The Private Origins of the Private Company: Britain 1862-1907

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Abstract

This article recalls the fact that in Britain (and elsewhere), until the mid-19th century, neither company legislation, nor jurists or economists, envisioned companies to be private or small. Nevertheless, once freedom of incorporation and general limited liability were enacted, a new practice was set in motion. Smaller companies were formed in growing numbers, replacing partnerships, family firms and even sole proprietorships, and operated in sectors in which corporations had not been found before. These companies did not seek access to the stock markets. The article tracks the take-up pattern of the corporate form in Britain. It analyzes the reasons for the decision of businesspersons to incorporate their small firms. It examines the reactions of the courts (in the famous *Salomon v. Salomon* case) and of the legislature to this unpredicted practice, which emerged from the bottom up. It argues that incorporators and their lawyers used the available contractual flexibility to privately design the Articles of Association and adjust them to the specific needs of private and small companies, often by introducing partnership internal governance rules into company Articles. Eventually, in 1907, the private company was recognized by the Companies Act. The article relies on newly gathered data on the take-up of the company form and a newly produced sample of company files. It is part of a wider collaborative and comparative project that studies private limited liability companies (PLLCs) in Germany, Britain, France and the US.

Unlike living organisms, and contrary to a common misconception, business corporations did not begin small (and private) and only then grow bigger (and public). The giant (public) English and Dutch East India Companies already dominated Eurasian trade shortly after 1600. The most famous single-person corporation "Aron Salomon and

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Company, Limited," one of the early private companies, was not formed until almost 300 years later, in 1892. This article explores the origins of the private company in Britain, which was first recognized by the Companies Act only in 1907. But during the second half of the 19th century, it gradually developed from below, created by businesspersons and their lawyers (thus the "private origins" in the title). The initial impetus for its development was the introduction of free incorporation and general limited liability in the mid-19th century. These first decades of the private company in Britain are a fascinating case study in private ordering and development of law from below.

The article first establishes the large public company as the paradigmatic company in the mid-19th century. Based on a quantitative study, it then reveals that the company form, in terms of size and number of shareholders, changed dramatically in the second half of the century. It examines which types of firms, in terms of kind of industry and previous form of organization, converted into private companies. It studies why the company form was attractive to businesspersons at the time, paying particular attention to the limited liability privilege as a benefit and the disclosure requirement as a cost. It then analyzes the legal reactions to the informal appearance of the private company as reflected in court decisions, legislative committees and the Companies Acts. It finally focuses on the adjustment of the internal governance rules of the company form, initially created for public companies, to the needs of small private firms. Contractual flexibility was the precondition and private ordering was the tool. The discussion examines the space created by the Companies Act; the contracting practices, as reflected in a quantitative sample and a case study; and the court responses.

This article reports on part of a wider comparative project. The introduction of a new form, the Private Limited Liability Company [PLLC], is a more widespread phenomenon. The form was first introduced in Germany in 1892 as the GmbH. After its introduction in Britain in 1907, it was introduced in France in 1925 as the SARL. The US is the outlier. Following an abortive attempt, in the 1870s and 1880s, to introduce the partnership association with most of the features of PLLCs in several states, the successful introduction of a PLLC form, the LLC, occurred only a century later, in the 1980s.

The project aims to shift some scholarly attention from the large public corporations to small- and medium-sized enterprises (SMEs). By offering a comparative perspective, it questions the assumed superiority of US organizational law. By examining the full organizational menu of SMEs in each country, including the various types of partnerships, it questions the assumed superiority of the corporate form for all types of enterprises. By collecting and analyzing incorporation contracts (bylaws/regulations/articles of association, as they are called in different jurisdictions), the project reveals the multi-dimensional and complex nature of organizational form choice and contracting. An analysis of these contracts is best done when examined against the background of both the typology of organizational forms and the contractual flexibility within each form. The different forms and different contracts can be understood as different tradeoffs between minority oppression and consensus requirement that creates deadlocks and between lock-in and untimely dissolution based on the identity of the contracting parties and the nature of the firm and its assets.[2]

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[2] Timothy W. Guinnane, Ron Harris, Naomi R. Lamoreaux, and Jean-Laurent Rosenthal, *Pouvoir et proprit dans lentreprise: pour une histoire international des socitis responsabilit limite,* Annales: Histoires, Sciences Sociales, 63 (janvier-fvrier 2008), pp. 73-110. (An English version available as *Ownership and Control in the*

First They were all Public

Until the introduction of the general incorporation Act in 1844, no one in Britain envisioned small, closely held corporations. A corporation could be formed only by royal charter, special act of Parliament, or a combination of the two. The King or Parliament had to be convinced that the incorporation could promote the public good. Promoters did not bother to take the long and expensive route of incorporation by act or charter, unless they wished to form a large enterprise and to raise substantial capital from outside investors. A typical 17th century corporation was an overseas trading corporation, the East India Company being the prime example. A typical early 18th century corporation was a financial corporation such as the Bank of England, the South Sea Company or the Royal Exchange Assurance. A typical late 18th century corporation was a canal company. A typical mid-19th century corporation was a railway company.

In 1776, Adam Smith stated that the joint-stock company form should be used only by large companies in four sectors: "first, the banking trade; secondly, the trade of insurance from fire, and from sea risk and capture in time of war; thirdly, the trade of making and maintaining a navigable cut or canal; and, fourthly, the similar trade of bringing water for the supply of a great city."[3] Interestingly, when 50 years later, the Committee of Privy Council for Trade announced its policy with respect to the granting of letters patents of incorporation based on the 1834 Companies Act, it related to the same sectors and

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Entrepreneurial Firm: An International History of Private Limited Companies, Yale University Economic Growth Center Discussion Paper #959 [December 2007]). Timothy Guinnane, Ron Harris, Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Putting the corporation in its place*, 8 Enterprise and Society 687 (2007). Naomi R. Lamoreaux & Jean Laurant Rosenthal, *Legal Regime and Contractual Flexibility: A Comparison of Business's Organizational Choices in France and the United States during the Era of Industrialization*, 7 American Law and Economics Rev. 68 (2005). Naomi R. Lamoreaux & Jean Laurant Rosenthal, *Entity Shielding and the Development of Business Forms: A Comparative Perspective*, 119 Harv. L. Rev. Forum 238 (2006).

[3] ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

envisioned the same scale.[4] Single proprietor enterprises never sought incorporation. Small enterprises of two or more proprietors were, by default, common law partnerships.

The 1844 Registration, Incorporation and Regulation Act shuffled the cards. Now corporations could be created by mere registration with the Companies Registry Office, the forerunner of Companies House, established by the Act. Registration required filing a few documents and forms that provided the public with basic information about the company. The Act also made a clear distinction between corporations and partnerships. The unincorporated company, a popular from used by some of the smaller firms to avoid the costs of incorporation, lost ground. Unincorporated companies could easily register and enjoy all the legal features of a corporation. On the other hand, they were obliged to register. It became illegal for partnerships with transferable shares and for partnerships with more than 25 members not to turn into registered corporations. The in-between space created from below by private ordering of lawyers and businesspersons, using contracts, partnership law and trust law, was eliminated by the 1844 Act.

The 1855-56 Companies Acts provided all corporations that decided to opt into it with limited liability. The consolidated 1862 Act was the basis for statutory law for the rest of the 19th century. It adopted the same framework, which assumed corporations to be large and public. The Act, like the 1844, 1855, and 1856 Acts, did not distinguish between corporations based on number of incorporators and shareholders, on capital, or on transferability of shares.

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[4] RON HARRIS, INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844 (2000). The only difference being that railway companies, which Smith had not foreseen, were included in the Board of Trade guidelines.

The emergence of the Private Company – Quantitative Trends

The diffusion of the corporate form after the introduction of freedom of incorporation and general limited liability and the 1862 Companies Act reflects at least two trends. The first is the shift to larger firms and the resulting incorporation of growing firms and newly established large firms. These were incorporated as what we today call public companies. The second trend is the incorporation of smaller firms, into what we have since 1907 called private companies.

The first trend, the development of public companies, has received most of the attention of the literature in law, economics, finance and business. It marginalized the second, which is at the center of the current article. The appearance of smaller companies, with fewer shareholders, less capital and no intention to raise capital on the stock exchange in the second half of the 19th century, is not unknown to historians. But this trend was surveyed mainly in older articles and dissertations.[5] In this section, I will consolidate some of the findings of this literature and add new quantitative findings, based on two datasets that I produced as part of the current project. The section will show that the trend toward the incorporation of small firms and the creation of informal private companies gathered momentum in the last three decades of the 19th century, and that eventually, the large majority of companies became small private companies.

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[5] J. B. Jefferys, *Trends in business organization in Great Britain since 1856: with special reference to the financial structure of companies, the mechanism of investment and the relations between the shareholder and the company* (Ph.D. thesis, London 1938);

H.A. Shannon, *The First Five Thousands Limited Companies and their Duration*, 3 Economic History 421 (1932);

Geoffrey Todd, *Some Aspects of Joint Stock Companies, 1844-1900*, 4 The Economic History Rev. 46 (1932).

The first pattern to be noted is the sharp increase in the total number of companies. Only 124 companies existed in 1824. In 1843, on the eve of general incorporation, about 720 companies were "known on the London market." These were concentrated mostly in the banking, insurance, canal, railway, mining and shipping sectors.[6] Quite what Adam Smith would have liked to see. In the late 1830s and early 1840s, a few dozen joint-stock companies were incorporated annually.[7] Within 14 months of the passage of the 1844 General Incorporation Act, 1,639 joint-stock companies were provisionally registered.

For the period 1844 to 2003, I have constructed a dataset of the adoption of the corporate form, which, for most of the period, is based on annual government reports.[8] Unless otherwise noted, the following figures are based on that dataset, the first of its kind. The average annual number of incorporations in the years 1846-55, after the release of the bottleneck, was 245. In 1856, there were 956 completely registered companies.[9] The passage of the Limited Liability Acts caused the re-registration of many companies as

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[6] RON HARRIS, INDUSTRIALIZING ENGLISH LAW ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844 222 (2000).

[7] Incorporation in this period could be obtained by acts of parliament, charters and letters patent issued by the Board of Trade. Some enterprises organized as unincorporated companies, relying on partnership, trust and contract law. Thus, precise figures cannot be offered here. See RON HARRIS, INDUSTRIALIZING ENGLISH LAW : ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844, 220-221 (2000); JAMES TAYLOR, CREATING CAPITALISM : JOINT-STOCK ENTERPRISE IN BRITISH POLITICS AND CULTURE 1800-1870 136 (2006).

[8] For the period until 1861, the figures are taken from several sources, mostly from LEONE LEVI, COMMERCIAL LAW OF THE WORLD (1854); H.A. Shannon, *The First Five Thousands Limited Companies and their Duration*, 3 Economic History 421 (1932). For the years 1856-61, I preferred Shannon's figures over Todd's which were somewhat higher. See Geoffrey Todd, *Some Aspects of Joint Stock Companies, 1844-1900*, 4 The Economic History Rev. 46 (1932). For the period 1862-2003, figures are all taken from official publications, the annual "Report of the Board of Trade," later called the Department of Trade and finally, the Department of Trade and Industry [DTI]. Figures are for Great Britain.

[9] Based on the 1844 Act. This act included two stages of registration: provisional and compete. Only a fraction of the companies that registered provisionally went through the entire process. Some neglected to do so, some were unable to raise capital, some were dissolved. In a few sectors, a different procedure applied. See RON HARRIS, INDUSTRIALIZING ENGLISH LAW : ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844, 288 (2000).

limited companies and a continued rise in the number of new registrations. The average number of registrations for the period 1856-1869 was 445. In most years after 1872, the number was over 1,000. In each year after 1889, the number was more than 2,500. The annual average for the 1890s was 3,661 [see figure 1]. The total net stock (registered minus dissolved) of companies in 1900 was 28,639, almost 30 times the number of completely registered companies in existence in 1856. In 1907, on the eve of the introduction of the private company, and despite the downturn in annual incorporation that followed the harsh 1900 Companies Act, the Boer War and the economic slowdown, 41,651 companies were registered.

The diffusion and expansion figures are impressive also when adjusted to population or GDP growth. Annual registrations per 1,000 people rose by 13, from 0.009 in 1860 to 0.118 in 1900. Registration per million pounds GDP rose by 8, from 0.004 in 1860 to 0.032 in 1900.[10] This in itself may hint that more also means smaller, and that firms, which were too small to incorporate during the era of incorporation as discretionary privilege, sought incorporation once restrictions were removed, a process that continued for the rest of the 19th century.

Another indication of a second major trend between 1862 and 1907 can be found in the nominal capital of registered companies. The total nominal capital of registered companies is not instructive because it may only reflect the first trend, the huge increase in registration. The second trend can be seen in the average registered capital per company, which declined from £170,188 in 1863-69, to £82,093 in the 1870s, to £54,479 in the

[10] Calculations based on GDP at constant 2002 market prices and population for Great Britain. Source of GDP and Population: Lawrence H. Officer, "The Annual Real and Nominal GDP for the United Kingdom, 1086 - 2004." Economic History Services, September 2005, URL: http://eh.net/hmit/ukgdp/ Update source and figures.

1890s to £33,519 in 1900-1907. This, despite the counter effect of the increase in the size of large and public companies, due to technology, networks and economies of scale effects.

Only 19 companies registered in 1877 with capital of less than £1,000 (2.3% of total number of registered companies). By 1906, there were 408 such companies (9.3%). The number of companies registered with capital of between £1,000 and 5,000 rose from 152 (18.6%) in 1877, to 1,341 (30.9%) in 1906. Companies with between £5,000 and 10,000, rose from 172 (13.5%) to 672 (17.1%). The total percentage of these low capital companies increased from 34.4% to 57.3%.[11] The share of each of the ranges above £10,000 lessened [see Table 1].

The capital data analyzed above has a major shortcoming. It relates to nominal capital, not called-up or paid-up capital. Nominal capital may not reflect much about the size of companies if it does not correlate with paid-up capital.[12] Its main advantage is that it is more readily available because it can be extracted from the annual reports of the Board of Trade on the activities of the Companies Registrar. It provides a snapshot on the day of incorporation of each company. Companies were required by the Companies Act to file their own annual reports as well as special reports with the Registrar. Based on a study of

[11] These are current nominal capital figures. Adjustment to the retail price index (that depreciated 13% over the period) would suggest a sharper reduction in the percentage of smaller companies.

[12] There are good reasons to believe that paid up capital was not inflated arbitrarily. For one, not all companies inflated their capital. One reason for this was that fixing of high nominal capital shifted control over the allocation of shares from the shareholders to the directors. An additional reason was that promoters paid stamp duty based on level of registered capital.

such records, scholars have concluded that the gap between nominal and paid-up capital narrowed over the second half of the century.[13]

The second dataset used in this section is a random sample of company files photocopied at the National Archive and Companies Registrar and coded.[14] It allows tracking of paid-up capital, as these files contain post-registration filings. Of the companies in the sample of companies registered in 1892, 46% had nominal capital of less than £10,000 at registration. Of those that reported paid-up capital, 67% had paid-up capital of less than £10,000 at the end of 1892 and 59% at the end of 1897 (see Table 1). While this one-year sample cannot indicate trends over time with respect to the gap, it supports the assertion that some two-thirds of the companies were small, in terms of paid-up capital.

Another perspective on the size of companies is the number of shareholders. As 7 was the minimum required by law, even one-person companies had 7 nominal shareholders. This issue will be discussed below. But apparently larger companies as well incorporated

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[13] Several scholars suggest that a significant gap existed between nominal and paid-up capital of companies in the mid-19th century and that the gap narrowed as the century progressed. For example, Shannon, based on an unspecified 20% sample, argued that the gap in low denomination shares narrowed considerably between the 1860s and 1880s but that this was not the case with high denomination shares. See H. A. Shannon, *The Limited Companies of 1866-1883,* 4 The Economic History Rev. 290 (1933). One could argue that the decline in average nominal capital reflects only a narrowing of the gap. But the sharp increase in the absolute number of companies and in low denomination shares suggests rather the emergence of the private company as a sole explanation for the data.

[14] A sample of 50 dissolved companies was drawn from National Archives BT 31 Board of Trade: Companies Registration Office: Files of Dissolved Companies 1855-1976 (45987 boxes, files and volumes). Files in the National Archives are kept in boxes that were received From Companies House. These are organized based on date of dissolution, not date of registration. They are kept in this order because this is how they were shipped from Companies House after being held there for about 20 years after dissolution. In order to avoid biases that result from sampling based on date of dissolution, I sampled 1892 companies based on their original running registration numbers, using a table titled "Last Company Number for each Calendar Year." I then located the files of these companies in the various Boxes sent over the years, and photocopied them. The sample is thus of companies that were registered with the Companies Registrar in England and Wales in 1892. This sample did not pose problems regarding active or recently dissolved companies or with destroyed files, as the numbers of these are insignificant for 1892. In samples for later years that will be used in future stages of the project, supplements and adjustments were made, insofar as feasible, to account for them.

with only 7 shareholders – the required signees of the memorandum. This became the standard practice of company lawyers. All but one of the companies in the 1892 sample had 7 shareholders at incorporation. Later, more shareholders were added to the larger companies. Most surviving and reporting companies had more than 7 shareholders by the end of the first year (all but 7 companies) and the fifth year (all but 2 companies; see Table 2). The figure is probably upward-biased because companies with few shareholders had higher representation among the non-reporting companies. So while this data does not suggest a strong shift to companies with a small number of shareholders, it may indicate their prevalence.

Several contemporaries observed this change and began to talk about a new type of company, the private company. In the preface to the tenth edition of his book, *Private Companies and Syndicates, Their Formation and Advantages* published in 1892, Francis B. Palmer wrote:

> *During the last ten years the conversion, under the Companies Act, 1862, of business concerns into private companies, i.e. companies started without any appeal to the public for capital has made extensive progress.*[15]

His testimony fits the trend I observed quantitatively:

> *It took a good many years before the immense advantages of the Act of 1862 were fully understood. At first, the Act was almost exclusively used for public companies with numerous shareholders … it came to be understood that the Act … had freed the community at large from the tyranny of unlimited liability. Since this discovery, thousands of private companies have been formed and the number is rapidly increasing, as day by day the advantages of the system become more and more appreciated.*[16]

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[15] FRANCIS BEAUFORT PALMER, PRIVATE COMPANIES; OR HOW TO CONVERT YOUR BUSINESS INTO A PRIVATE COMPANY, AND THE BENEFIT OF SO DOING (1892). He attributed much of this progress to the guidance provided by his own book that had come out in yearly editions during the previous decade.

[16] FRANCIS BEAUFORT PALMER, PRIVATE COMPANIES; OR HOW TO CONVERT YOUR BUSINESS INTO A PRIVATE COMPANY, AND THE BENEFIT OF SO DOING, 4-5 (1892).

The analysis of the datasets supports and quantifies what well-informed contemporaries and a few historians observed. Between the introduction of general limited liability (in 1856/62) and the formal introduction of the private company (in 1907), more and smaller firms were incorporated. This amounts to a dramatic turn, at least in terms of numbers, in the use of the corporate form. The private company diffused and prospered for at least three decades before it was finally introduced by the Companies Act of 1907.

Who were the Private Companies?

A formal legal distinction between public companies and private companies did not exist prior to the 1907 Companies Act.[17] Until then, private and public companies were not legally distinguishable. I would like to offer a range of types of companies. The types in the upper part of this range could, in retrospect, be considered public companies, as they raised external equity finance from the public. The types in the lower part of the range could be considered (both in retrospect and by some contemporaries such as Palmer) private companies. But rather than this dichotomizing typology, I would like to suggest a typology within each basic type, based on the level of resorting to the public for external finance for public companies and on the previous organizational form of the company for private companies. While there is a link between the organizational type and the size of the firm, this link is not necessarily very strong. To be clear: though the two are linked and sometimes overlap, in this typology and in the article as a whole, the focus is on organizational type and not on the size of the firm.

[17] The 1907 Act defined the private company as one whose articles of association prohibited inviting the public to subscribe to its share and debenture capital, restricted the transferability of its shares, and limited the number of its shareholders to 50. Companies Act, 1907, 7 Edw.7 c.50, s. 37(1).

Located on one side of the typology range was the standard, large, publicly held, widely dispersed, stock exchange listed and actively traded corporation, with which I will not deal here. Down from it were additional sub-types of public and semi-public companies. These include the publicly traded company with controlling shareholder, the company that was traded only in provincial stock exchanges, the company that turned to the primary market at its initial public offering (IPO) but was traded irregularly, with low liquidity, or not listed and quoted at all in any formal secondary market. Public companies could be found in infrastructure, utility and network sectors such as railway, canal, water supply, gas lighting and the developing telegraph and electricity sectors. They could also be found in second industrial revolution technology and capital intensive industries such as steel and chemical manufacturing, shipping, and the infant bike and automobile industries and in first industrial revolution sectors, textile, mining and metal manufacturing, in which some firms adopted mass production and economies of scale and grew larger and public.[18]

At the other end of the range were single-person companies (or in contemporary, gender-biased jargon, one-man companies). The Companies Act required a minimum of 7 members in a company. The simple solution was to use 6 dummy members. I will discuss its legality below. One step up was a family company in which one of the family members, typically the patriarch, controlled and managed the company by himself. Other

[18] The literature on public companies in this period is considerable. For literature on technological, financial, managerial and legal aspects of these companies see: JOEL MOKYR, THE LEVER OF RICHES: TECHNOLOGICAL CREATIVITY AND ECONOMIC PROGRESS (1990), 113-148; P. L. COTTRELL, INDUSTRIAL FINANCE 1830-1914: THE FINANCE AND ORGANIZATION OF ENGLISH MANUFACTURING INDUSTRY (1980); R. C. MICHIE, THE LONDON STOCK EXCHANGE: A HISTORY (2001), 70-142; WILLIAM ARTHUR THOMAS, THE PROVINCIAL STOCK EXCHANGES (1973); LESLIE HANNAH, THE RISE OF THE CORPORATE ECONOMY (1976), 1-28; ALFRED D. CHANDLER & TAKASHI HIKINO, SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM (1990), PART III; BRIAN R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED (2008) 175-220.

members could be employed by the company or receive some of the profits at the discretion of the patriarch. But governance was not an issue and was not regulated by law. I will discuss below whether the famous *Salomon v. Salomon* case, which is conventionally viewed as dealing with a company of the first sub-type, indeed belongs to the first, or in fact, to the second sub-type.

Another step up was a company that was originally controlled by a patriarch but by the second or third generation, its shares were held by several heirs, siblings, cousins, etc. Such companies could now encounter management and control conflicts.

A further step up included companies with a small number of shareholders who were not members of the same family. These could be partnerships, which turned into companies once incorporation became more accessible and cheaper, or new firms that decided for the same reason to incorporate rather than to be run as common law partnerships.

All the above were prototypical private companies. They did not intend to raise capital from a large number of outsiders. They were often small or medium-sized enterprises in terms of capital, revenues and employees. Like in partnerships, in such corporations, shareholders were often also employees and active in management. The relationships between them were personal. They did not want to share the company with strangers. These were closed corporations in the sense that transfer of shares was restricted, as we shall see, and often required consent of all shareholders or directors.

This article examines the emergence of all sub-types of the private company, as typified above, from the single-person company, to the family company, and to the

partnership-like company. Public and semi-public companies of the first type, and its sub-types, are not our subject.

What were all these private companies doing? Some of them were in traditional manufacturing sectors such as textiles. It is well known that most of the manufacturing firms of the first industrial revolution were small or medium sized and not incorporated. They were often part of the "family establishment" in terms of purpose, finance, accounting, residence and management. By the mid-19th century, more of these firms (among those that survived and did not grow large and public) were sufficiently separated from the household, in the immediate sense of physical location and in terms of their cultural conceptualization, to consider incorporation as private companies.[19]

Diffusion of the company form to the core of traditional manufacturing was partly related to the first trend of growing large and raising external capital in the market and partly to the second trend of turning family firms and partnerships into private companies. The private company form diffused to other sectors as well. The engineering and production of machines for the production line often remained a small business because of its individualized needs. The production of finished consumer goods such as shoes, cloths, kitchenware, clocks, books, processed food, also remained small scale as did trade, mainly but not only, retail.[20] Service firms, not including professional services that could not incorporate, also had a potential for incorporation. Birmingham and London's East End were more typical of these types of smaller firms than the industrial hubs of Manchester or Leeds. The firm of Aron Salomon, a leather merchant and wholesale boot manufacturer

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[19] LEONORE DAVIDOFF & CATHERINE HALL, FAMILY FORTUNES 195-315 (2002).

[20] M. J. DAUNTON, WEALTH AND WELFARE: AN ECONOMIC AND SOCIAL HISTORY OF BRITAIN 1851-1951, 76-165 (2007).

from Whitechapel, East London, to which we will soon turn, was prototypical of the sectors and scales to which the corporate form diffused in this period.

Why to Incorporate? Limited Liability

The debates in the 1840s and 1850s over the desirability of limited liability did not envision private companies. The question at stake was whether limitation of the liability of shareholders of public companies was morally just and economically beneficial.[21] Company promoters argued that unlimited liability would drain their ability to raise capital from the public in the stock market. Political economists argued that retaining unlimited liability would drive wealthy persons away from holding shares in companies.[22] Bankers feared that limited liability would increase the number of companies that resorted to equity finance through the primary stock market at the expense of debt finance supplied by banks. Depositors feared that that, under limited liability, banks would not survive runs for liquidity and collapse. None of these concerns were relevant to small private companies.

Once limited liability became generally available, it facilitated the creation of partitioning between a person's private assets and his business assets o. But the transition from a regime of unlimited liability to a regime of limited liability was not instantaneous. When general limited liability was introduced in 1855-56, most preexisting companies had

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[21] For recent interpretations of this debate, see PADDY IRELAND, *Limited liability, shareholder rights and the problem of corporate irresponsibility*, 32 Cambridge Journal of Economics (2008); JAMES TAYLOR, CREATING CAPITALISM : JOINT-STOCK ENTERPRISE IN BRITISH POLITICS AND CULTURE 1800-1870 (2006); TIMOTHY L. ALBORN, CONCEIVING COMPANIES : JOINT-STOCK POLITICS IN VICTORIAN ENGLAND (1998); BOYD HILTON, THE AGE OF ATONEMENT: THE INFLUENCE OF EVANGELICALISM ON SOCIAL AND ECONOMIC THOUGHT 1785-1865 (1991).

[22] For a recent empirical study of this hypothesis, see John D. Turner, *Wider share ownership? investors in English and Welsh Bank shares in the nineteenth century* 62 The Economic History Rev.167 (2009).

a significant balance of uncalled and unpaid capital. This balance had two main functions: raising additional capital according to investment needs from existing shareholders, and creation of reserve liability for creditors.

The nominal denomination of shares was reduced in the second half of the 19th century from tens or even hundreds of pounds to as low as one pound per share. In most sectors, the practice of issuing fully paid shares replaced a practice in which initial calls were made for only a fraction of the nominal capital of each share.[23] The two trends together closed the gap that had allowed company liquidators in the past to make substantial calls on shareholders' personal assets on behalf of creditors for the unpaid portion of issued shares. It made the protection provided by limited liability much more effective in large public companies.

But it also legitimized the registration of smaller private companies with low par value and fully paid capital.[24] In smaller companies that did not raise capital from the public, not only did reserve liability, based on the gap, become a matter of the past, but even legal capital, the paid-up capital itself, as a tool for protecting the interest of creditors, became immaterial as long as no minimum capital requirement was enacted. Such a requirement was introduced on the continent, even with respect to private companies. It was suggested to several of the committees that examined company law in England in the second half of the 19th century, but was not adopted in England.[25] The response of English law to newly

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[23] J. B. Jefferys, *The Denomination and Character of Shares, 1855-1885 The Denomination and Character of Shares, 1855-1885* 16 The Economic History Rev. 45 (1946); H. A. Shannon, *The Limited Companies of 1866-1883* 4 The Economic History Rev. 290, 389 (1933)

[24] FRANCIS BEAUFORT PALMER, PRIVATE COMPANIES; OR HOW TO CONVERT YOUR BUSINESS INTO A PRIVATE COMPANY, AND THE BENEFIT OF SO DOING 25-29 (1892) advises incorporators to do just this.

[25] In Germany, even the private company, the GmbH, when introduced, was required to have an issued capital of at least 20,000 Marks (about £1,000). In France, when the SARL was introduced in 1925, its

appearing private companies resorting to limited liability was a non-response. Private companies could benefit from this feature, though it was not designed for them.[26]

The introduction of general limited liability was only the first of several developments that made incorporation more attractive to shareholders vis-a-vis creditors. By the 1860s, the expansion, from railways to other sectors, of the use of debentures as a form of long-term finance legitimized their use in smaller private companies as well. The development of the floating charge as a means for creating secured debt over working capital provided floating charge creditors seniority over unsecured trade creditors.[27] The coupling of the two, from the 1870s on, opened up new avenues for the finance of large public companies. It was also very important for private companies. Promoters-turned-shareholders in such small firms issued debentures to themselves, secured by floating charges in consideration for assets or firms that they sold to the newly formed company. These debentures placed them as senior creditors in the event of insolvency. Before the 1900 amendment to the Companies Act, such charges were not even required to be registered with the Companies Registrar. This is exactly what Aron Salomon did, as is evident in the famous *Salomon v. Salomon* case. But his case was not exceptional. The Davey Committee, appointed in 1894

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minimum capital requirement was 25,000 francs. See Timothy Guinnane, Ron Harris, Naomi R. Lamoreaux & Jean-Laurent Rosenthal *Putting the corporation in its place,* 8 Enterprise and Society 697 (2007); Timothy Guinnane, *Using a new legal form: the GmbH from its Introduction to World War I* (Department of Economics, Yale University September 2008) http://yale.academia.edu/documents/0008/2285/Guinnane_GmbH_October_2008.pdf.

[26] Even modern theory of limited liability is built around the paradigm of the public corporation. See F.H. Easterbrook & D.R. Fischel, *Limited Liabilit and the Corporation*, 52 U. Chi. L. Rev. 89 (1985); H. Hansmann & R. Kraakman, *Toward unlimited shareholder liability for corporate torts*, 100 Yale L.J. 1897 (1991).

[27] R.R. Pennington, *The Genesis of the Floating Charge* 23 Mod. L. Rev. 630, (1960); R. Nolan, *Property in a Fund*, 120 Law Quarterly Rev. 27-32, (2004); J. Armour, *The Chequered History of the Floating Charge*, 13 Griffith Law Rev. 27 (2004); J. S. Getzler, *The Role of Security over Future and Circulating Capital: Evidence from the British Economy circa 1850-1920*, *in* Company Charges: Spectrum and Beyond, 227-251 (2006). To add reference to cases.

by President of the Board of Trade James Bryce to examine the need for amendments to the Companies Act, found the use floating charge debentures by incorporators to be a widespread practice.[28] The Committee characterized this practice as a means "to escape the operation of the bankruptcy law." Yet, it did not recommend prohibiting the practice; it only required disclosure to other would-be creditors, by filing with the registrar.

All of these changes amounted to a dramatic transformation. Before 1844, small firms were not likely to obtain incorporation at all or, at best, had to invest much time and money in incorporation. By 1855, their shareholders enjoyed limited liability. By the 1870s, shareholders were relieved of the threat of calls on an unpaid balance of their shares. By the 1880s, they had become senior creditors of their companies, able to collect from the firm when it became insolvent before most other creditors. Firms that remained sole proprietorships, unincorporated family firms and partnerships could not enjoy any of these privileges. Their partners remained liable, in Lord Eldon's words, to the last penny of debt and to the last penny of their assets.

Did the corporation have any disadvantages from the perspective of liability toward creditors and potential lenders? Could limited liability be a disadvantage for a small private company that had difficulty borrowing money or getting credit? Were potential creditors reluctant to deal with companies because of the concern that in case of insolvency, the feature of limited liability would kick in? Incorporators could opt out of limited liability altogether, yet maintain the corporate form. They could offer potential creditors an interim level of liability by organizing a company limited by warranty, form a

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[28] DEPT. COMMITTEE TO INQUIRE INTO AMENDMENTS IN ACTS RELATING TO JOINT STOCK COMPANIES INCORPORATED WITH LIMITED LIABILITY UNDER COMPANIES ACTS**,** REPORT AND APPENDIX, (c-7779), Parliamentary Papers (1895), vol. ?, p. 151, paragraph 8. [Davey Committee Report]

company with substantial paid-up legal capital, issue non-fully paid shares to themselves, avoid issuing debentures to themselves, offer lenders floating or fixed charges, grant personal guaranty, or a combination of the above. They could discriminate between sophisticated and unsophisticated creditors by offering the first increased security while leaving less limited company assets for the second. They could do any or all of these without fully relegating the corporate form. There was no reason to refrain from selecting the corporate form for this consideration alone. There was no tradeoff. Why not incorporate?

Why not incorporate? Disclosure

One consideration against choosing the corporate form was disclosure and privacy. Partnerships were not required to register or to disclose any information to the public. The codification of the common law and of some bits of statutory law in the 1890 Partnership Act did not introduce either registration or disclosure.[29] When the limited partnership was introduced in England in 1907, its formation required registration. Limited partnerships were required to disclose basic information at formation and on a regular basis, but not accounts or balance sheets.[30] The requirement was not extended to general partnerships.[31]

The 1844 General Incorporation Act was based on the rationale of registration and disclosure. Gladstone's Act replaced traditional State inspection and discretion at the incorporation stage with freedom of incorporation, public information and investor

[29] Partnership Act, 1890, 53 & 54 Vict. C. 39

[30] Companies Act, 1907, 7 Edw.7 c.24.

[31] With one exception, which originated long before the act: dissolution of partnerships had to be reported in the London Gazette in order to detach individuals from any new liabilities of their former partners.

discretion.[32] Incorporators had to provide information to the Companies Registrar and that officer made the information publicly available.[33] The information included deed of settlement, names of shareholders and directors, prospectus issued to the public and annual accounts and balance sheets. 1844 was a highpoint in terms of disclosure. But, as it turned out, the requirements for disclosure of the prospectus, accounts and balance sheet were soon bypassed and not enforced. They were officially abolished in 1847 and 1856, despite the fact that the introduction at the same time of general limited liability could have justified extended disclosure in order to protect creditors. The 1862 Companies Act retained only the more basic disclosure requirements.[34]

Though the demand for more significant disclosure was raised in the following decades and discussed by several legislation committees, the status quo was retained for the rest of the century.[35] The 1900 Act increased disclosure requirements for companies wishing to raise capital from the public and prescribed the content of the prospectus, which had to be registered. The companies had to provide information on the allotment of shares, particularly to promoters and vendors, with special emphasis on shares not issued for cash. False statements were criminalized. These requirements placed a considerable burden on public companies, reflected in the following years by both bypassing the

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[32] RON HARRIS, INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844 277-285 (2000); BISHOP CARLETON HUNT, THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND 1800-1867 90-115 (1936).

[33] The Joint Stock Companies Act, 1844, 7 & 8 Vict. C. 110. Some of the information had to be provided at the initial provisional registration stage and the rest was required in order to achieve full incorporation.

[34] It imposed more significant requirements, including reporting of liabilities and assets on banking and insurance companies.

[35] A. C. Storrar & K. C. Pratt, *Accountability vs privacy, 1844-1907: the coming of the private company* 10 Accounting, Business & Financial History 259, (2000); J. R. EDWARDS, LEGAL REGULATION OF BRITISH COMPANY ACCOUNTS 1836-1900 (1986).

prospectus requirement and a decrease in the number of company registrations. But they did not affect private companies. Even though these were not mentioned by name in the 1900 Act, they were in fact exempt from the requirements because they made no public offering of shares. One significant disclosure requirement placed on all companies including private companies in 1900 was the requirement to register all mortgages and charges. This was a response to the widespread use of floating charges by company promoters, making themselves senior creditors.[36] The 1907 Companies Act added another significant requirement, but only relating to public companies: balance sheets had to be filed with the Companies Registrar and made available to the public.[37] This enhanced disclosure requirement created, for the first time, a distinction between private and public companies.

While between 1862 and 1907, the level of disclosure in companies was more significant than the level of disclosure in partnerships (where it was nonexistent), it was nevertheless not substantial compared to earlier and later periods and other countries. By selecting the company form over the partnership form, promoters faced a tradeoff. In order to gain what they perceived as the advantages of the company form, definitely with respect to limitation of liability, possibly with respect to longevity and to separation of ownership from management, incorporators had to give up some of their privacy. But once the disclosure requirement was enhanced, in 1900 and 1907, the tradeoff was

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[36] The 1900 required the appointment of auditor for every company. The auditor had to review the balance sheet. But no requirement was yet made in 1900 to disclose the balance sheet to shareholders or to the public. In some sectors, including life insurance, banking, gas and electricity supply, a legal requirement was established in the 1870s and 1880s. Voluntary external auditing became widespread among large listed companies by 1900. See Leslie Hannah, *Pioneering Modern Corporate Governance: A View from London in 1900* 8 Enterprise and Society 653 (2007).

[37] BRIAN R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED 194-197 (2008).

mitigated. In 1907, a menu of four options in terms of level of disclosure existed. The public company required most disclosure, then the private company, then the limited partnership, and last, the general partnership.

Salomon v. Salomon and the legality of private companies

Until 1844, the state could control and prevent the formation of companies that, in the officials' view, were too small. The 1844 and 1862 Acts changed this.[38] The 1862 Act, the major consolidated act in force until 1907, required that any association or partnership with more than 20 partners (10 in banking) be incorporated.[39] It also required a minimum of 7 members for the incorporation of a company.[40] The Act did not include a minimum capital requirement for incorporation. Thus it allowed for the formation of small, family firm-like and partnership-like companies, as long as they had 7 shareholders. Could a corporation of less than 7 shareholders be formed? What could incorporators and their attorneys do when they wanted to form companies of 1-6 shareholders in the period 1862-1907? They used nominal shareholders. Was this legal? In other words, were companies formed in this way recognized as companies for every purpose? The Davey Committee report, published in 1895, dealt with a variety of problems. With respect to the issue at hand here, it first described the problem:

> *Your Committee were referred to an advertisement by an enterprising firm offering to turn a person into a corporation with limited liability for a modest fee, and pointing out the advantages of the proceeding.*

It then discussed the need for a remedy:

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[38] The Limited Liability Act, 1855, 18 &19 Vict. *C.* 133 set the minimum number for the formation of Limited Liability Company at 25. But it remained in force only until the following year.

[39] The Companies Act, 1862, 25 & 26 Vict. c. 89

[40] The Companies Act, 1862, 25 & 26 Vict. c. 89

> *There is no magic it has been said in the number of seven, and it must be admitted that to require that number of subscribers to the Memorandum to form* ***a*** *company, or that number of shareholders to maintain a company, does not secure seven substantial or real shareholders. But your Committee are not disposed to disturb the present practice in the registration of companies, or to recommend any alteration of the law either as regards the number of seven or the amount of their subscription.*[41]

How did the courts rule on this issue? *Salomon v. Salomon*, arguably the most famous case in the 400-year history of English company law, deals, among other issues, with this very question.[42] In this section, I will offer a new reading of *Salomon* as representing a range of responses to the emergence of the private company. Aron Salomon was a well to do boot and shoe manufacturer in July 1892. He traded as sole proprietor under the firm of "A. Salomon & Co." Beginning with little or no capital, over 30 years he gradually built up a thriving business.

In July 1892, "Aron Salomon and Company, Limited," was incorporated with liability limited by shares, and with nominal capital of £40,000 divided into 40,000 shares of £1 each. The memorandum of the company was signed by Aron Salomon, his wife, four sons and one of his daughters.[43] They were each initially allocated one share. Then Salomon sold his sole proprietorship business to the company for 20,000 fully paid shares of £1 and a debenture of £10,000. In the following year, the company had difficulties due to external factors, such as strikes and changes in the government contracting policy with suppliers, became insolvent, and went into receivership and liquidation. As holder of the debenture,

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[41] DEPT. COMMITTEE TO INQUIRE INTO AMENDMENTS IN ACTS RELATING TO JOINT STOCK COMPANIES INCORPORATED WITH LIMITED LIABILITY UNDER COMPANIES ACTS**,** REPORT AND APPENDIX, (c-7779), Parliamentary Papers (1895), vol. ?, p. 151, paragraph 4.

[42] In company law textbooks, it is also discussed in the context of separate legal personality, limited liability and veil piercing, contracts between promoters and newly formed companies, debentures and floating charges. See, for example, the references to *Salomon* in P. L. DAVIES, GOWER AND DAVIES PRINCIPLES OF MODERN COMPANY LAW (2008).

[43] *Salomon v. A. Salomon and Co. Ltd* [1897] AC 22

Salomon claimed a dividend as senior creditor, even though some of the unsecured creditors had not been paid.[44] Salomon utilized to the outmost the shielding not only of his private assets but also the business assets he had transferred from the sole proprietorship, by combining fully paid shares, a debenture and floating charges, a common practice at the time. He was protected not only by limited liability as shareholder but also by a senior claim that he personally had as a creditor of the company. The liquidator tried to invalidate Salmon's claim and to obtain a judgment against Salmon personally in order to pay the unsecured creditors.

In the Chancery Division of the High Court, Vaughan Williams J began with a factual finding:

> *I am perfectly convinced that the shareholders, who were all members of the family of Mr Salomon, were nominees of Mr. Salomon, and that no real interest was ever given to them in the company, and I do not believe that it was ever intended to give them any real interest whatsoever in the company.*[45]

He then held:

> *Under the Companies Act of 1862 a man may become what is called a private company so as to obtain the benefits of limited liability. I have already held, in a case where the founder of such a company had become bankrupt and the company claimed his assets, that the company was a mere fraud, and the Court of Appeal supported that decision. In this case I propose to hold the same thing - that this business was Mr. Salomon's business and no one else's; that he chose to employ as agent a limited company; that he is bound to indemnify that agent, the company; and that his agent, the company, has a lien on the assets which overrides his claims. The creditors of the company could, in my opinion have sued Mr. Salomon.*

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[44] At some stage, the debentures were cancelled and reissued to a man named Broderip who lent money to the company via Salomon. The initial proceeding was accordingly titled *Broderip v Salomon* [1895] 2 Ch 323. But Broderip was fully paid and the debentures ended up with Salomon again. This aspect is irrelevant to our reading of the case.

[45] *Salomon v. A. Salomon and Co. Ltd* [1897] AC 22.

As a leading bankruptcy jurist, he thought of the case in terms of bankruptcy, viewing the case as simple and somewhat trivial. The just solution was to allow the liquidator of the company and its creditors access to the private assets of Salomon, the person who remained solvent despite the liquidation of the company. This could be done either through principal's liability in agency or personal liability of the principal. Vaughan Williams thought in terms that more modern jurists would identify as the doctrine of veil piercing.

In the Court of Appeal, Nathaniel Lindley reached a similar outcome but framed the issue differently:

> *There can be no doubt that in this case an attempt has been made to use the machinery of the Companies Act, 1862, for a purpose for which it never was intended. The legislature contemplated the encouragement of trade by enabling a comparatively small number of persons - namely, not less than seven - to carry on business with a limited joint stock or capital, and without the risk of liability beyond the loss of such joint stock or capital. But the legislature never contemplated an extension of limited liability to sole traders or to a fewer number than seven. In truth, the legislature clearly intended to prevent anything of the kind, for s. 48 takes away the privileges conferred by the Act from those members of limited companies who allow such companies to carry on business with less than seven members; and by s. 79 the reduction of the number of members below seven is a ground for winding up the company.*

Applying to Salomon, he concluded:

> *Although in the present case there were, and are, seven members, yet it is manifest that six of them are members simply in order to enable the seventh himself to carry on business with limited liability. The object of the whole arrangement is to do the very thing which the legislature intended not to be done; and, ingenious as the scheme is, it cannot have the effect desired so long as the law remains unaltered.*

Lindley was one of the most distinguished jurists of the time and a leading authority on company and partnership law.[46] He accordingly framed the case as a company law

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[46] NATHANIEL LINDLEY, A TREATISE ON THE LAW OF COMPANIES: CONSIDERED AS A BRANCH OF THE LAW OF PARTNERSHIP (1889).

case, one that should be determined by a statutory interpretation of the 1862 Act. This was not an inconsequential bankruptcy case that should be determined by its exceptional facts as Vaughan Williams understood it; on the contrary:

> *The appeal raises a question of very great importance, not only to the persons immediately affected by the decision, but also to a large number of persons who form what are called "one-man companies." Such companies were unheard of until a comparatively recent period, but have become very common of late years.*[47]

The bottom line is that private companies of 7 or more genuine shareholders could be formed based on the 1862 Act. But "one-man companies" are illegal and ignored by law. The problem here, as with other cases of invalidation in company, partnership and agency relationships, was how to prevent those who acted without authority or organized illegally from discharging obligations and later benefiting from the invalidation of the wrongful acts. As long as the Companies Act is not amended, the incorporators of such a company should bear personal liability for all the debts of the company. Lindley can be interpreted as objecting to such an amendment – or willing to support it, subject to proper safeguards to creditors.

The case went all the way to the House of Lords, which reversed the decision. Lord Chancellor Hulsbury held:

> *I must pause here to point out that the statute enacts nothing as to the extent or degree of interest which may be held by each of the seven, or as to the proportion of interest or influence possessed by one or the majority of the share-holders over the others. One share is enough. Still less is it possible to contend that the motive of becoming shareholders or of making them shareholders is a field of inquiry which the statute itself recognises as legitimate. If they are shareholders, they are shareholders for all purposes; and even if the statute was silent as to the recognition of trusts, I should be prepared to hold that if six of them were the cestui que trust of the seventh, whatever might be their rights inter se, the statute would have made them shareholders to all intents and purposes with their*

[47] *Salomon v. A. Salomon and Co. Ltd* [1897] AC 22

respective rights and liabilities, and, dealing with them in their relation to the company, the only relations which I believe the law would sanction would be that they were corporators of the corporate body.

The Lord Chancellor tells us that not only are nominal shareholders legitimate shareholders for the purposes of the Companies Act; even when all the other shareholders are trustees of a single shareholder, the company is legal. All the other Law Lords held, similarly, that the question is one of statutory interpretation and that the statute is very clear. Any 7 members, whatever their interest in the company, even a single nominal share, and whatever the relationship between them, patriarchal subordination or entrustment, can constitute a company. One of the concurring lords was Lord Davey, who had chaired the committee appointed to consider amendment of the Companies Act and delivered its recommendations the year before.[48]

The Salomon Limited Company was portrayed by the liquidator, lower court judges, and later by historians and lawyers, as a one-man company with 6 nominal shareholders and a single real shareholder – Aron. They ignored the fact that Lord MacNaghten in the House of Lords had characterized Salomon Ltd. as a partnership-like company, when he described the circumstances leading to the incorporation of Salomon Ltd.:

Four of the sons were working with their father. The eldest, who was about thirty years of age, was practically the manager. But the sons were not partners: they were only servants. Not unnaturally, perhaps, they were dissatisfied with their position. They kept pressing their father to give them a share in the concern. "They troubled me," says Mr. Salomon, "all the while." So at length Mr. Salomon did what hundreds of others have done

[48] Davey and his committee were appointed in November 1894, shortly after Salomon's trial in the High Court. His Committee delivered its report in June 1895, shortly after the Court of Appeal's decision in Salomon and about a year before the case was argued in the House of Lords. The Court of Appeal decision in Salomon was the only court case listed among the 17 items of written evidence submitted to the Committee.

under similar circumstances. He turned his business into a limited company. He wanted, he says, to extend the business and make provision for his family.[49]

MacNaghten's description is remarkable. Incorporation was the first step in changing the governance structure of the firm, in preparation for transferring this family firm to the second generation. The firm was in the process of transforming from a single-person or patriarchal family firm into a second-generation family firm that is more like a partnership among the siblings. Within the typology offered in this article, the incorporation was into a partnership-like company and not into a single-person company. The motivation for incorporation related to internal relationships, decision making, the father's retirement, and the future exit of some of the children, more than with asset partitioning and protection against creditors. This motivation led hundreds of other family firms, moving from first-generation sole proprietorship to second-generation partnership, to the corporate form. What was at stake was not the fortune of Aron Salomon, a Jew from Whitechapel, East London's poor and crime-stricken immigrant district. What was at stake was a wide social-economic phenomenon. It is evident that the House of Lords, as the Court of Appeals before it, and unlike the High Court, realized that it was dealing with a major phenomenon and that the importance of the decision could not be overstated.

This narrative seems to portray the decision not as one that the Lords are compelled to deliver because it was determined in the province of legislation and forced upon the courts, or because the Lords were bound by a cannon of interpretation requiring literal interpretation of statutes rather than one that follows the purpose of the legislation. It was not a question of yielding to the inevitable due to the incorporators' ability to manipulate and bypass regulatory prohibitions by using nominal shareholders. The decision is not

[49] *Salomon v. A. Salomon and Co. Ltd* [1897] AC 22

even motivated by equitable sympathy for Salomon personally because of his misfortunes, even though this is how the Lords viewed him. The Lords in *Salomon v. Salomon* intended to facilitate a productive and advantageous social phenomenon – the conversion of under-legalized family firms into joint-stock companies with well-defined legal status.

The 1907 Act settled the issues of nominal shareholders and a single-person company by introducing the private company. This was defined, as mentioned above, as a company that, in its Articles of Association, commits not to raise capital from the public, to have restrictions on share transferability and to have no more than 50 shareholders. One of the features that distinguished this new type of company from the public company was that it could be formed with only 2 shareholders, unlike the public company that still required the magical number of 7.[50] In 1907, a firm like Salomon's did not need more than two shareholders, if all it wanted was the shield of limited liability. But if it wanted to solve the problem of intergenerational transfer, it still had to allocate shares to the children.

Internal Governance

The Acts of 1844-62 sharpened the organizational decision for multi-owner firms.[51] These were either companies or non-companies, meaning sole proprietorships or partnerships. Both were available, legal and cheap and there wasn't much between them. Did entrepreneurs have any reason to prefer the partnership or sole-proprietorship form of organization to the corporation? Did the former still have any advantage once the corporate form was freely available and the doubt with respect to the legality of

[50] Companies Act, 1907, 7 Edw.7 c.24, s. 37(4)

[51] Sole proprietorships and single-person companies are not relevant to the discussion in this section. Nor are family firms in which full trust prevails between family members and as a result, the inter se relationship is not a consideration in selecting organizational form.

corporations with less than 7 real shareholders removed? The limited liability and disclosure features that regulated external relationships did not point to any meaningful advantage for the partnership. Is this also the case regarding internal relationships? One can presume that because the corporate form was made for public companies, the rules that governed internal relationships in business corporations, from the time of the very first joint-stock company and until the 1862 Act, were tailored to public companies and were unsuitable for private companies.

A possible way to frame the comparison is to ask whether there exists a tradeoff between the company and the partnership. Did entrepreneurs lose anything by selecting the company rather than the partnership? Was the partnership form, which envisioned personal relationships, more suitable for governing internal relationships in small, closely held firms? Another way of presenting the question is: Were the internal governance rules of the corporate form sufficiently adjusted for use by small firms in our period?

There were at least three alternative modes for adjusting company law to the needs of small firms: statutory amendments, common law holdings and incorporation contracts. Statutory company law was not amended before 1907 to better suit private companies. I will discuss the second mode in this section and the third mode in the next.

The second mode was for common law to evolve. From partnership law, the original law of small firms, courts could adopt doctrines that better suited the governance of small firms. Alternatively, or concurrently, company law could adjust for small firms independent of partnership law. Minor adjustments of the common law are hard to track

down and map.[52] One place in which governance adjustments could take place is the relationship between corporation law and partnership law. In the 19th century, this relationship was perplexing. On one hand, the origins of partnership law and corporation law are different. Partnership law evolved in the vicinity of agency law, master and servant law, the law of private bailiffs, and generally in the field that in modern terms is called contract law, within the more general field of private law.[53] Corporation law evolved within the realm of the law of the prerogative of the Crown, as an authority of the King that was delegated to another body politic created by the King, an issue that in modern terms is part of constitutional law. [54] Much of partnership law was litigated through the writ of account in Chancery. Corporation law was litigated through the prerogative writs of *quo warranto* and *scire facias*, the procedure of visitation, and the doctrine of ultra vires, mostly in the court of King's Bench. Several 19th century jurists acknowledged this fundamental difference,[55] and reiterated its existence.[56] Other 19th century jurists stated that the rules governing internal relationship in both realms of law

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[52] It is sometimes difficult to distinguish between court decisions that are independent reactions to changing reality, decisions that apply partnership law and decisions that respond to attempts to exercise contractual flexibility.

[53] JOHN H. BAKER, AN INTRODUCTION TO ENGLISH LEGAL HISTORY (2002); D. J. IBBETSON, A HISTORICAL INTRODUCTION TO THE LAW OF OBLIGATIONS (1999); A. W. B. SIMPSON, A HISTORY OF THE COMMON LAW OF CONTRACT : THE RISE OF THE ACTION OF ASSUMPSIT (1975).

[54] WILLIAM SHEPPARD, OF CORPORATIONS, FRATERNITIES AND GUILDS (1659); STEWART KYD, A TREATISE ON THE LAW OF CORPORATIONS (1979).

[55] Complete references

[56] Lord Justice James in Baird's Case In re Agriculturalist Cattle Insurance Company The Law Reports, CA 5 (1869-70) 725, 733; JOHN WILLIAM SMITH, A COMPENDIUM ON MERCANTILE LAW 66-67 (1877); W. DOUGLAS EDWARDS, COMMERCIAL LAW 116 (1900).

were similar.[57] What can explain these conflicting statements is the dynamic and unsettled border between the governance rules of partnership law and company law.

Principles of partnership law entered corporation law through at least two routes. The first is the unincorporated company and the second is corporate personality theory. The restricted access to the corporate form, despite growing demand, in the century or so before 1844 gave rise to the development from below of the unincorporated company. Businessmen and their attorneys used existing building blocks in partnership law, trust law and contract law in order to create a substitute for the corporation without full incorporation.[58] Partnership law concepts that were first applied to unincorporated companies were at then applied to corporations. *Foss v. Harbotle* is the prime example.[59] By the early 19th century, a well-established equitable doctrine in partnership law provided partners with access to the remedy of account only upon the wingding up of the partnership. This doctrine restricted the review by Chancery of the everyday internal affairs of partnerships.[60] The doctrine was extended to the internal affairs of unincorporated companies that were viewed as partnerships. In 1843, only a year before the introduction of general incorporation, the doctrine was applied to a corporation incorporated by Parliament for the first time in *Foss v. Harbottle*. Once incorporation by mere registration became widespread, the doctrine applied to all corporations and became

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[57] References

[58] RON HARRIS, INDUSTRIALIZING ENGLISH LAW : ENTREPRENEURSHIP AND BUSINESS ORGANIZATION 1720-1844 137-167 (2000).

[59] *Foss v. Harbottle* (1843) 2 Hare 461

[60] Its rationale was that "since harmony between partners is not to be had by decree, equity would not act in vein." A more cynical interpretation would say that Lord Chancellor Eldon wished to ease the long delays in Chancery and his own overburdening.

the cornerstone governing the internal affairs of corporations.[61] The grieving minority in a corporation could not sue upon corporate cause of action; instead, it had to turn to the internal forums in a corporation before turning to court, and these could ratify and rectify alleged misconduct. The effect of *Foss v. Harbottle* was that litigation about internal conflicts became almost impossible.[62] Ironically, the main partnership doctrine that applied to companies only hindered the ability of minority shareholders to protect themselves against oppression by the majority.

The second route through which partnership conceptions could enter company law was the theory of corporate personality. Only after the introduction of general incorporation did the debate about the conceptualization of corporate personality begin. The traditional theory, that was called the grant, concession or hierarchical theory, viewed legal personality as public-law-created. It was challenged late in the 19th century by two other theories. The natural personality theory, originating in Germany, viewed corporate personality as stemming from the extra-legal real or natural existence of associations of individuals.[63] The aggregate, or partnership, theory of corporate personality, originating in the US, viewed corporations like partnerships as created by mutual agreement among the shareholders, a contractual private law creation.[64] It argued that in an era of free

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[61] A. J. BOYLE, MINORITY SHAREHOLDERS REMEDIES (2002); R.J. Smith, *Minority Shareholders and Corporate Irregularities*, 41 Mod. L. Rev. 147 (1978). For comparison between British and the American minority protection doctrines, see L.C.B. Gower, *Some contrasts between British and American Corporation Law*, 69 Harvard Law Rev. 1369 (1956); A.J. Boyle, *The Minority Shareholder in the Nineteenth Century: A Study in Anglo-American Legal History*, 28 Modern Law Rev. 317, (1965).

[62] Gradually exceptions to the Foss rule were defined and litigation became possible in some circumstances.

[63] FREDERIC WILLIAM MAITLAND: STATE, TRUST AND CORPORATION (David Runciman & Ryan Magnus ed., Cambridge Uni Press 2003).

[64] R. Harris, *The Transplantation of a Legal Discourse: Corporate Personality Theories from German Codification to British Political Pluralism and American Big Business*, 63 Washington and Lee Law Rev.

incorporation, the personality of corporations could no longer be justified by state grant. Registration with the state is merely technical and informative. The corporate personality is in fact formed by mutual agreement of the incorporators and reflected in the memorandum and articles of association that constitute a contract. This theory views corporation law as analogous to partnership law and justifies similar rules for governing their internal affairs. For example, it denounced majority dictatorship and justified consensual decision-making, particularly with respect to amending the basic contract – the Articles of Association.

The implication of partnership theory was that corporations, at least fundamental aspects of their existence, should be managed by consensus and not by majority. This is the ultimate means against minority oppression. But taken with the locked-in feature of the corporation, which contrary to partnership cannot be dissolved at will, it may lead to deadlocks. [65] The theory did not directly affect company legislation. But the Companies Act of 1862, which predated the articulation of the theory, reflects some similar notions. The capital structure of a company, as fixed in its Memorandum of Association, could be changed only by a special resolution that required a 75% majority.[66] The Articles of Association could be altered only through a special resolution that required the same 75%

1421-1478 (2006); MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1870-1960 : THE CRISIS OF LEGAL ORTHODOXY (1992).

[65] For the easy dissolvability of partnerships compared to companies, see: NATHANIEL LINDLEY, A TREATISE ON THE LAW OF COMPANIES: CONSIDERED AS A BRANCH OF THE LAW OF PARTNERSHIP (1889); JOHN COLLYER, WOOD'S COLLYER ON THE LAW OF PARTNERSHIP (1878); FREDERICK POLLOCK , A DIGEST OF THE LAW OF PARTNERSHIP 179 (1890); Partnership Act, 1890, 53 & 54 Vict.

[66] Name could also be changed. Other components of the Memorandum, the type of liability and objects, could not be altered at all after incorporation. Companies Act, 1862, 25 & 26 Vict. C. 89 s. 12.

majority.[67] These two examples of the influence of partnership governance rules on company law did not go far in introducing rules that were particularly suitable for small private companies. One could argue that they only augmented the problem by preventing judicial review of majority dictatorship and by increasing the likelihood of a deadlock without an exit option, which is a major concern of modern private companies. They only placed an additional burden on the parties to make sure that the Articles of Association they drafted and agreed upon would foresee the possible future contingencies and problems, and prevent them as completely as possible. The third mode, contractual freedom, was essential for achieving this.

Contractual Flexibility

Carving sufficient contractual flexibility to allow different companies, large and small, to draft significantly different articles of association suggests a change from below.[68] A number of questions arise: Could entrepreneurs select any trade-off on any of the relevant dimensions or were they constrained due to contractual rigidity and organizational gaps to select only one of the two ends of an imagined continuum: either a partnership suited to small private firms or a corporation suited to large public firms? Could entrepreneurs chose from the organizational menu the company tailor the organizational form of their choice to the specific needs and concerns of their small and private firm? More specifically, could entrepreneurs who chose the corporate form for

[67] Companies Act, 1862, 25 & 26 Vict. C. 89 s. 50-51.

[68] Naomi R. Lamoreaux & Jean Laurant Rosenthal, *Legal Regime and Contractual Flexibility: A Comparison of Business's Organizational Choices in France and the United States during the Era of Industrialization*, 7 American Law and Economics Rev. 68 (2005).

organizing private companies select any level of lock-in and any level of protection against minority oppression?

Gower, the leading English company law scholar of the second half of the 20th century, after spending a year in Harvard in the 1950s, concluded when comparing corporation laws in the two countries, that:

> *Whereas the American statutes tend to lay down mandatory rules, the British Companies Act relies far more on the technique of the Partnership Act, providing a standard form which applies only in the absence of contrary agreement by the parties. Much that in America is mandatory is in Britain included only in the optional model constitution - the famous table A. And this constitution, or whatever the parties substitute for it, is expressly declared by the act to bind the company and the members as if it were a contract under seal.*[69]

His main examples were contractual freedom in Britain with respect to the appointment of directors, the division of powers between the directors and the shareholders, the rules regulating meetings and votes, the pre-emptive right to take part in further issuing of shares, the right to inspect books and records, and the setting of restrictions on the transferability of shares.[70] Though most of Gower's references are to the 1948 Companies Act, the basic structure of Table A and the setting of major rules in these fields as default rules, both in Table A and in the act itself, originated in the 1862 Companies Act.[71] Palmer, writing in 1892, echoed the notion of flexibility: "The private

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[69] L.C.B. Gower, *Some contrasts between British and American Corporation Law*, 69 Harvard Law Rev. 1369 (1956)

[70] Gower was particularly puzzled by the fact that even the most liberal jurisdictions in the US, such as Delaware, which did not provide mandatory safeguards to small shareholders in public corporations, nevertheless did not provide incorporators in close corporations contractual freedom in designing their bylaws. He mentioned a few issues in which the mandatory rules of American law better protected shareholders than the default British rules. The essence of the puzzle as I understand it is that, generally speaking, American law was less protective of small shareholders in public companies and less flexible for shareholders in private/close companies that needed less protection.

[71] See the default rules in clauses 8, 32, 44, 55, 61, 63, 66 of Table A of the 1862 Act that deal with most of the issues mentioned by Gower.

company is, in many cases, the simplest mode of constituting what is in substance, though not in point of law, a partnership arrangement."[72]

Why did Britain resort to contractual flexibility based on standard default articles of association at this early stage? Gower does not explain. I believe that the main reason is that initially there was no general statute that fixed the internal governance of corporations. Each corporation was created by a specific charter or a specific private act. Governance structure was tailor-made in the charter/act and bylaws/articles of each corporation. There was, to be sure, some standardization. Applicants for charters and private bills and their parliamentary agents and attorneys used earlier texts as blueprints. But there were also considerable variations. To this factor, one has to add the fact that the basic assumption of Gladstone's 1844 Companies Act was that disclosure and not interventionist regulation was the solution for protecting shareholders and creditors. Lastly, the main concern of the 1862 Act, and the 1856 Act upon which it was built, was the protection of creditors in the face of limited liability. Shareholders were at risk only at the initial offering of shares to the public through a prospectus, with respect to which modest disclosure requirements were introduced (and more would be introduced in 1900 and 1907). Internal governance was basically a matter for the incorporators and shareholders to determine.[73]

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[72] FRANCIS BEAUFORT PALMER, PRIVATE COMPANIES; OR HOW TO CONVERT YOUR BUSINESS INTO A PRIVATE COMPANY, AND THE BENEFIT OF SO DOING 16 (1892).

[73] This interpretation does not explain why the US, which demonstrated similarity in the above factors, developed less flexible governance regime. For more on the rigidity of US law, see Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Legal Regime and Contractual Flexibility: A Comparison of Business's Organizational Choices in France and the United States during the Era of Industrialization*, 7 American Law and Economics Rev. 28 (2005); Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Entity Shielding and the Development of Business Forms: A Comparative Perspective*, 119 Harvard Law Review Forum 238,(2006); Naomi R. Lamoreaux, *Partnerships, Corporations, and the Limits on Contractual Freedom in U.S. History: An Essay in Economics, Law and Culture* 29-65 (2004) in CONSTRUCTING CORPORATE

Harwell Wells studied the ways in which close corporations (the rough equivalent of British private companies) in late 19th to mid-20th century US tried to overcome the mandatory rules of corporation law that were set to meet the needs and concerns of public corporations. The incorporators of close corporations and their lawyers had to resort not only to bylaws but also to private side-contracts in order to evade mandatory rules. While his study is not directly relevant to my study of Britain, I can learn from it what the distinct concerns of incorporators of small private companies were and which rules they wished to apply to their companies. These included restrictions on transferability of shares, supermajority voting requirements that would provide the minority with veto power at least on fundamental issues, entrenchment of minority shareholders on boards of directors, the fixing of employment and salary or of level of dividend, the right of shareholders to be bought out or to liquidate the company. In essence, many of these arrangements imitated partnership law rules or actual partnership agreements.[74] As we shall see, many of them appear in the British example to which I will turn in the next section.

The sample of company files for 1892, created for this research, demonstrate the level of opting out of the default company law rules. Of the 45 companies in the sample for which articles of association were preserved, only 11% adopted Table A in full; 33%

AMERICA: HISTORY, POLITICS, AND CULTURE, ED. KENNETH LIPARTITO AND DAVID B. SICILIA (2004), pp. 29-65. We hope to address this puzzle at a future stage of our comparative project.

[74] In the US, some of these attempts were invalidated by courts in very well known cases discussed by Wells. But one should keep in mind two types of invalidation. The first is grounded on the contradiction between the shareholders' contract and mandatory rules. The second is grounded in the use of an inappropriate tool, a shareholders' side-contract instead of the corporation's bylaws, for determining the internal rules of the corporation. An important distinction should be made between a side-contract that involved all shareholders and was suspected of being an attempt to evade mandatory rules, and a side-contract between some of the shareholders, who wished to act as a single block or to coordinate some aspects of control through voting agreements and the like, and could not be implemented in the bylaws, as they did not apply to all shareholders.

adopted it in part, and 56% rejected it altogether. Some of the clauses of Table A were opted out by as many as 80% of the companies. Two factors that could explain the high opting out rate are the fact that the 1862 Act and its Table A did not envision private companies and that, by 1892, they were 30 years old. Table A's default rules could have been outmoded, no longer reflecting what the majority of contracting parties would want.[75]

The Story of One Company: The Ollersett Collieries Company Limited

I would like to demonstrate the meaning of contractual flexibility by providing a relatively thick description of a single company, the Ollersett Collieries Company Limited.[76] Three criteria were employed for selecting a company from the 1892 sample for this purpose. First, not to select a public company – the kind of company that the act envisioned; second, not to select a single-person company – a company which does not give rise to internal governance issues; and third, not to select a company that applied Table A, which, as we have seen, the majority of companies rejected. The Ollersett Collieries Company Limited does not, in any statistical sense, represent the group of private companies that had more than one meaningful shareholder and that opted out of Table A. But, as far as I can tell, based on the current state of the analysis of Articles of Association in my samples, it is not exceptional in any sense.[77]

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[75] Preliminary data from samples of 1912 and 1927 indicate that percentage of opting out from the 1908 Act Table A was considerably lower in those years.

[76] Board of Trade: Companies Registration Office: Files of Dissolved Companies BT 31/15215/35928 (35928 being the original registration number of the company).

[77] A systematic analysis of the Articles of Association is planned for a future stage of the project.

The company was formed in 1892 by four persons Joseph A. Bennett, William Jones, Abel B. Wimpenny and Thomas Bennett. It was an amalgamation of two small pre-existing coal collieries in the High Peak District in north Derbyshire, which had been active for at least several decades and which, previously, had apparently been run as two separate partnerships: the Aspenshaw Coal Company owned by the first two incorporators, and the Ollerestt Hall Colliery owned by the latter two.[78] The two collieries, which together employed 58 workers, were not unique or large.[79] The new company was formed with nominal capital of £12,080, divided into 1208 regular shares of £10. From the pre-excising colliery partnerships, the company bought their leases and collieries, in return for the allotment of shares to the two owners of each. Such an agreement between vendors and the company they formed had become common practice by 1892. Thomas Bennett was allotted 467 shares, Wimpenny 314, Joseph Bennett 280 and Jones 140. All were credited with £9 per £10 par value of each of the shares allotted to them. In addition, 3 nominal shareholders were allotted 1 share each in order to meet the 7-member requirement of the Companies Act. This too was a common practice when converting partnerships into companies. The Memorandum of Association defined the objects of the company as owning colliers, mining, manufacturing, smelting and trading in coal, iron, and other metals and minerals. The objects clause goes on for 20 sub-clauses of primary

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[78] *Victoria County History Derbyshire: Derbyshire Collieries Index 1854-1881* (University of London, September 2007) *available at* http://www.englandspastforeveryone.org.uk/resources/assets/D/Derbyshire_Collieries_list_1854_1881_2530.pdf

[79] For the number of employees in 1896, see Derbyshire's Mining Industry in 1896 - A List of Coal Mines (Peak District Mines Historical Society Ltd.) *available at http://www.pdmhs.com/1896%20Lists/1896-1.htm*. Many coal mines in Derbyshire employed hundreds of employees; the largest over a thousand. There were 4,175 coal collieries in Britain producing about 134 million tons in 1877, of which 234 were in Derbyshire, producing some 7 million tons. See Office Great Britain. Home, Mineral Statistics of the United Kingdom of Great Britain and Ireland for the Year 1882-1896 etc (1884). *available at* http://www.archive.org/details/mineralstatisti01huntgoog

and auxiliary objects. The Articles of Association stated that Table A shall not apply, and then went on for 30 pages (117 clauses), detailing the contractual arrangements between the incorporators – the rules for running the new company. I shall focus on the internal relationship between the shareholders with an intention to demonstrate the level of contractual flexibility available to private companies in Britain of the time, which allowed the incorporators to tailor the company very precisely to their specific needs.

The length of the company's Articles necessitates even the highlights to be somewhat lengthy. Transferability of shares in the company was restricted. Directors' approval was required and could be denied, among others, when they were "of opinion that the proposed transferee is not a desirable person to admit to membership" or when "it is not proven to their satisfaction that the proposed transferee is a responsible person." The directors were not "bound to assign any reason for refusing to register the transfer" of shares.[80] It was prohibited to increase the capital and issue shares with a preferential right to dividend or that are otherwise ranked before existing shares, without the consent of all shareholders at a General Meeting.[81] The borrowing powers of the directors were limited to £6,000.[82] Voting at a General Meeting was based on one vote for each share.[83] The four named real shareholders were appointed Directors and their term of office was not limited.[84] Directors could serve as officers or servants of the Company. Their remuneration in each capacity was to be determined by the Directors. The number of votes of each Director at their

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[80] Articles of Association, clause 18.

[81] Clause 36.

[82] Clause 40.

[83] Clause 57.

[84] Their office was subject to termination upon bankruptcy, upon being found lunatics, resignation or not holding the minimum of 100 qualifying shares, and presumably death. Once the office of two or more of them is terminated new directors have to be elected and to be subject to two years term. Clauses 65-78.

meeting was based on the number of shares he held.[85] But with respect to one major issue, how the coal mines would be worked, including sinking a new pit or shaft, driving a new level, abandoning an undertaking or buying a new engine, when there was no unanimity among the Directors, the matter in dispute had to be referred to two named external arbitrars (a bleacher and a paper maker).[86] In a general clause, subject to unanimity among them, Directors were given powers to "exercise all such powers and do all such acts and things as may be exercised or done by the Company, and are not hereby or by any statutes expressly directed or required to be exercised or done by the Company in General Meeting."[87] They were then given 16 specified powers to run the business, buy, pay, appoint and remove, litigate, invest, make by-laws, etc. No one but the Directors was allowed to bind the company in a contract unless expressly authorized to do so. Directors were not personally liable for company debts and were entitled to indemnification for any liability. Dividends had to be declared by a General Meeting but the shareholders could not declare a larger dividend than was recommended by the Directors. The 117th and last clause was an arbitration clause that applied to any dispute between a shareholder and the Company with respect to the interpretation of the Articles of Association.

To sum up, the Articles demonstrate the utmost in contractual flexibility. They were used to turn partnerships into a joint-stock limited liability private company, yet a company that was governed internally much like a partnership. The Articles specified the internal governance rules of the company in great detail. The directors could run the company almost without resorting to the General Meeting; they were entrenched in their

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[85] Clause 87.

[86] Clause 89 (p)

[87] Clause 88

offices; they had to reach major decisions by consensus; they were company agents while others, as a rule, were not; outsiders were not allowed in without approval. All the same, they enjoyed the major corporate privilege of limited liability in their capacity as shareholders and as directors.

The company went through a few minor organizational changes over the years. Capital was marginally increased and then marginally reduced. Shareholding devolved to 5-6 non-nominal shareholders. In 1908 at an Extraordinary General Meeting, the Articles of Association of the company were altered. The maximum number of shareholders was limited to 50. The public offering of shares was prohibited. Further restrictions on transfer of shares were added. These changes qualified the company to be converted into a private company based on the recently enacted 1907 Companies Act.[88] In 1928, the company wounded up, probably due to the continuing decline of Derbyshire coal mining in the face of better quality, lower cost coal from distant, large scale mines, supplied through the expanding railway network.

Contractual Flexibility = Take 2

This, or any, example of company records provides us with a valuable perspective on what organizers of companies were concerned with and how they tried to address their concerns through contractual engineering. An analysis of the Articles of Association alone provides an indication of contractual flexibility but does not indicate the exact bounds of that flexibility. Incorporators and their attorneys must have had some sense of what they could definitely do, and what they could do and get away with on the margins of

[88] Special Resolution of February 8th 1908.

contractual flexibility.[89] Yet the courts had the last word; they could strike-down or not enforce arrangements that were fixed in Articles if these were, in the courts' view, contrary to the Companies Act or the common law. A survey of court cases cannot provide a full map of the extent of contractual freedom because various contractual stipulations in Articles were never litigated and concerning others, which were only mentioned, their validity was not directly determined. Let us examine a few examples that appeared.

One of the features that distinguish joint-stock companies from partnerships, and public companies from private companies, is the transferability of shares. In public companies, transferability is integral. When a multi-owner private company is incorporated, transferability is likely to be at the center of negotiation and contracting. *Weston's case* (1866) is instructive. A shareholder transferred his shares to two other persons for low payment at a stage at which the company was in debt and shortly before it wound-up. The directors refused to register the transfer. Thereafter, the liquidator sued the selling shareholder for the unpaid portion of the shares. It was clear from the fact that the transferees had no source of income or place of residence that the intention of the original shareholder was to avoid liability by transferring to judgment-proof persons. The main issue was whether the directors were authorized to refuse transfer in such circumstances. On appeal, the court distinguished between three levels. The first was the Companies Act. The court viewed section 22 of the Act as providing a default rule. The default was transferability. Then the court discussed the question of whether the general authority of the directors and their duty to act in the best interest of the company allowed them to refuse transfer on such grounds and held that it did not. Finally, the court read the Articles

[89] It is conceivable that incorporator and their attorneys would draft into the Articles arrangement that they know will not be enforced in order to mislead other less informed incorporators.

of Association and found in them grounds for refusal only when a shareholder is indebted to the company. Thus, the directors could not refuse transfer on the grounds of the identity of the transferee. The court mentioned the fact that in other companies, the Articles established other more severe restrictions on transfer of shares. From the above analysis by the court, it is clear that there is significant contractual flexibility with respect to the rules fixed in Articles of Association concerning transferability of shares. There is every reason to think that Articles such as those of the Ollersett Collieries Company Limited, which provided the directors with full discretion to refuse transfer without giving any reason, would have been upheld by the courts. Contractual flexibility in this dimension allowed the use of a framework originally intended for public companies with freely transferable shares to be used for forming partnership-like private companies, in which membership was based on personal relationships and could be altered only by consensus.

Another important dimension of private companies is the agreement regarding the distribution of income and profits. The two main components of this dimension are dividends and employment. Shareholders in private companies, like partners in partnerships, are often also their employees. Minority shareholders in private companies are concerned over freeze-out, namely that the majority will manage the company as it wishes; employ itself, but not the minority, at generous pay; not distribute dividends; and not offer to buy out the minority (which is not free to, or unable to, sell its shares) at a fair price. The doctrine of *Foss v. Harbottle*, discussed above, which considerably restricted the ability of courts to intervene in majority-based-decision making in companies, only increased the minority's concern regarding freeze-out and oppression.

Entrenched employment with guaranteed salary was one of the solutions.[90] In an 1875 case, article 118 in the Articles of a company stated that "Mr. W.E. shall be the solicitor of the company and shall transact all the legal business of the company, including parliamentary business, for the usual and accustomed fees, and shall not be removed from his office unless for misconduct." The article was probably included as consideration for services rendered at the stage of incorporation. The solicitor later became a minor shareholder in the company and the company at some stage resorted to other solicitors. E. sued the company for breach of contract. In his judgment, Amphlett B. held that article 118 did not amount to a contract that binds the company vis-a-vis a solicitor as such. The articles bind the shareholders in that capacity and only inter se. Technically, the articles were not made under the seal of the company or by the directors under authority of the company. Kelly C.B. expressed the doubt whether, even if approved by the board of directors, the board had the power to bind the company in an employment contract for all time to come.[91] Though this case does not determine the validity of all types of employment arrangements found in Articles, it does raise considerable doubts with respect to their validity.

The alternative to guarantying minority employment in Articles is doing the same in a side employment contract. There were two main problems with side employment contracts. The first was that they were subject to labor law and as such could be enforced for specific performance only insofar as other employment contracts could. The second was that their breach did not give rise to remedies within company law or with respect to

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[90] Another relevant issue that will not be discussed here is rules governing dividend decision making.

[91] Eley v. The Positive Government Security Life Assurance Company (Limited) LTR 33 (1876. 743, 747-749.

the governance of the company, and could not be seen within the wider reality of minority oppression.

One last dimension of contractual liability that will be examined here is the lock-in. As we have seen, partners in a partnership are subject to weak lock-in. Any change of status of a partner (bankruptcy, lunacy, death) dissolves a partnership. Partnerships were by default at-will and even partnerships for-term were relatively easily dissolvable. Companies, on the other hand, were not affected by a change of status of shareholders. Voluntary winding up of companies was regulated by the Act. There was contractual flexibility in the Articles with respect to initially determining the duration of the company. But if the company did not fix such duration at the onset, it could only be dissolved by passing a Special Resolution. Special Resolutions could only be passed with the support of 75% of shareholders. This supermajority requirement could not be contracted.[92] Another alternative for a semi-voluntary winding-up was resort to the court on the grounds that "it is just and equitable" to wind-up the company. This did not establish well-settled ex-ante predictability. It is not surprising that the Ollersett Collieries Company, our example, did not include winding-up rules in its Articles. There was little space for contracting. A company such as this, with firm specific assets and investments, did not want to fix the duration of existence in advance. Once it did not do so, it remained subject to a mandatory decision rule, 75%, and to ex-post court discretion. There was no feasible way to avoid these contractually.

[92] Companies Act, 1862, 25 & 26 Vict. C. 89. s. 79, 129.

The examples above demonstrate that significant contractual practices typical of private companies, such as the limitation on transferability of shares, were respected by the courts. Some practices, such as entrenchment of employment in Articles, were not given full effect. In a few realms, notably winding-up, the Act was conclusive in a manner that conveyed to incorporators that there is no room for contracting around.

Conclusion

The company form of organization was transformed between 1862 and 1907. Until the mid-19th century, the company was used exclusively for what was considered public purposes and for raising equity capital from the public. By 1907, most companies were small and did not resort to the stock market. They were family firms, sole proprietorships and partnerships, converted into joint-stock limited companies. The transformation did not rely on statutory amendments. It was privately ordered by incorporators and their attorneys by tailoring the basic contractual document of the company form, the Articles of Association, to the needs of private companies in general and to the specific concerns of each small company in particular. Such private ordering became possible because of the high degree of contractual flexibility available in Britain. This flexibility stemmed from the basic structure of the Companies Act, which included few mandatory rules and regulated much of the internal governance of companies through default rules, the famous Table A, that could be opted out. It also resulted from a few court cases that validated new types of rules fixed in Articles.

The private company as a term and a phenomenon was first found in the press and in legal literature. It was then discussed by review committees, legitimized by the courts and only in 1907, first defined by the Companies Act. Within a decade after its formal

introduction in 1907, and the reduction of disclosure requirements applying to it, more than 41,000 private companies were registered (compared to fewer than 9,000 public companies). By the end of the decade, more than 90% of newly registered companies were registered as private companies. In the same decade, nearly 145,000 existing companies (including the Ollersett Collieries Company), representing a majority of active companies, were converted into private companies. The transformation was completed.

This article is part of a wider project. With respect to Britain, a political economy study of the law reform committees of 1895 and 1906 and of parliamentary proceedings leading to the Acts of 1900 and 1907 can shed light on the ideological, political party and interest group aspects of the emergence of the private company. The post 1907 period, for which I have additional samples of company files, was not covered in this article. The comparative aspects of the project are also beyond the scope of this article. In our previously published articles, we called attention to the fact that the introduction of the private limited liability company (the PLLC) is a European phenomenon, introduced in Britain after Germany but before France. The flow of influences between countries was only hinted at and can be studied further. The exceptionality of the US merits further investigation, particularly in an attempt to explain why one key common law country, Britain, accepted considerable contractual flexibility while the other, the US, produced contractual rigidity and more mandatory rules, and rejected the private company. But though more can definitely be done, and hopefully will be done as part of the wider project, some important arguments can already be made. The focus on the history of public and large companies was misconceived. The study of the history of small- and medium-size firms and of private companies is both fascinating and indispensible for

those who are interested in the history of business organization as a whole. Our research challenges the previously presumed advantage of Anglo-American law that lumped Britain and the US together. A study of the details of organizational contracts of private companies yields insights into the governance problems of firms, the preferences of individuals and the development of the law.

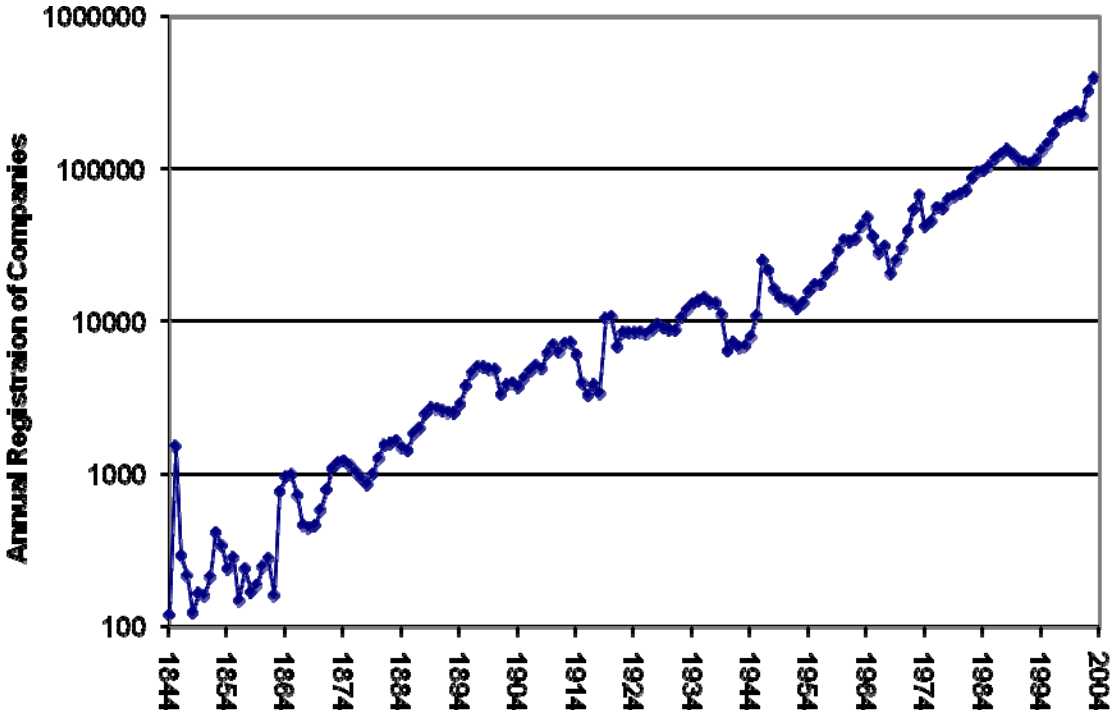


Figure 1: Annual Registration of Companies (GB): Logarithmic Scale

Table 1: Nominal and Paid-Up Capital of Companies Registered in 1892

Capital in £	Registered	%	Paid-Up end of 1892	%	Paid Up end of 1897	%
<1000	3	5%	8	30%	0	0%
1000-5000	14	25%	9	33%	8	47%
5000-10,000	9	16%	1	4%	2	12%
10,000-20,000	10	18%	5	19%	3	18%
20,000-50,000	7	12%	1	4%	1	6%
50,000-100,000	7	12%	1	4%	3	18%
100,000-200,000	6	11%	2	7%	0	0%
200,000-300,000	0	0%	0	0%	0	0%
300,000-400,000	0	0%	0	0%	0	0%
400,000-500,000	0	0%	0	0%	0	0%
500,000-750,000	0	0%	0	0%	0	0%
750,000-1,000,000	1	2%	0	0%	0	0%
>1,000,000	0	0%	0	0%	0	0%
Total	57		27		17	

Table 2: Number of shareholders in Companies Registered in 1892

Number of Shareholders	Registration	End of 1892	End of 1897
2	0	0	0
3-6	0	0	0
7	49	7	2
8-9	1	5	1
10-19	0	8	6
20-49	0	3	1
50-99	0	5	5
>100	0	4	3
	50	32	18