed the connection between the extent and nature of a firm's operations and the personal financial position of the owners" Nevertheless, the response was slow; by 1885 limited companies accounted for at the most between 5 per cent and 10 per cent of the total number of important business organizations and only in shipping, iron and steel, and cotton could their influence be said to be considerable. Although the firms that were limited were by far the most important in their spheres of activity judged by size of unit and amount of fixed capital, the vast majority of the manufacturing firms of the country continued to be family business in the eighties.<sup>129</sup>

The reason for the slow response of the "important business organizations" can be traced to the practices of the financial community which emphasized the importance of maintaining a high reserve of uncalled capital and fixing a high share denomination.

The typical shareholder's initial investment would be only a small proportion of the total stated capital of his stock, and he could be held responsible for the unpaid portion if it were needed to satisfy creditors' claims. This arrangement was not limited liability in the modern sense because the investors' liability could extend beyond their initial investment, although it was limited to the extent of the denomination of the stated capital. Because of this de facto unlimited liability method of financing, most shareholders were not

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<sup>129</sup>Payne, p. 520.

willing to invest in an enterprise unless they knew the trade. In short, although limited liability and other corporate privileges were available and utilized, partnership principles were still used to determine the desirability of investment in, and the financial security of, an enterprise.<sup>130</sup> The major reasons for using such devices to insure the solvency, not really the financial stability, are related to the strong empirical bias based on partnership experiences.

Whatever the reasons for adopting these measures (uncalled capital and high denomination shares), they had the effect of squeezing the small investors out of many opportunities for investment in the industrial growth. Thus, at least initially, the coming of limited liability did not have the effect of providing an investment outlet for the growing wealth of the middle class. In general, this was due to the underdeveloped state of capital markets:

The investment mechanism in the 'fifties and 'sixties was still in a very embryonic stage of development. The two main types of shareholders in the early limited companies were the successful capitalists connected with the basic and heavy industries and the early traders and merchants concentrated in the large commercial centres. The former, for the most part, became shareholders when their own going concern was converted into a limited company or they took shares in other companies which had a similar partnership background. The latter were prominent in financial and credit companies and in the larger hotel and wagon companies

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<sup>130</sup>J.B. Jefferys, "The Denomination and Character of Shares, 1855-1885," Economic History Review, 16 (1946); reprinted in E.M. Carus-Wilson, ed., Essays in Economic History, I (London: Edward Arnold Ltd., 1962): 344-57, 348.

popular in the early 'sixties. It was reported in this boom that "the great body of investors in recent undertaking do not belong to the class of simple investors but to the native trading community", and again that "successful traders hve been leaving trade and going into the money-lending and financial business....in proof....refer to the lists of Directors of our Banks and Finance companies to see how largely the money-lending community consists of mercantile men". Both of these groups of investors were wealthy, were not, and were not expected to be, "interested in more than two or three companies" and through their knowledge of the business took an active part in the management of the company. "Shares of high denomination" were effective with these investors "for the reason principally that when they were placed in good hands the capital was more easily raised." Individual holdings were large and uncalled share liability did not appear a disadvantage as they had a close control on the direction of the enterprise. There were other investors in the market; the "simple", "safe" or "steady and legitimate" investors who had been schooled in Consols, railway and other public utilities, and the frankly speculative investor interested in ready marketability of shares or high dividends. These investors had other concepts of investment and of the denomination and character of shares, but their influence was small. The confidence of the "safe" investor in the general limited companies was not great in the 'fifties and 'sixties and in any case the channels for bringing this class of investors into contact with the limited company were largely undeveloped. The speculative investors, while frequently named in the course of post-mortems on limited companies at no time, numerically or financially, constituted a significant section of investors. Consequently, while a few companies in certain industries issued shares of a denomination and character, small and fully paid, that would make an appeal to these classes, the majority of companies catered for the wealthy investor with whom the founders had connections or who was known to the brokers and financial agents in the commercial centres. The financial methods of these companies matched the needs, pockets and outlook of these investors.<sup>131</sup>

A financial crisis in 1866 forced the investment community to reconsider the desirability of large denomination shares with uncalled

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<sup>131</sup>Ibid., pp. 350-51.

reserves, but it was not until the 1880's that the trend towards fully paid-up shares was established.<sup>132</sup> However, once these improvements were made, the British economy in the 1890's still did not experience the trend toward industrial concentration which was the major characteristic of the American economy at that time. Because of the similarity of their legal environments, the explanation for such a divergence between the two countries must be found in non-legal explanations.<sup>133</sup>

#### K. Summary and Conclusion

The English history of the change in the method of incorporation from special charter to full corporate privileges has been presented and interpreted in an interest-group perspective. Perhaps the best way to summarize the interpretation presented in this chapter is to compare it with Shannon's summary of the traditional interpretation:

....the legislature at first saw in the company-form only a dangerous and unworthy innovation that should be suppressed. When companies were accepted as inevitable, perhaps laudable, in certain branches of business, no attempt was made to adapt the general law of the land to them, but they were left either largely remediless or forced to obtain a better standing by a private Act for suing powers. Other companies, thought more desirable, might be given superior privileges after a special application and examination.

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<sup>132</sup>Ibid., p. 356.

<sup>133</sup>A consideration of potential explanations is beyond the scope of this dissertation; for comparisons of the two economies during this period see Payne, "The Emergence of the Large-Scale Company;" Lance Davis, "The Capital Markets and Industrial Concentration: The U.S. and U.K., a Comparative Study," Economic History Review, Second Series, XIX (1966): 255-72; and Leslie Hannah, The Rise of the Corporate Economy (London: Methuen and Co., Ltd., 1976).

When it was realized that the defective state of the law left in companies and in company promotion an undesirably large and easy field for fraud, the legislature after twenty years' experience brought them into more effective control through compulsory registration. This, however, was meant more as surveillance than as encouragement. Unlimited liability was still insisted upon. After another ten years, and after at least twenty years of discussion and reports, the legislature was moved, by the realization of the amount of capital not most productively employed, to accept the limited company as a desirable form of business enterprise. In its new-found faith it removed some old checks and gave companies an almost unwise degree of freedom. Subsequent legislation, however, has limited that freedom.<sup>134</sup>

In contrast, from the perspective of this dissertation, Parliament at first saw in the development of the joint-stock company form an opportunity for entrepreneurial behavior. The passage of the Bubble Act in 1720 restricted the legal use of the joint-stock company form to those receiving special charters from the Crown or Parliament. In effect, Parliament solidified its monopolistic market position by erecting an entry barrier.

"When companies were accepted as inevitable," Parliament bowed to political pressures and repealed the Bubble Act in 1825. However, because of the inherent conservatism of the common law courts - which had not accepted (and had hinted that they would never accept) the joint-stock company as a legal entity - and the failure of Parliament to pass a general act granting corporate privileges when it repealed the Bubble Act, Parliament in effect did not alter the availability of corporate privileges. In other words, the statutory entry barrier was

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<sup>134</sup>Shannon, "The Coming of General Limited Liability," p. 379.

removed, but in removing it Parliament would have felt secure that the substitute common law entry barrier would remain intact; thereby preserving the value of the special charters and the special private acts conferring suing powers.

This "defective state of the law" was corrected by the common law courts in two cases in 1843 when joint-stock companies with freely transferable shares and suing powers (when organized as a business trust) were declared legal under the common law; that is, all of the corporate privileges except limited liability were made available through the common law. This major change in the property rights structure severely reduced the value of the special charters and the special private acts. Parliament quickly responded to this development by passing the Registration Act of 1844, which made all of the corporate privileges except limited liability available through registration.

After the passage of the Registration Act, the use of limited liability was still restricted to registered companies that had received special charters from the state. However, in 1852 and in the name of freedom of contract, contract clauses restricting the claims (of parties in a contract with a registered company) to the capital of the company were held legal under the common law. This development greatly reduced the value of special charters. Shortly thereafter, in 1855, Parliament responded to this change in the common law by passing the Limited Liability Act which made the limitation of liability available to all companies that registered for it.

In conclusion, the decline and fall of the special charter has been explained and shown to be consistent with the interest-group theory. The timing of the emergence of the changes in the method of incorporation has been explained as a response to exogenous changes in the common law.

## CHAPTER IV

### JURISDICTIONAL COMPETITION AND THE END OF SPECIAL CHARTERING IN THE UNITED STATES

The major distinction between the United States and England with respect to the granting of corporate charters was, and continues to be, the multiplicity of jurisdictions conferring corporate privileges in the American federal system of government. As a result of this difference, the evolution of the method of incorporation from special charter to general incorporation law followed a different, although contemporaneous, course.

Because of the large number of economically interdependent political jurisdictions, it is useful to view the individual states as open economies which were subject to not only exogenous economic changes but also exogenous legal changes from other state governments and the federal government. In this scenario, the legislature of an individual state was open to competition from outside its jurisdiction.<sup>1</sup> That is, in many instances there were no strong

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<sup>1</sup>Jurisdictional competition has been found to play an important role in other law and economics contexts; for example, see Barry D. Baysinger, "A Theory of the Efficiency of Jurisdictional Choice: The Case of Corporate Federalism," unpublished Ph.D. dissertation, VPI&SU (1978), for theoretical formulation and empirical testing of the efficiency effects of interstate incorporation competition; Michael Maloney, Robert McCormick and Robert D. Tollison, "Exporting Economic Regulation," manuscript, Emory University (July, 1981), for a public choice explanation of the structure of economic regulations across states; Wallace E. Oates, Fiscal Federalism (New York: Harcourt Brace Jovanovich, Inc., 1972) and Richard E. Wagner and Warren E. Weber, "Competition, Monopoly and the Organization of Government in Metropolitan Areas," Journal of Law and Economics, 18 (December, 1975): 661-84, for studies representative of the public finance literature on the interaction of governments at the same level in the federal system;

barriers to entry protecting a legislature's spatial monopoly in the production of special-interest legislation within its own state. This is almost the complete opposite of the British legal system, which is closed and not subject to exogenous legal shocks.

The individual states of the United States changed their method of incorporation from special charters to general incorporation laws neither suddenly nor at the same time. These important changes, which took place throughout the nineteenth century, developed in three overlapping stages. First, the era of special charters. Second, the dual system under which some companies incorporated under restrictive general incorporation laws while others continued to incorporate through special legislative acts. Third, interstate incorporation competition, which led the adoption of constitutional amendments forbidding the granting of special charters and requiring legislatures to provide for incorporation under general laws. The historical developments of these stages are presented and interpreted in Sections A, B, and C, respectively. Additionally, Section C includes a discussion of certain constitutional issues and developments relevant to the interaction of the open economies of the individual states. Finally, Section D offers a summary and some concluding comments on the American experience with this important legal institutional change.

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and, finally, for studies of the interactions of constitutional federalism and American economic development, see Harry N. Scheiber, "Federalism and the American Economic Order, 1789-1910," Law and Society Review, 10 (Fall, 1975): 57-117, and Tony A. Freyer, "The Federal Courts, Localism, and the National Economy, 1865-1900," Business History Review, 53 (Autumn, 1979): 343-63.

## A. The Special Chartering System

### 1. Background

Following the American Revolution, there was almost universal assent to the proposition that the power to form corporations was vested in the state legislatures. This consensus was formed in spite of the fact that most of the original constitutions of the states contained no reference to the process of incorporation. The legislatures' power to incorporate was an implied and exclusive right. New Jersey was the only state that went through a disputed period prior to establishing that the incorporating power was exclusive to the legislature.<sup>2</sup>

In the eighteenth century and early nineteenth century, all corporate charters were issued one by one by individual legislative acts. Almost all of the colonial charters were for churches, charities, and cities or boroughs. The overwhelming majority of the corporations chartered in the late 1700's were concerned with banks, insurance companies, water companies, and companies organized to build or run canals, turnpikes, and bridges. Many of the public utility or transportation corporations were awarded monopoly privileges and police

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<sup>2</sup>Joseph S. Davis, Essays in the Earlier History of American Corporations, 2 Vols. (Cambridge, Mass.: Harvard University Press, 1917): I, 15-17, 66-69, 85-86, and II, 9; John W. Cadman, The Corporation in New Jersey: Business and Politics 1791-1875 (Cambridge Mass.: Harvard University Press, 1949): 3; and E. Merrick Dodd, American Business Corporations Until 1860 -- With Special Reference to Massachusetts (Cambridge, Mass.: Harvard University Press, 1954): 196.

powers of the state (e.g., eminent domain) in exchange for the financing and construction of quasi-public goods by the private firms.<sup>3</sup>

Beginning in the nineteenth century, more and more charters were granted each year. The majority of these charters, which were theoretically tailor-made to the case at hand, were initially connected with financial institutions and transportation companies but became increasingly associated with general commercial or industrial aims. In other words, as the early nineteenth century economy developed, entrepreneurs demanded access to the corporate form as an efficient way to structure and finance business ventures of all types. The state legislatures responded to the increased demand for corporate privileges by granting charters to favored groups.

In drafting special acts of incorporation, the earliest American state legislatures had little from past experiences to guide them. There is no indication that they used earlier English charters as models.<sup>4</sup> The legislators, however, were not deterred by their inexperience. In fact, they did not have much choice because the political and economic separation from England demanded that they provide for the organization of banks and insurance companies. As a

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<sup>3</sup>See Davis, Earlier History of American Corporations, for a thorough discussion of eighteenth century corporations. His study is very enlightening with regards to the origins of the American business corporation as a device for engaging in banking, insurance, and the improvement of communications. It tells us very little, however, of the development of the corporation as a industrial organization, since the development did not occur on a substantial scale until after 1800.

<sup>4</sup>Dodd, American Business Corporations, p. 196.

consequence of their inexperience, there was a great deal of experimentation and the earlier charters exhibited great latitude in the powers conferred on the corporations.<sup>5</sup> Nevertheless, a generalization of the most familiar form of special charter is possible. It took the form of a legislative act bestowing upon a single group corporate privileges on specified terms and for a specific object. Some special acts specified conditions to be met before the privileges would be granted. The most frequent conditions was the subscription of a certain amount of capital. The basic theory of the special charter was that individual legislative sanction provided the necessary control and regulation of a new form of business association.<sup>6</sup>

The procedure for the passage of special charters was similar to that of any other type of legislation. A sponsoring legislator would petition the legislature, the bill would then go to the appropriate committees of both houses for hearings, then to the floor of both houses for debate and approval or rejection (by a simple majority at this early stage), and, finally, the Governor signed it into law. Of course, the procedure varied from state to state. The earliest

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<sup>5</sup>Ibid., and Davis, Earlier History of American Corporations, II, pp. 291-330.

<sup>6</sup>See Adolf A. Berle and Gardiner C. Means, The Modern Corporation and Private Property, Revised Edition (New York: Harcourt, Brace and World, Inc., 1967): 127-8; and Harold W. Stoke, "Economic Influence upon the Corporation Law of New Jersey," Journal of Political Economy, XXXVIII 9October, 1930): 551-579, 551-52.

deviations from the basic procedure with respect to the granting of corporate privileges were aimed at assuring that the bills were given adequate consideration. For example, the early practice of the New Jersey legislature was to defer actions on petitions in order to allow both sides ample opportunity to be heard.<sup>7</sup> In New York, Governor John Jay advocated publicity in connection with the granting of special charters. In a message in 1800, he announced his belief that a pre-passage publication requirement would avoid the difficulty of "correcting the evils resulting to the public from unforeseen defects" and asked that charters be passed "only under such circumstances of previous publicity and deliberation as may be proper to guard against the effect of cursory and inaccurate views and impressions."<sup>8</sup>

## 2. Special Charters and the Market for Special-Interest Legislation

These special charters were special interest legislation of the purest sense; each charter was adopted for the benefit of a specific group and, initially, each one was unique with respect to its provisions for powers, duration, limited liability, voting rights, etc. In fact, some of the special chartering bills provided specific relief from taxation. Lobbying, logrolling, and bribery -- all symptoms of a market for special-interest legislation -- appeared early and developed rapidly in connection with bills for special charters. In this subsection,

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<sup>7</sup>Cadman, p. 8.

<sup>8</sup>New York State, Messages from the Governors, II, 450, quoted from Cadman, p. 8.

evidence of the existence of this market for special-interest legislation is presented.

The special chartering system inherently possessed the potential for rent-seeking behavior. There are many examples of efforts by charter applicants to get more generous terms from their legislators than rival groups already in the field had obtained. And, of course, corporations already in existence were not likely to be content to allow the legislature to grant more favorable terms to potential competitors in their field. In this regard, a New Jersey newspaper declared in an editorial: "We believe it is the habit of all corporations to resist the charter of competitors. They do not willingly divide their business..."<sup>9</sup> In fact, in discussing the manifestation of these competing pressures and demands for legislative favor, one author has remarked that it is appropriate to describe the legislature as "the 'clearing house' for these competing demands and projects."<sup>10</sup>

The effects of this systematic competition for legislative favors were evident in every state and -- as the following statement by the Governor of the Wisconsin Territory reveals -- in the territories as well:

The monopolies which have been created within this territory, by acts of incorporation granting exclusive privileges to certain individuals, have, from their number and character, justly excited alarm in the minds of all men who are friendly

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<sup>9</sup>Newark Daily Advertiser, April 8, 1972, quoted in Cadman, p. 171.

<sup>10</sup>George J. Kuehnl, The Wisconsin Business Corporation (Madison: The University of Wisconsin Press, 1959): 190.

to equal rights, and the establishments of all such institutions as are most favorable to democracy. These combinations of political power and wealth, these petty aristocracies -- the offspring of the last four years -- have been planted in almost every neighborhood; and although they may now give temporary benefits to a few individuals, we may expect the time will soon arrive then they will yield only bitter fruit for the people. Many of them appear to have been granted to favor particular persons, by creating a value for their property over that of their neighbors, or by thus distinguishing it to render it more saleable. They are incorporations to aid in speculation. Your attention is respectfully invited to all the acts of incorporation which have been passed, that all such as are not lawfully in existence, may be repealed without delay.<sup>11</sup>

As mentioned earlier, special-charter legislation was subject to essentially the same procedures as other types of legislation. Furthermore, the lobbying, bribery and logrolling that accompanied the special charters surely does not distinguish special-charter legislation from other types of legislation -- that is, bribery, logrolling and lobbying are attributes of almost all types of legislation. Nevertheless, it is descriptively accurate to characterize special-charter legislation as a subset of interest-group legislation that is almost entirely special interest because in most instances it is impossible to see how the legislators could have been engaged in the vote-trading with the goal of increasing their political support by obtaining more benefits of government for any meaningful number of their voting constituents. In almost all corporate charters for industrial purposes, the legislation was aimed at benefiting a specific group and the side effects of this were injuries to

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<sup>11</sup>Governor James Doty, address to the legislature on Dec. 6, 1841. Quoted by Kuehn, p. 3, from 1841-41 Council J., Wis. Terr. 21-22.

competition and the public at large. The stakes in the competitive rent-seeking process were high, and the special-chartering system was subject to a number of abuses:

If every proposed corporation must obtain the consent of the legislature, then it must make friends of the legislators. Incorporation for many companies, of course, was purely perfunctory, but for the larger enterprises, whose stock would become marketable securities, the legislature often had to be persuaded in various ways. Lobbies and personal pressure were methods known to the privilege-seeker even of that early day, and in some instances darker and more sinister methods must be called upon to explain the inconsistency and vacillation which the legislature displayed.<sup>12</sup>

In many states, the special-chartering system was rocked by scandals and charges of corruption.<sup>13</sup> In New Jersey, for example, bribery of the legislature was freely charged in connection with the activities of lobbies pressing for the granting of special corporate privileges.<sup>14</sup> In 1824, in New Jersey, suspicions of bribery were strong enough to occasion the appointment of a joint committee of the legislature to investigate. However, the investigation was superficial and failed to lead to any prosecutions.<sup>15</sup> In 1855, another special

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<sup>12</sup>Harold W. Stoke, "Economic Influences Upon the Corporation Laws of New Jersey," pp. 557-558.

<sup>13</sup>Lawrence Friedman, A History of American Law (New York: Simon and Schuster, 1973): 173.

<sup>14</sup>Cadman, p. 10. In fact, bribery was suspected by many in the granting of the charter of "The Society for Establishing Useful Manufactures" in 1791 -- the first business corporation chartered by New Jersey. Davis, however, has concluded that bribery would not have been necessary since many of the legislators were subscribers to the project. See Davis, Earlier History of American Corporations, Vol. I, pp. 377 and 449.

<sup>15</sup>Cadman, p. 11.

investigating committee was formed to look into rumors that a legislator took payments in exchange for favorable votes on bank charters. Once again, the results of the investigation were inconclusive. Nevertheless, the investigation apparently had some effect as evidenced by the passage of a law near the end of the 1855 session declaring that both parties to legislative bribery were to be judged guilty of high misdemeanors and to be "forever disqualified to hold any office of honor, trust or profit under this state."<sup>16</sup> In 1871, the New Jersey legislature enacted more extensive legislation against bribery. The target of this legislation was the corporation itself and the penalty was revocation of the corporation's charter if its agents were found to have bribed members of the legislature.<sup>17</sup>

An example of another state's efforts to deal with the abuses of the special-chartering system is the response to the 1856 Wisconsin Railroad Scandals. The stakes were particularly high as the scandals concerned the battle between competitors for a rich federal land grant subsidy. In the competitive rent-seeking to win the subsidy, competing company promoters bought the Governor, a state Supreme Court justice, and nearly every member of the state legislature. Kuehnl, who claims that "...most of the time the legislature discharged its economic clearing house functions rather well...", refers to the Wisconsin Railroad Scandals as the "...one outstanding episode in which the corporations it had created turned and corrupted and nearly destroyed

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<sup>16</sup>Ibid., pp. 139-140.

<sup>17</sup>Ibid., p. 163; the legislation was also concerned with corporations' behavior aimed at influencing citizens in their voting.

the state government."<sup>18</sup> Apparently, there was a temporarily-successful cover-up, but the 1858 legislature devoted most of its time to investigation of the scandal and, in the process, uncovered considerable graft in the granting of all corporate charters. The specific result of the investigation was the passage of acts aimed at curtailing bribery and regulating the practices of lobbyists.<sup>19</sup>

Logrolling was especially prevalent with respect to the granting of charters for transportation projects because of the importance of the projects to different sections throughout a state:<sup>20</sup>

Another practice arising from the system of special charters, and one causing much concern, was the logrolling that occurred when numerous bills were before the legislature. No estimate of the prevalence of this practice can be hazarded because of the lack of positive evidence. Considering the sectional and special nature of the charters and the frequent charges of logrolling made, however, there is little doubt that special acts of incorporation became the state counterpart of federal tariff legislation in engendering logrolling tactics.<sup>21</sup>

It has been suggested that the force of logrolling would not have been as strong with respect to the granting of corporate charters for

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<sup>18</sup>Kuehnl, p. 190.

<sup>19</sup>Ibid., pp. 190-191.

<sup>20</sup>See Louis Hartz, Economic Policy and Democratic Thought: Pennsylvania, 1776 - 1860 (Cambridge: Harvard University Press, 1948) pp. 62-69, for a through development of this point.

<sup>21</sup>Cadman, p. 11. See F.W. Taussig, The Tariff History of the United States, 8th edition (New York: Capricorn, 1964) for documentation of federal tariff legislation, and Jonathan J. Pincus, Pressure Groups and Politics in Antebellum Tariffs (New York: Columbia University Press, 1975), for a public choice interpretation of the passage of tariff legislation.

industrial purposes because of the suspicion that there would have been relatively less importance placed on sectional consideration.<sup>22</sup> It is not immediately clear why this would hold true -- for example, there is no apparent reason why votes for canal charters would have to be exchanged for votes for other canal charters. Also, in general, it is expected that the legislatures would be organized in a manner which would allow legislators from non-industrial areas to receive some of the benefits from the passage of corporate charters for industrial organizations. It is interesting to note that in 1855 the New Jersey legislature recognized the problems caused by logrolling and declared a legislator to be guilty of a high misdemeanor if he agreed with another member to vote or abstain from voting on any manner before the legislature in return for a similar vote in connection with some other proceeding before the legislature.<sup>23</sup>

The special-chartering system was often criticized for the amount of legislative time it occupied. In particular, it was frequently argued that the legislature spent more time on private legislation than "important" public legislation. This objection was often dismissed as a failure to understand that many of the private corporations were actually in the public interest -- an argument that was especially applicable to transportation companies which were to provide quasi-public goods through the granting of a natural monopoly. It was also argued that the granting of corporate charters to encourage

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<sup>22</sup>Hartz, pp. 64-65.

<sup>23</sup>Cadman, p. 139.

developing industries served public ends.<sup>24</sup> This infant-industry defense of the special-chartering system would have made more sense had the legislators granted the charters in a less discriminatory manner -- an observation that might explain the fact that the objection to the special chartering system on the ground that it monopolized the legislatures' time was "offered more frequently and with more cause after the middle of the nineteenth century..."<sup>25</sup> when the corporate form had become the dominant form of industrial organization.

In order to put some restraint on the legislatures and, thus, the special chartering system, several states altered the voting requirement for the passage of special acts granting corporate privileges. For example, under the New York Constitution of 1821, the "assent of two-thirds of the members elected to each branch of the legislature" was needed for passage of any bill "creating continuing, altering, or renewing any body politic or corporate."<sup>26</sup> A similar provision appeared in the Delaware Constitution of 1831.<sup>27</sup>

The purpose of this subsection has been to establish that the special-chartering system was, as its name suggests, a system of special-interest legislation. It will be shown in subsequent sections of this chapter that the "many objectionable features attendant upon

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<sup>24</sup>Ibid., pp. 11-12.

<sup>25</sup>Ibid., p. 11.

<sup>26</sup>Friedman, p. 173.

<sup>27</sup>S. Samuel Arsht, "A History of Delaware Corporation Law," Delaware Journal of Corporate Law, I (1976): 1-21, 3-4.

the system of incorporation by special act"<sup>28</sup> led to increased agitation for the adoption of general incorporation laws. In fact, although it does not explain why the law changed at any particular time, some scholars believe that the symptoms of the special-interest legislation were major factors in the demise of special corporate chartering: "Corruption and bribery of state legislators, coupled with the impact of the Industrial Revolution, called for a change."<sup>29</sup>

### 3. The Use of Special Corporate Charters to Grant Monopoly Privileges

The focus of this dissertation is the evolution of the use of special corporate charters as a means to confer regular corporate privileges on business or industrial organizations. Nevertheless, for two reasons, it is worthwhile to mention the use of the corporate charter as an instrumentality for conferring special privileges (i.e., privileges not related to the basic corporate form as it is known today) on transportation and financial companies. First, an awareness of the history of the monopoly-granting charter and its influence on the public's conception of the corporation will lead to a better understanding of the political opposition to granting charters for general business purposes.<sup>30</sup> Second, an understanding of the basic philosophy underlying the granting of these charters, coupled with a

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<sup>28</sup>Cadman, p. 18.

<sup>29</sup>Harry C. Henn, Handbook of the Law of Corporations (St. Paul: West Publishing Company, 1972): 18.

<sup>30</sup>See subsection IV A.6, *infra*.

recognition that this philosophy also influenced the granting of regular business charters, will lead to a better understanding of the alleged "public policy" bases for granting general business charters.

In the first half of the nineteenth century, the role of government was promotional. It is not clear, however, whether this role was the result of an ideological goal of creating a sound basis for economic growth or the result of competition between interest groups within each state.<sup>31</sup> In speaking of the role of government in general in the first half of the nineteenth century, Lawrence Friedman has stated:

If this was an age of laissez-faire philosophy at all, it came later in the century;. . .There was a public right -- a public duty -- to lend a hand to productivity. This meant that the government must provide public goods, especially transportation, but also currency and credit.<sup>32</sup>

The policies of the states with respect to internal improvements were manifest in the following ways: (1) actual construction and control by the states of the canals, turnpikes, railroads, etc.; (2) state guarantees of the bonds issued through the corporations; (3) state assistance to the corporations through subscriptions to their

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<sup>31</sup>See Stephen Salsbury, The State, the Investor, and the Railroad: The Boston and Albany, 1825-1867 (Cambridge, Mass.: Harvard University Press, 1967), for a study of the political and economic forces within Massachusetts that dictated the policy of that state with respect to the building of railroads. Also, see Kuehnl for an articulation of the opinion that the major reason for the use of the corporate form was to spur economic growth.

<sup>32</sup>Friedman, p. 158.

stock; and (4) the granting of monopoly privileges.<sup>33</sup> Of course, the first three policies also included the granting of monopoly privileges -- the primary vehicle of which was the corporate charter. States also promoted financial institutions by granting special privileges.

Very few states undertook the actual construction and control of internal improvements -- it was the dominant policy in only New York, Pennsylvania, and Ohio. Most of the other states, especially the Southern States, followed the policy of financial assistance through loan guarantees to corporations chartered for specific projects.<sup>34</sup> Callender argues that reliance on state financial backing can be traced to the overaccumulation of capital in England, England's corresponding need for an outlet for its venture capital, plus contemporary problems with trans-Atlantic financial transactions:

. . .it is safe to conclude that corporations before 1820 were not able to raise any large amounts of capital without public assistance. This was not due to lack of capital. . .The difficulty related rather to the means of securing control of the existing supply -- of inducing its owners to invest it in the various enterprises of the day. The nature of that difficulty will be apparent if we consider for a moment the position and character of the persons who did the saving and supplied the capital for the community at that time. So far as domestic capital was concerned, there was no large class of persons, who on account of large incomes were willing to devote a part of their savings to risky investments or to

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<sup>33</sup>See G.S. Callender, "The Early Transportation and Banking Enterprises of the States in Relation to the Growth of Corporations," Quarterly Journal of Economics, XVII (November, 1902): 111-162 for an excellent, early study of the effects of exogenous factors on state enterprises and corporations.

<sup>34</sup> Ibid., pp. 154-162.

those from which a return must be slow as well as uncertain. Such capital as existed was chiefly in the hands of small savers, who were naturally more interested in security than the chance of large returns. . . .Regarding foreign capital the situation was somewhat different. There were many people in England ready to risk their capital in all sorts of uncertain undertakings rather than accept the inevitable fall in the rate of interest, as the wild speculation which preceded the crisis of 1825 abundantly proves; but, from the nature of the case, before modern means of communicating came into existence a foreigner could have but an imperfect knowledge of the character of the enterprise for which his capital was sought. He could not acquire the knowledge necessary to judge the merits of the project he was asked to support. Consequently, it was necessary, in order to secure his capital, to offer him a pledge of the faith and credit of some individual or combination of individuals who were able to command his confidence, as well as to present a promising enterprise. Accordingly, we find that English foreign investments in the early part of the nineteenth century were made chiefly in public securities. The stock and bonds of private corporations formed in foreign countries, unless endorsed by the government, played a very small part on the London stock market until after the middle of the century.<sup>35</sup>

As a result of this dependence, it is not hard to see why most states' work on internal improvements was checked when the market for American securities in London failed in 1839.<sup>36</sup>

Other states were more cautious when it came to risking their funds for the development of internal communication. The following statement, from a petition written by the mayor of Trenton in 1796, is illustrative of this cautious approach to alternative methods of developing public works projects:

Only three methods present themselves by which works of public utility, attended by heavy expenses, can be effected.

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<sup>35</sup>Ibid., pp. 151-152.

<sup>36</sup>Ibid., p. 146.

The first is, by Government undertaking the task of the public expense - here the government having the Revenues of the State at command have more power than can be otherwise acquired - it is in this way without doubt, that all great improvements of general advantage to the community ought to be effected, because where all are benefited all ought to be obliged to contribute; yet where the expense is certain and considerable and the advantage or success problematical, Legislators will rarely think themselves justifiable in sporting with the property of their constituents; therefore little is to be expected from this quarter.

The second method, is by men of large Fortune & Property, undertaking works of public Utility with a view to increase their fortunes and advance the value of their property, but if we look through the State of New Jersey we shall find few if any Men of property sufficient to induce us to expect any thing from them.

The last Method then is the only one from which we are to hope for important public improvements, Viz. By Companies of Men joining together and risking part of their property in order to form a joint Stock sufficient to defray the expense of the improvement contemplated. Under this Idea we see almost every State in the Union has encouraged the forming [of] such Companies, and especially for promoting an inland Navigation, by authorizing their improvements and ensuring to them and their successors the emoluments arising from them should their undertakings prove successful - It was under an Idea that a like disposition prevailed in the Legislature of New Jersey that your Petitioners came forward on the present occasion.<sup>37</sup>

In several states, this conservative attitude led legislators to look to private sources for funding even though the undertakings were seen as legitimate subjects for government enterprise.

Many states sought to attract private capital for the construction of internal improvements by granting special corporate charters that included monopoly privileges along with the usual corporate privileges.

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<sup>37</sup>Manuscript petition, dated March 15, 1796, in the collection of the New Jersey State Library; quoted from Cadman, pp. 42-3.

Typically, these charters were for a specific project and included the right to bring private eminent domain proceedings.<sup>38</sup> These entrepreneurs were usually given complete discretion in setting the rate structure for their natural monopolies. As one would expect when monopoly profits were involved, this method of encouraging internal improvements was not without faults:

One bad result of this method of creating corporations was the deliberate exclusion of many legitimate corporations because of the opposition of others already in the field. The rail and water transportation companies, with their monopolistic rights, prevented the establishment of competing corporations and thus actually hindered the industrial development of the state. Although the early charters were granted by the legislators with a sincere regard for the public interest, time showed that the gift of monopolistic rights was really opposed to the object sought, namely, the promotion of public welfare.<sup>39</sup>

Before concluding this brief sketch of the use of corporate charters as vehicles for conferring monopolistic privileges, a cursory examination of New Jersey's experience with the famous (or infamous) Camden and Amboy Rail Road and Transportation Company is called for.<sup>40</sup> This is so because it illustrates an interesting economic point about the method of allocating monopoly privileges and, also, because it was the beginning of New Jersey's experience with corporate charters as revenue raising devices.

At a time when most states were either giving their financial backing to transportation projects or simply granting natural

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<sup>38</sup>Cadman, p. 47.

<sup>39</sup>Stoke, p. 558.

<sup>40</sup>The following is a summary of information gathered from Stoke, pp. 554-555 and Cadman, pp. 54-59.

monopolies with no strings attached, New Jersey was apparently the only state to realize that by entrusting transportation projects to private companies the state could increase public revenues by selling the privileges to the companies. In each of two separate transactions, the Camden and Amboy gave the state one thousand fully-paid shares of Camden and Amboy stock. In return for the first one thousand shares, the Camden and Amboy was given a monopoly for the transporting of passengers and goods across New Jersey -- the shortest route between New York and Philadelphia -- for nine years beginning in 1831. After merging with a competing canal company, the second transaction was negotiated with the state. The major features of this involved the transfer of stock in return for a grant of irrevocable monopoly privileges.<sup>41</sup> The second deal, by adding additional measures (similar to modern cumulative dividend provisions with respect to preferred stock dividends), guaranteed the state sizable revenues that promised to reduce state taxes to the vanishing point. In fact, the revenues to the state from the Camden and Amboy made it possible for the state to avoid direct taxes in several years before 1848 and unnecessary for the state to levy any direct taxes in any year between 1848 and the Civil War.<sup>42</sup>

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<sup>41</sup>The Camden and Amboy was also granted a tax exemption which later became quite burdensome for the state because all property acquired by the Camden and Amboy, whether by purchase or merger, became tax exempt. See Stoke, p. 555.

<sup>42</sup>Cadman, p. 59.

New Jersey's experience with the Camden and Amboy is the closest approximation to above-boards competition "for the field"<sup>43</sup> that was uncovered in the course of research for this dissertation. Since there was no evidence, however, of other firms competitively bidding against the Camden and Amboy for the rights to the monopoly privileges, it is not a perfect example of the theoretical notion of competition for the field. Why other states did not allocate their grants of monopolistic privileges in a similar manner is not clear. What is clear is that the states did allocate these valuable privileges (of course, state financial backing must also be considered a privilege), and that the state treasuries did not capture the monopoly rents that were created. Thus it is evident that the competition for the field took the form of classic rent-seeking activities.<sup>44</sup> The major difference between these two methods of allocating the field is that under the method used by New Jersey with respect to the Camden and Amboy the state captures a fraction of the monopoly rents, while under the rent-seeking method of allocation some multiple of the rents are captured by the legislators. This might explain why very few states chose to follow New Jersey's example.

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<sup>43</sup>See Gordon Tullock, "Entry Barriers in Politics," American Economic Review, LV (May, 1965): 458-466; Harold Demsetz, "Why Regulate Utilities?" Journal of Law and Economics, XI (October, 1968): 55-65; and W. Mark Crain and Robert B. Ekelund, Jr., "Chadwick and Demsetz on Competition and Regulation," Journal of Law and Economics, XIX (April, 1976): 149-162 for the development of the principle of competition "for the field."

<sup>44</sup>See section I B, supra for a discussion of rent-seeking activity.

New Jersey's experience with the Camden and Amboy is also significant because it revealed to the state the notion that it could generate revenues by marketing corporate privileges. In subsequent sections of this chapter, it will be argued that New Jersey's desire to increase revenues by marketing corporate charters eventually led to the end of the special-chartering system.

#### 4. Special Corporate Charters: Early Development and Public Control

In the first third of the nineteenth century, states were interested in using the corporate form to promote industrial independence from England, but they were also conservative in their initial application of the corporate form to industrial and business organizations. The result of these conflicting considerations was an interesting combination of relative generosity in granting special charters and a fairly restrictive policy with respect to the terms of the charters. The usual corporate privileges restricted by these early charters were the rights to perpetual succession and limited liability. With respect to perpetual succession, the life of most charters was usually limited to 20 to 30 years. The limited liability provisions displayed a great deal of variation including, inter alia, provisions for full (i.e., partnership) unlimited liability, pro rata limited liability, and liability limited to twice the individual's contribution to the firm. Thus, it has been said that the "...recipients of many charters had to rest content with the doubtful legal privileges of suing and being sued as an entity, a different tax status, and the pomp

of a corporate seal."<sup>45</sup> In this subsection, several issues related to the demand for and the evolving substance of these special corporate charters are discussed.

#### Public Control Over Corporations

The issue of public control over corporations was perhaps more important in relationship to ordinary industrial corporations than with respect to corporations chartered for the construction of public works for which there was at least some clear-cut justification for the granting of the privileges. English corporation law, in the area of public control over corporations, was necessarily of little help to American lawyers and judges. This was so because the omnipotent Parliament was not limited by constitutional constraints. In the United States, the state legislators. . .

were limited not only by the terms of the state and federal constitutions, but also according to a view then widely prevalent among judges and lawyers, by restrictions on the legitimate scope of legislative action in a society based on private property. . .the private corporation differs from the private property owner or unincorporated association of private property owners in that its right to hold property as a corporation is derived from a grant which the state and the state alone -- in America the legislature and it alone -- has the power to make. The question of the legal right of a state legislature to affect private property by amending or repealing the charter of a corporation which owns the property is thus not identical with the question of the power of that legislature to abrogate or modify the private property rights of natural persons.<sup>46</sup>

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<sup>45</sup>Shaw Livermore, "Unlimited Liability in Early American Corporations," Journal of Political Economy, XLIII (October, 1935) pp. 674-687, 677.

<sup>46</sup>Dodd, American Business Corporations, p. 16.

Thus, the issue of public control of corporations boiled down to whether the property rights created and granted by a state could be revoked by that state.

The Supreme Court had foreshadowed things to come in a case in 1810 involving the Yazoo land scandals in Georgia. In Fletcher v. Peck,<sup>47</sup> the Marshall Court held that a legislative land grant was a "contract" within the meaning of Article I, Section 10 of the Constitution which forbids the impairment of contracts by a state. Since the land grant was a contract, the grant of one legislature could not be revoked by a subsequent legislature.<sup>48</sup> Thus, the issue of the public control of corporations was further narrowed to whether or not the special corporate charter was a constitutionally-protected contract.

The Supreme Court came face to face with the issue in 1819 in the landmark case of Dartmouth College v. Woodward.<sup>49</sup> In summary, the

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<sup>47</sup>Fletcher v. Peck, 6 Cranch 87 (1810).

<sup>48</sup>"Fletcher v. Peck had the double claim to fame in that it was the first case in which the Supreme Court held a state enactment to be in conflict with the Constitution, and also the first case to hold that the contracts clause protected public grants." Congressional Research Service, Library of Congress, The Constitution of the United States of America: Analysis and Interpretation -- Annotations of Cases Decided by the Supreme Court of the United States to June 29, 1972, Washington: U.S. Government Printing Office, 1973): 393.

<sup>49</sup>Dartmouth College v. Woodward, 4 Wheat. 518 (1819). For a detailed discussion of Dartmouth College, see Charles Grove Haines, The Role of the Supreme Court in American Government and Politics, 1789-1835 (Berkeley: University of California Press, 1944): 379-423; for a more general discussion of the case, see Dodd, American Business Corporations, pp. 141-142, Friedman, pp. 174-75, and U.S. Constitution, pp. 394-96.

Court held that corporate charters were "contracts" -- the terms of which could not be changed by subsequent legislatures without violating the contracts clause of the Constitution. Although the case involved an educational institution, it was clear that the Court intended that the principles of the decision were to apply to all business corporation charters. Consequently, the "later extension of the benefits of the Dartmouth College decision to corporations organized under the general law took place without discussion."<sup>50</sup>

The Dartmouth College decision generated considerable public debate,<sup>51</sup> but subsequent developments all but negated the impact of the decision with respect to the legislatures' power to revoke a charter. In a concurring opinion, Justice Story had suggested that if a state desired to have future control over grants of corporate privileges, then it could avoid the impact of the rule by simply reserving the right to alter the charter by inserting a reserve clause into the contract (i.e., into the charter). In subsequent years, it became quite common to insert standard reserve clauses into all special corporate charters. And, beginning with a New York Act in 1827, such reservation clauses were made applicable to corporations generally by

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<sup>50</sup>U.S. Constitution, p. 395.

<sup>51</sup>See Friedman, pp. 174-75, and Haines, pp. 415-423, for presentations of the contemporary interpretations of the decision.

inserting them into general regulating statutes,<sup>52</sup> general incorporation laws, and state constitutions.<sup>53</sup>

Dartmouth College and subsequent developments are interesting from an interest-group perspective because the decision (on its face) suggested that state legislators would be able to grant privileges which were essentially permanent. Although a strict construction policy for charter privileges and immunities was subsequently adopted by the Supreme Court,<sup>54</sup> the Landes-Posner interest-group perspective suggests that the demand for corporate charters would have increased as a result of the increased certainty as to the durability of corporate privileges.<sup>55</sup> However, the adoption of Story's reserved clause suggestion would have surely mitigated this effect. Thus, the more interesting question is why the legislators were willing to use the

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<sup>52</sup>General regulating statutes are discussed in the next subsection.

<sup>53</sup>See Dodd, American Business Corporations, pp. 141-42, and Friedman, p. 174, for lists of the statutes and constitutional provisions containing reserve clauses. Legislative attempts to exercise these reserved powers led to a considerable amount of litigation -- the result of which was the upholding of the legislatures' reserved power to repeal. See Dodd, pp. 141-50, for an extended discussion of the litigation and issues surrounding reserve clauses.

<sup>54</sup>"Nothing passes by implication in a public grant," Charles River Bridge v. Warren Bridge, 11 Pet. 420 (1837).

<sup>55</sup>William M. Landes and Richard A. Posner, "The Independent Judiciary in an Interest-Group Perspective," Journal of Law and Economics, 18 (December, 1975): 875-901. Landes and Posner argue that the bids for special-interest legislation will be higher if the present value of the legislation is increased by lengthening the time span of its effectiveness.

reserve clauses. The answer is most likely related to the political pressures and controversy surrounding the corporate form at this early time.<sup>56</sup>

Exogenous Changes Affecting the Demand for Corporate Privileges

In spite of, rather than for lack of, legislative encouragement, early American manufacturing companies, both incorporated and unincorporated, failed to prosper.<sup>57</sup> After the Revolution, the change from an economy of individual artisans to the factory system of organization was slow and uneven.

The northeastern states led the way in the development of the factory type of manufacturing, but it was not until over a decade after the turn of the century that the technology utilized in the United States was sufficiently advanced to serve as an adequate foundation in any large-scale enterprises necessitating a complex business structure. To be sure, there were instances of the introduction of technology that would have made the corporate form more desirable. For example, an Englishman, Samuel Slater, introduced the Arkwright spinnery machinery into the United States and his mill, which was equipped with water-driven spindles, went into operation in the winter of 1790-91. Nevertheless, the progress of mechanization was slow and by 1800 there appear to have been only seven Arkwright mills in the country and all

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<sup>56</sup>See subsection IV A.6., *infra*, for a discussion of the political controversy surrounding the corporate form in the first half of the early nineteenth century.

<sup>57</sup>See Davis, II, pp. 279-83.

of them were in southern New England.<sup>58</sup> This early introduction foreshadowed the role that the cotton-textile industry would play in increasing the use of the corporate form for industrial organizations. Before considering the most important technological improvement in the cotton-textile industry in this early period, a consideration of the effects of an earlier exogenous change on the demand for the corporate form is appropriate.

With respect to the increasing utilization of the corporate form beginning in 1809, the significance of the effects of the limitations on the importation of European goods which were imposed by the Embargo Act of 1807 and its successor, the Non-Intercourse Act of 1809, is undeniable. It was not merely coincidental that 1809 was the first year in which Massachusetts was confronted with a substantial number of applications for manufacturing company charters. This increased demand for charters was accompanied by a substantial increase in factory building in Massachusetts and other Northeastern States.<sup>59</sup> In 1809, Massachusetts, which had incorporated only ten manufacturing companies in the previous twenty years, granted charters to eleven companies, eight of which were textile companies. The 1809 figures for other

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<sup>58</sup>Victor S. Clark, History of Manufactures in the United States, 1929 edition, 3 volumes (New York: Peter Smith, 1949): I, 535.

<sup>59</sup>Dodd, American Business Corporations, p. 375. Also, see Oscar Handlin and Mary F. Handlin, Commonwealth: Study of the Role of Government in the American Economy: Massachusetts, 1774-1861, Revised Edition (Cambridge: The Belknap Press of Harvard University, 1969) for an examination of the effects of the embargo on the demand for Massachusetts manufacturing charters.

Northeastern States are equally impressive with respect to the effects of the embargo: New York, Vermont, and New Hampshire granted eight, five and five charters, respectively.<sup>60</sup>

The importance of these developments is that they influenced the public's and business community's attitudes about the proper role for the corporate charter. It has been suggested that "...it was not until 1809 that the corporate device, already common in transportation and finance, became anything other than exceptional in manufacturing."<sup>61</sup>

Another writer summarized his interpretation as follows:

In short, under the artificial protection and stimulus derived from the Embargo and War of 1812, the corporate device in business expanded from its traditional fields of public utilities and finance to those of manufacturing and mining, even without the encouragement of limited liability and federal incorporation.<sup>62</sup>

In spite of these effects of the embargo on the use of the corporate form, it must be noted that there is not universal agreement that the net effect of the embargo was a boon to American industry. It is undeniable that the embargo itself was a stimulus to industry for two reasons. First, it cut off foreign competition in manufactured goods. Second, it caused capital and labor which could no longer be employed in

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<sup>60</sup>Dodd, American Business Corporations, pp. 367-68.

<sup>61</sup>Ibid., p. 368.

<sup>62</sup>William C. Kessler, "Incorporation in New England: A Statistical Study, 1800-1875," Journal of Economic History, VIII (May, 1948): 43-62, 52.

foreign trade to seek employment in other occupations.<sup>63</sup> Nevertheless, in considering the net effect, these positive developments must be balanced by the total disruption of the shipping industry which seriously reduced the purchasing power of the seaport towns -- the principal markets for the products of American factories.<sup>64</sup> Partially because of this negative consideration, one author has concluded that "...the commercial restriction of the Embargo period did not have the importance generally attributed to it in the initial industrial development."<sup>65</sup> With this in mind, consideration of the next major exogenous shock is called for.

The year 1813 saw the introduction of a major technological development to the infantile American industry: the power loom. This is the key invention that brought the manufacture of cloth -- particularly cotton cloth -- out of the home and into the factory. Efficient utilization of this new technology required the use of factories on a previously unheard of scale.<sup>66</sup> Relatively large sums of money were necessary in order to build a factory of the efficient size and the complex business structure of the corporation was the logical

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<sup>63</sup>Caroline F. Ware, The Early New England Cotton Manufacture: A Study in Industrial Beginnings (Boston: Houghton Mifflin Company, 1931) p. 44.

<sup>64</sup>Ibid., p. 39, and Clark, I, p. 536.

<sup>65</sup>Clive Day, "The Early Development of American Cotton Manufacturing," Quarterly Journal of Economics, XXXIX (May, 1925), pp. 450-468, 463.

<sup>66</sup>Clark, I, p. 449.

form of industrial organization. In 1813, the Boston Manufacturing Company of Waltham, Massachusetts, the first corporation in America to take advantage of the power-loom breakthrough, was chartered with a capitalization of \$400,000, a sum previously unheard of for manufacturing firms.<sup>67</sup>

The immediate success of the Waltham Company showed investors the advantages of complete factory organization.<sup>68</sup> As individual firms increased in size and complexity, the advantages of the corporate form of organization became more appealing. The preamble of most New Jersey manufacturing and mining company charters justified the acts of incorporation on the ground that the enterprises required more capital than could be obtained by more traditional means.<sup>69</sup> Implicit in these preambles was the notion that limited liability was necessary to raise the large sums. Another advantage of limited liability was recognized in the charters:

A futher advantage enjoyed by incorporated proprietors, one deriving largely from the corporate attribute of limited

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<sup>67</sup>Ware, p. 138. Also, see Hugh L. Sowards and James S. Mofsky, "Factors Affecting the Development of Corporation Law," University of Miami Law Review, XXIII (Winter/Spring 1969): 476-94, 490 for a discussion of the importance of this technological development with respect to the use of the corporate form.

<sup>68</sup>Handlin and Handlin, Commonwealth, p. 183. They also note what was considered to be another positive attribute of the corporate form: "The corporate form permitted traders who acted as selling agents to participate without assuming the identity of the project and to earn dividends and commissions from the same venture;" p. 184.

<sup>69</sup>Cadman, pp. 39-40.

liability, was the possibility of more safely delegating managerial functions to persons who were not owners. Such advantages were frequently set forth in manufacturing company charters as the reason for incorporation. An 1813 charter for an established textile factory stated that the proprietors "in order that the business may be conducted with more facility, have prayed to be incorporated," and eight manufacturing company charters passed between 1814 and 1816 contained similar expressions of purpose.<sup>70</sup>

Nevertheless, limited liability was not a universal attribute of corporate charters in the first third of the nineteenth century.

### The Availability of Limited Liability

Before turning to the statutory bases of corporate limited liability, it must be recognized that in the United States at the turn of the century it was not clear whether a corporation necessarily included limited liability under the common law when the charter was silent with respect to shareholders' obligations to creditors. This issue was not affirmatively settled until 1824 when a federal circuit court, in a case where there was no express exemption from liability in the company's charter, stated: "The individual shareholders are liable for the debts of the bank in their private capacity. The charter relieves them of personal liability and substitutes the capital stock in its stead."<sup>71</sup>

In any event, most corporate charters contained a statement about the extent of liability of the shareholders. New York was the first

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<sup>70</sup>Ibid., p. 41.

<sup>71</sup>Wood v. Drummer, 3 Mason 308, 311 (C.C.D. ME., 1824). See Dodd, American Business Corporations, pp. 370-73, for a discussion of the status of limited liability under the common law.

state to alter the basic limited liability provision of corporate charters. In 1786, she granted to a manufacturing company a corporate charter that included a provision for proportional liability for any debts incurred -- the proportionality being determined by the contribution of each member.<sup>72</sup> Although New York was the first state to alter the liability principle, she experimented with it less extensively than other states, New England states in particular, during the first three decades of the nineteenth century.

In this era, the first American industry to become mechanized, the cotton-textile industry, was largely concentrated in the New England area. Because of this it is somewhat surprising to note that all of the New England states at one time or another adopted the unlimited liability manufacturing corporation as their usual policy. An underlying rationale for this policy was a belief that unlimited-liability tended to protect creditors from abuses of the corporate form. The policy also included granting charters in relatively large numbers as a manifestation of their desire to encourage industry and, at the same time, protect creditors.<sup>73</sup>

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<sup>72</sup>Livermore, "Unlimited Liability," p, 683.

<sup>73</sup>See Dodd, American Business Corporations, pp. 365-66 and 391-92, for the conflicting considerations underlying New England legislative policy.

Massachusetts was the first state to adopt and, with the exception of Rhode Island, the last to abandon the unlimited-liability policy.<sup>74</sup> In 1809, Massachusetts adopted a general regulating statute<sup>75</sup> that provided for unlimited liability for all specially-chartered manufacturing corporations. This policy was reversed with the passage of a second general regulating for manufacturing corporations in 1830. The other New England states, which did not have general regulating statutes during that period, imposed the unlimited-liability policy but were not as consistent as Massachusetts in its application. For example, Vermont, which never became an important industrial state, imposed unlimited liability in about one half of the manufacturing charters it granted between 1810 and 1815, but rarely imposed it thereafter. The dates the other New England states abandoned the unlimited-liability policy for industrial charters varied widely. Connecticut and New Hampshire accepted the limited liability principle in almost all charters after 1816. Maine abandoned the Massachusetts unlimited-liability policy in 1823, three years after separating from Massachusetts. Finally, Rhode Island, which did not begin to grant

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<sup>74</sup>It is interesting to note: "Even prior to 1800 Massachusetts had shown some tendency to impose personal liability on members of corporations. Thus the inhabitants of Massachusetts towns had from very early times been held personally liable for town debts and that liability remained unaffected by the statute of 1786, which declared 'the inhabitants of every town...to be a body politic and corporate'." Ibid., p. 374, citing the Act of March 23, 1786 (Mass. Laws 1784-5, c. 75, p. 605).

<sup>75</sup>General regulating statutes are the topic of the following subsection.

charters in substantial numbers until the 1830's stuck with a policy of full liability until 1847.<sup>76</sup> It has been suggested that Rhode Island's reluctance to abandon its unlimited-liability policy was the primary reason for its losing of its position as the second state in the country in value of cotton products.<sup>77</sup>

Outside of New England, unlimited-liability corporations were rare. In Pennsylvania, manufacturing corporation charters were silent with respect to shareholder liability both before and after it had become a definitely established principle of American law that silence implied limited liability.<sup>78</sup> The situation in Pennsylvania was also unusual because, in spite of the fact that she granted numerous charters for other purposes, she was extremely stingy in granting manufacturing corporation charters when contrasted with other industrial states. By 1835, Pennsylvania had incorporated only eighteen manufacturing corporations,<sup>79</sup> while New York and Massachusetts had incorporated approximately 300 and 350, respectively.<sup>80</sup> The reasons for the state's policy of granting very few industrial charters are not clear, but it is interesting to note that Pennsylvania did have...

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<sup>76</sup>For a thorough discussion of the evolution of limited liability in New England industry, see Dodd, American Business Corporation, pp. 364-437.

<sup>77</sup>Ibid., pp. 387-88.

<sup>78</sup>Ibid., p. 388.

<sup>79</sup>William Miller, "A Note on the History of Business Corporations in Pennsylvania, 1800-1860," Quarterly Journal of Economics, LV (November, 1940): 150-60, 156.

<sup>80</sup>Dodd, American Business Corporations, p. 389.

...a liberal policy of incorporating associations for purely promotional objectives in industry and in agriculture, a policy that expanded with the growth of such associations after 1819, when a number of them were organized to express the state's heightened protectionist ardor.<sup>81</sup>

In other words, the state legislature helped organize lobbyists to go to Washington to influence national policies to Pennsylvania's benefit.

In order to understand the value of limited liability at this early stage in the development of the corporate form, it is necessary to first understand the dominant method of financing a corporation in the first half of the nineteenth century.<sup>82</sup> The usual practice was for the incorporators to obtain stock subscriptions on which only a small percentage of the par value of the stock was paid at the outset and then to assess the subscribers up to the amount of the subscription in order to meet future needs of the company.<sup>83</sup> A stock subscription was a legal contract and the failure of shareholders to meet assessment calls resulted in considerable litigation. This was especially true when the interval between the subscription and the demand for payment was unusually long because the extra time allowed many events to take place which the subscribers could attempt to use as defenses against non-payment suits. Nevertheless, this method of financing provided a basis for shareholders liability to creditors of the corporation because

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<sup>81</sup>Hartz, pp. 56-7.

<sup>82</sup>Discussed in Dodd, American Business Corporations, pp. 74-84.

<sup>83</sup>It is the common practice today to use shares which are fully paid at the time of issue.

a court of equity would treat an assessment or potential assessment as an asset of the corporation. In other words, even after the general principle of the non-liability of shareholders for corporate debts had become established, a shareholder's liability was not limited to his initial contribution; it was, however, limited to the unpaid portion of the subscription.<sup>84</sup>

There is some dispute between legal scholars as to the importance of limited liability at this early stage in the development of the corporate form,<sup>85</sup> but, as illustrated by the following quotation from the first edition of Angell and Ames' pioneer American treatise on private corporations which appeared in 1832, there seems to have been little dispute between incorporators:

It is frequently the principal object, in this and in other countries, in procuring an act of incorporation, to limit the risk of the partners to their shares in the stock of the association; and prudent men are always backward in taking stock when they become mere co-partners as regards their personal liability for the company debts.<sup>86</sup>

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<sup>84</sup>It has sometimes been suggested that the correct answer to the question of the existence of shareholder liability for corporate debts in the eighteenth century was that such liability did exist but that it was indirect rather than direct and resulted from the corporate power to make assessments. See Samuel Williston, "History of the Law of Business Corporations Before 1800," Harvard Law Review, II (October, 1888 and November, 1888), pp. 105-124 and 149-166, at 160, and Oscar Handlin and Mary F. Handlin, "Origins of the American Business Corporation," Journal of Economic History, V (May, 1945): 1-23, 13.

<sup>85</sup>Handlin and Handlin, "Origins," Livermore, "Unlimited Liability," and Dodd, American Business Corporations, p. 390.

<sup>86</sup>Joseph K. Angell and Samuel Ames, A Treatise on the Law of Private Corporations Aggregate, First Edition (Boston: 1832): 23.

At any rate, from the perspective of this dissertation, the importance of limited liability is not limited to whether it actually encouraged the formation of corporations but must also include whether the presence of limited liability affected the legislators behavior with respect to the granting of corporate privileges. The importance of limited liability in the market for corporate privileges is emphasized in the subsection on limited jurisdictional competition through capital markets.<sup>87</sup>

#### 5. General Regulating Statutes

The passage of special charters and supplementary acts<sup>88</sup> modifying original charters occupied increasingly large portions of legislative sessions in the first third of the nineteenth century. In order to ease this burden, many legislatures passed general regulating statutes. These acts did not provide for incorporation by procedure, instead they merely established the powers and restrictions applying to corporations created by special charter. By referring to the general regulating statutes, the special charter did not have to include the general powers and restrictions. In effect, the passage of a special charter subject to the general regulating statute involved the legislature filling out a form: adding a few details such as the name

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<sup>87</sup>See Section IV.A.7, *infra*.

<sup>88</sup>"The practice of the legislature passing supplementary acts modifying original charters became an integral part of the special chartering system. ...Supplemental Acts were sought as a means of providing for contingencies unforeseen at the time of original incorporation or of securing some desired privilege that a former legislature had not seen fit to include in the charter." Cadman, p. 14.

of the corporation, names of the incorporators, and the capital stock pertaining to the particular case.<sup>89</sup> In this subsection, the need and purposes, the sources, and the basic provisions of these general regulating statutes are examined.

The absence of general regulating statutes meant that legislators had to devote much of their time to the passage of special acts -- both special charters and supplements. In Massachusetts, the first state to pass a general regulating statute, the Manufacturing Corporations Act of 1809 can be seen as a direct result of the increased demand for charters that accompanied the Embargo and Non-Intercourse Acts.<sup>90</sup> Another example where saving the legislature's time was cited as the primary reason for passage of a general regulating act was Maryland:

...The statute was designed to speed up the procedure of incorporation. This was indicated in a communication which passed between the House of Delegates and the Senate that: "There are numerous applications before the Legislature for acts of incorporation, many of which require speedy action, and especially those of Silk Companies, if they are to be made available this session."<sup>91</sup>

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<sup>89</sup>Cadman, pp. 15-16.

<sup>90</sup>Dodd, American Business Corporations, pp. 375-76. Cadman discounts the importance of general regulating statutes as time-saving devices. He claims that the certainty in the common law of corporations prior to the passage of the first New Jersey general regulating statute in 1846 made it possible for corporate charters and special acts to omit a listing of most corporate powers. Thus, he claims that the only really significant feature of the 1846 statute was the insertion of a reserve clause declaring all future charters subject to alteration or repeal -- a section which he says seems to have passed without comment. Cadman, pp. 116-17.

<sup>91</sup>Joseph G. Blandi, Maryland Business Corporations, 1783- 1852 (Baltimore: The Johns Hopkins Press, 1934): 11-12, and the quoted material was taken from Journal of the Proceedings of the Senate of Maryland, 1838, p. 191. The Maryland general regulating statute was passed in 1839.

In the debates over the New Jersey general regulating statute it was suggested that, as a by-product of saving the legislature's time, the general regulating statute would lead to a decrease in printing expenses.<sup>92</sup>

The absence of a general regulating statute made it easier for the legislators to pass customized special corporate charters:

Whatever the reasons for New Jersey's failure to adopt general regulating statutes during the pre-1845 years, the absence of such laws had considerable significance. When a group approached the legislature for a charter of incorporation, there was no general legislation to hamper them in pressing for any special privileges they desired. The road was open to secure a charter with as few or as many provisions and with as liberal terms as they had influence or tactical ability to obtain; there were no statutory obstacles to getting favors that would put the petitioning group at an advantage with respect to competitors or even with respect to the general public. In the absence of general regulating statutes, particular groups could obtain special assistance from a legislature that would have been unwilling to go so far as to change a general statute for their benefit. Finally, the New Jersey situation made it rather easy for petitioners and their legislative sponsors to include in special bills clauses or phrases conferring special privileges or to omit some generally used restrictive clause and have the fact go unnoticed as the bill progressed to final passage. These tactics had an increasing chance of success as the number of charter applications multiplied to the point where it became impossible for even the most conscientious legislator to give more than cursory inspection to every application acted upon during a session of a few weeks. The wide variety of privileges and restrictions appearing in business corporation charters granted by New

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<sup>92</sup>Cadman, p. 15.

Jersey bear testimony to the results of treating each charter as a separate and independent grant without the salutary influence of statutes of general applicability.<sup>93</sup>

Thus, it might be argued, one of the goals in adopting general regulating statutes was to restrict the abuses of the special charter system.

General regulating statutes were also needed to correct a more technical legal problem. In the absence of these statutes, the kinds of provisions included in special corporate charters varied widely. Even similar and partially-standardized clauses differed from charter to charter and, as a result, court decisions interpreting one charter were of limited application to cases involving another corporation. Consequently, the uncertainty as to the exact privileges and immunities of individual corporations led to large amounts of litigation.<sup>94</sup> In discussing the technical problems associated with nonstandardized charters, one author said:

It was the pressure of these technical problems, added to the dissatisfaction arising from the political and financial evils which the special charter system had created, which started the battle for general corporation laws in New Jersey. ...The legislature took the first step in the direction of a general law in the Act of 1846, which defined the general rights thereafter to inhere to every corporation,

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<sup>93</sup>Cadman, pp. 17-18.

<sup>94</sup>Cadman, pp. 9-18; Blandi, pp. 11-12; and Stokes, pp. 358-59. For an economic analysis of the effects of uncertainty as to the applicable legal rule -- and thus the outcome of litigation -- on the decision to settle or litigate, see John P. Gould, "The Economics of Legal Conflicts," Journal of Legal Studies, 2 (June, 1973): 279-300.

even when such general rights were not specifically stated in its special charter.<sup>95</sup>

Thus, one of the reasons for the passage of general regulating statutes was to clear up the courts.

Massachusetts, as mentioned earlier, enacted the first general regulating statute for manufacturing corporations in 1809. Since no other state had any experience with respect to the drafting of general statutes of this type, plus the fact that Massachusetts herself at that time had not had extensive experience in the drafting of special charters for manufacturing corporations, it is interesting to examine the sources of this law and subsequent other general regulating statutes.

The joint stock association was used as a substitute for the corporate charter in many late eighteenth century and early nineteenth century business ventures, particularly mining and land speculation, where the corporate form would seem to have been the most desirable form of business organization.<sup>96</sup> A comparison of the provisions of some of the joint stock agreements that governed those associations with the provisions of the Massachusetts Companies Act of 1809 has revealed a remarkable correlation of substance. In particular, Sowards and Mofsky point to the Articles of Association of the Lehigh Coal Mining Company, which was organized as a joint stock company in 1791, as the true progenitor of the Massachusetts Companies Act of 1809:

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<sup>95</sup>Stoke, p. 359.

<sup>96</sup>See Shaw Livermore, Early American Land Companies: Their Influence on Corporate Development (New York: The Commonwealth Fund, 1939).

...It is clear that most of the provisions of that act had already been utilized without legislative sanction by the promoters of a coal mine in 1791. A careful reading of the act with the Lehigh Articles of Association reveals a remarkable similarity in the actual words and phrases employed by the Massachusetts legislators and the attorneys for the coal mine promoters. ...The Lehigh document more closely resembles the 1809 act than it does the charters granted to early financial institutions and public utility companies. The latter observation lends credence to the theory that the early general incorporation acts owe a greater debt to the innovations of the joint stock association than to early bank, insurance company and public utility company charters.<sup>97</sup>

The major substantive difference between the two was that the Massachusetts general regulating statute provided that the corporations formed under it would be subject to unlimited liability. This is not surprising in light of the fact that the joint stock association did not have any reason to mention the limitation of liability of shareholders because under the common law (which governed joint stock associations) its members were subject to unlimited liability.<sup>98</sup>

In spite of the fact that the 1809 Act had used the Lehigh articles as a model, there appeared to have been several flaws in the act as initially enacted.<sup>99</sup> The reason for these flaws can most likely be traced to the legislature's failure, in drafting the agreement, to take into account the common law doctrines that supported the joint stock agreement. Because of this, the legislature went through a

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<sup>97</sup>Sowards and Mofsky, p. 483.

<sup>98</sup>See the discussion of alternatives to the corporate form in subsection IV A.8, *infra*.

<sup>99</sup>For analysis of the Act see Dodd, American Business Corporation, pp. 228-31, 377.

trail-and-error process of refining the law so that it would reflect the policy of the state. One example of this process was the legislature's efforts to close a loophole in the law that apparently allowed a shareholder of an insolvent corporation to avoid liability by finding an impecunious person who was willing to accept his shares as a gift. Liability could not have been avoided in this manner when organized as a common-law joint stock association. In 1818, the legislature amended the 1809 Act in order to broaden the liability provisions as so to include members who owned shares at the time the debt was accrued.<sup>100</sup>

In 1823, when she abandoned the unlimited liability policy she had inherited from Massachusetts when they separated in 1820, Maine made several other substantial alterations in the Massachusetts statute. Thus, when Massachusetts adopted a new Manufacturing Corporations Act -- another general regulating statute -- in 1830, it was very much like the Maine Act. When New Hampshire enacted its first general regulating statute in 1837, the Massachusetts Act was its model.<sup>101</sup> This evolutionary pattern of adoption and modification of statutes from other states also developed with respect to the earliest general incorporation laws.<sup>102</sup>

Although differences existed between the states, it is possible to generalize with respect to the policies and substantive provisions of

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<sup>100</sup>Ibid., p. 377.

<sup>101</sup>Dodd, American Business Corporations, pp. 387-88.

<sup>102</sup>See Sec. IV.B.1, *infra*.

the general regulating statutes and the common law. Berle and Means have described the regulating features of the law in the first half of the century as follows:

With a lively appreciation of the possibilities of the corporate mechanism during the first half of the Nineteenth Century, the various states erected a series of protections. They were thinking primarily of three groups: the general public, the corporate creditors, and (to a less extent) the corporate shareholders. At this time there seems to have been no thought that shareholding might become so common as to make shareholders' interests a consideration in protection of the public at large though the English experience with the South Sea Bubble a century before might have suggested caution. Shareholders were supposed to be capitalists reasonably able to protect themselves. Nevertheless, the protections erected served to assist shareholders almost as much as any other group.

The Typical Protections were three:

(1) The enterprise was required to be defined and was carefully limited in scope. This acted as a check on the management of the corporation. In theory this was probably designed to prevent corporations from dominating the business life of the time; to the shareholder, however, it meant that he knew the particular enterprise, or at the widest, the type of business in which his capital was to be embarked.

(2) The contributions of capital were rigidly supervised. The corporation was not allowed to commence business until a certain amount of its shares had been "paid-up." It is probably at this period that such legislators expected such payment to be in cash. At the same time it was contemplated that all additional shares issued should be paid for at a fixed minimum rate--viz., the "par value" of these shares. The penalty for failure to do so was, among other things, that any shareholder who acquired shares without paying in the fixed minimum, presumably in cash, was liable to creditors to pay the balance in the event that the corporation became insolvent; but the Attorney General of the state could also enforce this requirement if he felt it necessary, which he frequently did not. This was designed frankly to protect creditors -- the fear being that a corporation would run up the bills and having no contributed capital would be unable to pay them. To the shareholder, however, it meant a certain

protection against dilution of his interest. Every shareholder was required to contribute not less than a stated amount for his share; and the result was that "free" stock or stock which did not represent the minimum contribution could not legally be issued. This served as a powerful safeguard for his pro rata interest in the corporate assets.

(3) A rigid capital structure was set up. Shares even in those early days could be classified to some extent into preferred and common stock; but the entire system had to be carefully laid out, embodied in the charter, and passed upon by the legislature; so that the participations were thoroughly scrutinized by the state authorities; and their number and incidence were at all times subject to careful control.

On the top of these the common law added a few safeguards on its own behalf:

(4) Under the jurisprudence of the time, residual control -- i.e., decisions affecting the general interest of the group, lay in the shareholders or in a specified proportion. The management of the enterprise was by contract commonly delegated to the board of directors; but any change in the capital structure or in the nature of the enterprise of any amendment of the arrangement had to be passed upon by the shareholders. In the event of any fundamental change the vote had to be unanimous; thus giving every shareholder a considerable degree of control over the policies of the corporation.

(5) Likewise, the common law asserted that the shareholders had the sole right to invest new monies in the enterprise; and they worked this out by granting to each shareholder a pre-emptive right to subscribe to any additionally issued stock of the corporation. This rule, evolved by the Massachusetts courts in Gray v. Portland Bank (3 Massachusetts, 363 (1807)) -- the foundation of the present "law of pre-emptive rights," was assumed to be sweeping and absolute.

(6) In general dividends were permitted to be paid only out of surplus profits arising from the operations of the business. This may have been an American invention, the English law not having laid down any clear principle until the latter half of the Nineteenth Century; but the result was that whenever a distribution of profits did take place, it represented in theory a real profit; the capital could not be frittered away in small payments to the contributors. The rule was designed to protect creditors -- i.e., to maintain

the integrity of the capital subscribed for the purposes of paying corporate debts, or rather to prevent its impairment through payments to shareholders; but it also operated to maintain a sound financial position for the shareholders.

Even at this period it was possible to qualify a good many of these protections by contract; but as the state insisted on supervising the contract, and was not favorably impressed by innovations, the corporate mechanism was rigid and carefully protected. The effect was to set up a business organism conducting a limited enterprise with participations settled in advance, and safeguarded either by the statutory contract or by the common law in various ways. Investors could and did place their reliance at least partly on the state, since in theory the state would sanction no contract which was not approximately fair to all concerned including the shareholders.<sup>103</sup>

General regulating statutes were an advancement in legal technology, and they appear to have reduced the legislature's time devoted to each special charter. However, in the interest-group perspective, the general regulating statutes would not necessarily lead to less total time spent by the legislatures on special chartering. In this framework, the general regulating statutes were a move towards a standardized, lower cost-of-production product. However, this move did not necessarily mean lower prices for the purchasers of special charters since perfect price discrimination was still possible because each special charter was marketed individually. Furthermore, the legislators of many of the states that enacted general regulating statutes continued to grant customized special charters to firms willing and able to put in the extra effort necessary to secure more favorable

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<sup>103</sup>Adolf A. Berle and Gardiner C. Means, The Modern Corporation and Private Property, Revised Edition (New York: Harcourt, Brace and World, Inc., 1967): 122-24.

privileges. Thus, since the general regulating statutes did not affect the demand for special charters but did lower the marginal cost of production of many special charters, the expected increase in the quantity of special charters (which did in fact occur after the passing of general regulating statutes) leads one to speculate that the real purpose of these statutes might not have been to save the legislatures' time, but rather to enable them to capture additional rents from the production of additional special charters.

#### 6. Political Controversy and the Corporate Form.

The corporation as a means of organizing and conducting general commercial and industrial activities was the object of great political controversy in the first fifty years of the nineteenth century. Much of this was related to the monopoly franchises granted to earlier transportation and finance corporations.<sup>104</sup> In some circles, it was feared that the monopoly aspects of these franchises would be carried over in charters granted to firms in other segments of the economy.<sup>105</sup> In general, this fear of an explicit grant of monopoly was not realized; nevertheless, the liberal special charters granted to manufacturing and commercial firms gave those favored firms considerable cost advantages over their competitors (i.e., the charters did create rents which were partially captured by the legislators).<sup>106</sup>

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<sup>104</sup>See subsection IV.A.3, supra.

<sup>105</sup>Friedman, p. 171

<sup>106</sup>See section I.A for a discussion of the legal and economic advantages of the corporate form.

In this subsection, the political unrest surrounding the corporation and its effects on individual states' policies toward corporations are examined.

The anti-corporation arguments of "aristocracy", "monopoly", and "special privileges", which were the catch-words of the Jacksonian Democrats in the 1830's and 1840's, actually were first utilized in the United States before 1800. Joseph Davis made a thorough study of public attitudes towards corporations in late eighteenth century America and found that the opponents of corporations, which even then were more vocal than the proponents of corporations, were not very successful in influencing legislators actions with respect to the passage of special charters.<sup>107</sup> He concluded his investigation with the following statement:

Actions, however, proverbially speak louder than words. Despite the prevalence of such talk as has been quoted, the extent and intensity of the distrust and hostility is easily magnified. The unprecedented growth of corporations emphatically attests to the weakness of the opposition. Not many charters were sought in vain, and these chiefly because of local objection to the particular project. And it is significant that expressions of fear and criticism were more common before 1792 than after, when more experience with actual corporations had accumulated. It is probably fair to say that the broader opposition rested on traditional antipathy to such corporations as the close corporations of the English boroughs, the restrictive guilds, and the monopolistic companies for foreign trade; and that the American business corporation turned out to be something quite different.<sup>108</sup>

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<sup>107</sup>Davis, II, pp. 303-9.

<sup>108</sup>Ibid., p. 309.

As mentioned earlier, the early distrust of corporations tended to be reflected not in a refusal to incorporate the few business groups that desired the corporate form, but rather in the policy on the part of legislators to impose restrictions on the corporation with respect to the liability and term-of-existence provisions.<sup>109</sup>

While the special chartering system was under continuous attack because of alleged abuses such as bribery and logrolling, the basic concept of the general business corporation was attacked by Jacksonian Democrats throughout the 1830's and 1840's.<sup>110</sup> The Jacksonian Democrats were fundamentally opposed to the granting of limited liability, which they viewed as an unjust and illegitimate creature of the state, and they feared that widespread use of the corporate form would lead to increased concentration of wealth and economic power.<sup>111</sup> The theoretical bases for the Jacksonian attack on corporate chartering were the following:

Despite the extent of its acceptance in fact, however, the charter principle from the outset came into conflict with the democratic theory of the time. An anti-charter philosophy emerged which became one of the most powerful, repetitious, and exaggerated themes in the popular literature. ...It is clear, at any rate, that it drew most of its strength from two main concepts of the democratic theory:

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<sup>109</sup>See subsections IV.A.4 and IV.A.5, supra; Livermore, Early American Land Companies, pp. 258-71; and Cadman, p. 74.

<sup>110</sup>For a thorough examination of the general and specific policies advocated by the Jacksonian Democrats, see Arthur M. Schlesinger, Jr., The Age of Jackson (Boston: Little, Brown and Company, 1948).

<sup>111</sup>See Dodd, American Business Corporations, pp. 392-6; Cadman, pp. 72-9; and Hartz.

the individual and the community. If the idea of 'individual enterprise' became insignificant as a challenge to banking and transportation companies in economic terms, on the philosophic plane it flourished with a vengeance. There it was grounded not on statistics of capital investment or theories about the most economic division of labor but on the natural law doctrine of the Revolution and the various constitutions which embodied it. Corporations were "monopolies" and "aristocracies". Their creation violated rights insured by the 'social compact'."

Every obvious contrast between individual and corporate enterprise was used to polemical advantage. The corporate characteristic of indefinite duration was a good target, though the early establishment of a policy of limiting the life of charters made the attack upon it somewhat unreal. "A company never dies," a House committee dramatically declared in 1830. It was said that the growth of the corporate system was undoing the work of the state's intestate laws, and in the mining field where corporations were chartered to hold land the reinstatement of a new kind of primogeniture was seen as taking place. With the legal recognition of limited liability for stockholders, a new contrast between individual and corporate action was supplied. ...The truth is that the vigorous individualism of the theory itself contributed to a glorification of property rights. Embracing a denunciation of eminent-domain privileges granted to transportation companies, ...the anti-charter doctrine assailed the appropriation of private property for corporate purposes. ...Above all it was contended that the granting of corporate privileges in fields where unincorporated entrepreneurs had made investments was itself an infringement upon the property rights of the latter. Ingersoll even went so far as to contend that the mere limitation of individual initiative which the growth of a corporate system presumably involved amounted to an attack of the right of property. The "real and legitimate meaning" of the property right included the prerogative of men "to follow such callings as they prefer."<sup>112</sup>

Schlesinger adds the following observation:

For a people still yearning for an economy dominated by individual responsibility, still under the Jeffersonian

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<sup>112</sup>Hartz, pp. 91-92.

dream, the corporation had one outstanding characteristic: its moral irresponsibility. "Corporations have neither bodies to be kicked, nor souls to be damned," went a favorite aphorism.<sup>113</sup>

Jackson's veto of the bill for the rechartering of the second Bank of the United States in 1832 touched off the Democrats' attack on all business corporations. The following excerpt from an editorial in the Trenton Emporium and True American is representative of the attack on corporations:

We say all incorporated companies are, more or less, monopolies, and while the Legislature ought not to violate their rights, or stain the sacred faith of the whole people...yet the Legislature ought cautiously to refrain from increasing the irresponsible power of any existing corporations, or of chartering new ones...upon this great subject, we have all slept too long...<sup>114</sup>

The attack on business corporations was sustained by the Locofoco or Equal Rights wing of the Democratic party until the attack received fresh impetus from the severe depression that began in 1837. The bankruptcies of the depression undoubtedly prolonged the attack on corporations as creditors of insolvent corporations showed increased interest in enforcing some degree of individual liability on shareholders.<sup>115</sup>

In spite of the Democrats' threat to the practice of chartering corporations for business purposes, by 1835 there were equally-

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<sup>113</sup>Schlesinger, p. 335.

<sup>114</sup>Emporium and True American, April 25, 1835 as quoted in Cadman, p. 76.

<sup>115</sup>Cadman, p. 75.

powerful forces operating to defend the use of the corporation as a form of industrial organization.<sup>116</sup> First, the political economy of the country had changed as an increasing number of individuals had their wealth tied-up in limited-liability corporations.<sup>117</sup> Second, by 1835, the corporation had become a familiar fact of American industry and was no longer opposed simply because of conservative opposition to new and strange developments. Third, it had become clear that the most efficient way to manufacture goods was through large-scale mechanization, and much pro-corporation sentiment was based on the belief that the corporation was the only type of business association that could provide the necessary characteristics of size and permanency. Thus, Jacksonian Democrats were not in a strong enough position to simply dictate policy with respect to corporate chartering.

The Democrats are given credit for having had a major impact on the granting of corporate charters for industrial purposes in Pennsylvania. In the first half of the nineteenth century, less than ten percent of the charters granted were for industrial purposes.<sup>118</sup> Hartz explains that sectional interests, and the corresponding

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<sup>116</sup>See Dodd, American Business Corporations, pp. 393-4, for an elaboration of these points.

<sup>117</sup>For example, the tendency of shipowners and importers to oppose the incorporation of manufacturing firms in order to retard the development of domestic manufacturing so as to encourage the importation of manufactured goods diminished as they began investing in American manufacturing corporations. See Dodd, American Business Corporations, pp. 380-81 and 393-94.

<sup>118</sup>Hartz, pp. 56-7.

logrolling, would have been important enough to lead to the passage of charters for public works projects in spite of Democratic supremacy; but, on the other hand, in the "industrial field, where considerations of section and state finance were relatively unimportant, Democratic supremacy resulted in a more stringent charter policy than would have resulted under Whig deminance."<sup>119</sup>

In South Carolina, the dual influence of the Democratic agitation against granting charters for industrial purposes and the 1837 depression appear to have influenced legislative policy. A pamphleteer, writing in 1845 in behalf of persons seeking charters for manufacturing companies, made the following observation:

Will South Carolina refuse to grant charters of incorporation for manufacturing and other purposes, or will she not? She has heretofore acted with the utmost liberality in granting unrestricted charters, and not until 1837, did she entertain apprehensions of harming the public wealth by such acts.<sup>120</sup>

The anti-corporate sentiment seems to have made relatively little impact on legislative policy in Massachusetts prior to 1843. In that year, the Democrats had control of the legislature and there was a radical Jacksonian Democrat as Governor. As a result of their opposition to incorporation by special act with limited liability, and also possibly as a result of the lingering effects of the 1837

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<sup>119</sup>Ibid., pp. 64-65.

<sup>120</sup>An Enquiry into the Propriety of Granting Charters of Incorporation for Manufacturing or Other Purposes, in South Carolina, by One of the People, p. 3, quoted in Cadman, p. 79.

depression, only three unlimited-liability charters for manufacturing purposes were chartered.<sup>121</sup> However, the Democratic influence was short lived as the Whig triumph at the polls in the fall of 1843 coincided with improved business conditions, which lead to an increased demand for charters. Eleven manufacturing corporations with limited liability were chartered by the 1844 legislature, and the Whigs stayed in control as business continued to boom.<sup>122</sup>

In other states, the Democrats were not so successful in stemming the corporate tide. Maryland, for example, seems to have been unaffected by Jacksonian doctrines with respect to the use of the corporate form. One author, in concluding his study of incorporations in Maryland from 1783 to 1853, states "...it should be mentioned that there was not substantial outcry against the corporation during this period...the use of this form was certainly not retarded in Maryland through unfavorable legislation..."<sup>123</sup>

The more interesting state, as an example of the Democrats' failure to control a state's chartering policy, is New Jersey. This is so because the New Jersey Democrats had control of the legislature between 1835 and 1838 and, despite their anti-corporation rhetoric, the Democrats were just as active in passing special acts of incorporation as were their opposing political parties when they were in control of

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<sup>121</sup>Dodd, American Business Corporations, p. 312.

<sup>122</sup>Ibid., p. 313.

<sup>123</sup>Blandi, p. 92.

the legislature.<sup>124</sup> In general, the statistics of incorporation in New Jersey, Pennsylvania and Maryland reveal a direct relationship between the number of charters granted and the state of business activity.<sup>125</sup> Thus, the interest groups appear to have been more persuasive than either ideology or political affiliation.

In summary, the anti-corporate sentiment of the era of Jacksonian Democracy evolved through a variety of forms. Democrats initially showed hostility towards all corporations. In this regard, the efforts of the anti-corporation forces were mainly directed toward making incorporation difficult, either by imposing constitutional restrictions on the legislative power to grant charters or by pressuring legislators to deny most petitions for incorporation presented to them. Eventually, however, most Democrats recognized that they could not abolish business corporations and turned their energies from efforts to prevent the creation of corporations to the advocacy of schemes to rid the special-chartering system of what they considered to be its worst features. In doing this, the Democrats even abandoned their opposition to limited liability. They advocated general regulating statutes and later general incorporation laws. The Jacksonian Democratic policy, thus, went the complete circle from advocating absolute prohibition to advocating general availability.

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<sup>124</sup>Cadman, pp. 82-3.

<sup>125</sup>Ibid., pp. 83 and 445.

## 7. Limited Jurisdictional Competition Through Capital Markets

Under the special-chartering system, there were very few interstate corporations. In this era, to incorporate in a state meant to locate and operate in that state.<sup>126</sup> This was long before the era of the "tramp" corporation which would incorporate in one state and conduct all of its business in other states. Because of these considerations, it would appear that each state had a complete spatial monopoly with respect to the market for corporate privileges within its political boundaries which were effective barriers to entry. This was not entirely true, however, because a state's political boundaries were ineffective exit barriers with respect to the capital accumulated by its citizens. In other words, the legislators' of any particular state did not have complete control over the corporate privileges that could be purchased by her capitalist citizens. In the special-charter era, much of the public-interest rhetoric surrounding the passage of special charters dealt with this competition in capital markets -- the state's desire to attract capital or prevent the flight of capital. Success in the capital markets translated into the chartering of firms which would build factories and increase the wealth of the state. In this subsection, evidence of this early limited jurisdiction competition is presented.

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<sup>126</sup>In fact, manufacturing company charters of this period usually required that the enterprise be located not only in the state, but also in a particular town. Dodd, American Business Corporations, pp. 178-80, 400.

The system of protective tariffs that developed after the War of 1812 was indicative of the national policy of promoting American manufactures by assisting domestic producers in their competition with imported products.<sup>127</sup> Most northern states accepted this legislative policy while attempting to frame it in their own best interests. In Pennsylvania, for example, the legislature granted charters to trade associations in order to help them organize to go to Washington to lobby for protectionist policies for the benefit of Pennsylvania.<sup>128</sup> In New Jersey, after mentioning the national legislative policy of promoting domestic manufacturing, manufacturing charters usually made special mention of the benefit to New Jersey which would be derived from the resulting increase in manufacturing capital.<sup>129</sup> A South Carolina pamphleteer, in advocating a more liberal incorporation policy in his state, gave the following example of New Jersey's success in attracting foreign (i.e., out-of-state) capital:

A very large manufacturing establishment has recently been put in operation at Gloucester-Point in New Jersey, three miles below Philadelphia. The owners are Philadelphians, who made choice of that location, because a more liberal charter could be obtained from that State than from Pennsylvania. What will be the result of that move? It will be the

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<sup>127</sup>See F.W. Taussig, The Tariff History of the United States.

<sup>128</sup>Hartz, pp. 56-57.

<sup>129</sup>Cadman, pp. 35-36.

building up of a town in New Jersey, and the investment of some millions of Pennsylvania capital, to give employment to the poor, and pay taxes to the former state.<sup>130</sup>

In New England, flight-of-capital arguments were influential in debates on the expediency of including unlimited liability provisions in manufacturing corporation charters. The debate on limited liability in Massachusetts, the last state in New England (except for Rhode Island) to abandon the unlimited liability policy, illustrates the perceived effects of jurisdictional competition. Massachusetts Governor Levi Lincoln, in his message to the legislature on June 20, 1826, urged more liberal treatment of shareholders and referred to the large sums that Massachusetts citizens had invested in limited-liability manufacturing corporations in New Hampshire and Maine. In particular, the Governor assailed the law that extended shareholders' liability beyond the sale of shares.<sup>131</sup> The drive to adopt the policy of limited liability continued through the depression years of 1828-29 and, although expectations based on the protective tariff of 1828 had stimulated the promotion of new manufacturing corporations despite the adverse business conditions,<sup>132</sup> the flight-of-capital point was reasserted.<sup>133</sup> The writer of an 1829

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<sup>130</sup>An Enquiry into the Propriety of Granting Charters of Incorporation for Manufacturing and Other Purposes, in South Carolina, by One of the People, p. 9, quoted in Cadman, p. 37.

<sup>131</sup>Dodd, American Business Corporations, pp. 377-78.

<sup>132</sup>Ware, p. 91.

<sup>133</sup>Dodd, American Business Corporations, pp. 232-33 and 378-79.

article in the American Jurist phrased the argument as follows:

That this personal responsibility has, in fact, drawn manufacturing capital from Massachusetts, we do not affirm; for other causes may have operated to prevent this result. But the tendency is obvious, and it has been frequently asserted that the injurious consequences resulting from it are very great. It is sufficient, however, for us to show the tendency, since it is not to be taken for granted that Massachusetts will, in spite of these laws, always offer attractions for manufacturing capital superior to those of any of the surrounding territories.<sup>134</sup>

This agitation finally produced the desired result with the passage of the Massachusetts Manufacturing Corporation Act of 1830 which provided for limited shareholder liability.

It is interesting to note that, despite the emphasis placed on inter-jurisdictional flight-of-capital arguments, the coming of limited liability was not a major stimulus to Massachusetts manufacturing. This point is supported by two observations. First, a comparison of the ratio of the annual number of Massachusetts manufacturing incorporations to New Hampshire limited-liability manufacturing incorporations for the period 1820 to 1840 reveals that the ratio varied very little after Massachusetts adopted the limited liability policy in 1830.<sup>135</sup> Second, there was no noticeable increase in the trend of the amount of manufacturing charters granted after 1830.<sup>136</sup>

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<sup>134</sup>American Jurist, 1 (1829): 92, 104 as quoted in Ibid., pp. 378-9.

<sup>135</sup>Dodd, American Business Corporations, p. 402.

<sup>136</sup>Ibid., p. 233.

These figures could be interpreted as evidence of a spatial monopoly based on considerations other than limited liability -- such as superior water power or the proximity to Boston -- or evidence that the legislators increased the necessary bids for the charters instead of increasing the quantity sold as their response to the increased demand for charters that was expected to result from the change in the liability rule. Another interest-group explanation for these figures, however, can be found by looking to the supporters of the petition that spurred the passage of the 1830 act. The supporters of the petition were a "large number of Massachusetts industrialists"<sup>137</sup>-- presumably investors in Massachusetts corporations. To the extent that limited liability was a valuable privilege at this time, these industrialists stood to gain a considerable amount when their previously unlimited-liability shares were converted to limited-liability shares as was possible under the Manufacturing Corporation Act of 1830. And, of course, the value of the shares held by these influential industrialists would have been maintained by continuing the policy of granting charters in moderate amounts.

Nevertheless, since this subsection is concerned with jurisdictional competition, it is important to recognize that in Massachusetts there was a widespread belief that investment in Massachusetts manufacturing corporations was dependent on the liability rules of other states and that this belief, regardless of whether it

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<sup>137</sup>Ibid., p, 378.

was correct, had an influence on Massachusetts' policy. In effect, this capital-market jurisdictional competition created an ideal situation for New England legislators in that it provided them with a public-interest rationale for granting increasingly valuable corporate privileges in order to attract capital.

The consideration of potential effects on interstate capital markets also played a significant role in the constitutional convention of New Jersey in 1844. New Jersey was located between the major financial centers of the country, New York and Philadelphia, and the delegates were careful to avoid adding any provisions which might tend to cut off those sources of capital. In this regard, the convention defeated proposals to require all corporate charters to be subject to repeal and to require two-thirds vote for the passage of special charters.<sup>138</sup> Cadman's account of a Whig delegate's defense of a simple majority for the passage of special charters provides a good synopsis of the importance placed on capital markets at that time:

After appealing to a particular concern of Jerseymen -- attracting capital to develop industry within the state, -- he continued: "the soundness of the proposition is abundantly sustained by reference to the condition of those states where industry and enterprise have been fostered by legislative patronage. In what States of this Union do we find industry and productive labor in all its ramifications more abundantly rewarded than in Massachusetts?" The industrial supremacy of that state could be attributed to liberal legislation, and New Jersey could by similar means experience the same result. Trenton and Paterson would rival Lowell.<sup>139</sup>

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<sup>138</sup>Cadman, pp. 94 and 99-100.

<sup>139</sup>Ibid, p. 100. The simple majority rule was adopted.

Finally, in concluding this subsection on the beginnings of interstate competition in the market for corporate privileges, it is interesting to note what one author has said about the effects on corporation law of this competitive process. Blandi, writing in 1934, said:

As corporations were not -- as they are now -- an important source of state revenue, there was little to incite among the states rivalry for the incorporation business of the country. On the other hand, there were forces which tended to promote in the various states a more or less uniform development in legislation concerning the corporation. It has frequently been brought out in this study that the people and the press felt that undue strictness in the handling of corporations would tend to drive capital out of the state. The fear of a capital flight, thus, promoted uniformity in corporate law. Whatever progress -- progress in the sense of adaptability to changing economic conditions -- was made in this field of law must be attributed to the self-interest of the individuals who sought charters or amendments thereto. In contrast today the parallelism, and paradoxically, whatever lack of uniformity exists, is due not only to individual self-interest but to the desire for state revenue in the form of incorporation fees and franchise taxes.<sup>140</sup>

It will be argued in Section C of this chapter that the transformation of jurisdictional competition with respect to corporate privileges from an emphasis on the flow of capital between states to an emphasis on exporting corporate privileges in order to raise state revenue was the major factor in decreasing legislators' rates of return from passing special corporate charters and that this led to the end of the special chartering system.

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<sup>140</sup>Blandi, pp. 91-92.

## 8. Alternatives to the Corporate Form and Their Effects on the Market for Corporate Privileges

The advantages of the corporate form over non-statutory forms of business associations were examined in the first chapter and, in Chapter III, the evolution of the common-law joint stock company and business trust were shown to explain the timing of the major development in English corporation law. Therefore, before continuing on to the next stage in the development of American incorporation law, it is appropriate to examine the extent of utilization of alternatives to the corporate form in the United States. In this subsection, two main alternatives to the corporate form are examined. The first is the non-statutory joint-stock company, which for present purposes is lumped together with the business trust. The second is the limited partnership which, being based on the Napoleonic Code's société en commandite, had no common law basis and was made available through statutes.<sup>141</sup> The use of these types of business association, like the

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<sup>141</sup>The limited partnership is an ancient institution as the following synopsis of its history illustrates:

The limited-liability partnership is a commercial institution of great antiquity and of non-English origin. It is supposed to have been in use in Asia in the twelfth century before the Christian Era. There is a theory that it became a part of the European law merchant as a contribution from Mohammedan law. In Italy under the title societas in commendam, and in France as the société en commandite, it early became differentiated from the ordinary or unlimited-liability partnership. Employed in its early history as a device for foreign maritime commerce whereby a relatively inactive and limitedly liable capitalist might intrust a

corporate form, became more desirable as businesses began to operate on a scale larger than that that could be managed by a sole proprietorship or partnership.

#### Joint Stock Companies

The joint stock company resembled a partnership except for its capital being divided into shares. The differences between the joint stock company and the business trust are not significant as the Articles of Association which set up the internal organization of joint

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stock-in-trade to an active risk-taking merchant mariner, its use was extended to meet requirements of domestic trade and local industry. It was a device also whereby the medieval ecclesiastical prohibition of the taking of interest was circumvented, as were also the 'fuedal' restrictions upon business activity by clergy and nobles. Local statutes were enacted to govern its use, as in Florence, Genoa, and Marseilles; and concerning it the scholars of law developed an elaborate body of doctrine. As an important measure its use was regulated, by the famous Ordonnance pour de Commerce (1673) of Louis XIV. Later the Napoleonic Code de Commerce (1807) continued the statutory recognition of and provision for this ancient form of business enterprise organization. This revision of the articles of the old ordinance made more explicit the rules governing its use, and ratified the fait accompli of the device of transferable shares issued to limited partners. Although the code of 1807 provided a statutory basis for the business corporation, it thereby merely opened the door for the development of an interesting competition between the limited liability partnership and the corporation as rival forms of organization. In general the limited-liability or special partnership in France did not yield much ground to incorporated enterprises until after the middle of the nineteenth century.

Stanley E. Howard, "The Limited Partnership in New Jersey," Journal of Business, VII (October, 1934): 296-317, 297-8.

stock companies really set up a trust relationship between the managers and the "partners."<sup>142</sup>

Although these quasi-corporations had abandoned every characteristic, except unlimited liability, which in a business sense distinguishes partnerships from corporations, they were treated as partnerships under the law. This was so for two reasons. First, the slowness of the common law to adapt to economic realities.<sup>143</sup> Second, the English Bubble Act of 1720,<sup>144</sup> which made common law joint stock companies illegal, was extended to the American colonies in 1741.<sup>145</sup> As a result, lawyers and businessmen in the eighteenth century were forced to walk a tightrope between the statute and the common law.

After the Revolution and the inapplicability of the Bubble Act, the same problems continued for joint stock companies because they did not exist as a common law association and because of the lack of enabling statutes: "Lawyers and businessmen were thus forced to seek inconvenient devices to overcome judicial attitudes. Even armed with such devices, however, they were still in doubt as to the reaction of

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<sup>142</sup>See Kuehn1, pp. 38-39, and Livermore, Early American Land Companies, for descriptions of the internal organization of these companies.

<sup>143</sup>See Sowards and Mofsky, p. 477.

<sup>144</sup>See Section III.B.

<sup>145</sup>Dodd, American Business Corporations, pp. 366-67. However, it appears from studies of the organization of business in Colonial America that the Bubble Act was not viewed as a serious deterrent to organizing as a joint stock company. See Livermore, Early American Land Companies.

the common law."<sup>146</sup> Nevertheless, these de facto corporations enjoyed a healthy existence along side earlier chartered bodies -- most notably in the field of land speculation.<sup>147</sup> In fact, as mentioned earlier,<sup>148</sup> the articles of association of these joint stock companies evolved to a level of sophistication which resulted in the use of them rather than earlier corporate charters as the model for early nineteenth century general regulating statutes and manufacturing company charters.<sup>149</sup>

Apparently the earlier popularity of these quasi-corporations can be attributed to the expense and difficulty of obtaining a special corporate charter, which was an obviously superior form of organization.<sup>150</sup> On the other hand, the popularity of the corporate form can be attributed to the use of the special corporate charter as the vehicle for bestowing monopoly privileges. For example, the fact that unincorporated banks were established both before and after it became common for banks to be incorporated<sup>151</sup> indicates that the

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<sup>146</sup>Sowards and Mofsky, p. 477. As an example of the uncertainty of the common law, which often existed as the result of the lack of a settled case on point, Sowards and Mofsky point to the fact that it was not until 1827 that an American court recognized free transferability of shares in an unincorporated joint stock association. *Avord v. Smith*, 5 Pickering 232 (1827).

<sup>147</sup>Livermore, "Unlimited Liability," pp. 674-75, and Livermore, Early American Land Companies.

<sup>148</sup>See Section IV A.5.

<sup>149</sup>Sowards and Mofsky, pp. 481-82.

<sup>150</sup>Kuehnl, p. 6.

<sup>151</sup>Dodd, American Business Corporations, p. 205.

uncertainty as to the judicial treatment of unincorporated joint stock companies should be discounted as the primary reason for seeking charters. It might, however, indicate that the legislators were restricting the granting of charters in order to increase their value. Also, this fact has been viewed as evidence that the "primary motivation in this area probably stems from the special privileges granted to these companies in their charters."<sup>152</sup>

Due in part to the non-statutory status of joint stock associations in most states, the evidence of the extent of the use of joint-stock associations as substitutes for the corporate form is sketchy. Nevertheless, it is interesting to note that at least one state took steps as late as 1864 to prevent joint stock associations from becoming perfect substitutes for the corporate form. Wisconsin passed an act providing for improved civil procedures with respect to suits by and against the firm.<sup>153</sup> In concluding his discussion of this

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<sup>152</sup>Sowards and Mofsky, p. 480. In discussing a Massachusetts act forbidding the forming of unincorporated banking associations, Dodd, American Business Corporations, p. 206, made the following point:

This limitation of banking to corporations was soon adopted in several other states, apparently more because the shareholders of incorporated banks had sufficient political influence to get legislation of this sort adopted than because the legislatures believed unincorporated banking likely to prove injurious to the community. The extent to which legislation of this sort tended to establish a banking monopoly in any particular state depended on the extent to which the legislature of that state was willing to grant bank charters.

Thus, these acts appear to have played an entry barrier role similar to that of the English Bubble Act of 1720. See section III.B, supra.

<sup>153</sup>Kuehnl, p. 126.

1864 act, Kuehnl stated:

The legislature added a final provision to make it clear that the procedural innovations were not to be regarded as abandoning authority to limit and define corporate powers: "Nothing herein contained shall be construed to confer upon any joint stock company or association mentioned in the first section of the act, any of the rights or privileges of corporations, except as herein specifically provided." ...We see here direct evidence of deliberate legislative policy to prevent usurpation of corporate status.<sup>154</sup>

Thus, at a time when it was still granting special corporate charters, the legislature took steps to defend its monopoly in the market for corporate privileges.

#### Limited Partnership

The limited partnership was introduced to American law by New York in 1822.<sup>155</sup> New York's statute was widely copied, and, by 1853, twenty-one states had enacted limited partnership laws.<sup>156</sup>

There appear to be two reasons for this general movement in American law. First, limited partnership legislation can be seen as an effort to meet the requirements of an expanding economy. In discussing the reason for the passage of the 1836 Pennsylvania limited partnership statute, the Pennsylvania Supreme Court described that act as

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<sup>154</sup>Ibid.

<sup>155</sup>Livermore, "Unlimited Liability," p. 685, and Howard, pp. 296-7. In speaking of the New York Limited Partnership Act, Kent said, "it is the first instance in the history of legislation of New York that the statute law of any country other than that of Great Britain, has been closely imitated or adopted." Kent, Commentaries on American Law, 12th edition, 4 Vols., edited by Charles M. Barnes (Boston: Little, Brown and Company, 1884): III, 36.

<sup>156</sup>Soward, p. 296.

"one step in a line of concessions to the business views and habits of a commercial age and community."<sup>157</sup> A second motivating force behind the passage of limited partnerships was a fear of economic domination by business corporations. Though the New York act has been defined as "an indirect attack upon the business value of corporate charters,"<sup>158</sup> the attack on the corporation was more direct in some states. For example, the Governor of Pennsylvania described the purposes of Pennsylvania's Act of 1836 as follows:

It should hereafter, to a great extent, prevent the increase of corporations. And a due regard for the public welfare demands that no new corporate bodies should be created, except upon the most certain proof of their necessity, and of the accomplishment of the proposed object being beyond the power of individual enterprise. This is the sound old rule in this State on the subject, and it should in no case be departed from.<sup>159</sup>

And, the Democratic Governor of New Jersey pressed the New Jersey legislature to pass a limited partnership act in his message to the legislature in January, 1837:

As to corporations for manufacturing, or other purposes, which may be considered of a private nature, as distinguished from those in which the public have a more direct and important interest, I am of the opinion, that most, if not all, of the benefits to be derived from such corporations, may be obtained by adopting a general law upon the subject of regulating limited partnerships. And I would

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<sup>157</sup>Lafin and Randle Power Co. v. Steytler et al., 146 Pa. 434, 439, 23 Atl, 215 (1892), cited in Howard, p. 299.

<sup>158</sup>Livermore, "Unlimited Liability," p. 685.

<sup>159</sup>Quoted in Howard, p. 299, from Francis J. Toubat, The Law of Commandatory and Limited Partnership in the United States (1853): 143.

recommend the adoption of such a system, not only because I consider its results will be beneficial particularly to the commercial and manufacturing portions of our State, but because such a system being open to all alike, will do away with at least one odious feature of those corporations, and its adoption will tend to prevent legislation upon the subject.<sup>160</sup>

The New Jersey legislature passed a limited partnership bill in the 1837 session.

There is some evidence that the limited partnership may have served as an alternative to the corporate form for smaller enterprises in the Wisconsin Territory,<sup>161</sup> but there is very little evidence as to the usage of the limited partnership under a comprehensive limited-partnership statute passed by the Wisconsin state legislature in 1857: "Though it may be assumed that the limited partnership device and the joint stock company were practical alternatives to incorporation, there is no evidence to provide a basis for comparison in terms of actual use."<sup>162</sup> In New Jersey, however, where the limited partnership act of 1837 required the filing of forms in county offices, a thorough study of use of the limited partnership has revealed the following about its use as an alternative to the corporate form:

The fact which seems to stand out most prominently as a result of the examination of these records is that the employment in New Jersey of the limited partnership form has been almost negligible...It appears...that after the enactment and subsequent amendments of the statute of 1837

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<sup>160</sup>New Jersey, Votes and Proceedings of the General Assembly, 61 sess. 2 sit. (1837), pp. 128-9, as quoted in Cadman, p. 81.

<sup>161</sup>Kuehnl, pp. 36-7.

<sup>162</sup>Ibid., p. 140.

made legally possible the use of businessmen of an institutional device for which a few had been asking; but that after the accomplishment of this legislative feat, the business community failed to demonstrate that it had any very active interest in the matter.<sup>163</sup>

Thus, limited-partnership statutes do not appear to have been successful deterring the use of the corporate form.

#### B. The Dual System of Incorporation

Under the dual system of incorporation, it was possible to incorporate in two ways: either by a simple procedure under a general incorporation statute or by special act. The system developed after the passage of the first general incorporation act of wide coverage in the United States -- the New York Act of 1811. General incorporation laws of widespread applicability were passed by only three states (New York, New Jersey, and Connecticut) prior to 1845,<sup>164</sup> and the dual system reached its peak between 1845 and 1875.<sup>165</sup> The first "modern" or "liberal" general incorporation act was passed by New Jersey in 1875 marked the beginning of the end of the dual system. It must be stressed, however, that all states do not fit into this general time period nor did all states adopt the dual system. One notable anomaly was Delaware, which did not enact a general incorporation law until 1875 and continued to grant special charters until 1896 when she

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<sup>163</sup>Howard, pp. 309-10.

<sup>164</sup>Cadman, pp. 118-19. See subsection IV B.1, *infra*.

<sup>165</sup>Kessler, "Incorporation in New England," pp. 43-44.

adopted a liberal general incorporation law based on the New Nersey statute.<sup>166</sup> In this section, the dual system of incorporation and its role in the market for corporate privileges are examined.

#### 1. Early General Incorporation Laws

The New York Act of March 22, 1811 -- entitled "An Act Relative to Incorporations for Manufacturing Purposes" -- was the first general incorporation law for American business companies. When compared with the terms of the special manufacturing charters granted during the same time, the terms of the act were relatively unattractive. For this reason, little importance has been attached to the Act by scholars working in the field of the history of business associations because firms would tend to go to the special charter route.<sup>167</sup> It has been shown, however, that the Act was a more popular method of incorporation for manufacturing and business purposes than the special corporate charters.<sup>168</sup>

The terms of the New York Act of 1811 which are usually cited as making it relatively unattractive are the low maximum capitalization of

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<sup>166</sup>See Russel C. Larcom, The Delaware Corporation (Baltimore: The Johns Hopkins Press, 1937): 4-16 for a discussion of the dual system in Delaware. Also, see subsection IV.C.6, *infra*.

<sup>167</sup>See Berle and Means, p. 136; Livermore, Early American Land Companies, p. 261; Livermore, "Unlimited Liability;" and Dodd, American Business Corporations, p. 388.

<sup>168</sup>William C. Kessler, "A Statistical Study of the New York Incorporation Act of 1811," Journal of Political Economy, XLVIII (December, 1940): 877-882.

\$100,000, a short life of only twenty years, and the liability provision. There is some dispute in the literature as to the extent of shareholder liability under the Act. One author claims that the Act provided for proportional liability,<sup>169</sup> another has claimed that the courts interpreted the Act to provide for limited liability,<sup>170</sup> and others have suggested that double liability -- liability to pay, if needed for the benefit of creditors, an amount equal to the par value of their shares even if the shares had been paid for in full at the time of issue -- was the courts' interpretation.<sup>171</sup> The latter conclusion is the better reasoned. Nevertheless, the importance of the Act of 1811 from the perspective of this dissertation is not its terms but rather the reason for its passage and its effects on the market for corporate privileges.

The passage of the New York Act of 1811 was closely connected with national Democratic policies of the period.<sup>172</sup> Supporters of Jefferson's Embargo and Madison's succeeding hostile policy toward England regarded domestic manufacturing as a desirable weapon. In this

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<sup>169</sup>Livermore, "Unlimited Liability," pp. 684-85.

<sup>170</sup>Larcom, p. 1.

<sup>171</sup>Stanley E. Howard, "Stockholders' Liability Under the New York Act of March 22, 1811," Journal of Political Economy, XLVI (August, 1938), pp. 499-514, 501; and Dodd, American Business Corporations, p. 388.

<sup>172</sup>Kessler, "New York General Incorporation Act," pp. 878-9; and Livermore, pp. 684-5. Also, see the discussion of exogenous changes that affected the demand for corporate privileges in the early nineteenth century in subsection IV.A.4, supra.

regard, it was passed simply as a means of encouraging groups with small amounts of capital to enter general manufacturing:

The object and intention of the legislature in authorizing the association of individuals for manufacturing purposes, was in effect, to facilitate the formation of partnerships without the risks ordinarily attending them, and to encourage internal manufactures. There is nothing of an exclusive nature in the statute; but the benefits from associating and becoming incorporated, for the purposes held out in the act, are offered to all who will conform to its requisitions. There are no franchises or privileges which are not common to the whole community. In this respect, incorporations under the statute differ from corporations, to whom some exclusive or peculiar provisions are granted. The only advantages of an incorporation under the statute over partnerships, and the only substantial difference between them, consists in a capacity to manage the affairs of the institution, by a few select agents, and by an exoneration from any responsibility beyond the amount of individual subscription.<sup>173</sup>

In any event, it seems clear that the passage of the first American or English general incorporation law was influenced by the patriotic movement to stimulate home manufacture. Monopolistic legislators, it seems, can be influenced by patriotic notions. But, it must be remembered that the patriotic legislators did not relinquish control over the important corporate privileges of perpetual existence and limited liability.

The Act of 1811 was not replaced until the legislature passed a more comprehensive general incorporation statute in 1848. As indicated by Table 1,<sup>174</sup> the 1811 Act was a far more popular method of

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<sup>173</sup>Slee v. Bloom, 19 Johnson 456, 473-4 (N.Y., 1821) cited in Larcom, p. 1. The last statement has been interpreted to be a statement of double liability. See Howard, "Stockholders' Liability in New York," pp. 508-511.

<sup>174</sup>Source: Kessler, "New York General Incorporation Act," p. 879.

TABLE IV. I  
 NUMBER OF MANUFACTURING COMPANIES INCORPORATED UNDER NEW YORK  
 GENERAL AND SPECIAL ACTS (1811-48)

General Act						Special Act
Year	Total	Textiles	Metals	Glass	Mixed & Misc.	Mfg. Cos.
1811.....	11	6	2	1	2	13
1812.....	12	10	1	.....	1	5
1813.....	29	25	3	1	.....	4
1814.....	39	33	3	1	2	4
1815.....	19	17	2	.....	.....	1
1816.....	8	6	2	.....	.....	1
1817.....	5	2	1	.....	2	.....
1818.....	4	4	.....	.....	.....	1
1819.....	1	1	.....	.....	.....	.....
1820.....	1	1	.....	.....	.....	.....
1821.....	3	1	.....	.....	2	.....
1822.....	3	2	.....	.....	1	1
1823.....	6	4	2	.....	.....	1
1824.....	2	1	.....	.....	1	1
1825.....	10	2	2	.....	6	9
1826.....	10	2	5	.....	3	7
1827.....	9	5	3	.....	1	.....
1828.....	9	3	3	1	2	9
1829.....	9	8	.....	.....	1	1
1830.....	2	.....	.....	.....	2	4
1831.....	8	5	2	.....	1	4
1832.....	3	2	1	.....	.....	14
1833.....	6	3	1	1	1	7
1834.....	10	5	2	2	1	9
1835.....	13	3	5	1	4	7
1836.....	20	10	3	1	6	15
1837.....	17	6	6	.....	5	7
1838.....	4	1	.....	1	2	7
1839.....	4	1	1	.....	2	8
1940.....	5	2	1	2	.....	2
1841.....	12	6	1	.....	5	4
1842.....	3	3	.....	.....	.....	.....
1843.....	.....	.....	.....	.....	.....	1
1844.....	13	9	1	2	1	.....
1845.....	12	4	4	1	3	2
1846.....	24	20	3	.....	1	1
1847.....	13	11	2	.....	.....	.....
1848.....	3	2	.....	.....	1	.....
TOTALS	362	226	62	15	59	150

incorporation for manufacturing purposes than the special charter during the Act's period of effectiveness. The Act had the desired effect -- "If the legislature wished to aid 'war babies' by means of this law, they must have been quite satisfied with the results"<sup>175</sup> -- and the popularity of the act, relative to the special charter, continued through the period of its effectiveness despite the supposed handicaps and limited life. The major difference between the corporations formed by different means was that the general-law companies were smaller on average.<sup>176</sup> In effect, the legislators gave inferior privileges to smaller firms while continuing to sell the superior privileges to the firms that valued the privileges more highly. This market segmentation is the essence of the dual system of incorporation when viewed in the interest-group perspective.<sup>177</sup>

The New York General Incorporating Act of 1811 was duplicated by New Jersey in 1816.<sup>178</sup> The New Jersey Act has a strange history in that there is no evidence that it was ever used and no explanation for why it was repealed in 1819, two years before its was to expire.<sup>179</sup>

A general incorporation law applicable to the manufacturing

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<sup>175</sup>Ibid., p. 878.

<sup>176</sup>Ibid., p. 882.

<sup>177</sup>For further analysis, see subsection IV B.4, *infra*.

<sup>178</sup>Cadman, p. 23; and Dodd, American Business Corporations, p. 388.

<sup>179</sup>Cadman, pp. 23-5.

industry was passed by Connecticut in 1837.<sup>180</sup> The Act was passed by a legislature dominated by Jacksonian Democrats who opposed the corporation regardless of its method of creation. The Democrats, however, wound up favoring a general act because they found themselves in a dilemma,<sup>181</sup> which is illustrated by the following excerpt from a Report of the Joint Standing Committee on Incorporation in 1837:

The effect [of the special-chartering system] has been to induce large investments to be made, and capital to an immense amount has been expended on the faith of grants so obtained. To abolish these grants and vacate their charters, it is claimed, would be violating the pledged faith of the State. On the other hand, to permit their continuance, and to deny all future applications, would be to confirm and aggravate existing monopolies.<sup>182</sup>

Thus, the Democrats were forced into passing a general law in spite of their well-known objections to the corporation. Also, the logic of the report called for a relatively comprehensive and relatively liberal general incorporation law. Consequently, the Act was popular. Nevertheless, chartering by special act remained the predominate method of incorporating.<sup>183</sup>

This completes the survey of the early general incorporation laws. These early laws, it will be shown, were the forebearers of the full-fledged development of the dual system beginning in 1845.

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<sup>180</sup>Ibid., p. 118; and William C. Kessler, "Incorporation in New England: A Statistical Study, 1800-1875," Journal of Economic History, VIII (May, 1948): 43-62, 43.

<sup>181</sup>Dodd, American Business Corporation, pp. 414-19.

<sup>182</sup>Ibid., p. 415.

<sup>183</sup>Kessler, "Incorporation in New England," pp. 43-44.

## 2. Qualified Constitutional Prohibitions of Special Corporate Charters, and Dual-System General Incorporation Laws

The dual system of incorporation involved the opportunity to incorporate under a general incorporation law or a special legislative act. The dual system was functional in only 11 of 37 states between 1846 and 1875. The general incorporation laws, which ushered in the dual system were statutes passed by state legislatures under either the authority or command of the state's constitution. For our purposes, the era of the dual system began in 1846 with two events: the ratification of a new New York Constitution and the passage of the first New Jersey manufacturing general incorporation law. In this subsection, the constitutional framework and statutory developments of the dual system are examined.

### Qualified Constitutional Prohibitions of Special Corporate Charters

Prior to 1845,<sup>184</sup> constitutional provisions dealing with corporations were designed to correct abuses and weaknesses in the special chartering system rather to dismantle the system. Beginning with the Louisiana Constitution of 1845, which mandated an absolute prohibition of special corporate charters,<sup>185</sup> the trend of constitutional provisions on the matter of incorporating procedure was

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<sup>184</sup>See subsection IV A.2, supra, for a discussion of the earlier constitutional restraints. It should be noted that many states had statutory provisions dealing with special acts of incorporation, but these did not carry the force of constitutional provisions and did not necessarily limit the actions of future legislators.

<sup>185</sup>Absolute constitutional prohibitions of special corporate charters are discussed in subsections IV C.1 and IV C.6, infra.

towards the prohibition of special acts of incorporation. In this regard, the dual system of incorporation was the result of constitutional provisions limiting to "special" circumstances the use of special corporate charters.

New York, which had been operating under the dual system since 1811, ratified a new constitution in 1846 which restricted the granting of special charters to "cases where in the judgment of the Legislature, the objects of the corporation cannot be attained under general laws."<sup>186</sup> It is not clear why this provision was added to the new constitution. It surely was not added because the legislature was overburdened with special charter applications as attested to by the figures in Table I.<sup>187</sup> For example, for the years 1840 to 1845, there were sixty-nine manufacturing company incorporations under the Act of 1811 while only nine by special act. Nevertheless, it is interesting to note that even after passing a more comprehensive general incorporation law for manufacturing firms the legislature was quite accommodating in making the judgment that the general incorporation was not suitable for a particular firm:<sup>188</sup>

...it became evident soon after 1847 that the "judgment" of the legislature could be easily warped to the opinion that incorporation by general law was impossible in a great many cases...the New York legislators continued to pass special acts of incorporation for types of corporations already

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<sup>186</sup>B.P. Poore, Clerk of Printing Records, The Federal and State Constitutions, Colonial Charters, and other Organic Laws of the United States, 2 Vols. (Washington: U.S. Government Printing Office, 1878): II, 1368.

<sup>187</sup>Table I is located in the preceding subsection.

<sup>188</sup>Friedman, p. 172-3.

provided for by general laws...The 1846 constitution of that state had prohibited special charters for commercial banks, but in regard to other types of corporations the constitution left a small loophole for special charters by prohibiting special acts of incorporation except in cases where, in the judgment of the legislature, the objects of the corporation could not be obtained under general laws...During the following twenty-five years, the legislature continued to pass special charters even when general laws were available to cover the cases. Some of the governors made free use of the veto power in attempting to stem the tide. By 1872, however, the pressure for private acts of incorporation was still so strong that the governor declared in his annual message: "There should be more specific constitutional restraints upon legislative power to grant special charters for private corporations..."<sup>189</sup>

Thus, the dual system in New York does not appear to have been a major deterrent to special charter legislation.

Four other states, following the lead of New York, added qualified constitutional prohibitions against special corporation chartering between 1845 and 1875: Illinois and Wisconsin in 1848,<sup>190</sup> Maryland in 1851,<sup>191</sup> and North Carolina in 1868.<sup>192</sup> Of these, the dual system created by the Wisconsin constitutionally-mandated statute is the better documented. Between 1848 and 1871, only 143 business corporations were created under Wisconsin general incorporation laws while 1130 were created by special acts -- a ratio of almost eight to one.<sup>193</sup> Thus, as in New York, the constitutionally-mandated dual

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<sup>189</sup>Cadman, pp. 172-3.

<sup>190</sup>Poore, I, p. 465, and II, p. 2039.

<sup>191</sup>Ibid., II, p. 1431.

<sup>192</sup>Ibid., II, p. 1431.

<sup>193</sup>Kuehnl, pp. 143 and 146.

system in Wisconsin did not significantly alter the legislators' behavior with regards to special charters.

There is also indirect evidence in Maryland that the 1851 constitutionally-mandated general laws were regularly judged by the legislature to be unsuitable for the objects of incorporation -- that is, to fit within the loophole of the qualified constitutional prohibition of special charters. The Maryland Constitution of 1867 made special corporate charters void if they did not fit within the loophole -- that is, if they were enacted where a general law was available. Furthermore, the Constitution directed the governor to appoint a commission to draw up additional general laws, to revise existing general laws in order to widen their applicability (and, thereby, close the loopholes), and to submit their recommendations to the legislature for action.<sup>194</sup> In general, it appears that the constitutionally-mandated dual system failed to have a major impact on the market for special corporate privileges.

#### General Incorporation Laws Initiated by the Legislatures

The earliest nonconstitutionally-mandated general incorporation laws, as mentioned in the preceding subsection, were the New York Act of 1811 and the Connecticut law of 1837. The first such general law in the dual incorporation era, 1845-1875, was the New Jersey manufacturing law of 1846.<sup>195</sup> This illiberal, strict law was passed as the result of

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<sup>194</sup>Poore, I, p. 900.

<sup>195</sup>Cadman, pp. 118-9.

an unsuccessful attempt by the Democrats to abandon the system of special chartering and force all incorporation under general statute.<sup>196</sup> The opposition of the Whigs was sufficient to maintain the possibility of incorporation by special charter:

At the time of the passage of the 1846 manufacturing law, doubtful members of the legislature had been assured that enactment of the general law would not prohibit special charters, and the general notion of the general law was that it merely afforded an alternative system of incorporation for those who wished to "save the time and trouble of applications for special acts..." Legislators opposing the 1846 law on the ground that its terms were too strict to permit any "healthy" company to rise under it had been reassured by other members of the assembly in words that foreshadowed troubles to come. Citing the dual system in New York, one member declared that he did not suppose that the bill would prevent the legislature from incorporating other companies by special act at its discretion, and another said anyone who thought the law was "fire" did not have to play with it.<sup>197</sup>

It was immediately clear that the 1846 Act was not a suitable alternative to incorporation by special act and, as a result, the Democrat-dominated legislature passed a revised general incorporation law in 1849 with a view towards improving the relative desirability of the general law corporations.<sup>198</sup> Nevertheless, the pressures for special charters continued, and the Democrats, who often succumbed to this pressure while they controlled the legislature, pushed for more

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<sup>196</sup>Ibid., pp. 124-5.

<sup>197</sup>Ibid.

<sup>198</sup>Ibid., p. 127.

liberal laws. As a result, the Democrats opened themselves up to ridicule from the Whigs:

...The strongest argument against the existing general laws was furnished by the Democrats themselves; namely, that the laws were ignored by Democratic legislatures that passed special charters. The Advertiser frequently pointed out that although the Democrats had "resolved and re-resolved" to substitute general for special charters, those most loud in favor of general laws were most forward in pressing certain special charters. When special charter bills were held up by the talk of general laws, it was pointed out that the "ardor could not of course hold out even if it had been real -- which it was not, as it originated in mere check and counter-check among a few members -- for too many have private bills which they wished to have passed."...The many instances of the Democrats' disregard for their own general laws in the face of private acts were powerful ammunition when used by opponents of the existing system of general laws.<sup>199</sup>

Thus, as under the special chartering system,<sup>200</sup> the dual system witnessed the overpowering of ideology and party policies by interest groups. It has been suggested, however, that the failure of New Jersey's early general law movement to result in satisfactory general incorporation laws should be attributed to the fact that the issue became a matter of party politics.<sup>201</sup>

It should be noted that the New Jersey manufacturing general incorporation laws of 1846 and 1849 were employed fairly frequently in their early years. Between 1847 and 1857, inclusive, sixty-four manufacturing and mining corporations were chartered under the general

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<sup>199</sup>Ibid., pp. 147-8; citing the Newark Daily Advertiser, January 24 and February 4, 1852.

<sup>200</sup>See subsection IV A.2, supra.

<sup>201</sup>Ibid., pp. 124 and 148.

laws, while sixty-eight were formed by special act.<sup>202</sup> Beginning in 1856 with the conversion of three general law manufacturing company charters into specially-chartered corporations,<sup>203</sup> there emerged a new trend towards more frequent use of the special charter for almost every category of business -- manufacturing and mining, transportation and communication, public utility, and finance. Special charters, between 1858 and 1875, totaled 1455 while only 361 corporations were formed under the general laws. These figures can be broken down to reveal that 702 corporations organized for general business purposes (including 398 manufacturing and mining) were chartered by special act and only 358 (including 156 manufacturing and mining) by virtue of the general laws.<sup>205</sup> After consideration of these facts, there can be little doubt as to the correctness of the following statement:

Altogether the period of 1858 to 1875 was the heyday of special chartering in New Jersey. This situation arose in spite of the availability of general incorporation laws and in spite of the fact that the final decade of the period was marked by a revived public and legislative interest in the potentialities of incorporation by procedure....The most significant fact about these years is that the legislature did not manifest the slightest disposition to cease chartering by special act...special charters were the order of the day.<sup>206</sup>

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<sup>202</sup>Ibid., pp. 207-8.

<sup>203</sup>Ibid., pp. 143-4.

<sup>204</sup>Ibid., pp. 207-8.

<sup>205</sup>Ibid., p. 160.

It is not surprising, therefore, that the dual system came under attack for many of the same abuses that accompanied the simple special chartering system.<sup>206</sup>

During the dual incorporation era, 1845 to 1875, five states -- besides New York, Connecticut, and New Jersey -- passed nonconstitutionally-mandated general incorporation laws: Michigan in 1846,<sup>207</sup> Pennsylvania in 1849,<sup>208</sup> Massachusetts in 1851,<sup>209</sup> Vermont in 1853,<sup>210</sup> Maine in 1862,<sup>211</sup> and New Hampshire in 1866.<sup>212</sup> Of these, the New England States -- the only ones for which more than sketchy data are available -- present an interesting picture. For the period of 1863 to 1875, a period when all of the New England States except Rhode Island had general incorporation laws, these states incorporated a total of 4,575 companies: 2,390 by special act and 2,185 by general law. Of these, nearly all of the general-law corporations can be attributed to Connecticut and Massachusetts with both showing more general-law than special-act companies. Manufacturing and mining charters accounted for 3,136 (about 69 percent) of the 4,575 total. Of

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<sup>206</sup>See subsection IV A.6, *supra*, and IV B.4, *infra*.

<sup>207</sup>Cadman, p. 119.

<sup>208</sup>Miller, p. 158.

<sup>209</sup>Dodd, American Business Corporations, pp. 314-18.

<sup>210</sup>*Ibid.*, p. 410.

<sup>211</sup>*Ibid.*, p. 428.

<sup>212</sup>*Ibid.*, p. 407.

the 3,136, almost 65 percent of the corporations were organized under general laws (2,016).<sup>213</sup> Thus, it appears that the New England States, while showing more of a proclivity towards the utilization of their general corporation laws than the other states studied, maintained a functioning market for special corporate privileges.

It has been suggested that the utilization of the general laws, under the dual system, was even less than indicated by the statistics because it is probable that many of the corporations initially chartered under the general laws used the general law as a temporary convenience or as a testing ground prior to attempting to receive a special charter. For example, since the legislatures were not in session year round, a special charter could not always be obtained when a company decided to begin operations. Thus, it is probable that the best plan in many cases was to secure a general-law charter to fill the interim until the legislature reconvened. Another example of the temporary use of the general-law corporation would have been when the promoters of an enterprise were unsure of its success. In such a case, the promoters may have preferred to postpone the investment of time and expense necessary to secure a special charter until they were reasonably certain that it was worthwhile.<sup>214</sup>

In concluding this survey of the statutory bases of the dual system of incorporation, it must be noted that a consistent picture

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<sup>213</sup>Kessler, "Incorporation in New England," pp. 46-7.

<sup>214</sup>Cadman, pp. 166-7.

has emerged and that this picture is the same regardless of the source of the motivation for the passage of the general laws. It is a picture of legislators clinging to their position as suppliers of corporate privileges in the face of constitutional and public pressures for abandoning the special-chartering system. It is appropriate, therefore, to turn to an examination of why the special charters remained so popular when general incorporation laws were available.

### 3. Reasons for the Continued Popularity of Special Charters

Many of the dual-system general incorporation laws, especially those constitutionally mandated, were enacted with the expectation that they would lead to a system under which specially-chartered corporations would be rare and unusual exceptions to the general rule. It has been shown, however, that the actual experience was contrary to expectations. In this subsection, some explanations for the continued popularity of the special charter are presented.

The period of the dual incorporation system, 1845 to 1875, was "marked by a desire to not only achieve equality of privilege as between corporations themselves but also as between incorporated and unincorporated enterprises."<sup>215</sup> The problem with this desire, however, was that the equality of privileges was fulfilled with respect to unincorporated companies and general-law corporations but not with respect to general-law and specially-chartered corporations. Because of this, it is clear that the primary reason for the continued use of

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<sup>215</sup>Cadman, p. 189.

special charters after the passage of the earlier general incorporation acts was the restrictive nature of the corporate privileges available under the statutes. The privilege of incorporation under the early general acts was circumscribed with limitations and requirements as to permissible purposes, maximum authorized capital, duration, residence of shareholders and directors, maximum indebtedness, publication of records, shareholders' and directors' liability, etc. Thus, the customized special charters were more desirable because they could circumvent these limitations and requirements.<sup>216</sup> Because of this, a brief comparison of some of the terms in the charters of the two types of corporations is warranted.

The terms of special corporate charters were either specified in the charter, governed by general regulating statutes, or implied from common law doctrines. The terms controlling general-law corporations were set forth in the pertinent general incorporation law. A major difference between the terms of general- and special-law charters was the rules affecting the liability of the corporations' directors -- in fact, this might be the most important difference since the prospective directors were most likely the entrepreneurs who made the decision with respect to method of incorporation. Some of the dual-system general

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<sup>216</sup>Although no complete study of restrictions included in the general incorporation laws adopted by the various states in the middle decades of the nineteenth century is available, a broad sample of them can be found in Justice Brandeis' dissent in Liggett Co. v. Lee, 288 U.S. 517, 541-580 (1932).

incorporation laws contained very strict rules with respect to directors' liability.<sup>217</sup> In Wisconsin, for example, whenever any general-law corporation violated any provision of the act and the violation caused the corporation to become insolvent, the directors who assented to the violation became jointly and severally liable for all corporate debts contracted subsequent to the violation.<sup>218</sup> Almost all special corporate charters were silent with respect to director's liability and the common law knew no personal liability of directors to creditors.<sup>219</sup> Thus, in order to prevent liability from arising from their mistakes, the directors were acting in their own self-interest when seeking a special charter. There were only minor differences between the terms of the two types of corporations with respect to shareholders' limited liability.<sup>220</sup>

Many of the general incorporation laws required annual reports to be submitted to not only the stockholders but also to a government agency.<sup>221</sup> These publicity requirements, which were unpopular because of their added expenses and the desire for confidentiality as to shareholders' identity, could be avoided by securing special acts of incorporation.<sup>222</sup>

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<sup>217</sup>Cadman, p. 169; and Kuehnl, pp. 125-6 and 151.

<sup>218</sup>Kuehnl, pp. 125-6.

<sup>219</sup>Ibid., p. 151.

<sup>220</sup>Ibid., pp. 123-4 and 150-1; Cadman, p. 169; and Dodd, American Business Corporations, pp. 418-9.

<sup>221</sup>Kuehnl, p. 124; Cadman, p. 169; Dodd, American Business Corporations, pp. 319-320.

<sup>222</sup>Ibid.

The low limit on capitalization set by some of the general incorporation laws was another reason for preferring the terms of a special charter. It has been suggested that this was the major reason for seeking special charters under the dual system in Connecticut and Massachusetts.<sup>223</sup> While this was not recognized as the primary reason for seeking special charters in Wisconsin, the low capitalization limits in the Wisconsin law of 1848 was recognized as one of the many faults that made special charters so much more desirable.<sup>224</sup>

There were several other important exemptions and positive rights included in the terms of special charters. Special charters allowed a company to escape the over-all debt limits established in the general laws as well as to obtain certain positive rights not included in the general laws. For example, special charters often included the rarely-granted powers to mortgage property and to issue bonds.<sup>225</sup> It would appear that the ability to leverage the capital structure of a firm was a major advantage in that it would allow for a larger return to the equity interests in the firm.<sup>226</sup> Another important difference

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<sup>223</sup>Kessler. "Incorporation in New England," pp. 48-49, 62; and Dodd, American Business Corporations, pp. 418-19.

<sup>224</sup>Kuehnl, p. 124.

<sup>225</sup>Cadman, p. 169.

<sup>226</sup>The allowable degree of leverage would have been relevant to the value of the firm at this time as the capital markets were underdeveloped and far from perfect. The existence of perfect capital markets is a crucial assumption of the Modigliani-Miller irrelevancy theorem -- see Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment," American Economic Review, 48 (June, 1958): 261-97.

in the terms of the two types of charters that also increased the value and desirability of special charters was the outright exemption of specially-chartered companies from state and local taxation.<sup>227</sup> Also, many of the special charters included the rare privilege of being able to issue stock in exchange for property other than money.<sup>228</sup>

Before turning to explanations for the use of special charters that are based on factors other than the substantive provisions of the charters, one final point about the general nature of the charters should be considered. In the years following the passage of the restrictive general laws, the provisions of the special charters and the acts amending special charters were changed to reflect changes and trends in corporate finance, while the provisions in the general incorporating statutes became outdated and increasingly less desirable.<sup>229</sup> In other words, business practice -- as reflected in the terms of special charters secured from legislatures by entrepreneurs -- led the way in developing the modern law of corporation.<sup>230</sup> In general, liberal special charters, in addition to allowing specific tax breaks in some cases, could result in considerable cost savings because they allowed for the necessary economic and legal flexibility in a rapidly expanding economy. It

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<sup>227</sup>Cadman, p. 169.

<sup>228</sup>Ibid.; and Kuehnl, p. 125.

<sup>229</sup>Cadman, pp. 170-71; and Kuehnl, pp. 146-47, 192.

<sup>230</sup>Friedman, pp. 168-69.

seems clear that the businessmen who secured special charters from the legislature at great expense expected the charters to give them a competitive advantage which would transform into an above normal net rate of return on their investments.

Two other conditions predisposing business groups in favor of special charters, even when they contained nothing more than the same privileges as general incorporation charters, should be noted. First, the controversial status of the corporation raised fears that future legislatures would alter the general laws to further restrict the rights and privileges of all corporations formed under the general law, while it seemed less likely that the legislature would pass the individual pieces of legislation that would be necessary to restrict the rights of any specially chartered corporation.<sup>231</sup> In other words, the increased durability of the special charter increased the present value of the corporate contract embodied in a special charter vis-a-vis the contract embodied in the general incorporation statute. Second, a charter granted by special act of the legislature was important to business promoters because it gave added prestige to the company and aided in marketing the initial stock issue.<sup>232</sup> For example, the Governor of New York, in pleading for the observation of constitutional

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<sup>231</sup>Cadman, pp. 169-70.

<sup>232</sup>Ibid., p. 170; Dodd, American Business Corporations, p. 320; and Kuehnl, p. 146.

restraints on special charter legislation, declared in 1874 that:

...it is well known that charters are frequently sought and obtained by individuals desirous of being associated for private purposes, not because there is any difficulty in effecting their object under existing general laws, but because a special act of the legislature is regarded as attaching to such associations a public estimation, even when conferring no additional privileges or powers.<sup>233</sup>

Thus it appears that the special charter by itself had some additional value by virtue of its role as a signalling device.

In conclusion, the continued popularity of the special charter under the dual system of incorporation can be seen as the outcome of a competitive rent-seeking process within the market for corporate privileges. Two observations provide the requisite support for this conclusion. First, the dual-incorporation era occurred at a time when there was a tendency for nearly all economic transactions and conflicts to find their way into the state legislatures. Because of this, the legislature was a "clearing house" for competing demands. In many instances the special corporate charter was the vehicle for distributing legislative favors.<sup>234</sup> The special corporate charter, in other words, was valuable for reasons beyond the granting of regular corporate privileges. Second, the influential firms that had already received their own "liberal" special charters had reasons to oppose truly "liberal" general incorporation laws: "We believe it is the habit of

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<sup>233</sup>State of New York, Messages from the Governor, VI, p. 640, quoted in Cadman, p. 170.

<sup>234</sup>Kuehn1, pp. 147 and 157; and subsections IV A.2 and 3, supra.

all corporations to resist the charter of competitors. They do not willingly divide their business..."<sup>235</sup> It appears that the remnants of the special-chartering system were self-perpetuating.

4. Some Effects of the Dual System General Incorporation Laws on the Market for Corporate Privileges

The interest-group interpretation of the passage of general incorporation laws of wide applicability which fostered the dual system should take into account the fact that some of the laws were initiated and passed by the legislatures and others were passed by the legislatures in response to constitutional restraints on the passage of special charters. In this subsection, the effects of the dual system of incorporation on the market for corporate privileges are analyzed in strictly interest-group terms, and some of the criticisms aroused by the dual system are shown to be consistent with the interest-group interpretation.

At first glance, the initiation and passage of a general incorporation law by a legislature appears to be inconsistent with the legislature's monopoly position. However, under the dual system, the legislatures did not entirely abandon the market for corporate privileges, and this leads one to expect that their behavior might have been consistent with their politically-constrained monopoly position. In other words, the legislators' behavior must be viewed as the behavior of monopolists faced with a real and continuous threat of regulation in

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<sup>235</sup>Newark Daily Advertisers, April 8, 1872, quoted from Cadman, pp. 170-71.

the form of a constitutional prohibition against the granting of special charters.<sup>236</sup> Thus, because of this "threat effect," instead of behaving as pure monopolists, the legislatures chose to give away substitute, but inferior, products - the right to a restrictive corporate charter under a general law - while continuing to market the superior, customized special charters. The legislature's need for this form of market segmentation grew out of the expanding economy of the Industrial Revolution and the accompanying increased demand for the corporate form.

As suggested by Friedman's hypothesis,<sup>237</sup> the legislatures in some states were literally swamped with bills for special corporate privileges, and this situation posed a dilemma for the legislators. Much of their time spent on special charters could have been more profitably devoted to the passage of other types of special-interest legislation or public laws, but the surging popularity of the corporate form made it politically impossible to restrict the corporate form to only the highest bidders. The legislatures' solution to this dilemma was, in effect, to segment the market for corporate privileges into two categories according to elasticity of demand. The business associations with the greater elasticity were granted restricted corporate privileges through a simple administrative procedure and

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<sup>236</sup>See subsection IV C.1, *infra* for a discussion of constitutional prohibitions against special charters that were adopted in several states during the dual-incorporation era.

<sup>237</sup>See Chapter II, *supra*.

uniform fees. Those with inelastic demands were sold customized liberal corporate privileges at whatever price the legislatures could extract. The most straightforward example of this market segmentation and price discrimination concerned the conservative capitalization limitations contained in dual-system general incorporation laws.<sup>238</sup> Assuming use of the corporate form became more desirable as firms became larger in terms of capitalization, then it is readily apparent that the general-law capitalization limitations forced the firms with the more inelastic demands for corporate privileges to seek a special charter from the legislatures. Thus, the legislatures were able to continue creating and extracting monopoly rents while at the same time satisfying the political challenges to the special charter by giving up some control over the market for corporate privileges.

Constitutional restraints on the passage of special charters can be seen as the direct result of the same forces that led some legislatures to independently initiate the passage of general incorporate laws; namely, the Industrial Revolution and the increasing amount of legislative time devoted to satisfying the accompanying increase in demand for corporate privileges. Between the late 'forties and 1870, all state constitutional conventions, whatever the reasons for being called, addressed the burden that special-chartering legislation put on the legislature's time and on the state's budget by prolonging

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<sup>238</sup>See the preceding subsection.

legislative sessions. The opportunities for lobbying, logrolling and bribery had multiplied as the volume of special-chartering legislation increased, and it is apparent that the constitutional conventions were more articulate than the voting public in expressing their objections to the abuses of the special-chartering system.

Whatever the motivation for the constitutional restraints on the special-chartering system, the resulting passage of restrictive general incorporation laws had essentially the same effect on the market for corporate privileges as did the general incorporation laws initiated by the legislature's themselves. The market was segmented by the general statutes, and the more valuable (liberal) corporate privileges were sold to the highest bidder.

The principal attack on the dual system of incorporation, as on the special-chartering system, was the burden the special acts placed on the legislatures' time.<sup>239</sup> Although the dual-system general incorporation laws decreased the rate of increase in the annual number of special charters, the annual number of special charters continued to exceed the annual number of general-law corporations in most dual-system states.<sup>240</sup> These effects of dual-system special chartering are not inconsistent with the expected behavior of a price-discriminating monopolist faced with a constantly increasing demand for its products. In other words, although the availability of

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<sup>239</sup>Cadman, pp. 161-2; and Kuehnl, pp. 114-5.

<sup>240</sup>See Kessler, "Incorporation in New England," pp. 48-50 for a detailed study of incorporation trends in New England.

incorporation by general law might have deterred some marginal firms (i.e., marginal with respect to the decision to seek a special charter) from seeking special charters, it is not unreasonable to expect that small effect to be overwhelmed by the overall increasing demand for corporate privileges. Nevertheless, the increasingly large quantity of special charters carried with it considerable political costs to the legislators.<sup>241</sup>

One of the political costs of continuing to grant special charters was the outcry against the expenses of the systems -- particularly the cost of publishing charters -- which were supposed to be borne by the corporations. Many corporations, however, failed to pay their fees because of exemptions or outright refusal.<sup>242</sup> As indicated by a Wisconsin governor's explanation for vetoing a charter which he claimed should have come under the state's general laws, these expenses were not inconsequential:

The special legislation of the State has become a great evil, and it is a growing one. It interferes with the necessary general legislation of every session of the legislature. The general laws, resolutions and memorials of the legislature of 1857, are all contained in a volume of one hundred and fifty-seven pages, while the private and local laws of 1857 fill a volume of eleven hundred and thirty-seven pages. Three-fourths of the time of every session of the legislature is taken up by this species of local legislation

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<sup>241</sup>Cadman, pp. 154-5, suggests that the burden of this private legislation may have led to a bipartisan movement towards liberal general laws in New Jersey in the 1870's. The Democrats' equality-of-privileges argument took a secondary role, thereby preventing the campaign for general incorporation from becoming intertwined with party politics.

<sup>242</sup>Ibid, pp. 163-4.

to the neglect of such general legislation as is absolutely necessary for the public benefit, and a vast amount of business which ought to be done, is left undone, for want of a portion of that time unnecessarily and injudiciously consumed in local legislation...The people suffer in the payment of large and unnecessary expenses in public printing and loss of time, and in ill-considered and defective general laws. More than one-half of the printing expenses and legislative expenses grew out of this system of useless legislation.<sup>243</sup>

It must be emphasized that he was referring to all special legislation and not just special charters. Nevertheless, it is apparent that he was concerned with the expense of the special chartering of corporations. That legislators continued to pass the special charters despite these political pressures is further evidence that the legislators were direct beneficiaries of the passage of the special acts of incorporation.

Other objections to the granting of special charters such as the alleged corruption, the inequality of privileges contained in the special charters, and the granting of special tax exemptions<sup>244</sup> are evidence of the existence of price discrimination in the market for corporate privileges. The legislators' reactions to these and other objections indicate that the legislators were very reluctant to give up special chartering. The typical legislative response was to pass an act aimed at "purifying the procedure of special chartering rather than of ending the practice altogether."<sup>245</sup> Furthermore, in spite of the

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<sup>243</sup>1858 Wisconsin Senate Journal, pp. 857-58, quoted in Kuehnl, p. 161

<sup>244</sup>See Cadman, pp. 139-40, 154-5, and 163-4; and the preceding subsection.

<sup>245</sup>*Ibid.*, p. 140.

justifiable criticism of the dual-system special chartering, and although the state legislators recognized the importance of liberal general incorporation laws as a means for relieving the legislative work-load and as a device for reducing the chances that special favors would be granted, the legislators made no significant attempts to make the existing general laws more responsive and in line with the needs of the business community.<sup>246</sup> That is, for obvious reasons, the legislators were reluctant to make inexpensive, close substitutes for special charters available to their potential customers.

In summary, under the dual system, the legislators segmented the market for corporate privileges, and their actions indicate that they had every intention of maintaining control of the more lucrative segments of the market until the threat of regulation was realized in the form of a constitutional prohibition of special corporate charters. The following observation provides support for this interpretation:

The Newark Daily Advertiser was at this time willing to advocate adoption of general statutes to deal with those who had looked upon the state as a "mere machine for the furtherance of individual ends and the promotion of private gain" but doubted the efficacy of any cure for special legislation unless the constitution was amended to outlaw private acts.<sup>247</sup>

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<sup>246</sup>Ibid., p. 165; and Kuehn1, pp. 115-6.

<sup>247</sup>Cadman, p. 157, referring to the Newark Daily Advertiser of January 17, 1871.

##### 5. Early Exportation of Corporate Privileges and Continued Jurisdictional Competition Through Capital Markets

The use of the dual system of incorporation coincided with subtle changes in the nature of jurisdictional competition. As mentioned in the discussion of the special-chartering system, the earlier jurisdictional competition took the form of legislatures attempting to offer more liberal charters in order to attract capital from other jurisdictions.<sup>248</sup> While this source of jurisdictional competition continued to exert considerable influence in the market for corporate privileges, the new types of competition went beyond influencing the flow of capital between states and involved the granting of the corporate privilege to carry on business outside of the state of incorporation. In other words, the dual-system era witnessed the beginnings of a form of jurisdictional competition in which the competition was manifested in the flow of corporate privileges, rather than the flow of capital, across the state lines. This new form of competition appeared in two distinct variations. The first variation involved allowing firms incorporated in the state where they conducted most of their business to expand their business into other states -- a privilege made necessary by the growth of interstate commerce. The second variation of this new form of jurisdictional competition involved the granting of special charters to firms from outside the chartering state that had no intentions of making the chartering state their primary place of business. For example, if a business desired

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<sup>248</sup>See subsection IV A.7, supra.

corporate privileges of a kind which were either unavailable under its state general incorporation law or too expensive via its state's special chartering system, it could seek a special charter from a different state. In this subsection, the statutory bases of jurisdictional competition and the effects of jurisdictional competition on the market for corporate privileges are examined.

Although fear of adverse effects in the capital market influenced the adoption of a fairly liberal shareholder liability provision in the New Jersey general incorporation law of 1846,<sup>249</sup> it is clear that most of the capital-market type of jurisdictional competition involved the granting of liberal special charters to out-of-state capitalists. In this regard, the states who retained their systems of special chartering had a competitive advantage. Since the statutory bases and effects of this type of competition have already been discussed,<sup>250</sup> an examination of the competition's results in a state with a liberal special charter policy -- New Jersey -- is all that is necessary on this type of jurisdictional competition in this subsection.

Whether a state could increase her wealth by adopting of a policy granting liberal corporate privileges was a much debated issue when states were formulating their initial policies with respect to the terms of business corporation charters.<sup>251</sup> New Jersey's success in

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<sup>249</sup>Cadman, p. 188.

<sup>250</sup>See subsection IV A.7, supra.

<sup>251</sup>Ibid.

attracting numerous industries to a state with few natural resources appears to have settled the issue. As late as 1869, the Governor of New Jersey was praising the State's success:

The community that invites labor and capital within its border by liberal legislation, adds to its own stability and enriches its citizens....I feel assured you will fully appreciate the propriety of continuing that policy which has heretofore induced manufacturing enterprise and capital to seek our protection.<sup>252</sup>

The governor of New York, in 1873, expressed concerned over the pro-business policies -- especially the tax policies -- of New Jersey and Pennsylvania, and he sounded jealous in commenting on New Jersey's rapid population growth:

The natural advantages of New York, especially for commerce, far exceed those of other States; but they are not great enough to enable us to contend successfully with the rivalry of our neighbors, quite as enterprising as ourselves, unless labor and capital are encouraged by laws as liberal as theirs.<sup>253</sup>

Although it appears that New Jersey was able to increase her wealth by passing favorable legislation, it is not readily apparent that this was the necessary result of New Jersey's policies. The real reason behind New Jersey's long-term success in this form of capital-market competition was not her policies but rather the failure of other states to adopt her policies once the policies appeared to be successful. That is, it is not clear why New Jersey was able to capture monopoly profits over a long period in the absence of entry barriers.

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<sup>252</sup>New Jersey Legislative Documents, 1869, pp, 185-6, quoted in Cadman, p. 177.

<sup>253</sup>State of New York, Messages From the Governors, VI, p. 530, quoted in Cadman, p. 177.

Nevertheless, it is clear that she learned a valuable lesson in jurisdictional competition in the market for corporate privileges as evidenced by her passage of the first modern, "liberal" general incorporation law in 1875.<sup>254</sup>

Prior to the 1850's it was either assumed or required that the operations of corporations -- both special and general-law -- would be confined within the chartering state.<sup>255</sup> Beginning in the mid-1850's, it became common to include in the articles of special charters a provision authorizing the corporation to carry on a part of its business outside the state -- the intention being that the corporations primary place of business would remain the chartering state. That is, these provisions, coupled with the rules of comity, allowed corporations chartered in the state of their primary place of business to exercise their corporate privileges in another political jurisdiction subject to the regulation in the foreign state.<sup>256</sup> One writer has suggested that such a provision was a major reason for the continued use of special charters under the dual system in the New England States.<sup>257</sup> The status of "foreign" corporations -- corporations operating outside their state of origin -- was uncertain at

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<sup>254</sup>See subsection IV C.4, *infra*.

<sup>255</sup>Stoke, p. 561.

<sup>256</sup>See subsection IV C.1, *infra* for a consideration of the constitutional protections of foreign corporations engaged in interstate commerce.

<sup>257</sup>Kessler, "Incorporation in New England," pp, 48-9. Cadman, p. 170, makes the same suggestion, albeit less enthusiastically, for New Jersey.

this time.<sup>258</sup> In order to alleviate this uncertainty, the ever-accommodating state of New Jersey during the 1860's began to pass special laws enabling certain "foreign" corporations to hold land and establish operations in that state. These laws were very similar to granting special charters and in many instances included authorizations for incorporating in New Jersey.<sup>259</sup>

The other type of early jurisdictional competition related to the exportation of corporate privileges was the beginning of the competition that has influenced the character of general incorporation laws since the passage of the 1875 New Jersey general incorporation law -- namely, the practice of incorporating in a state other than the state of the primary place of business. In most instances, the capitalists behind the incorporation were residents of the incorporating state. This was particularly true of western mining operations financed by eastern capitalists.<sup>260</sup> In other instances, more similar to the modern practice, the capitalists sought the most liberal corporate privileges without regard to their residences or the location of the corporation's operations. Once again, the experience of New Jersey is illuminating:

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<sup>258</sup>See subsection IV C.1.

<sup>259</sup>Cadman, p. 177.

<sup>260</sup>Kessler, "Incorporation in New England," p. 60. The legislators of Western States would not have been jealous of this activity since most of those states had constitutional prohibitions against special corporate charters in their initial constitutions. See subsection IV C.1, *infra*. Furthermore, the western legislators most likely viewed the infusion of eastern capital as important impetus to growth and development.

In other cases it is entirely clear that New Jersey was used as a mere accommodation. The incorporators of the Lower California Company, chartered in 1867, were such well-known New York financiers as August Belmont, Leonard Jerome, and William Fargo. The company, with authorized stock of \$15,000,000, was established as a mining company and as an agency to transport immigrants westward, its only identification with New Jersey being the obligation to maintain one "office" in the state. The Hispano-American Telegraph Company holding a franchise from the government of Peru, had been organized under a New York general law. On the ground that the New York law was not of sufficient scope and did not admit enough freedom of corporate action for the objects intended, New Jersey obliged with a special charter in 1868.<sup>261</sup>

This policy of exporting liberal corporate privileges through special charters apparently involved greater political costs than the earlier practice of granting liberal charters with a view towards attracting industry into the state. The following excerpt not only presents an example of this political controversy but also presents one of the few examples of the value placed on liberal corporate privileges:

When the policy went further, however, and embraced special charters for out-of-state promoters whose projects were not to be put into operation in New Jersey, a considerable clamor was heard. An early example was the criticism arising when in the early eighteen sixties a group of New York men applied to New Jersey for a charter for The Central American Transit Company. The sponsor of the bill in the assembly remarked that the men wished to obtain their charter in New Jersey because "they feel more confidence in the legislation and legal decisions of this State, and because we had more than once granted charters to companies out of the State." In the senate, however, it was declared that the true reason for applying in New Jersey was that a New York charter would have cost the promoters \$50,000. Although the company was to be chartered in New Jersey, it was under no obligation to

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<sup>261</sup>Cadman, p. 180.

transact any business there except, as expressed by a supporter of the bill, "the guarantee of one of the corporators -- a gentleman whose word no one can doubt, that he would use all his influence to fix the place of business in Jersey City." While the debate on the bill was in progress, the Newark Daily Advertiser ran a leading editorial entitled "Legislating for other States."...Not until the governor himself objected to the lack of identification of the company with New Jersey, was the bill modified to require the principal depot of the company to be located in Jersey City and elections of directors to be held in the same place.<sup>262</sup>

The development of these additional forms of jurisdictional competition reduced each state's control of the market for corporate privileges within its jurisdiction. However, the states' spatial monopolies were still secure because 1) the great majority of firms were engaged in intrastate commerce and were not large enough to warrant entering the interstate market for corporate privileges, 2) the tax breaks which were important in many special charters could not be granted to corporations operating outside the incorporating state, and 3) the status of foreign corporations and their relationship to their state of operation under the Constitution were still in doubt.<sup>263</sup> In other words, this method of incorporation was not very important at this stage of the change in method of incorporation; the reason it is mentioned at this point is that it was the beginning of the type of interstate incorporation competition that eventually destroyed the states' spatial monopolies and the special chartering system.

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<sup>262</sup>Ibid., pp. 178-9, (emphasis added); referring to the Newark Daily Advertiser, February 25, 1862.

<sup>263</sup>See subsection IV C.1, infra.

C. The Death of the Special Charter: Interstate Incorporation  
Competition and Liberal General Incorporation Laws

The preceding sections of this chapter have described the evolution through two overlapping stages of the procedures for granting corporate privileges. It has been shown that the special charters were allocated through the legislative market for corporate privileges and that, in spite of adamant criticisms of the corporate form and the negative attributes of the rent-seeking activity surrounding the special-chartering system, state legislators did not voluntarily relinquish their dominant position in their respective markets. In this section, which recounts and interprets the final stage in the evolution of the utilization of the special corporate charter, exogenous legal and economic changes affecting the legislative markets for corporate privileges are identified and shown to explain the ultimate demise of the special charter. This section opens with a discussion of early (i.e., pre-1875) clear constitutional prohibitions of the granting of special charters. It will be readily apparent that not only did the special-chartering and dual-incorporation systems appear at the same time across states, but that they also existed in some states after other states had completely abolished their special charter systems. It will be established in this chapter that, in spite of the fact that there was a trend towards the constitutional prohibitions of special corporate charters, the primary reason for the complete demise of the special charter in the final quarter of the nineteenth century was the result of changes in the legislative market for corporate privileges.

## 1. Early Absolute Constitutional Prohibitions of Special Charters

The use of the corporate form for general business purposes was the subject of great controversy throughout the 1830's and 40's,<sup>264</sup> and the time, expense and abuses of the granting of special charters aroused protests under both the special-charter and dual systems of incorporation.<sup>265</sup> Because of the early distrust of the corporate form, coupled with the acceptance of the theory that the special charter was a strong method of control of the corporation, the early constitutional provisions dealing with corporate chartering were designed to correct abuses and weaknesses in the system of granting incorporation by special act without abandoning the system. For example, some state constitutions had tried to reform the special-chartering system by requiring a two-thirds vote of the legislature for granting special charters.<sup>266</sup> Mounting problems with the special-chartering system plus a recognition of the inevitability of the corporate form led to a movement for general incorporation laws. It has been suggested that

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<sup>264</sup>See subsection IV A.6, supra.

<sup>265</sup>See *Ibid.*, and subsection IV B.4, supra.

<sup>266</sup>Provisions of this type became less common as the general law movement progressed, possibly because experience had indicated that they were ineffective in stemming the tide of special charters. See James Kent, Commentaries on American Law, 12th edition, edited by Oliver Wendell Holmes, Jr., (Boston: Little, Brown and Company, 1873): II, 340-1. One commentator's view of the two-thirds requirement was that "it led to greater scandals in the legislature, since more money was required to secure the necessary two-thirds vote." J.H. Dougherty, Constitutional History of the State of New York, p. 167, quoted in Cadman, p. 108.

general-law corporations were viewed as the lesser of two evils:

The movement toward general laws is not, however, to be interpreted as marking the end of distrust and apprehension regarding corporate enterprises. The general law movement in all states seems to have grown out of the widespread distrust of the monopolistic character of corporations arising soon after 1830 and out of a desire to make it impossible for certain groups to gain privileged positions denied to others.<sup>267</sup>

As a result of these considerations, beginning in 1845, constitutional provisions relating to incorporation were concerned to a large extent with eliminating all private acts of incorporation.<sup>268</sup> The corollary of the absolute prohibition of special acts was the duty of the legislatures to pass general incorporation laws. This duty was usually made explicit.

The first state to adopt an absolute prohibition of special acts of incorporation for business organization was Louisiana in her 1845 constitution.<sup>269</sup> Louisiana's subsequent policy was, to say the least, erratic. When a new constitution was adopted in 1852, it did not include the prohibition of special corporate charters. In 1864, the prohibition was reinstated only to be omitted from a new constitution in 1868.<sup>270</sup> In spite of this uncertainty, the Louisiana prohibition was the beginning of a significant movement to prohibit special acts of incorporation.

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<sup>267</sup>Cadman, p. 188.

<sup>268</sup>New Jersey's 1844 Constitution was the last to be adopted before this movement got underway.

<sup>269</sup>Poore, I, 721.

<sup>270</sup>Ibid., I, 751; and Cadman, p. 186.

By 1875, as indicated by Table II,<sup>271</sup> eighteen of the thirty-seven states then in the union had followed the example of Louisiana and had made all special acts of incorporation unconstitutional. Of these, two were states that had tried qualified constitutional prohibitions of special charters (i.e., adopted the dual system) and had found them to be inadequate. Illinois and Wisconsin adopted absolute constitutional prohibitions in 1870 and 1871, respectively.<sup>272</sup> When coupled with the three dual-system states with qualified constitutional prohibitions -- New York, Maryland, and North Carolina -- and Florida, where the 1868 constitution required the passage of general incorporation laws but did not limit the passage of special charters,<sup>273</sup> the number of states by 1875 with a constitutional mandate for general incorporation laws was twenty-three. Thus, it appears that the trend inaugurated by Louisiana was on course to put an end to the special chartering of corporations.

The tenacity of the legislators in the other states, on the other hand, is quite impressive. By 1875, forty years after Louisiana first prohibited special acts of incorporation, the special charter was still and accepted incorporation procedure for almost one-half (18 of 37) the states. Furthermore, the fact that nineteen states no longer

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<sup>271</sup>Source: Poore, various pages.

<sup>272</sup>Poore, I, 488 and II, 1050.

<sup>273</sup>Ibid., I, 350.

TABLE IV.II

Chronology of Pre-1875 State Constitutional Provisions That  
Absolutely Prohibited Special Acts of Incorporation

<u>State</u>	<u>Date</u>
Louisiana	1845
Iowa	1846*
California	1849*
Michigan	1850
Ohio	1851
Indiana	1851
Minnesota	1857*
Oregon	1857*
Kansas	1959*
Nevada	1864*
Missouri	1865
Nebraska	1866
Alabama	1867
Arkansas	1868
Illinois	1870
Tennessee	1870
Wisconsin	1871
West Virginia	1872
Pennsylvania	1873

\*State's first constitution.

allowed their legislatures to grant special charters should not be interpreted as evidence of a voluntary relinquishment of monopoly power by those states legislatures. This is so because all of the prohibitions of special charters were adopted in constitutional conventions that were called to revise the state's entire constitution -- seven of the constitutions containing prohibitions were the original constitutions of the states. A presumption of voluntary relinquishment of monopoly power would be justified when the prohibition was the result of an amendment to the constitution as opposed to a general revision. The bases of these presumptions is a belief that, in general, legislatures are more likely to exert a dominant influence with respect to the procedure for amending a constitution vis-a-vis a general revision at a constitutional convention.

Thus, it is clear that as recent as 1875 the special act was an important means of granting corporate privileges. The remainder of this section is devoted to explaining the demise of the special charters in the last quarter of the nineteenth century in spite of the fact that it was not constitutionally prohibited in many states.

## 2. Exogenous Economic Changes Affecting the Market for Corporate Privileges

In the early nineteenth century, entry barriers created by geographic isolation resulted in spatial monopolies for many local producers. At that time, the legislative market for corporate

privileges was characterized by spatial monopolies within each state. As the century progressed, technological breakthroughs in transportation and communication overcame the geographical entry barriers in goods markets. In this subsection, a cursory examination of these economic changes is presented. The changes in the goods market are then related to the spatial monopolies in the legislative markets for corporate privileges.

There is general agreement among economic historians that improvements in inland transportation and the resulting lowering of transportation costs were the most important catalysts in the development of a national economy of integrated markets in nineteenth century America. In particular, the period from 1815 to 1860 has been identified as the period in which the most important developments in transportation occurred.<sup>274</sup> These developments can be broken down into two categories -- internal water transportation and railroads.

The earliest efforts to improve inland water transportation were directed towards the development of an extensive canal system.<sup>275</sup> The

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<sup>274</sup>See, for example, George R. Taylor, The Transportation Revolution, 1815-1860 (New York: Holt, Rinehart, and Winston, 1862).

<sup>275</sup>For surveys of the economic impact of the canal era, see Carter Goodrich, ed., Canals and American Economic Development (New York: Columbia University Press, 1961), and Roger L. Ranson, "Interregional Canals and Economic Specialization in the Ante-Bellum United States," Explorations in Entrepreneurial History, 2nd series, V (Fall, 1968): 12-35. For case studies of canal projects, see Harry Scheiber, Ohio Canal Era: A Case Study of Government and the Economy, 1820-1861 (Athens: Ohio University Press, 1969) and Ronald E. Shaw, Erie Water West: A History of the Erie Canal, 1872-1854 (Lexington: University of Kentucky Press, 1969).

canal era, however, was cut short, and its influence diluted, by the development of the railroad. The more important technological development in inland water transportation appears to have been the steamboat:

The dramatic effect of technological change in inland transportation is not the advent of the railroad (which is the one that we customarily think of), but rather the development of the steamship on inland waters. The consequent fall in rates of upstream river transportation in 1816 directly reflects the use of steamboats on the Mississippi River and its tributaries. Here is clearly a case of technological development playing a significant part in lowering transportation costs.<sup>276</sup>

Subsequent studies and economic analysis have reinforced the conclusion that the steamboat was the most important factor in the transformation and development of the Ohio, Mississippi, and Missouri River basins into agricultural heartlands.<sup>277</sup>

The railroad, of course, played the major role in the integration of the United States into a national economy. Most of the recent research has been devoted to studying the importance of the railroad as a substitute for other forms of transportation. In other words, the fact that rails replaced other means of transportation when they came into direct competition establishes that the railroads provides more

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<sup>276</sup>Douglas C. North, Growth and Welfare in the American Past (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1966): 111.

<sup>277</sup>For economic analyses of the evolution and contribution of this technology see James Mak and Gary M. Walton, "Steamboats and the Great Productivity Surge in River Transportation," Journal of Economic History, XXXII (September, 1972): 619-40, and Eric F. Haites, James Mak, and Gary M. Walton, Western River Transportation: The Era of Early Internal Development: 1810 - 1860 (Baltimore: Johns Hopkins Press, 1975).

efficient transportation and the recent research has concentrated on how much more efficient. This research points to a probability that the railroad was not so all-important as was formerly believed.<sup>278</sup>

Nevertheless, the important point is that the railroads, and not some other means of transportation, were built and linked into an interstate network.

Finally, these revolutionary changes in transportation were accompanied by an equally important development in the field of communications. The development of the telegraph led to an enormous decrease in information and transactions costs. The value of this breakthrough is emphasized by the rapid rate of its deployment:

The fact is that although the first small railroads came a decade earlier, the telegraph preceded the railroad in forging extralocal and interregional links among mechants, bankers, brokers, and shippers. Samuel F. B. Morse's experimental line between Baltimore and Washington carried its "What hath God wrought!" on May 24, 1844. Telegraph systems, which achieved commercial practicability in 1845-1846 had blanketed the east and west and reached Chicago, St. Louis, and New Orleans, as well as other principal northern and southern cities, by

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<sup>278</sup>Representative works on the social savings of railroads vis-a-vis other means of transportation are Robert W. Fogel, Railroads and American Economic Growth: Essays in Econometric History (Baltimore: The Johns Hopkins Press, 1964); Albert Fishlow, Railroads and the Transformation of the Ante-Bellum Economy (Cambridge, Mass.: Harvard University Press, 1965); J. Hayden Boyd and Gary M. Walton, "The Social Savings for Nineteenth Century Railroad Passenger Services," Explorations in Economic History, IX (Spring, 1972): 233-54; Patrick K. O'Brien, The New Economic History of the Railways (New York: St. Martin's Press, 1977); and a survey article, Robert W. Fogel, "Notes on the Social Saving Controversy," Journal of Economic History, XXXIX (March, 1979): 1-54. For a brief discussion of the counterfactual methodology of these studies see Susan P. Lee and Peter Passell, A New Economic View of American History (New York: W.W. Norton and Company, 1979): 7-9.

early 1851. The transcontinental line to California was completed in October 1861. In both cases the "iron Horse" trailed by at least eight years.<sup>279</sup>

It is not hard to see how the increased speed and certainty of distant transactions made possible by the telegraph network would have improved the functioning of extralocal markets and increased the feasibility of an integrated national economy.

The cumulative effects of these developments have been described as follows:

It is not an exaggeration to term these developments a transportation revolution. The internal markets of the United States at the start of the nineteenth century were for the most part scattered and local affairs. By the 1850s, and in many cases as early as the 1820s, this was no longer the case. The products of the farm, the forest, the mine, and the factory -- and people themselves -- were moving more quickly and at greatly reduced costs in regional and interregional trade. In consequence producers received higher real prices for their goods and services and saw the value of their resources increased, while consumers witnessed declines in the prices they paid for goods and services. Greater specialization in production based on individual, local and regional comparative advantage was encouraged and even demanded by the increased competition of distant producers as markets were extended by improved transportation. The Constitution had created the possibility of a great common market throughout the United States. The transportation revolution made it a reality.<sup>280</sup>

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<sup>279</sup>Richard B. Du Boff, "Business Demand and the Development of the Telegraph in the United States, 1844 -1860," Business History Review, LIV (Winter, 1980): 459-79, 461 (his emphasis). For a complete history of the development of the national telegraph system, which culminated in 1866 when Western Union Telegraph Company emerged as a nationwide monopoly when it swallowed up its last two competitors, see Robert L. Thompson, Wiring a Continent, The History of the Telegraph Industry in the United States, 1832-1866 (Princeton, New Jersey: Princeton University Press, 1947).

<sup>280</sup>Sidney Ratner, James H. Soltow, and Richard Sylla, The Evolution of the American Economy: Growth, Welfare, and Decision Making (New York: Basic Books, Inc., 1979): 123.

Although these exogenous changes and the Constitution had broken down local monopolies in goods markets, the spatial monopolies in the legislative markets for corporate privileges appear to have withstood these shocks in spite of the fact foreign corporations engaged in interstate commerce reduced the individual states' control over the market for corporate privileges within their own boundaries; however, since the special chartering and dual incorporation systems continued after these exogenous changes, it appears that the growth of interstate commerce was a necessary but not sufficient condition for the development of a national market for corporate privileges. The missing condition, necessary for the complete downfall of the special chartering system, was a change in the legal environment in the form of a Constitutional guarantee that a state had no power to exclude a foreign corporation from conducting business within the state.

3. The Legal Basis of Jurisdictional Competition and a National "Free Market in Corporate Privileges: Foreign Corporations and Constitutional Issues

From its beginnings, the American law of corporations has wrestled with the legal status of foreign corporations -- corporations outside the jurisdiction in which they were created. The earliest issues surrounding foreign corporations related to the basic question of legal existence outside the state of incorporation. In this regard, the federal and state courts addressed questions related to access to courts and the enforceability of contracts. These and other related issues necessarily became intertwined with the status of the corporation under the United States Constitution. The question of

whether a corporation is a citizen with constitutional rights and guarantees was a major problem for the United States Supreme Court in the early nineteenth century. This question and other constitutional issues concerning the corporation were settled by the Supreme Court in the first seventy-five years of the nineteenth century, and they are discussed in this section.<sup>281</sup>

There are two opposing theories of the nature and status of corporations which operate outside of the state of their creation. The restrictive theory tends to emphasize the extraordinary privileges with which the corporation is endowed, and, in its most radical form, denies the existence of the corporation beyond the boundaries of the state of its birth. The logical extension of this theory is that if a foreign court were to treat a foreign corporation as a legal entity, " it would be setting up, by judicial fiat, the fiction to which alone corporate personality owes its existence. It would be not recognizing, but creating a corporation, a high prerogative of sovereignty which courts

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<sup>281</sup>The following discussion is a synthesis of materials gathered from many sources including: Gerald C. Henderson, The Position of Foreign Corporations in American Constitutional Law (Cambridge: Harvard University Press, 1918); H.A. Haring, Corporations Doing Business in Other States (New York: The Ronald Press, 1927); John W. Cadman, The Corporation in New Jersey: Business and Politics, 1791-1875 (Cambridge: Harvard University Press, 1949); E. Merrick Dodd, American Business Corporations Until 1860-With Special Reference to Massachusetts (Cambridge: Harvard University Press, 1954); Harry G. Henn, Handbook of the Law of Corporations (St. Paul: West Publishing Company, 1972); and Congressional Research Service, Library of Congress, The Constitution of the United States of America: Analysis and Interpretation -- Annotations of Cases Decided by the Supreme Court of the United States to June 29, 1972 (Washington: U.S. Government Printing Office, 1973).

may not usurp."<sup>282</sup> The liberal theory tends to look upon the corporation as a normal business unit, and its legal personality as nothing more than a convenient mechanism of commerce and industry. Not only civil recognition, but a certain degree of equality of treatment; is called for by this view.<sup>283</sup>

A leading scholar on the nature and status of foreign corporations has said:

"In broad outline the history of foreign corporations in American public law has taken the form of a gradual evolution from the extreme restrictive theory, through various midway stages of compromise toward a close approach to the doctrine of compulsory registration."<sup>284</sup>

As will be shown in this section, the judicial changes in the status of foreign corporations explain some major events in the history of the decline and fall of the special chartering system.

The restrictive theory was clearly inadequate for corporations conducting interstate business because it denied foreign corporations access to the courts. The beginning of the downfall of the restrictive theory was recognition of the right of a foreign corporation to sue in federal courts outside of the state in which it was incorporated. In Bank of United States v. Deveaux,<sup>285</sup> the Supreme Court of the United

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<sup>282</sup>Henderson, p. 4.

<sup>283</sup>Ibid., pp. 3-6

<sup>284</sup>Ibid., p. 6.

<sup>285</sup>Bank of United States v. Deveaux, 5 Cranch 61 (1809).

States was faced with the fundamental question whether a corporation created by the law of the United States could sue in the federal courts on the ground of diversity of citizenship.<sup>286</sup> Chief Justice Marshall, speaking for the Court, held that since the jurisdiction of the Circuit Court with respect to the character of the parties was limited to controversies between citizens of different states, then both parties must be citizens and that the "invisible, intangible, and artificial being, that mere legal entity, a corporation aggregate, is certainly not a citizen; and, consequently, cannot sue or be used in the courts of the United States."<sup>287</sup> Nevertheless, Marshall suggested that in the future, for purposes of establishing jurisdiction in the federal courts, the Supreme Court would look to the citizenship of the shareholders of the corporation, and allow the shareholders to sue in their corporate names, in determining the state of residence of the corporation. The theory of this decision was not that corporations were citizens but that the individual citizens who own the corporation were entitled by that clause to sue in their corporate capacity.<sup>288</sup>

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<sup>286</sup>Article 3, Section 2, U.S. Constitution, confers jurisdiction on the federal courts.

<sup>287</sup>Bank of United States v. Deveaux, 5 Cranch 61, 86(1809).

<sup>289</sup>It is interesting to note the political interpretation of this decision:

"By declining to accept jurisdiction the Court in this case failed to pass judgment on the real issue -- the validity of a state tax on a national bank. It is probable that the political aspects of the case caused Chief Justice Marshall to defer the settlement of this natty constitutional question

The state courts, on the other hand, did not have to deal with the jurisdictional issues which confronted the Supreme Court. In a series of cases beginning in 1813, the courts of seven states had by 1830 decided, stated or assumed that a foreign corporation had legal capacity to sue.<sup>289</sup> The first state court case to reject the contention that a foreign corporation had no legal capacity to sue was Portsmouth Livery Co. v. Watson,<sup>290</sup> where the Massachusetts court held that a foreign

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until a more propitious occasion. Despite the probable embarrassment to the bank and similar institutions there was a general belief that to ascribe citizenship to a corporation would give it rights under the privileges and immunities clause, which would thereby place corporations above the state. Corporations were detested in the South, and these states would have resented the placing of such an artificial entity on the same plane as individuals, especially with relation to the privileges of trade and commerce. To have declared that corporations were citizens would have enabled the North to force its corporations on the South, and 'to persons familiar with the political passions which the bank controversies have aroused, it must have been apparent that such a doctrine would have seriously imperilled the Union'."

Charles Grove Haines, The Role of the Supreme Court in American Government and Politics, 1789 -1835 (Berkeley: University of California Press, 1944), pp. 278-79. Haines' quote is from Henderson, p. 62. A "more propitious occasion" arose in 1819 in the famous case of McCulloch v. Maryland, 4 Wheaton 316 (1819).

<sup>289</sup>Contentions that a foreign corporation has no legal capacity to sue were rejected in Portsmouth Livery Co. v. Watson, 10 Mass. 91 (1813); Silver Lake Bank v. North, 4 Johns. Ch. 370 (N.Y. 1820); Bank of Marietta v. Pindall, 2 Rand. 465 (Va. 1824); New Jersey Protection & Lombard Bank v. Thorp, 6 Cow. 46 (N.Y. Sup. Ct. 1826); and Lucas v. Bank of Georgia, 2 Stew. 147 (Ala. 1829). Cf. Williamson v Smoot, 7 Martin (O.S.) 31 (La. 1819) (foreign corporation permitted to intervene and claim a steamboat which had been attached as the alleged property of one of its shareholders). See Dodd, American Business Corporations, p. 50-53, for a discussion of these cases.

<sup>290</sup>Portsmouth Livery Co. v Watson, 10 Mass. 91 (1813).

corporation was a legal person, whose identity was to be established like any other material fact. In Silver Lake Bank v. North,<sup>291</sup> an 1820 New York case, Chancellor Kent allowed a Pennsylvania bank to file a bill to foreclose a mortgage on New York land. To the argument that a foreign corporation could not be recognized, he replied:

"...I cannot see, that the objection is even plausible. It is well settled, that foreign corporations may sue here in their corporate name, and may prove, as a matter of fact, if the same were denied, that they were lawfully incorporated."<sup>292</sup>

Thus, the restrictive theory was not applied to foreign corporation's capacity-to-sue in either federal or state courts.

The question of whether a foreign corporation could transact business within a state, to the extent of making an enforceable contract, was answered in the affirmative in 1839 by the important case of Bank of Augusta v. Earle.<sup>293</sup> The United States Supreme Court managed to justify this decision in spite of its avowed continued acceptance of the restrictive (geographic) theory of the nonexistence of the corporation outside the boundaries of its state of origin. The basis for the decision was the principle of comity -- a principle of international law and conflict of laws under which nations give effect to each others' laws. The majority of the Court accepted Chief Justice Taney's reasoning that under the principle of comity a corporation has the

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<sup>291</sup>Silver Lake Bank v. North, 4 Johns, Ch. 370 (N.Y., 1820).

<sup>292</sup>Ibid., p. 372.

<sup>293</sup>Bank of Augusta v. Earle, 13 Pet. 519 (1839).

power to make contracts and perform acts outside the boundaries of the state which created it, provided those contracts and acts were consistent with the corporations charter powers and not in conflict with the statutes or legal policies of the state in which they took place.

However, in Bank of Augusta v. Earle, the Supreme Court rejected the argument that a foreign corporation was entitled to the protection of Article IV, Section 2 -- the Privileges and Immunities Clause - of the Constitution, and in doing so it refused to extend the device (employed to establish jurisdiction in Bank of United States v. Deveaux) of looking through the corporate entity to the citizenship of the shareholders. The effect of the denial of the protection of the Privileges and Immunities Clause was made explicit by the Court's proclamation of a state's constitutional power to repudiate the principal of comity, and not only to refuse recognition of foreign corporations but also to prevent their transacting any sort of business within the state. Counsel for the plaintiff's argument that foreign corporations had rights by virtue of the Commerce Clause were totally ignored by the majority.

Although the practical consequences of the failure to arm foreign corporations with any constitutional shields were not serious because the state courts accepted Taney's view that foreign corporations could legally engage in business in the absence of restrictive legislation, which was not often enacted, the decision in Bank of Augusta v. Earle

did create an atmosphere of uncertainty concerning the utility of operating in a foreign jurisdiction.<sup>294</sup> It was not until 1869 that the Supreme Court decided that corporations on their own account have constitution rights under the Commerce Clause -- but not under the Privileges and Immunities Clause.

In Paul v. Virginia,<sup>295</sup> a case dealing with state regulation of multi-state insurance companies, the Supreme Court, although stating that issuance of an insurance policy was not a transaction of commerce under the Constitution, said that the power of Congress to regulate interstate commerce included commerce carried on by corporations and intimated that such commerce could not lawfully be hampered by the states. In other words, the Court held that a state could exclude a foreign corporation from engaging in intrastate commerce within its jurisdiction or could attach reasonable conditions to the permission given such corporations to carry on such business,<sup>296</sup> but that a state could not exclude a foreign corporation from doing interstate business.

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<sup>294</sup>Dodd, American Business Corporations, p. 152. and pp. 179-181.

<sup>295</sup>Paul v. Virginia, 8 Wall. 168 (1869).

<sup>296</sup>See Conrad Reno, A Teatise on the Law of Non-Residents and Foreign Corporations (Chicago: T.H. Flood and Company. 1892) for early state regulation of foreign corporations. The bulk of the regulations were aimed at insuring service of process of foreign corporations and prohibiting foreign corporations from removing cases to the federal courts.

The impact of Paul v. Virginia on the legislative market for corporate privileges was enormous:

With the denial of the right to exclude, there fell to the ground, as to these corporations, the whole traditional theory by which state regulation of foreign corporations had been justified. For if the right to exclude is denied, the right to admit on condition necessarily falls with it. Thenceforth, if the state was to regulate foreign corporations engaged in interstate commerce, it must be as a lawmaker with qualified legislative jurisdiction, not as a person making a bargain, who may exact whatever price he can get.<sup>297</sup>

As Henn says: "Interstate enterprises could now shop for the most favorable state of incorporation,"<sup>298</sup> and within a few years the national "free market" in incorporation laws was dominated by smaller states attempting to raise revenue by offering liberal corporate charters at low prices.<sup>299</sup>

In this subsection, some major constitutional developments in the legal status of foreign corporations in the nineteenth century have been discussed. As is shown in the following subsection, the decision in Paul v. Virginia was one of the major exogenous changes behind the demise of the special chartering system.

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<sup>297</sup>Henderson, p. 116, (emphasis added).

<sup>298</sup>Henn, p. 19.

<sup>299</sup>bid.

#### 4. Smaller States and Liberal General Incorporation Laws

##### The Expected Effects of the Identified Exogenous Changes

The corporation, whether formed by special charter or general law, was viewed with distrust throughout the nineteenth century. Because of this, the general laws passed before 1875 tended to be restrictive in substantive terms. Under the dual system of incorporation, for example, the continued popularity of the special charter has been shown to be attributable to the restrictive nature of the general laws.<sup>300</sup> Furthermore, general laws tended to be illiberal even in states where special charters were unconstitutional. It appears, therefore, that legislators were not willing to incur the political costs of passing truly liberal general incorporation laws. A plausible explanation for that situation would have been that the legislators' did not perceive the possibility of any benefits, either direct or indirect, which would outweigh the costs of passing the general laws. An exogenous change, the decision in Paul v. Virginia, however, altered the legislators' opportunity costs -- or profit possibilities frontier --with respect to the granting of liberal general incorporation laws.

By breaking down the entry barriers of the spatial monopolies in the legislative markets for corporate privileges and providing the Constitutional protection necessary for a national "free market" for corporate privileges, the Paul decision presented the legislators with new opportunities for entrepreneurial behavior. In particular, it presented the opportunity to pass liberal general laws that would attract

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<sup>300</sup>See subsection IV B.3, supra.

incorporators from across the nation and increase the revenues of the legislators' home states with taxes and franchise fees on the firms chartered under their laws but operating in other states. Thus, the political costs of passing a general law could be alleviated by the political benefits of exporting some of the costs of the state government.<sup>301</sup> Thus, it seems clear, a priori, that the reason the smaller states were the first to pass the liberal general incorporation laws was undoubtedly related to the proportion of state revenues that a liberal law could be expected to generate. That is, if as liberal law would generate a fixed amount of revenue regardless of the size of the state passing the law, then the liberal law would most likely raise a larger proportion of total state revenues for smaller states vis-a-vis larger states; thereby lowering the political costs to the legislators in smaller states of passing such a controversial law.<sup>302</sup>

The expected net benefits to legislators from passing a liberal general incorporation law would have differed depending on whether or not the particular state was still passing special acts. In states where special charters were unconstitutional, the legislators' trade-off was a straightforward balancing of the expected political costs of

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<sup>301</sup>See Maloney, McCormick and Tollison, "Exporting Economic Regulation," for theoretical and empirical support for the proposition that legislators export the real costs of economic regulation in order to maintain electoral support. Also, see W. Mark Crain and Robert E. McCormick, "Regulators as an Interest Group," manuscript, VPI&SU (February 1981) for a model of regulator-legislator behavior in which the decision-maker's calculus involves a trading-off of electoral support for direct pecuniary gains from catering to the demands of interest groups.

<sup>302</sup>See Chapter II, supra., for a more thorough integration of the revenue-generating and interest-group models.

passing a controversial law versus the expected political benefits from exporting some of the burden of financing the state. The situation was more complicated, however, in states where the special charter was the norm. In those states, it is not clear whether the legislators would have expected a liberal general incorporation law to involve an increase in net political costs as the political costs of the still-controversial special charter would have been negated simultaneously with the passage of the liberal general law. On the benefit side, it is also not clear what the legislators would have expected the net effect to be. The legislators would have had to abandon their direct pecuniary benefits from passing special charters in exchange for the less direct expected benefits in the form of increased electoral support which would result from the new source of state revenues. The more opportunistic legislators, however, would have realized that the expected future benefits from special chartering would have to be very small in the framework of a national free market in corporate privileges where liberal corporate privileges would be available at much lower costs. In other words, the passage of a liberal law would not have involved the surrendering of a monopoly power of significant capitalized value. The legislators' trade-offs in special chartering states vis-a-vis strict general-law states appears to favor the passage general laws by special charter states because, although the expected benefits of passing the law would be approximately the same in both types of states, the net costs of

passing a liberal general incorporation law would have been much lower in the states that had continued passing special charters. That is, there are a priori reasons for expecting that the exogenous changes would have had a greater impact on legislators' decisions in special-chartering states.

The theoretical effects of the identified exogenous changes on the market for corporate privileges leads one to expect that the states most likely to pass a liberal general incorporation law were those with the combined attributes of smallness and the practice of granting special charters.<sup>303</sup> These predicted effects of the exogenous changes did in fact occur, as is shown below.

The First "Mother of Corporations" -- New Jersey

Throughout this study, New Jersey legislators have exhibited keen entrepreneurial instincts with regards to granting of special charters. The most outstanding example of this attribute was the selling of monopoly privileges to the Camden and Amboy which generated all of the states fiscal needs for several years prior to the Civil War.<sup>304</sup> Furthermore, the legislators had shown a special proclivity

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<sup>303</sup>One is reminded of Justice Fortas' famous, sarcastic remark in registering his objections to the Supreme Court's gerrymandering of a "relevant market" in an antitrust case: "This Court now approves this strange red-haired, bearded, one-eyed man-with-a-limp classification." United States v. Grinnell Corp., 384 U.S. 563 (1965), 591.

<sup>304</sup>See subsection IV A.3, *supra* for a discussion of New Jersey's selling of the field. Also, note that at least one writer has suggested that the property tax exemptions granted the Camden and Amboy caused the state considerable financial difficulties after the Civil War; see, Stoke.

towards the granting of special charters from the years 1857 to 1875 and they were less hesitant than other states to grant charters to firms operating outside their jurisdiction. The geographical location of New Jersey between New York City and Philadelphia presented many of the entrepreneurial opportunities. New Jersey in 1869 attempted to impose an income tax upon all firms chartered by her but the law was repealed in 1872 because of difficulties in collection and doubts about its constitutionality.<sup>305</sup> It is clear, therefore, that New Jersey was aware of the revenue generating aspects of corporate chartering:

It is also significant that almost from the beginning of business corporation history in their state, Jerseymen had foreseen the possibility of providing for the state's financial needs through the sale of corporate privileges. In this New Jersey may not have differed greatly from other jurisdictions, but it was unique in having for a time actually arrived at the happy situation in which the revenues derived from the corporations chartered by the state paid all the cost of the state government. As the state budget grew and the revenues derived from the railroad monopoly diminished, it was almost inevitable that New Jersey should turn once again to an old plan -- that of making its corporations the source of supply for the public purse. In looking back, it appears that the stage was finally and fully set in 1875 for the drama that was soon to make New Jersey nationally famous as the bountiful provider of generous charters of incorporation under "liberal" general laws.<sup>306</sup>

The stage was not set, however, by New Jersey's historical role in the granting of corporate privileges, but rather it was set by the exogenous changes that provided the institutional framework necessary for a national "free market" in corporate privileges. New Jersey's

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<sup>305</sup>Cadman, pp. 409-14.

<sup>306</sup>Ibid., p. 201.

history, coupled with the model of legislative behavior developed in the earlier part of this subsection, merely explains why she was the first state to take advantage of the entrepreneurial opportunities presented by the exogenous legal and economic changes.

Three governors of New Jersey, beginning in 1869, were adamant in their support of a system of general incorporation laws which would make special corporate charters unnecessary.<sup>307</sup> At first the legislators ignored the governors recommendations. In 1873, however, the legislators appointed a constitutional commission to propose changes in the constitution's provisions relating to method of incorporation. The commission reported the following year and proposed an absolute constitutional prohibition of all special corporate charters. Although the legislature continued to pass special laws during this period, it did submit the proposed amendment to the people for approval in 1875. Before the amendments were approved, the New Jersey legislature passed the nation's first modern general incorporation law.<sup>308</sup>

New Jersey's experience with the constitutional prohibition of special charters was different than the previous experiences of any other states in two important aspects. First, she was the first state in which the constitutional provision prohibiting special acts had been adopted as an amendment to an existing constitution. Prior to that

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<sup>307</sup>See Cadman, pp. 155-60 and 196-200, and Keasby, pp. 205-7, for a discussion of the events leading to the 1875 changes in the New Jersey law.

<sup>308</sup>Keasby, p. 205.

time, all other constitutional prohibitions had been included in the complete revision of state constitutions or the adoption of a state's first constitution.<sup>309</sup> The significance of this fact is that the New Jersey prohibition was the result of an amending process in which the legislators played a significant role in the instigation of the change, whereas it is presumed that in the other states the legislators would have had less control over a general constitutional convention. That is, the New Jersey legislature's relinquishment of its monopoly power over the granting of special charters appears to have been of a more voluntary nature than the earlier prohibitions of special charters. Second, the prohibition of special charters and accompanying mandate for a general incorporation law did not include many of the restrictions on the terms of the charters granted under general laws: "...the legislature of New Jersey was at an advantage as compared with the legislatures of many states, for it was permitted an almost free hand in deciding on the terms of charters to be granted under general laws."<sup>310</sup> This aspect of the New Jersey constitution was undoubtedly related to the legislature's role in the amendment process and might be construed as a manifestation of a desire to enter the national market for corporate privileges with a comparative advantage over her constitutionally-constrained competitors.

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<sup>309</sup>George H. Evans, Business Incorporations in the United States, 1800-1943 (New York: National Bureau of Economic Research, Inc., 1948): 11.

<sup>310</sup>Cadman, p. 200.

The New Jersey general incorporation act of 1875 was at the time of passage by far the broadest and most enabling general law ever passed. The procedure for incorporating under the law was very simple -- clearly the dominant ancestor of modern incorporation procedure. There were no requirements of notice and the granting of the charter was not subject to any judicial or administrative judgments. The act authorized the directors to issue stocks in exchange for property -- an authorization previously limited to the most liberal special charters. The corporations were required to keep books available for inspection by the shareholders, but there were no publicity requirements for corporations since there were no such requirements for partnerships and sole proprietorships. The incorporators were free to adopt whatever by-laws they felt were suitable for the internal regulation of the corporation. Additionally, debt limitations were removed, directors' liability provisions were liberalized, and no limit was placed on the amount of the capital stock.<sup>311</sup> Another important provision allowed corporations to be formed without regard to the residency of the incorporators or the corporation's primary place of business. In conjunction with these provisions the

.....act declared that, if the by-laws should so provide, the directors of any company might hold their meetings, have an office and keep the books, except the stock and transfer books, outside the state, on condition, however, that they should always maintain a principal office within the state and have an agent in charge thereof;...<sup>312</sup>

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<sup>311</sup>See Keasby, pp. 205-6.

<sup>312</sup>Ibid., p. 206.

In general, the New Jersey Act of 1875 reflected a philosophy that was not yet generally accepted:

...The purpose was to treat the property and business of corporations in the same way as that of natural persons, and the only restrictions imposed were such as were thought necessary for the protection of stockholders and creditors. Corporations were not considered as being hostile in any way to public interests, and the regulations were intended for the protection of the person interested in the companies rather than of the public.<sup>313</sup>

Because of this philosophy, the 1875 act provided that the tax status of corporations would be the same as that of individuals. However, within a few years the legislators imposed filing fees and annual franchise taxes on corporations formed under the 1875 act. These rates were low and the tax base was the amount of capital stock. The use of the capital stock as the tax base was particularly attractive to foreign incorporators in that it was certain and left nothing to the discretion of tax assessors.<sup>314</sup>

New Jersey's early entry did not prevent the entry of competitors into the national market for corporate privileges. In the 1880's, she was faced with active competition from Maine and West Virginia. Of these, West Virginia was the most successful in challenging New Jersey's

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<sup>313</sup>Ibid., pp. 206-7.

<sup>314</sup>Ibid. The same point was stressed in testimony before the U.S. Industrial Commission in 1899, see, e.g., U.S. Industrial Commission, Preliminary Report on Trusts and Combinations (Washington: U.S. Government Printing Office, 1900), V. I, Part II, pp. 971, 975, 996, 1035-7, 1081, 1986.

preeminence, but its potential was limited by two major defects from the point of view of promoters. The first of these was a limitation on capitalization to \$5,000,000 -- a relatively small amount which undoubtedly made West Virginia unacceptable to most large companies. Also, the corporation laws did not provide for the maintaining of any records or agents in West Virginia and this resulted in "roving" or "tramp" corporations over which even the state of incorporation could not guarantee jurisdiction. Obviously, this created opportunities for fraud and would have increased the difficulty of marketing the corporations' stocks and bonds.<sup>315</sup> In spite of these defects, West Virginia was the second most popular state of incorporation because her taxes and fees on foreign corporations were extremely low. These factors combined to make West Virginia a "snug harbor for roaming and piratical corporations" -- "the tramp and bubble companies of the country" -- and "the Mecca of irresponsible corporations."<sup>316</sup>

In 1876, Maine, like New Jersey, adopted an amendment to her constitution prohibiting the granting of special charters. The resulting general incorporation law was fairly liberal in its terms

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<sup>315</sup>Ibid., pp. 1077-9, 1111, 1119, and 1125. Also, see Russel C. Larcom, The Delaware Corporation (Baltimore: Johns Hopkins Press, 1937): 14-5. These adverse effects of an extremely lax corporation law provide additional support for Baysinger's thesis that the most efficient jurisdiction for incorporation is not necessarily the jurisdiction with the most permissive laws. See Barry D. Baysinger, "A Theory of Jurisdictional Choice."

<sup>316</sup>William A. Cook, A Treatise on Stock and Stockholders, Bonds, Mortgages and General Corporation Law, 3rd edition (1894): II, 1603-5, in Friedman, p. 458.

except for a relatively low maximum capitalization of \$500,000.<sup>317</sup> In 1883, in an effort to become more competitive, Maine increased the amount to \$2,000,000.<sup>318</sup> A decision by the state Supreme Court in 1890 holding stockholders liable on stock issued for property where the court found the property was not worth the par value of the stock, however, rendered the state a dangerous place to incorporate.<sup>319</sup> Although she increased her capitalization limit to \$10,000,000 in 1891 and removed it altogether in 1901,<sup>320</sup> Maine was not successful in regaining her competitiveness.

New Jersey, in spite of her position as the favorite state of incorporation, did not receive a substantial portion of her revenues from foreign corporation fees until she embarked on a second liberalization program in 1888.<sup>321</sup> The first step in this program was the amendment of the New Jersey constitution to allow corporations to hold and dispose of the stock of other corporations -- that is, to

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<sup>317</sup>The New Jersey law of 1875 contained no limitation on maximum capitalization.

<sup>318</sup>Dodd, American Business Corporations, p. 428.

<sup>319</sup>The case is Libby v. Tobey, 82 Me. 397, 19 A. 904 (!890), cited and discussed in Larcon, pp. 14-5.

<sup>320</sup>Dodd, American Business Corporations, p. 428.

<sup>321</sup>For discussion of this movement, see Stoke, pp. 570-2; Keasby, pp. 207-9; and Robert Hessen, In Defense of the Corporation (Stanford: Hoover Institution Press, 1979): 68-71. Ralph Nader's account of how New Jersey came to liberalize its corporation law -- primarily through bribery and corruption -- in the late 1880's (see Ralph Nader, Mark Green, and Joel Seligman, Taming The Giant Corporation (New York: W.W. Norton Co., 1976): 43-4) has been thoroughly discredited by Hessen.

legalize holding companies or the "trust organization".<sup>322</sup> The following year, James B. Dill, a young corporation lawyer from New York who clearly had his own interest at heart, and Leon Abbett, a former governor of New Jersey lobbied the New Jersey legislature to amend the 1875 corporation law to clarify and elaborate the 1888 amendment.

Under the plan, New Jersey would benefit from a substantial increase in revenues, and Dill and his associates would benefit from the profits of the Corporation Trust Company of New Jersey -- a company organized by Dill to advertise the advantages of incorporating in New Jersey and to act as agents and handle the incorporation formalities for out-of-state incorporators.<sup>323</sup> Dill's recommendations were adopted in 1889,<sup>324</sup> and in 1894 it was estimated that almost all of New Jersey's state budget was funded by fees and taxes on firms incorporated in New Jersey but primarily conducting business in New York.<sup>325</sup>

Thus, the entrepreneurial efforts of a lawyer and a receptive legislature led to New Jersey's early dominance in the national market for corporate privileges.

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<sup>322</sup>James Bonbright and Gardner Means, The Holding Company (New York: McGraw Hill Book Company, 1932): 57; Henry R. Seager and Charles A. Gidlick, Jr., Trust and Corporation Problems (New York: Harper and Bros., 1929): 361-2; and Archibald H. Stockder, Business Ownership Organization (New York: Henry Holt & Co., 1922): 203.

<sup>323</sup>See the testimony of Howard K. Wood, Assistant Secretary of the Corporation Trust Company of New Jersey, U.S. Industrial Commission. Report, 1900, V. I, Part II, pp. 1089-94, for a description of the subsequent activities and services performed by Dill's company.

<sup>324</sup>New Jersey Laws of 1889, Chapter 265.

<sup>325</sup>Cook on Stock and Stockholders (3rd ed.), Vol. II, pp. 1604-1605, cited in *Liggett Co. v. Lee*, 288 U.S. 517 (1932), 557.

It will be shown in Chapter V that the competition between states for the revenues generated by foreign incorporators which was made possible by the development of a national economy and the decision in Paul v. Virginia and initiated by New Jersey has continued into the 1980's. The effects of this interstate incorporation competition on substantive corporation law has generated considerable controversy. The important inquiry at this juncture, however, is the effects of the interstate incorporation competition on the legislative market for special corporate charters.

5. Interstate Incorporation Competition and its Effects on the Legislative Market for Special Corporate Charters

The continued popularity of the special corporate charter under the dual system of incorporation was, it will be recalled,<sup>236</sup> the ability of the special charters to confer more liberal corporate privileges than were available under the strict general incorporation laws which were prevalent until New Jersey passed the first modern general incorporation law in 1875. The passage of liberal general incorporation laws and the development of the national market for corporate privileges provided a relatively inexpensive substitute for the special charter in the states that had strict general laws under the dual system of incorporation -- namely, the option of incorporation under a liberal statute in another jurisdiction. The following quotation not only illustrates the use of foreign incorporation as a

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<sup>326</sup>See subsection IV B.3, supra.

means of avoiding restrictive local incorporation laws, it also emphasizes the importance of the identified exogenous changes -- the emergence of the national economy and the constitutional protections of Paul v. Virginia -- on the market for corporate privileges in the late nineteenth century:

Big business spilled over state lines. It was only natural that multistate business should be concerned with federal law; and should resist the idea that every state in which it operated could regulate it -- particularly, if no single guiding hand co-ordinated all this regulation. And, true enough, each state created its own corporate jurisprudence. Economically, the lines between states were almost meaningless. Nothing separated one jurisdiction from its neighbors except a cornfield, a bridge, a short ride on a ferry, an invisible line. A corporation could be chartered in one state, and do business in another. This was both a danger and an opportunity for the interstate corporation. The opportunity consisted of playing one state off against another; or migrating, like divorce-hunting wives to the laxest of states. For this reason, it made little difference to the giants that some states had strict corporation laws. In Massachusetts, for example, there were not supposed to be any "mechanical, mining, and manufacturing" corporations with large capitalization; the limit was \$500,000 until 1871, \$1,000,000 until 1899. (In New York, too, there was a limit on capitalization: \$2,000,000 until 1881, \$5,000,000 until 1890.) Massachusetts law also made no provision for the issue of different classes of stock. Any change in the nature of the corporation's business had to be unanimously approved by the stockholders. Massachusetts directors had no power to increase the stock without stockholder permission; any new stock had to be offered to old stockholders, at par. These statutes "plainly envisaged" the corporation as an enterprise of limited scope "simple in its capital structure," and incapable of "changing its general character" against the opposition of a single shareholder.

For the big corporation, Massachusetts law was plainly out of date; so too were the laws of other stringent states. But the laws were ineffective; they were victims of the national free market in laws. There were states with more hospitable laws. And the easy states no doubt helped sustain the hard states in their resolve. This was a moral division

of labor quite similar to the evolving case of divorce law. Massachusetts might keep its attitude of rectitude, without actually interfering with interstate business. Business simply went elsewhere to be chartered. This company then would do business as a "foreign corporation," in Massachusetts. The federal constitution protected it against the worst forms of discrimination.<sup>327</sup>

Apparently, foreign incorporation was resorted to for the same reasons special charters were utilized only a decade earlier.

In the perspective of this dissertation, the most important effect of the interstate incorporation competition spurred by the decision in Paul v. Virginia was the drastic reduction in the legislators' rates of return from the passage of liberal corporate charters because the firms demanding liberal corporate privileges had access to liberal general incorporation laws as inexpensive substitutes for the special charters. In other words, the availability of a relatively inexpensive substitute through foreign general incorporation laws greatly reduced the demand for special charters in all jurisdictions. The development of interstate incorporation competition evidently shifted the legislators marginal tradeoff between the passage of special charters or the production of other forms of special-interest legislation in favor of abandoning altogether the production of special charters.

The most convincing evidence of the effect Paul v. Virginia on the legislative market for corporate privileges and the marketability of special charters is the experience of the New England states after

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<sup>327</sup>Friedman, pp. 456-7 (the latter emphasis is Friedman's).

1875. In spite of the facts that the economies of these states were thoroughly integrated and general incorporation laws were available in all but Rhode Island, special charters accounted for approximately one-third of the mining and manufacturing incorporations in New England in the decade before 1875.<sup>328</sup> The Paul decision coupled with New Jersey's quest for revenues drastically altered the market for corporate privileges in New England. Although Maine had altered her constitution in 1876 to prohibit the creation of corporations by special act and had enacted a relatively liberal general incorporation law in 1876, her competitiveness was hampered by a low capitalization limitation of \$500,000. Maine increased her capitalization to \$2,000,000 in 1883 an effort to compete with New Jersey,<sup>329</sup> but by that time the special charter had lost significance in New England. Kessler conducted an extensive study of incorporation by special act in New England<sup>330</sup> and chose to conclude his study in 1875 because:

...[a]nother decade was to pass before general incorporation dominated the scene...the appearance of general incorporation and of corporation chiefly for out-of-state operations, the

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<sup>328</sup>Kessler, "Incorporation in New England," p. 47.

<sup>329</sup>Dodd, American Business Corporations, p. 428. It will be recalled from section IV C.4, supra, that Maine enjoyed considerable success in the interstate incorporation competition until she was knocked out by a dangerous court decision in 1890. Also, it should be noted that Maine fulfills the small state classification suggested by the model of legislative behavior.

<sup>330</sup>Kessler, "Incorporation in New England: A Statistical Study, 1800-1875."

stage was set for the next important event in the relations of the state to the private corporation; interstate rivalry for the lucrative charter business.<sup>331</sup>

The demise of the special charter in New England in the decade beginning with 1875 is even more impressive from the point of view of this dissertation when it is realized that Maine was the only New England state in the nineteenth century to adopt a constitutional prohibition of special acts of incorporation.<sup>332</sup> Massachusetts, for example, which has been singled out for her particularly strict general incorporation law and low capitalization limitation throughout the latter part of the nineteenth century,<sup>333</sup> abandoned the practice of granting special charters shortly after 1875 without being forced to do so by constitutional authority. Evidently, the legislators in Massachusetts and the other New England states halted the production of special charters because the market for them had been undermined by an inexpensive and, in many instances, superior alternative product.

It will be recalled that prior to 1875 several states had adopted general incorporation laws in response to qualified constitutional prohibitions of special charters.<sup>334</sup> However, even with constitutional

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<sup>331</sup>Ibid., p. 62.

<sup>332</sup>Evans, p. 11. Vermont enacted a constitution requiring general incorporation laws in 1913. Connecticut, Massachusetts, New Hampshire, and Rhode Island do not have constitutional provisions mandating general incorporation laws.

<sup>333</sup>See the lengthy quote from Friedman in the opening paragraph of this subsection.

<sup>334</sup>See subsection IV B.2, supra.

authority leaning strongly against special charters, the legislators of those states were unable to resist the pressures to continue to incorporate by special charter prior to 1875. For example, two of these states, Wisconsin and Illinois, abandoned their constitutionally-mandated dual incorporation systems in favor of an absolute constitutional prohibition of special charters because of the legislators' practice of granting special charters continued even after the privileges were available under general laws.<sup>335</sup> New York, which had adopted the first qualified constitutional prohibition of special charters in 1846,<sup>336</sup> found that the pressure for special charters was still so strong in 1872 that the governor declared in his annual message: "There should be more specific constitutional restraints upon legislative power to grant special charters for private corporations..."<sup>337</sup> However, additional constitutional restraints on the legislators' behavior was not necessary as evidenced by the fact that they stopped granting special charters shortly after 1875.<sup>338</sup> Evidently, the restraint on the legislators' behavior that ended their practice of granting special charters was the exportation of corporate privileges by New Jersey into the New York legislative market for

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<sup>335</sup>See subsection IV C.1, supra.

<sup>336</sup>See subsection IV B.2, supra.

<sup>337</sup>State of New York, Messages from the Governor, IV, 402, quoted in Cadman, p. 173.

<sup>338</sup>Cadman, p. 175.

corporate privileges. The complete removal of barriers to entry by the decision in Paul v. Virginia, coupled with the enterprising behavior of New York's neighbor, New Jersey, was much more effective in limiting the New York legislators' discretion with respect to the granting of special charters than was the 1846 qualified constitutional prohibition of special charters.

Thus, it appears that the first casualty of the development of jurisdictional competition for revenues in the market for corporate privileges was the special corporate charter. As clearly illustrated by the situation in Delaware in the last quarter of the nineteenth century,<sup>339</sup> however, this interpretation should not be taken to suggest that states lost complete control of the incorporation process within their jurisdictions. The states' spatial monopolies were still important to many corporations which could not justify the added transactions costs of securing a more flexible law from another jurisdiction: "...the burden of strict statutes fell only on those small corporations which could not afford to escape to some faraway haven."<sup>340</sup> Many of these corporations would have been similar to those which chose to incorporate under the general incorporation laws when the dual system was functioning. Today, many firms still incorporate in their home state in spite of the availability of more liberal general incorporation laws in other jurisdictions.

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<sup>339</sup>See subsection IV C.6, *infra*.

<sup>340</sup>Friedman, p. 457.

## 6. The Delaware Corporation

The evolution of Delaware incorporation law<sup>341</sup> occupies a somewhat anomalous position with respect to the thesis of this dissertation. This is so because Delaware, which did not even pass a general incorporation law until 1875, continued to pass special charters until they were prohibited by the constitution of 1897. Surprisingly, the dual system of incorporation in Delaware continued after the development of the national market for corporate privileges for the many of the same reasons that the dual system existed in other states prior to, but not after, the development of jurisdictional competition in the market for corporate privileges -- namely, the desire to receive more liberal terms than were available under the state's general laws.<sup>342</sup> Since the liberal privileges were available through incorporation in New Jersey, an examination of why the Delaware special charter remained popular -- or alternatively, why the Delaware legislators were willing to grant special charters after the rates of return from their passage had been depleted by developments in New Jersey -- is warranted.

Delaware's first comprehensive general incorporation law was passed in 1875, and repealed and replaced by another general law in 1883. The terms of the charters granted under these statutes, while not as restrictive as some states, were far from the liberality of the

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<sup>341</sup>See Russel Larcom, The Delaware Corporation (Baltimore: Johns Hopkins Press, 1937) and S. Samuel Arsht, "A History of Delaware Corporation Law," Delaware Journal of Corporate Law, I: 1 - 32, for thorough treatments of the evolution of Delaware incorporation law.

<sup>342</sup>See subsection IV B.3, supra.

New Jersey law of 1875. The onerous aspect of these laws was the method of incorporating under them:

The procedure for incorporating under the foregoing general laws was both cumbersome and time-consuming. In order to incorporate under the 1875 Act it was necessary to submit a certificate of incorporation, signed by not less than three persons, two-thirds of whom were required to be citizens of the State of Delaware, to an associate judge of the Superior Court in the county in which the corporation intended to be situated or have its principal business transacted. The application could only be submitted during a vacation of the Court and was required to be preceded by a newspaper notice, published at least thirty days before the application was submitted indicating the incorporator's intent to so apply. The associate judge, upon receipt of the proposed certificate of incorporation, was required to examine it and if the objects, articles, and conditions therein set forth appeared to the judge to be lawful and not injurious to the community, the judge was required to direct that the certificate be filed in the records of the Superior Court and to order the Prothonotary to publish in a newspaper of the county in which the judge was sitting, for at least three weeks, a notice setting forth that an application had been made to said judge to grant the certificate of incorporation. If no sufficient reason was shown to the contrary, the judge was then permitted, at the ensuing term of the court, to declare and decree the existence of the corporation and direct that the certificate, with the judge's endorsement thereon, be delivered to and filed in the office of the Secretary of State, and a copy of the same, furnished and certified by the Secretary, be recorded in the Recorder's office of the county in which the application was made. Only upon such recording did corporate existence commence.

The 1883 Act did little to simplify this process, although it did make it somewhat more rapid. For example, the statute no longer required that the application for a certificate of incorporation be presented to an associate judge of the Superior Court during a vacation of the Court, that the judge order a publication of the fact that the application had been made, or that he wait until the next term of Court to approve a charter. Nevertheless, review by the associate judge was still required and the effective date for a charter continued to be governed by the date it was recorded.<sup>343</sup>

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<sup>343</sup>Arsht, pp. 4-5.

Thus, the procedure for incorporation under the general law does not appear to have been much of an improvement from the incorporator's perspective over the special act procedure, which promised to yield more liberal corporate privileges.

Another procedural development that would have biased Delaware incorporators in favor of special chartering vis-à-vis incorporating under the Delaware general law was the fact that the special chartering procedure of incorporation had been taken over by incorporating agencies (permanent, professional lobbyists) whose primary service was to secure the necessary votes in the legislature for their clients.<sup>344</sup> These incorporating agencies undoubtedly lowered the transactions costs of securing a special charter, and it seems equally plausible that these agencies also used their purchasing power to lower the overall expenditures on rent-seeking. Furthermore, at about the same time, similar agencies for incorporating under New Jersey laws were developing throughout the country,<sup>345</sup> and this competitive phenomenon undoubtedly reduced the value of the rents that could be created and captured by the Delaware legislators. Thus, the key to explaining the continued passage of special charters might be found in the similarity of the methods of incorporating under the New Jersey general incorporation law and through special chartering in Delaware -- namely,

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<sup>344</sup>Ibid., p. 5.

<sup>345</sup>The most successful, but not the first, of these was James Dill's Corporation Trust Company of New Jersey which was organized in 1889 to organize "trusts" in New Jersey. See subsection IV C.5, supra.

in each instance the least cost method of incorporation involved hiring the services of an incorporating agency. Because of the interstate competition and the activities of the intermediaries, the total costs in Delaware of securing a liberal special charter from the Delaware legislature versus securing a liberal charter under New Jersey's general law would have been driven towards approximately the same levels. The Delaware legislators were evidently satisfied with the small return they received from the granting of special charters, perhaps the legislators' perceived opportunity costs were lower than the opportunity costs of legislators in larger states.<sup>346</sup>

The special corporate charters were still desirable after 1875 because they could be customized and drafted in such a manner as to remove all ambiguities as to the powers and privileges conferred on the corporation. Although this desirable feature dissipated after a few legal battles and judicial interpretations had increased the certainty as to the meaning of the general statute, the following excerpt indicates that the uncertainty as to the meaning of a provision of the New Jersey Holding Company Act of 1889 shortly after it was adopted was

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<sup>346</sup>This appears to be inconsistent with the model of legislative behavior developed in subsection IV C.4, *supra*, where it was suggested that the smaller states were most likely to pass liberal general incorporation laws because of the higher relative importance of the revenues they would generate. Alternatively, however, legislators in smaller/poorer states may have been satisfied with lower returns than their counterparts in larger/wealthier states because of the lower value (determined by rent seekers) placed on devoting their time to redistributing wealth in their relatively poorer state. That is, the opportunity cost of foregoing the production of alternative forms of special-interest legislation in favor of special charters would have been relatively lower in the poorer states, ceteris paribus.

the primary reason one promoter sought a special charter from the Delaware legislature:

....Although the powers necessary for corporate combination had been made available in New Jersey a year earlier by an amendment to the general corporation law conferring upon corporations the power to own and hold stocks of other corporations, Addicks - a promoter in the legislature - preferred a special charter from the Delaware legislature. The New Jersey statute was ambiguous in that it might be construed to limit the power of purchase to the stocks of other New Jersey companies. With his influence in the Delaware legislature Addicks no doubt believed he could procure the exact powers he desired for his proposed company.<sup>347</sup>

The availability of extremely liberal charters from other jurisdictions made this practice the exception, rather than the rule.

The continuing practice of granting special charters in Delaware after 1875 was subjected to the same criticisms as had been raised earlier against special chartering in other states.<sup>348</sup> The Delaware Constitutional Convention of 1897 responded to these criticisms and adopted an absolute constitutional prohibition of incorporation by special act.<sup>349</sup> Although this dissertation is limited to the history of special chartering, further examination of the evolution of Delaware incorporation procedure is warranted because of the fact that Delaware has come to dominate the national market for corporate privileges.

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<sup>347</sup>Larcom, p. 6.

<sup>348</sup>See subsections IV A.6, IV B.2, and IV B.4, supra. See Larcom, pp. 5-7 for the attack on the special-chartering system in Delaware.

<sup>349</sup>Delaware Constitution, 1877, Article IX, Section 1.

Unlike New Jersey, however, the Delaware Constitution does not appear to have been changed with a view towards becoming an aggressive competitor in the national market for corporate privileges. This statement is supported by the fact that the Delaware legislators made no efforts in 1897 to improve and update the onerous 1883 general incorporation law, and in 1898 the legislature came extremely close to passing as new general incorporation law which was also obsolete.<sup>350</sup>

Due primarily to the efforts of entrepreneurs cast in the mold of James Dill in New Jersey in 1889,<sup>351</sup> however, the Delaware legislature was convinced of the revenue-raising possibilities of a liberal general incorporation law:

During the interval between the session of 1898 and the regular session of 1899, the present competitive incorporation policy of Delaware was formulated. By 1899 the number of "trusts" being formed was rapidly increasing and a small group of individuals perceived the possibilities of large revenues if a share of this incorporating business could be attracted to Delaware. James L. Wolcott states in his "The Development of the Delaware Corporation Law" that this group consisted of a financial editor of a New York paper, a New York lawyer, and two Dover lawyers. According to Mr. Wolcott's account, the Dover lawyers planned to organize a corporation, modelled upon similar organizations operating in New Jersey, to engage in the business of incorporating companies and representing them as resident agents. The New York members, because of their Wall Street connections, believed they could obtain business for the proposed company. These men drew up a bill for a corporation law which the Dover residents of the "unofficial committee" piloted through the legislature. In the House, where the Bill of 1898 had failed to pass, the Act of 1899 was passed without a dissenting vote.<sup>352</sup>

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<sup>350</sup>Larcom, pp. 9-10.

<sup>351</sup>See subsection IV C.4, supra.

<sup>352</sup>Larcom, p. 9; Arsht, pp. 6-7, makes the same points and says of the "unofficial committee,": "their efforts were not altogether altruistic."

Also, during the interval, the press was attacking the legislature's policy of not passing a liberal corporation act with the result that "thousands of dollars were being lost when the state treasury was in need of funds."<sup>353</sup>

Since it was the desire of the Delaware legislators to become competitive in the market for corporate privileges, the drafters of the Delaware Corporation Act of 1899 looked to the laws of New Jersey, the most popular state of incorporation at that time, as the source of the principal features of the Delaware law. In fact, several clauses of New Jersey law were copied, almost word for word, in the Delaware statute.<sup>354</sup> The competitive position of Delaware was also improved by a decision of the Court of Chancery of Delaware in 1900. In Wilmington City Ry. Co. v. People's Ry. Co.,<sup>355</sup> the court reasoned that the legislature, in adopting the language of the New Jersey statute, had intended that the courts of Delaware adopt the New Jersey courts' construction of the statute. The effect of this interpretation was to confer a level of certainty on a new statute that would normally take years of litigation to develop. This was extremely important because the greater the certainty of the law, the lower the likelihood of

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<sup>353</sup>Daily Republican, Wilmington, February 11, 1899, quoted in Larcom, pp. 9-10.

<sup>354</sup>Stockder, pp. 162-3; and Larcom, pp. 29-30.

<sup>355</sup>Wilmington City Ry. Co. v. People's Ry. Co., 47 A. 245 (Del. Ch., 1900), cited in Larcom, pp. 25-6.

becoming engaged in costly litigation.<sup>356</sup> Thus, by adopting New Jersey's judicial precedents, the expected costs of organizing and operating under the new Delaware law were brought into line with the expected costs under the older New Jersey statute. Even today, the preeminence of Delaware, in spite of the fact that several states have statutes at least as liberal as Delaware's, is attributed to Delaware's well-developed body of judicial decisions on the meaning of virtually every point that might be the subject of litigation.<sup>357</sup>

Delaware, nevertheless, was not immediately successful in attracting large numbers of corporations even though she had lower taxes than New Jersey. Apparently, in order to capture the market for corporate privileges, a state must do more than just meet the terms of the corporation laws of the leading states and undercut their taxes. In other words, a new competitor must make a fairly major change in its laws in order to induce existing corporations to change their state of incorporation. However, Delaware managed to capture the market without further altering her 1899 law because Governor Woodrow Wilson took New Jersey out of competition in 1913 when he engineered the passage of the "Seven Sisters Acts" -- antitrust measures which severely restricted

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<sup>356</sup>For an economic analysis of the effects of uncertainty on the decision to litigate or settle, see John P. Gould, "The Economics of Legal Conflicts," Journal of Legal Studies, 2 (June, 1973): 279-300.

<sup>357</sup>See Hugh L. Sowards, Corporation Law Cases and Materials (New York: Matthew Bender, 1974), p. 2-10. The same point is also made by Hessen, p. 74.

permissible corporate activities.<sup>358</sup> "Corporations flocked to Delaware, and the phrase 'Delaware corporation' passed into the bloodstream of the English language."<sup>359</sup> The "Seven Sisters Acts" were repealed in 1917, but New Jersey had lost her advantage -- just as firms saw no reason to shift from New Jersey to Delaware when Delaware entered the race, corporate officials saw no reason to switch back to New Jersey in 1917.<sup>360</sup> Today Delaware is undeniably the leader in the marketing of corporate privileges.

#### D. Summary and Conclusion

In summary, the decline and fall of the special charters has been explained as the direct result of two changes beyond the control of state legislatures: the growth of interstate commerce and the decision in Paul v. Virginia. The growth of interstate commerce at the middle of the nineteenth century eroded spatial monopolies and helped create and strengthen competition for all goods and services. Analogously,

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<sup>358</sup>Henn, p. 20. Since the beginning of the national market for corporate privileges, it had been clear that state action could not be effective in providing a responsible corporate statute. In discussing the late nineteenth century differences between state incorporation laws, Friedman said, "...This was a moral division of labor, quite similar to the evolving case of divorce law. Massachusetts might keep its attitude of rectitude, without actually interfering with interstate business. Business simply went elsewhere to be chartered..." Friedman, p. 457. Thus, it appears that Woodrow Wilson -- the great reformer -- had a larger impact on New Jersey's main source of revenue than on corporate practices within New Jersey. For an analysis that provides a philosophical base for the contrasting development in state corporation law on the one hand and federal securities law on the other, see J. Willard Hurst, The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970 (Charlottesville: University of Virginia Press, 1970).

<sup>359</sup>Friedman, p. 458.

<sup>360</sup>Hessen, p. 73.

the spatial monopolies of state legislatures with respect to the production of corporate charters within their jurisdictions were also eroded, but not at a very rapid rate until 1869 when the Paul decision opened up a national free market in incorporation laws. The passage of liberal general incorporation laws by small states eager to capture the revenues from fees and taxes destroyed the legislatures' spatial monopolies and greatly reduced the value of the special charter as a marketable piece of special-interest legislation. As a result, legislatures stopped producing special charters and all states enacted general incorporation laws (some more liberal than others). Thus, the availability of the corporate form in the United States had completed its evolution from a special privilege to a right.

The evidence presented in this chapter supports the thesis that legislators abandoned the market for special charters because events beyond their control made it difficult or impossible for them to continue to create and capture rents through the passage of special charters. Of the alternative explanations for the emergence of general incorporation laws, the revenue-generating model was found to be complementary to the thesis in that it helped explain which particular states were most likely to be the first to abandon the special charter in favor of the revenues from general incorporation laws. Finally, the saving-of-legislative time thesis, while not providing a satisfying explanation for the legislators' voluntary relinquishment of their strict control over incorporation procedures, appears to help explain the adoption of constitutional limitations on the legislatures' control of the allocation of corporate privileges.

## CHAPTER V

### IMPLICATIONS AND CONCLUDING COMMENTS

The historical evidence presented in this dissertation supports the thesis that legislators in both the United States and Great Britain abandoned the legislative market for special corporate charters because events beyond their control made it difficult or impossible for them to continue to create and capture rents through the passage of special acts of incorporation. The importance of understanding this historical episode is magnified by its suggestion of implications of current proposals for changes in incorporation laws and by its ability to explain an historical development that has perplexed a pair of distinguished legal historians.

The 1970's witnessed a series of calls by legal commentators<sup>1</sup> and consumer advocates<sup>2</sup> for federal chartering legislation to replace the current system of state corporation laws. These critics, who appear to have been influenced by the Berle and Means notion of separation of ownership and control,<sup>3</sup> fear that competition among the states for the lucrative charter business has allowed corporate managers too much

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<sup>1</sup>See, e.g., William L. Cary, "Federalism and Corporate Law: Reflections upon Delaware," Yale Law Journal, 83 (March, 1974): 663-705; Donald E. Schwartz, "Federal Chartering of Corporations: An Introduction," Georgetown Law Journal, 61 (October, 1972): 71-88; and Donald E. Schwartz, "A Case for Federal Chartering of Corporations," Business Lawyer, 31 (February, 1976): 1125-1159.

<sup>2</sup>See, e.g., Ralph Nader, Mark Green, and Joel Seligman, Taming the Giant Corporation (New York: Norton, 1976).

<sup>3</sup>Adolph A. Berle and Gardiner C. Means, The Modern Corporation and Private Property, revised edition (New York: Harcourt Brace Jovanovich, 1968).

freedom from shareholder or public controls and that this development enables managers to exploit shareholders.<sup>4</sup> Frustrated at the success of Delaware in the infamous "race for the bottom," and cognizant of the fact that individual state action cannot be effective in providing a "responsible" corporation statute,<sup>5</sup> these critics claim that a national incorporation law is the only feasible way to correct what they perceive to be the failure of our traditional system of state incorporation laws.

The critics, however, have not gone unanswered -- in fact, they have spurred a large amount of economic, legal, and historical scholarship in the field of corporate theory.<sup>6</sup> On the popular front, Hessen<sup>7</sup> has explored the historical foundations of the corporate form to demonstrate that the corporation itself does not represent a grant from the government or a special privilege that itself justifies political interference with an essentially private activity -- that is, he provides support for the thesis that the corporation is the product

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<sup>4</sup>It is unfortunate that these critics did not recognize the market for corporate control as an effective substitute for direct shareholding voting in constraining the behavior of managers. See, Henry G. Manne, "Our Two Corporation Systems: Law and Economics," Virginia Law Review, 53 (March, 1967): 259-84.

<sup>5</sup>Recall Governor Woodrow Wilson's disastrous attempt at reform in New Jersey in 1913; see subsection IV.C.8, supra.

<sup>6</sup>See M. Bruce Johnson, ed., The Attack on Corporate America: The Corporate Issues Sourcebook (New York: McGraw-Hill Book Company, 1978) for a wide-ranging response to the critics.

<sup>7</sup>Robert Hessen, In Defense of the Corporation (Stanford: Hoover Institution Press, 1979). The book includes a scathing attack on Nader's scholarship.

of purely private contracts and market forces and that general incorporation laws are merely enabling. The important implication of this is that it demonstrates that regulation by federal incorporation law would be an interference with private property rights.

Additionally, Hessen theorized that the Delaware corporation law, contrary to the critics of the "race for the bottom," was the most popular law because the competitive process had fostered a desirable set of substantive laws and clear legal precedents resulting in an enormous economic benefit for shareholders of Delaware corporations. Two recent empirical studies by economists<sup>8</sup> have provided overwhelming support for Hessen's thesis by studying how the stock market responded to Delaware incorporations. Although utilizing different theoretical approaches, both studies demonstrate clearly that management's decision to reincorporate in Delaware does not reduce, and may even increase, stockholders' wealth. That is, the studies refute the contention of the proponents of federal chartering legislation that the existing competition among states for corporate charters enables management to exploit shareholders.

The most obvious implication of this dissertation with respect to proposed federal chartering legislation relates to the return to monopoly control in the market for corporate privileges. Prior to the exogenous changes that led to interstate incorporation competition,

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<sup>8</sup>Barry D. Baysinger, "A Theory of the Efficiency of Jurisdictional Choice: The Case of Corporate Federalism," unpublished Ph.D. dissertation, VPI&SU (1978); and Peter Dodd and Richard Leftwich, "The Market for Corporate Charters: Unhealthy Competition versus Federal Regulation," Journal of Business, 53 (1980): 259-83.

state legislatures had monopoly control over the use of corporate privileges within their jurisdictions. A direct result of this monopoly control was the granting of special privileges via the special corporate charter to a favored few at the expense of the public. Times have changed, but businesses still demand, and all levels of government still supply, regulation, monopoly, and special privileges. Federal chartering with special charter provisions and regulations would represent a return to monopoly in the market for corporate privileges, and this dissertation suggests that it could lead to the same types of abuses that occurred prior to the demise of special chartering at the state level. Certainly, there is no reason to believe that the federal government, as sole providers of corporate privileges, would be immune to the pressures that influenced state legislators in the nineteenth century. In fact, the historical record suggests the federal government could be an extremely effective cartelizing agent. For example, producers came close to cartelizing some 300 industries under Roosevelt's NIRA before the act was invalidated as an unconstitutional delegation of legislative power. Also, although the railroad's involvement in the creation of the I.C.C. is not fully documented, several studies have suggested that the railroads sought federal regulation as a means of enforcing previously-unsuccessful cartel arrangements.<sup>9</sup> In this regard, it has been suggested:

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<sup>9</sup>Gabriel Kolko, Railroads and Regulation: 1887-1916 (Princeton: Princeton University Press, 1965); and Robert Spann and Edward Erickson, "The Economics of Railroading: The Beginning of Cartelization and Regulation," Bell Journal of Economics and Management Science, 1 (Autumn, 1970): 227-44.

"One should not overlook the similarity between the effects of legislation and the chartering by federal legislators of business enterprises. One might argue that the entire history of federal legislative regulations presents quite a massive case study of what society could expect with federal chartering and 'common-law control' of corporations."<sup>10</sup>

The findings of this dissertation reinforce that view.<sup>11</sup>

The evidence presented in this dissertation also provides support for the proposition that jurisdictional competition leads to a more efficient set of substantive laws. The discussion of the continued popularity of charters under the dual incorporation system<sup>12</sup> suggests that early general incorporation laws were not popular because they did not change to reflect trends in corporation finance, organization, and management. This was so because monopolistic legislators put their energies into liberal and up-to-date special charters while there were few incentives for the monopolistic legislators to improve the terms of general incorporation laws. On the other hand, the existence of competition among states for the lucrative chartering business since

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<sup>10</sup>Robert B. Ekelund, "Have State Regulations led to Corporate Monopoly Power?" in M. Bruce Johnson, ed., The Attack on Corporate America, pp. 135-40, 39040.

<sup>11</sup>Also, it might be argued that there is a causal link between monopoly in the market for corporate privileges and England's tendency towards nationalization of industries. For an examination of England's intermediate step from free competition to nationalization -- "rationalization", which involved horizontal amalgamation, the elimination of competition, and private ownership (i.e., a cartelization of major industries) -- see Leslie Hannah, The Rise of the Corporate Economy (London: Methuen and Co., Ltd., 1976).

<sup>12</sup>See subsection IV.B.4, supra.

1875 has assured that corporation laws are constantly adjusted to meet the needs of business organizations in a dynamic economy. Thus, the historical evidence suggests that a federal chartering system would result in a set of substantive laws that clearly lags behind the changing needs of the business community. This suggestion is reinforced by the English experience. In England, the corporation laws have been subject to review and revision at intervals of about twenty years since the 1860's.<sup>13</sup> It seems clear that the business environment undergoes considerable changes in the course of twenty years and that the lag in legislative response would lead to unnecessary constraints on business behavior. Furthermore, there is no reason to expect the changes, when they do occur under a national incorporation system, to be in the most efficient direction. For example, the trend of British Companies Law since the 1860's has been towards the imposition of greater controls and increased provisions for publicity.<sup>14</sup>

On a similar note, England's recent entry into the European Economic Community presents the opportunity for jurisdictional competition in an international market for corporation privileges. The "harmonization" of corporation laws, however, appears to be a goal of the E.E.C. Commission. The preeminent authority on English companies law, L.C.B. Gower, warns against this development because that it will

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<sup>13</sup>L.C.B. Gower, Principles of Modern Company Law, Fourth Edition (London: Stevens & Sons, 1979): 53-7.

<sup>14</sup>Ibid., p. 49. Of course, much of this body of law fulfills the role played by the S.E.C. in the U.S.

be difficult to get multinational agreement on reforms once the uniform code is established.<sup>15</sup> Because of this, he prefers "the comfortable old pattern of a major reform every 20 years or so."<sup>16</sup> On the other hand, this dissertation also suggests that England's autonomy should be maintained, not because the comfortable old pattern is superior, but because of the potential benefits of the recently-available possibility of jurisdiction competition from the E.E.C. market for corporate privileges.

Finally, this dissertation provides the answer to a question that has troubled some leading legal historians -- namely, why did the less advanced American economy produce more corporate charters than England and other European countries? Handlin and Handlin are clearly perplexed:

...Nor is it enough to point to the relative ease of incorporation in America without answering why it was less difficult to secure charters in the New World. If the weight of common-law inertia was not quite so heavy on one side of the ocean as on the other, and if independence freed colonial merchants from some imperial restraints it nevertheless would be rash to claim that after 1776 enterprisers in the United States had more influence in government than did their European counterparts.<sup>17</sup>

The comparative histories presented in this dissertation provide a clear and simple answer: although the enterprisers in the United

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<sup>15</sup>Ibid., p. 93.

<sup>16</sup>Ibid.

<sup>17</sup>Oscar Handlin and Mary F. Handlin, Commonwealth: A Study of the Role of Government in the American Economy: Massachusetts, 1774-1861, Revised Edition (Cambridge, Mass.: The Belknap Press of Harvard University Press, 1969): 4.

States might not have had more influence in government, it is clear that the enterprisers in America had more governments to influence. The multiplicity of political jurisdictions in the United States, coupled with the early jurisdictional competition through capital markets that encouraged otherwise reluctant states to grant liberal special charters,<sup>18</sup> led to a proliferation of corporate privileges at a very early date. In England, the closed political economy and smaller geographic size resulted in a smaller monopoly output. Because of differences in geographic size, it is difficult to predict what the distribution of corporate privileges in the United States relative to England would have been had the power to grant corporate privileges been reserved to the federal government. It seems clear, however, that there would have been fewer special corporate charters granted by the federal government for the simple reason that granting special charters at a rate equal to the combined rate of all the states would have placed a prohibitive burden on the Congressional calendar.

This dissertation, in conclusion, makes a significant contribution to understanding how and why the corporation -- one of the most important and influential institutions in the industrialized world -- evolved. It is hoped that an appreciation of the implications of the historical development of this legal institution will influence its development in the future.

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<sup>18</sup>See subsection IV.A.7, *supra*.

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APPENDIX A  
TABLE OF CASES -- AMERICAN

## TABLES A.I

## AMERICAN CASES

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- Bank of Augusta v. Earle, 13 Pet. 519 (1839)
- Bank of Marietta v. Pindall, 2 Rand. 465 (Va., 1824)
- Bank of United States v. Deveaux, 5 Cranch 61 (1809)
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- Libby v. Tobey, 82 Me. 397, 19 A 904 (1890)
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- Paul v. Virginia, 8 Wall. 168 (1869)
- Portsmouth Livery Co. v. Watson, 10 Mass. 91 (1813)
- Silver Lake Bank v. North, 4 Johns. Ch. 370 (N.Y., 1820)
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- United States v. Grinnel Corp., 384 U.S. 563 (1965)
- Williamson v. Smoot, 7 Martin (O.S.) 31 (La., 1819)
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APPENDIX B

TABLE OF CASES -- ENGLISH

## TABLE B.I

## ENGLISH CASES

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- East India Co. v. Sandys, 10 St. Tr. 371 (1684)
- Garrard v. Hardy, 5 Man. and Cr. 471 (1843)
- Hallett v. Dowdall, XXI L.J.Q.B. 98 \*1852)
- Harrison v. Heathorn, 6 Man. and Gr. 81 (1843)
- Horne v. Ivy, 1 Ventr. 47 (1668)
- Metcalf v. Briun, 12 East 405 (1810)
- Rex v. Dodd, 9 East 516 (1808)
- Van Sandau v. P. Moore et al., 1 Russell 572 (1825)
- Walburn v. Ingelby, Mylne and K. 61 (1833)

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LEGAL CHANGE IN AN INTEREST-GROUP PERSPECTIVE: THE  
DEMISE OF SPECIAL CORPORATE CHARTERS

by

Henry Nolde Butler

(ABSTRACT)

This dissertation presents a legal and economic history of the change in method of incorporation from special corporate charters via legislative act to general incorporation laws which make corporate privileges available to all who meet certain, minimal procedural requirements. Prior to the mid-1800's, corporate privileges were allocated by special legislative act in a market for corporate privileges. In this market, legislators had monopoly control over the use of corporate privileges within their respective jurisdictions. Thus, the issue examined is why the legislators relinquished their monopoly control. The thesis of this dissertation, stated briefly, is that legislators in both the United States and Great Britain abandoned the market for special corporate charters because events beyond their control made it difficult or impossible for them to continue to create and capture rents through the passage of special acts of incorporation. Exogenous legal and economic changes are identified and shown to be reliable predictors of the demise of special corporate chartering. In England, changes through the common law courts produced an inexpensive alternative to the corporate form and lowered the rates of return to legislators from passing special acts. In the United States, the growth of interstate commerce and an important Supreme Court decision,

Paul v. Virginia, changed the legislative market for corporate privileges from one of localized monopolies into a competitive, national free market in corporate privileges. The historical experience suggests that the passage of a national incorporation law could lead to the same type of abuses that occurred prior to the development of the national free market in incorporation laws and the passage of liberal state general incorporation laws.