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# Factors Affecting the Development of Corporation Law

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# FACTORS AFFECTING THE DEVELOPMENT OF CORPORATION LAW

HUGH L. SOWARDS\* AND JAMES S. MOFSKY\*\*

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## I. INTRODUCTION

The preeminence of the corporation in the modern business scene is an unassailable fact. Yet there has been a surprisingly small amount of published scholarly analysis concerning the development of the corporate form in America. Many of the legal texts in this area offer broad, oversimplified statements on the origin of the corporation and trace it back to Crown-chartered institutions: craft guilds, boroughs and trading monopolies such as the East India Company. Careful examination reveals that incorporation associated with a simple, inexpensive procedure is manifestly different from petitioning a sovereign for a monopoly grant or the privilege of exercising some quasi-public function. It is submitted that the failure to recognize this fact has resulted in misleading conclusions. Moreover, such failure has evidenced a serious non-recognition of the economic forces which have caused entrepreneurs to experiment with business devices in an effort to free themselves from traditional business vehicles which no longer fit the needs of prevailing conditions. It is equally unsatisfactory simply to conclude that the role of the legislature in granting corporate charters became more and more insignificant. Clearly the transition from legislative grant to general incorporation acts has greater depth.

While cataloguing the provisions of corporate charters does indeed provide interesting insights into legal history and is certainly a valuable contribution, such scholarship has not answered fundamental questions concerning the development of the modern corporation.<sup>1</sup> In addition, while the many business histories written in the past one hundred years provide fascinating reading, the stories of fortunes made and lost and businesses

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1. With respect to the analysis of special charters, see J. BLANDI, *MARYLAND BUSINESS CORPORATIONS, 1783-1852* (1934); J. CADMAN, *THE CORPORATION IN NEW JERSEY: BUSINESS AND POLITICS, 1791-1875* (1949); DAVIS, *ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS* (1965); E. DODD, *AMERICAN BUSINESS CORPORATIONS UNTIL 1860* (1954); Handlin & Handlin, *Origins of the American Business Corporation*, J. ECON. HIST. 22 (May, 1945); Williston, *History of the Law of Business Corporations Before 1800*, 2 HARV. L. REV. 105 (1888).

built and destroyed do not yield a more satisfactory answer.<sup>2</sup> For some inexplicable reason, most legal writers have concluded that the "secret" to corporate developments is to be found within either the four corners of a charter or some ancient institution such as a craft guild. Indeed, most business scholars have failed to recognize that there is a "secret" to uncover.<sup>3</sup>

It is submitted that productive study in this area must combine two disciplines: analysis of legal norms *and* analysis of the economic forces which influenced such norms. Accordingly, the development of corporation laws should be viewed from the perspective of the changing needs of the business community in which traditionally conservative courts and legislatures adjusted to such needs.

The thesis of this article is that American businessmen and lawyers developed modes of doing business which strongly resembled modern corporations before general incorporation laws were enacted and even before legislatures had any significant experience in molding corporate charters. These patterns were devised because economic forces demanded them. But the common law has been a conservative institution, often slow to adapt itself to economic realities. It is not surprising, therefore, to find that unless a particular method of doing business fell within the categories of traditional partnership or chartered corporation, courts were reluctant to recognize it. Lawyers and businessmen were thus forced to seek inconvenient devices to overcome judicial attitudes.<sup>4</sup> Even armed with such devices, however, they were still in doubt as to the reaction of the common law.<sup>5</sup>

If the common law had responded quickly and flexibly to the needs of businessmen, general incorporation laws might never have been enacted. Promoters and investors would simply have continued to associate themselves freely without legislative sanction; they would have continued to experiment with business forms until they devised the most efficient and convenient methods for transacting their affairs. But the courts were not prepared to accommodate the business community, and legislatures finally responded by enacting laws which formally approved what businessmen were already doing with uncertainty and inconvenience.

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2. See, e.g., J. BRIDGE, *THE INSIDE HISTORY OF THE CARNEGIE STEEL COMPANY* (1903); S. DAGGETT, *CHAPTERS ON THE HISTORY OF THE SOUTHERN PACIFIC* (1922); J. MOODY, *THE RAILROAD BUILDERS* (1919); TARBELL, *HISTORY OF THE STANDARD OIL COMPANY* (1925).

3. Most of the business histories provide single paragraph explanations for the use of the corporate form. Generally, they fail to recognize a developmental process in the history of corporate norms. See, e.g., WARE, *THE EARLY NEW ENGLAND COTTON MANUFACTURE* 145 (1931).

4. An example of such a device was holding real property in the name of a trustee rather than in the names of the partners.

5. Such uncertainty often existed by virtue of an absence of a settled case on the point. For example, 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).

## II. BACKGROUND

During and immediately after the colonial period most manufacturing in America was accomplished by individual families for their own use. This method of production has been defined as "homespun industry."<sup>6</sup> As the United States emerged as an independent nation, household industry—"manufacturing by families for outside markets,"<sup>7</sup>—began to complement and in some areas supersede homespun enterprise, and it has been estimated that as late as 1820, two-thirds of the textiles used in the United States were manufactured by families.<sup>8</sup> Business histories are replete with descriptions of how farmers, their wives and children tended the field during the day and spun cloth and hammered nails at night, first for their own use and later for sale or barter.<sup>9</sup>

While most manufacturing was carried on within the family, manufacturing outside the family unit began to achieve some significance after the Revolutionary War; and by the beginning of the nineteenth century, there existed such enterprises as glass establishments, fulling mills, grist mills, slitting mills, iron forges, hat manufacturers and nonpower-operated textile concerns.<sup>10</sup> These firms did not attain great sizes.<sup>11</sup> Generally, they were operated by one or two men who either risked their own or borrowed capital for the venture. Thus, most of these firms were conducted as partnerships or as sole proprietorships.<sup>12</sup> The chartered corporation was practically unknown in the manufacturing area at this time; only eight manufacturing company charters were granted in the United States by 1800.<sup>13</sup>

Some of these early ventures gradually grew to be relatively large enterprises, but they generally did not attain size through amassing sizable amounts of capital from investors. They usually grew through the constant reinvestment of earnings. By way of illustration, the records of the Almy and Brown textile partnership, formed in 1793, indicate the manner in which a successful partnership commenced operations on a small scale, supplying materials piece by piece as they were needed and reinvesting earnings to generate growth.<sup>14</sup> Since there were only one, two, or three partners actively engaged in managing most of these firms, and since a large amount of capital was not required in most enterprises until the factory system with the power loom was introduced, the promoters of these early ventures were probably unconcerned with such concepts as division of capital into shares, free transferability of interests, delegation

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6. 1 V. CLARK, HISTORY OF MANUFACTURE IN THE UNITED STATES 428 (1929).

7. *Id.*

8. *Id.*

9. *Id. passim.*

10. 2 J. DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 256 (1965).

11. *Id.*

12. *Id.*

13. *Id.* at 26.

14. C. WARE, *supra* note 3, at 124.

of powers of management, holding property in a firm name, and suing and being sued as a firm rather than as individuals.

Although most of these ventures were conveniently conducted as partnerships and sole proprietorships, there were a number of enterprises, as early as 1760, which required a relatively large pool of capital to commence business. These businesses included certain land merchandising, banking, insurance underwriting, mining, shipping and some textile promotions.<sup>15</sup> Since capital was contributed by what was then a significant number of persons who did not contemplate engaging in management activities, the aforementioned concepts, generally associated with the modern corporate form, became increasingly important.

The traditional partnership form of doing business did not fill the needs of some of these undertakings, and the law did not immediately provide a simple, inexpensive alternative for investors to freely associate in these more complex ventures. The limited partnership, derived from the French *Société en Commandite*,<sup>16</sup> was unknown in the common law and was first recognized in the United States by New York in 1822.<sup>17</sup> The New York statute authorizing the creation of joint stock associations was not passed until considerably later.<sup>18</sup> Thus for several decades before the beginning of the nineteenth century there was a gradual application of corporate concepts to businesses actually labeled partnerships by their owners. However, it is not submitted that this application of corporate notions to non-chartered business forms was wide-spread during this period. Technology was not sufficiently advanced in the United States to serve as an adequate foundation for many large-scale enterprises necessitating a complex business structure. It was not until the year 1813, which witnessed the first use of the power-loom in the United States, that technology provided a basis for the introduction of the factory system and an immediate need for businesses requiring a relatively large amount of capital for the commencement of operations.<sup>19</sup> In that year the Boston Manufacturing Company of Waltham, Massachusetts was established with a capitalization of \$400,000, a sum previously unheard of for manufacturing firms.<sup>20</sup> However, there were some enterprises that called for the use of corporate standards for several decades before the factory system was introduced.

If corporate concepts were in fact known and used as early as 1760, why did banks, insurance companies, and public utility companies begin seeking corporate charters in large numbers in 1792?<sup>21</sup> Why were no less

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15. *Id.* at 138.

16. See BATES, *THE LAW OF LIMITED PARTNERSHIP* 20 (1886).

17. N.Y. Laws, ch. 244 (1822).

18. 1839.

19. 1 V. CLARK, *supra* note 6, at 449.

20. See C. WARE, *supra* note 3, at 138.

21. For statistics on the number of such incorporations before and after 1792, see 2 J. DAVIS, *supra* note 1, at 26.

than 66 canal, 77 turnpike, 69 toll-bridge, 32 water supply, 29 bank, and 33 insurance company charters granted in the United States by 1800?<sup>22</sup>

It is true that most of these enterprises required substantial initial capital and that such capital was in many instances contributed by investors who did not participate in management;<sup>23</sup> for this and other reasons, the corporate form was more appropriate than the partnership. But the corporate devices utilized in certain non-chartered land promotions, mining ventures, shipping businesses and large-scale textile operations were surely known to the promoters and lawyers of the financial institutions and public utility companies;<sup>24</sup> before and after 1792, some banking and insurance underwriting businesses were conducted without the benefit of corporate charters. Limited or modified-limited<sup>25</sup> liability was generally provided in the charters for early American financial and public utility companies.<sup>26</sup> While there is some evidence that limited liability was important in the more speculative insurance company ventures,<sup>27</sup> it does not seem that it was a critical factor with respect to banks, almost all of which were immediately successful, and public utility companies.<sup>28</sup> In Massachusetts, for example, a "vigorous agitation" for limited liability first occurred in 1828.<sup>29</sup> Although uncertainty over judicial treatment of unincorporated businesses that attempted to adopt corporate norms may have contributed to the application for charter by promoters of financial institutions and public utility companies, this factor does not appear to be critical. Unincorporated banks and insurance companies were formed before the rush for charters, and private banks were established after incorporation became common for these ventures.<sup>30</sup>

The primary motivation for incorporation in this area probably stems from the special privileges granted to these companies in their charters. With respect to banking, monopoly rights to engage in that business were granted by charters<sup>31</sup> and legislative acts were passed quite early in several states making it illegal to engage in this activity without a charter.<sup>32</sup> Monopoly rights were also granted to insurance companies. For example, as long as the Massachusetts Hospital Life Insurance Company paid one-third of its life insurance profits to the Massachusetts General Hospital, the company was granted the exclusive privilege of insuring lives on land

22. See E. DODD, *AMERICAN BUSINESS CORPORATIONS UNTIL 1860* at 366 (1954).

23. 2 J. DAVIS, *supra* note 1, at 300.

24. Many of the promoters were involved in both chartered corporations and nonchartered enterprises that adopted corporate norms.

25. A form of limited liability such as the "double liability" of Massachusetts bank shareholders. See E. DODD, *supra* note 22, at 209.

26. E. DODD, *supra* note 22, *passim*.

27. See 2 DAVIS, *supra* note 1, *passim*.

28. E. DODD, *supra* note 22, at 232.

29. *Id.*

30. *Id.* at 205.

31. *Id.* at 202.

32. *Id.* at 205.

(as opposed to lives at sea).<sup>33</sup> The few manufacturing companies which sought corporate charters during this period were also granted special privileges. To illustrate, the Beverly Cotton Manufactory was granted a trademark for a label on its goods, a grant of state lands in the District of Maine, exemption of foremen from poll taxes, and tickets in a state lottery.<sup>34</sup> Toll-bridge, turnpike and canal companies were granted franchises to collect tolls and the power of eminent domain.<sup>35</sup> In addition to other exclusive franchises, many of these companies were granted tickets to the state lottery. These are only a few examples of the many monopolistic and special powers granted these early business organizations. It is submitted that these special privileges provided the most significant underlying reason for incorporation at that time.

Those firms which did not seek special grants but which desired the advantages of the corporate form devised their own unique business structures by borrowing corporate norms. Before attempting to analyze the reasons why firms did not continue to use these unchartered associations and why general incorporation acts were ultimately adopted in all American jurisdictions, it is in order to examine the home-made, unchartered firms that resembled corporations.

### III. THE JOINT STOCK ASSOCIATION

As early as 1760 promoters began devising a form which became known as the "joint stock association." The association was not an immediate innovation. Rather, analysis of the literature and some of the business documents which have survived indicates that the association was developed over a period of years as businessmen sought to free themselves of orthodox partnership constraints. Thus, it is not surprising that early articles of association were relatively simple and that only one or two corporate notions were applied in a fairly crude manner.<sup>36</sup> However, as experimentation continued, more and more corporate norms were included in articles of association with increasing sophistication. The language employed in many of the documents prepared before the beginning of the nineteenth century closely resembles that found in early general incorporation acts and manufacturing company charters granted between 1810 and 1830.

Although there is no method for computing the total number of associations, there is ample proof that many were formed before the year 1800.<sup>37</sup> Some of these associations eventually sought corporate charters, but most retained their original form. One eminent authority has offered important evidence of the existence of joint stock associations established

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33. *Id.* at 224.

34. *Id.* at 226.

35. *Id.* at 241.

36. See S. LIVERMORE, *EARLY AMERICAN LAND COMPANIES* (1939).

37. See 2 J. DAVIS, *supra* note 1 at 258.

for the purpose of merchandising land, particularly in the decade 1785-1795.<sup>38</sup> A review of his analysis and the provisions from the articles of association cited by him reflect the adaptation of corporate norms to a structure which was not recognized in the common law at that time as a separate business unit.

While there is a paucity of research in this area, there is nevertheless evidence of the use of the joint stock association before the year 1800 in such enterprises as banking, underwriting of insurance, and shipping.<sup>39</sup> An early study of the textile industry<sup>40</sup> indicates the effective use of joint stock associations in the pre-power loom stage of the American textile business—prior to 1813—before the corporation became increasingly popular and eventually dominant.<sup>41</sup> Although the author of that work does not use the term “joint stock association” in describing any of the early textile firms, many of those firms clearly resemble joint stock associations rather than traditional partnerships. For example, there were many investors, such as doctors, lawyers, merchants and local businessmen, who purchased shares in some of these ventures but who did not actively participate in management, and there is evidence that these investors considered their shares to be freely transferable.<sup>42</sup> Although shares had to be transferred by deed because the investors or a trustee on their behalf had title to real property, this requirement appears to be the only restriction on transferability contemplated in many instances. It is true that the courts did not clearly recognize such free transferability in American judicial decisions until 1827;<sup>43</sup> nevertheless, promoters and investors in the textile industry and in the business of land merchandising treated their shares as freely transferable for several decades before the beginning of the eighteenth century.

Two business histories dealing with this area describe delegation of authority to boards of directors or managers in early textile firms in a manner generally associated with modern corporations.<sup>44</sup> Such delegation existed in joint stock associations before the promoters of textile firms first made extensive use of the corporate form. A third study also describes several mining companies which were formed as joint stock associations around 1790. The articles of association of one such firm, the Lehigh Coal Mining Company, provided for the following: 1) division of the capital into 40 shares of \$200 each; 2) payment for shares in three installments; 3) in the case of a default on any of the installments, a forfeiture of shares and a sale at public auction; 4) the election by the shareholders of a president, eight “managers,” and a treasurer; 5) the

38. S. LIVERMORE, *supra* note 36.

39. *Id.* at 238.

40. W. BAGNALL, *TEXTILE INDUSTRIES OF THE UNITED STATES* (1893).

41. *Id.* at 217-219 *passim*.

42. *Id.* at 406-409.

43. *Avord v. Smith*, 5 Pickering 232 (1827).

44. W. BAGNALL, *TEXTILE INDUSTRIES OF THE UNITED STATES* 406-409 (1893); C. WARE, *THE EARLY NEW ENGLAND COTTON MANUFACTURE* 21 (1931).



promulgation of by-laws; 6) the president and "managers" vested with complete authority over the property of the business; and 7) upon completion of installment payments, the receipt by each shareholder of a deed representing his share of the business.<sup>45</sup> Approximately twenty years after the execution of these articles of association, the Massachusetts Legislature passed its first general Manufacturing Corporations Act in 1809.<sup>46</sup> Most of the provisions of that act bear a striking similarity to the elements of the Lehigh articles.<sup>47</sup> For example, the statute provided for the division of capital into shares which were transferable by deed. The shares of those associates who failed to pay assessments could be sold at auction. Moreover, shareholders were authorized to elect a clerk, treasurer and directors, and to adopt by-laws. Except for provisions requiring notice of the first meeting, unlimited liability of shareholders and assessments for necessary capital, the act contained no other significant provisions. 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.

There were very few corporate charters for manufacturing companies granted by the Massachusetts Legislature prior to the 1809 statute. The first such charter was granted in 1789,<sup>48</sup> and the second in 1794 to the Newbury-Port Woolen Manufactory.<sup>49</sup> It was the Newbury-Port charter which served as the model for the 1809 act.<sup>50</sup> Thus it is evident that elements of the Lehigh articles even pre-dated the provisions of the second manufacturing company charter granted in Massachusetts. (The Newbury-Port charter was the fifth manufacturing firm charter granted in the United States).<sup>51</sup> There were charters granted to banks, insurance companies and public utility companies prior to the execution of the Lehigh articles of association. But those charters reveal provisions which were significantly different from the provisions contained in the Lehigh articles. 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. While the Lehigh articles resemble the 1809 act in language and simplicity, there were many articles of association drafted in the 1770's which were more complex than the 1809 act and the Lehigh

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45. S. LIVERMORE, *supra* note 36 at 240.

46. Mass. Laws May Sess. 1806—Jan. Sess. 1809, ch. 65.

47. See analysis of the 1809 act in E. DODD, *supra* note 22, at 228.

48. Mass. Acts and Resolves 1788-89, ch. 43.

49. Mass. Acts and Resolves 1792-93, ch. 27.

50. See E. DODD, *supra* note 22, at 227.

51. See J. DAVIS, *supra* note 1, at 277.

articles, and in which were included provisions very similar to those found in the more modern general incorporation acts.<sup>52</sup> The articles of association of the Illinois-Wabash Land Company<sup>53</sup> were executed in 1774, during the colonial period and before any manufacturing, bank, toll-bridge or turnpike charters were granted. An analysis of that firm's articles vividly illustrates the use of many sophisticated corporate norms at an early date. One of the most interesting aspects of the Illinois-Wabash document was the provision merging two separate land companies into a single firm:

[I]t was proposed that the two companies should be united on the terms in the minutes of the said Company then and therefore made and particularly expressed: and the same two companies were then and there resolved and declared accordingly to be and continue from thenceforth united, and the lands should be common between them. And whereas it is most expedient and for the better and easier management of the said companies interest in the said land that a certain Constitution or Articles of Agreement should be formed and drawn up to be for the further governance and directions of and obligatory upon all and singular the members of the United Companies. . . .<sup>54</sup>

After providing for the "merger," the articles proceeded to establish the following governing standards: 1) regular meetings of the shareholders and special meetings "on business of emergency" to be called by the President and Council (board of directors) with 30 days' notice to be given by the Secretary; 2) voting by members either in person or by proxy; 3) division of the capital into 84 shares, the owners of a majority of which to constitute a quorum to do business at meetings; 4) election of a President, Council of four members (directors) and such other officers as are necessary; 5) delegation of authority by the members to the President and Council for the management of the company; 6) transfer of shares by deed attested to by a magistrate or notary public and recorded in the company's book; and 7) sale by the company of shares if a member should default on assessments.<sup>55</sup>

There is evidence that some investors in land companies such as the Illinois-Wabash did not attend many meetings in person.<sup>56</sup> It is not surprising, therefore, to find proxy and quorum provisions included in the articles of association. Explicit in the Illinois-Wabash document was a provision for unlimited assessment against shareholders, a provision included in the 1809 Massachusetts General Manufacturing Corporations Act and in many early charters granted by the Massachusetts and other legislatures. The Illinois-Wabash provisions for sale of defaulting members' shares and for transfer of shares by recordation in the company

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52. See S. LIVERMORE, *supra* note 36, at 223-37.

53. See *id.* at 303-308.

54. *Id.* at 306.

55. *Id.* at 303-308.

56. *Id.* *passim*.

books are almost identical to norms established in early general incorporation statutes and in early manufacturing company charters. However, such standards are noticeably absent from early bank, insurance and public utility charters in Massachusetts. Again there is evidence that some provision of general incorporation acts were modeled more after the innovations of joint stock association promoters than after early bank, insurance and public utility company charters.

Articles of association for a number of the land companies contained detailed provisions regarding the voting rights of shareholders.<sup>57</sup> Some articles provided for one vote per member regardless of the size of his proportional interest.<sup>58</sup> Other articles provided for an increased number of votes as the proportionate interest became larger but with a maximum number of votes specified.<sup>59</sup> Still other articles provided for a number of votes proportionate to the investment and with no ceiling.<sup>60</sup> These provisions can be found in documents drafted in the 1770's, before legislators first incorporated such provisions into bank, insurance company and public utility company charters. Although banks, insurance companies and public utility companies incorporated primarily to gain some monopoly or quasi-public advantage, the corporate form was nevertheless advantageous to these institutions, and it is submitted that the experimentation by joint stock association promoters with corporate devices, such as the voting arrangements described above, paved the way for the use of such provisions in the early charters granted by the legislatures.

The foregoing examples represent only a few of the several joint stock association records which have been preserved. Undoubtedly, there are many more such records which have not yet been uncovered by scholars, inasmuch as there has been relatively little research in this area. And there were probably other associations whose records were destroyed. Consequently, the exact number of such businesses which existed before incorporation became popular may never be ascertained.

#### IV. ATTITUDE OF THE COURTS

It has already been observed that courts tended to classify businesses into partnerships and corporations and to apply the common law relative to each category. This attitude caused businessmen and their lawyers to seek devices within the framework of the common law to circumvent classification to achieve desired ends. For example, while a corporation under the common law had the ability to hold title to real property in its corporate name, title to partnership property rested in the partners as tenants in common. At common law the courts were inflexible in retaining this distinction. To avoid this problem, the promoters of joint stock asso-

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57. *Id.* at 227 *passim*.

58. *Id.* at 240.

59. *Id.* at 307.

60. *Id.* at 227.

ciations placed title in the name of a trustee who made conveyances. Such trustees could be partners in the firm or non-partners. The rules of trusts were so securely established in the common law that lawyers probably felt fairly safe in using this device with respect to the land associations; thus for a considerable period before the American courts formally sanctioned such conveyances by trustees, the concept was applied to land associations.<sup>61</sup>

At common law there was a basic difference between the manner in which partnerships and corporations could sue and be sued. While suits could be brought by and against corporations in the corporate name, suits by and against partnerships had to be brought in the names of all the partners. This rule was rigidly upheld until legislatures finally passed statutes permitting joint stock associations to participate in the more convenient arrangement. To overcome the disadvantage at common law, associations provided that business contracts be executed for them by trustees. Again because of the sanctity of the trust notion, courts upheld such devices. Thus the Connecticut Land Company, the North American Land Company and other associations made extensive use of trustees in entering into contracts.<sup>62</sup> Another method of overcoming the sue-and-be-sued problem was for associations to appoint an officer to represent the firm in litigation. This arrangement was recognized by courts either if there was statutory authority authorizing representation by an officer or if there was an agreement to such representation entered into by the litigants prior to the institution of the suit. But as previously mentioned, statutory authorization came quite late in the United States, and it is submitted that there were probably practical problems in securing permission from an antagonistic party for a suit to be brought against him by a representative officer.

There was also a problem at common law with respect to suits by a partner against his partners collectively. However, research has not yielded any early cases illustrating the manner in which members of associations handled this matter. With respect to suits by partnerships and corporations against shareholders who failed to pay subscriptions or assessments, both forms of doing business were on an equal footing during the early period, neither being permitted such actions.<sup>63</sup> Both forms were restricted to forfeiture of shares.<sup>64</sup>

The right to delegate authority to a board of directors or to officers for the management of the firm is a basic tenet of modern corporation laws. Although courts were slow to recognize this power with respect to joint stock associations, such associations nevertheless used the concept

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61. *Id.* at 276.

62. *Id.* at 278.

63. See E. DODD, *supra* note 22, at 228-29, 233. See also S. LIVERMORE, *supra* note 36, at 279-80.

64. *Id.*

in creating business organizations quite similar to contemporary forms.<sup>65</sup> There is evidence that early traditional partnerships used this device. For example, authority to manage the Almy and Brown textile mill was delegated to Samuel Slater; Almy and Brown did not actively participate in the day-to-day operations of the venture.<sup>66</sup>

Transferability of shares has already been discussed. While the first American case sanctioning freely transferable shares was not decided until 1827, the evidence indicates that members of associations acted as though their shares were indeed freely transferable<sup>67</sup> despite uncertainty as to how the courts would rule on the question.

With respect to the terms of existence of corporations and joint stock associations, the early law provided disadvantages for both forms. Legislatures granted most early charters for limited periods, and usually reserved the right to amend or revoke the charter.<sup>68</sup> Joint stock associations, being classified as partnerships, were deemed dissolved upon the death of a member or transfer of his shares. Associations attempted to overcome the latter problem by drafting provisions into the articles of association permitting successors' heirs or transferees to become members of the association without dissolution.<sup>69</sup>

At the common law, members of joint stock associations did not have the privilege of limited liability. While early bank, insurance company, and public utility company charters did grant limited liability or double-liability privileges, unlimited liability was sometimes expressly reserved for shareholders in early general manufacturing incorporation acts.<sup>70</sup> However, many firms incorporated under such acts, but as previously mentioned, limited liability did not seem to be the principal reason for securing a corporate charter during the early period. Eventually limited liability did become a matter of controversy and the officials of some unlimited liability states felt that charters were being lost to limited liability states. This occurred in Massachusetts around 1828.<sup>71</sup> But the record of the number of incorporations before and after limited liability was granted to manufacturing firms in Massachusetts leaves some doubt as to the validity of the arguments of these state officials.<sup>72</sup>

The foregoing analysis regarding the manner in which association members attempted to circumvent common law concepts and adopt norms associated with the corporation is illustrated by the following excerpts from various articles of association:

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65. See, e.g., Extract from the Articles of Agreement of the Illinois-Wabash Land Company in S. LIVERMORE, *supra* note 36, at 305.

66. See C. WARE, *supra* note 44, at 21.

67. See S. LIVERMORE, *supra* note 36, at 229.

68. See, e.g., E. DODD, *supra* note 22, at 202.

69. See extracts of article of association in S. LIVERMORE, *supra* note 36, *passim*.

70. See, e.g., Mass. Laws May Sess. 1806—Jan. Sess. 1809, ch. 65.

71. See E. DODD, *supra* note 22, at 232.

72. *Id.*

*Free transferability of shares:*

And be it further known, that if any or either of the aforesaid partners, should Give, Grant, Sell or Devise, or otherwise dispose of his particular part of the aforesaid Tract or Territory of Land to any or either of the said partners, or any other Person whatever, such Donee, Grantee, or Devisee, shall by the rest of the Copartners be considered as Tenants in Common with them and have all the Rights, Privileges and Immunities which the said Donor, Grantor, or Devisor could or might have had or enjoyed, from the benefit or advantage of the first purchase . . . .<sup>73</sup>

*Perpetual existence:*

[I]f any or either of the said partners, their or either of their assigns shall die and depart this life without having first given, Granted, Sold, Devised, or otherwise disposed of his or their particular part of the aforesaid Lands . . . then and in that case the part of such person or persons so dying without having disposed of the same as aforesaid, shall remain to devolve upon the right Heir or Heirs of such Decedent or Decedents, and such heir or heirs, or such Decedent or Decedents, shall be considered Tenant or Tenants in Common . . . with the other Copartners . . . to have all the rights, privileges, benefits, advantages and emoluments which his, her, or their Predecessor or Predecessors could or might have had were he, she, or they, then living . . . .<sup>74</sup>

*Delegation of Authority:*

That there shall be five directors, a treasurer and secretary . . . . That the directors shall have the sole disposal of the company's funds . . . that they shall by themselves or such person or persons as they may think proper to entrust with the business, purchase lands for the benefit of the company, where, and in such way . . . as they shall judge will be most advantageous to the company.<sup>75</sup>

*Voting:*

That all votes under this association may be given in person or by proxy, and in number justly proportionate to the stock holden, or interest represented.<sup>76</sup>

*Authority to make by-laws:*

[T]hat the rules and laws made at any of the four stated meetings and also the ordinances made at any special meeting . . . shall be obligatory upon and duly observed by all and every one of the . . . members . . . .<sup>77</sup>

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73. From articles of association of the Transylvania Company, executed Jan. 6, 1775, in S. LIVERMORE, *supra* note 36, at 300.

74. *Id.* at 301.

75. From articles of agreement of the Ohio Company, executed May 4, 1786, in S. LIVERMORE, *supra* note 36, at 310.

76. *Id.* at 311.

77. From articles of agreement of the Illinois-Wabash Land Company, executed March 13, 1779, in S. LIVERMORE, *supra* note 36, at 306.

*Quorum for meetings:*

[T]he owners of a majority of appropriated shares . . . shall constitute a quorum to do business . . . .<sup>78</sup>

While these writers have not had access to articles of association of the relatively large unincorporated textile associations, it may be tentatively stated from analysis of the secondary sources that such articles would probably contain provisions comparable to those in the land company document previously mentioned.

V. FACTS CONTRIBUTING TO THE ENACTMENT OF  
GENERAL INCORPORATION LAWS

At the time when joint stock associations were formed, there existed the possibility of petitioning for a corporate charter and thereby circumventing the necessity for devising judicially untested techniques to avoid the common law attitude toward partnerships. Why then did some promoters choose the joint stock association form? These writers have found no significant study examining the cost and difficulty of obtaining a corporate charter prior to the general incorporation laws. It is therefore impracticable to offer a well-reasoned analysis of whether or not cost may have been prohibitive in some cases. However, in the case of some of the large land companies where a substantial amount of capital was raised, it seems unlikely that expenses were a critical factor. But cost may have been a contributing factor in many smaller ventures. Statutes such as the 1811 New York General Incorporation Act<sup>79</sup> were probably detrimental to the incorporation of many large-scale enterprises. That statute limited the general incorporation of manufacturing ventures to firms with a maximum capital of \$100,000. While that act was in force, the factory system had been introduced and textile corporations were being established in other states with capitalizations of as much as \$1,000,000.

It has been suggested that anti-corporate sentiment may have been a factor.<sup>80</sup> While it cannot be denied that at times there was such sentiment, research has revealed few corporate charters that were sought but not granted. It must be remembered that by 1800 there were 335 charters granted in the United States.<sup>81</sup>

As previously stated, legislatures granted most early charters for limited durations and usually reserved the right to amend or repeal them. Research has failed to reveal any index by which these writers can measure the importance of these factors in determining whether they deterred joint stock association promoters from seeking charters. However, it has been suggested that these factors were significant.<sup>82</sup>

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78. *Id.*

79. 3 N.Y. STAT. 726 (1863).

80. *See, e.g.,* 2 J. DAVIS, *supra* note 1, at 304-06.

81. *Id.* at 27.

82. S. LIVERMORE, *supra* note 36, at 260-61.

Finally, analysis of many corporate charters and other relevant materials provides evidence that it often took a considerable period of time to obtain charters. Although no single one of these factors prompted businessmen to utilize the joint stock association rather than the traditional partnership, it is submitted that collectively these factors contributed to the development of the association. And if monopoly rights and other special privileges had not been granted in bank, insurance, and public utility charters, those promotions might not have sought charters in abundance beginning with the last decade of the eighteenth century.

Thus businessmen fashioned devices to fit their needs despite the inconvenience in avoiding certain common law notions, and the uncertainty as to how the courts would react. But such application of corporate norms to non-chartered associations was not widespread; although it was quite prevalent in the land merchandising industry, it was only occasionally used in other areas of business. There was not, therefore, significant pressure for an inexpensive and quick method of securing the greater legal certainties that accompanied a corporate charter. It was not until technology had advanced sufficiently to permit large-scale enterprises in other areas of greater economic significance that there developed sufficient demand for general incorporation laws. This occurred as the factory system was adapted to the textile industry in New England. Many firms converted to integrated factories after the power loom was introduced at the Boston Manufacturing Company plant in Waltham, Massachusetts. Such activity required significantly more capital than had ever been amassed for a manufacturing company in the United States. And it was with the advent of these firms that many outside investors, some of whom were secretaries, clerks, students and mechanics, began to subscribe for shares.<sup>83</sup> Although this process first began with great force in the textile industry, it was in connection with the growth of railroads that the process was extended and applied most dramatically. As early as 1831, the year of incorporation of the Boston and Worcester Railroad, shares of stock were sold from door-to-door in an attempt to raise a great amount of capital from a large number of persons, many of whom subscribed for only a few shares.<sup>84</sup> As the factory system was expanded and as the railroads were promoted, corporate norms became increasingly important; and although limited liability was not of great significance in the first two decades of the nineteenth century, there is evidence that it became more important during the period that the textile mills and railroads were established.<sup>85</sup> Accordingly, the promotion of these large firms provided impetus for the enactment of general incorporation laws.

Modern corporation laws owe a great debt to the businessmen and

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83. See C. WARE, *supra* note 44, at 150.

84. See S. SALSURRY, *THE STATE, THE INVESTOR, AND THE RAILROAD—THE BOSTON & ALBANY, 1825-1867* 80-92 (1967); see also JOHNSON & SUPPLE, *BOSTON CAPITALISTS AND WESTERN RAILROADS* 33-59 (1967).

85. See E. DODD, *supra* note 22, at 364-437.



lawyers who experimented with the joint stock association in the three decades before the beginning of the nineteenth century. Many of the norms associated with modern corporation laws were applied to unincorporated firms before they were written into charters by American legislatures. If the courts had recognized the joint stock association as a distinct business form and if the limited liability concept had been applied to the associations when it became important, there might have been no need for general incorporation laws for manufacturing firms. However, the courts were slow to meet the needs of business developments; thus when there was sufficient economic pressure, the legislatures supplied the general incorporation device.

## VI. THE NEW LOOK: CLOSE CORPORATION LAW AND FEDERAL CORPORATION LAW

The general incorporation laws were a welcome innovation to the promoters of large-scale enterprises. Incorporating by special act was difficult, uncertain and time consuming.<sup>86</sup> In addition to expediting the procedure of incorporating, general incorporation laws attempted to codify the relationships among corporate managers, owners and the public. These relationships were originally codified with standards which were appropriate for the publicly held corporations and in many respects inappropriate for the close corporation.<sup>87</sup>

As noted above, the first general incorporation laws were enacted as early as 1809 in Massachusetts and 1811 in New York.<sup>88</sup> But the first modern "liberal" general corporation act was passed in New Jersey in 1875.<sup>89</sup> It was this statute which brought to New Jersey the holding companies, known as "trusts," during the last decade of the nineteenth century and the early 1900's.<sup>90</sup> Delaware followed with a permissive act of its own, and when New Jersey modified its laws to be more restrictive, Delaware became, and still is, among the most popular states in which

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86. As a consequence the Legislature at every session was asked to grant many special charters, especially for mercantile and transportation companies. By reason of this fact the business before the Legislature became congested, matters of the utmost public importance were delayed, and many bills of both a public and a private nature were enacted without mature consideration, and corporations frequently obtained peculiar advantages in their special charters to the detriment of other bodies of like nature.

State *ex rel.* Moodie v. Bryan, 50 Fla. 293, 382, 39 So. 929, 957 (1905).

87. The early general corporation laws codified the norms already established during the special charter period for publicly held corporations. See Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 276 (1967). Until the second half of the nineteenth century, the corporate device was not widely used by small firms which generally operated as partnerships or sole proprietorships.

88. For the Massachusetts Act, see MASS. LAWS May Sess. 1806—Jan. Sess. 1809. ch. 65; for the New York Act, see 3 N.Y. STAT. 726 (1863).

89. By amendment to its general corporation law, [1875] N.J. LAWS, New Jersey was the first state to permit inter-corporate stock ownership. Chs. 269, 295, §§ 1-2 [1888] N.J. LAWS (repealed 1896); Ch. 171, § 1-3 [1893] N.J. LAWS (repealed 1896).

90. See *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 548-64 (1933) (Brandeis, J. dissenting opinion).

to incorporate large-scale, interstate businesses.<sup>91</sup> Delaware's attitude had been and is "to maintain a favorable business climate and encourage corporations to make Delaware their domicile."<sup>92</sup> While some states have not followed the liberal trend,<sup>93</sup> competition among the states for incorporations has caused most states to enact increasingly permissive statutes,<sup>94</sup> often modeled after the Delaware law. The most recent Delaware revision resulted in the 1967 Delaware Corporation Law.<sup>95</sup> It is interesting to note that the great popularity of Delaware's statute over the last fifty years worked against certain further modernization in the most recent revision; the members of the Delaware Law Revision Commission felt compelled to retain many portions of the older law because lawyers throughout the country had become so familiar with it.<sup>96</sup>

While general incorporation laws were not enacted with the nonpublic corporation in mind, the ease of incorporating under these laws made their use attractive to the promoters of close corporations,<sup>97</sup> and in the last half of the nineteenth century a significant number of small firms began using the corporate device.<sup>98</sup> It was not, however, until the enactment of high personal income tax rates in the 1940's that there occurred the greatest expansion in the use of the corporate form of doing business by closely held firms.<sup>99</sup> The courts were at first inflexible in applying the same rules to all corporations, whether public or private, and there arose a large body of literature criticizing the corporation laws for their lack of adaptability to the needs of small firms.<sup>100</sup> In response to these needs, some amendments to the general incorporation laws occurred as early as the 1930's, a few courts eventually liberalized their attitudes, and recently several states have enacted special statutes for the close corporation.<sup>101</sup> For unexplained reasons, some of these recent statutory changes have not met with immediate acceptance by the legal and business communities.

An analysis of the provisions of the general corporation statutes is not within the scope of this article. The point is, however, that in each

91. Ch. 18, §§ 1, 2 [1913] N.J. LAWS (repealed 1917).

92. See G. SEWARD, BASIC CORPORATE PRACTICE 5 (1966).

93. E.g., California. See Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROB. 193 (1958).

94. See Manne, *supra* note 84, at 269, n.20.

95. 56 Del. Laws, ch. 50; see Arsht and Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75 (1967).

96. See Corroon, *The Proposed New Delaware Corporation Statute*, 20 J. LEGAL ED. 522, 523 (1968).

97. See Manne, *supra* note 87, at 277.

98. See G. EVANS, BUSINESS INCORPORATIONS IN THE U.S. 1800-1943 75 (1948).

99. U.S. Bureau of the Census, HISTORICAL STATISTICS OF U.S. COLONIAL TIMES TO 1957 572 (1960).

100. See, e.g., Hornstein, *Stockholders' Agreements in the Closely Held Corporation*, 59 YALE L.J. 1040 (1950); Israel's, *The Close Corporation and the Law*, 33 CORNELL L.Q. 488 (1948); O'Neil, *Recent Legislation Affecting Close Corporations*, 23 LAW & CONTEMP. PROB. 341 (1958); Powers, *Cross Fire on the Close Corporation: Norms Versus Needs*, 11 U. FLA. L. REV. 433 (1958).

101. See, e.g., FLA. LAWS ch. 63 (1963); 56 DEL. LAWS ch. 50 (1967).

instance the corporation and its activities were governed by *state* law. Congress consistently rejected proposals for general federal corporation act. But this is not the whole story; it is merely the first chapter. The remainder is recent in origin and current in significance: the story of the federal common law of corporations. In short, federal statutes, rules and regulations, especially in the area of securities regulation, have formed a base for gradual development of what has been aptly termed "a new federal law of management-stockbroker relations"<sup>102</sup> and "a federal common law of corporate responsibility."<sup>103</sup> More important, decisions interpreting these federal statutes, rules and regulations have superimposed upon state corporation codes an imposing and voluminous body of law that cannot be ignored.<sup>104</sup> It is a sign of the times that an entire book has been written on one rule dealing with securities regulation.<sup>105</sup>

In addition to the securities laws, other federal statutes have augmented the body of so called "federal corporation law." For example, Congress has granted the Civil Aeronautics Board authority to approve accounting methods and consolidations and mergers of air transportation companies;<sup>106</sup> the Interstate Commerce Commission has been vested with power to regulate accounting procedures, mergers and consolidations of railroads;<sup>107</sup> the Federal Communications Commission has been granted authority to regulate consolidations, mergers, accounting methods and interrelated boards of directors of certain communications companies;<sup>108</sup> and the Federal Power Commission has been given jurisdiction to regulate the sale of securities, mergers and consolidations of electric utility firms.<sup>109</sup>

As the states have liberalized their general corporation laws permitting businessmen flexibility in using the corporation, federal laws have developed with increasing restrictions. It has been suggested that "the development of federal corporation law has usurped the states' functions" and even "hampered states' efforts to develop viable rules."<sup>110</sup> While this

102. Biggs, C.J., in *McClure v. Borne Chemical Co.*, 292 F.2d 824, 834 (3d Cir. 1961), *cert. denied*, 368 U.S. 939 (1961).

103. Friendly, J., *In Praise of Erie—and of the New Federal Common Law*, 39 N.Y.U.L. REV. 383, 413 (1964). See also Cohen, *Federal Corporation Law*, 20 J. LEGAL ED. 529 (1968); Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965).

104. See, e.g., *SEC v. Texas Gulf Sulphur Corp.*, — F.2d — (2d Cir. 1968); *Globus v. Law Research Service Inc.*, 287 F. Supp. 188 (S.D.N.Y. 1968); *Escott v. Barchris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). For a recent case illustrating the impact of "federal thinking" on state law, see *Diamond v. Oreamuno*, 29 App. Div. 2d 285, 287 N.Y.S.2d 300 (1968) (holding that under New York common law, officers and directors may be required to disgorge to the corporation benefits realized from their trading in the corporation's shares on the basis of material inside information).

105. A. BROMBERG, *SECURITIES LAW: FRAUD*, SEC RULE 10b-5 (1967).

106. See Federal Aviation Act of 1958 § 1378, 49 U.S.C. § 1378 (1964).

107. See Interstate Commerce Act § 5, 49 U.S.C. § 6 (1964).

108. See, e.g., Communications Act of 1934 § 222, 47 U.S.C. § 222 (1964).

109. See, e.g., Federal Power Act § 824c, 16 U.S.C. § 824c (1964).

110. These suggestions have been challenged by the Chairman of the Securities and Exchange Commission. "My own feeling is that the development has taken place generally in the areas where state law did not and could not provide the type of investor protection

statement may be accurate in some respects, it is nevertheless true that the states have enacted a body of law, known as the Blue Sky laws, regulating the sale of securities and broker-dealers in the securities industry. The first state securities act was passed by Kansas in 1911 followed shortly by statutes in North Carolina, Arizona and Louisiana. With the sole exception of Delaware, states, as well as the District of Columbia and Puerto Rico, have enacted some form of Blue Sky law. New York finally enacted a statute, effective November 1, 1968, requiring the registration of intra-state securities issues.<sup>111</sup> These state securities laws vary from state to state, the most liberal jurisdictions requiring only full disclosure of pertinent facts and the more restrictive jurisdictions judging the merits of the securities and denying registration if the issuer does not conduct its affairs upon "sound business principles" or if the terms of sale of the securities would be unfair, unjust, or inequitable.<sup>112</sup> To implement these latter statutes, state securities administrators have adopted comprehensive rules and regulations regarding specific qualifications, such as limitations on promoters' shares,<sup>113</sup> options,<sup>114</sup> dilution of equity<sup>115</sup> and net worth,<sup>116</sup> for firms seeking to sell shares publicly. The economic implications of the restrictive type of state securities law are considerable; yet this area<sup>117</sup> and the economic implications of the federal securities acts have been sorely neglected by most commentators.<sup>118</sup>

In sum, there has been superimposed upon state corporation law a vitally important and constantly expanding area of regulation consisting of the federal securities acts and their rules and regulations, decisional law interpreting these statutes, rules and regulations, the federal and state laws regulating firms engaged in specific industries, and the Blue Sky laws. In this connection, major attention has been focused on federal securities regulation. This aspect of "federal corporation law" looms large on the current corporate scene. It is the writers' opinion that its impact on state corporation law, considerable as it is, has just begun and that its influence will expand immensely in the years ahead.

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which is essential to informed allocation of savings, so necessary to the continued growth of our economy." Cohen, *Federal Corporation Law*, 20 J. LEGAL ED. 529, 534 (1968).

111. N.Y. GEN. BUS. LAW § 359-ff (McKinney 1968).

112. See, e.g., FLA. STAT. § 517.09 (1963).

113. See, e.g., Rules of Florida Securities Commission § 330-1.08.

114. See, e.g., *id.* §§ 330-1.06, 330-1.07.

115. See, e.g., Rules and Regs. under Colo. Sec. Act, Rule V(D)(5) (1967).

116. See, e.g., Rules of Florida Securities Commission, § 330-1.04.

117. See Manne & Mofsky, *What Price Blue-Sky?*, BARRON'S, August 5, 1968, at 5.

118. For a notable exception, see the excellent analysis in H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966). Papers, as yet unpublished, by prominent economists were delivered on March 7 and 8, 1968, at a symposium entitled, *Economic Policy and the Regulation of Corporate Securities*. Professor Henry G. Manne was the Director of this symposium which was sponsored by the American Enterprise Institute and the National Law Center of the George Washington University.