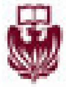

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NINETEENTH-CENTURY JURISDICTIONAL COMPETITION IN THE GRANTING OF CORPORATE PRIVILEGES

*HENRY N. BUTLER**

THE history of regulation does not offer many illustrations of a voluntary reduction in the level of government control over private business organizations. Yet just such a reduction occurred during the nineteenth century as state legislators relinquished their strict control over the power to grant or deny special corporate privileges to the particular groups that sought them. The corporate charter, which originated as an exclusive privilege to the few, by the end of the nineteenth century had become a general privilege available to all. The move from special charters by individual legislative act to general incorporation on compliance with simple and inexpensive procedures represents a major change in the structure of property rights. This paper offers a legal and economic account of the decline and fall of the special charter in the United States and seeks to explain how and why legislators abandoned the market for special charters.

The paper proceeds as follows. Section I examines the ways in which the methods of legal and economic historians can be brought to bear on the basic question. Thereafter it advances the central thesis of the paper, that legislators abandoned the market for special charters only after

* Assistant Professor of Management, Business and Public Policy Group, Texas A&M University. This paper is taken from my Ph.D. dissertation, Legal Change in an Interest-Group Perspective: The Demise of Special Corporate Chartering (V.P.I. & State Univ. 1982). I thank Robert D. Tollison, my dissertation chairman, as well as the other members of my dissertation committee, James M. Buchanan, W. Mark Crain, Dwight Lee, and Gordon Tullock, for their assistance. I also thank Barry Baysinger, Henry Manne, James Mofsky, and Louise Nelson for helpful comments on earlier versions of this paper. The usual caveat applies. I gratefully acknowledge support provided by the University of Miami Law and Economics Center and the Liberty Fund/Center for Libertarian Studies under the Summer Research Fellows Program. An earlier version of this paper was presented at the 1983 annual meeting of the Southern Economic Association.

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events beyond their control made it impossible to continue to create and capture the monopoly rents from the business of issuing them. Section I then considers a number of alternative explanations for this deregulatory episode. Section II offers a detailed reinterpretation of the evolution in the availability of corporate privileges in the nineteenth century. This evidence indicates that two exogenous events—the persistent expansion of interstate commerce and one major Supreme Court decision—led to the development of a national free market in corporate privileges, decreased the economic rents obtainable from spatial monopolies in corporate privileges, and thereby facilitated the adoption of general incorporation laws. Section III briefly explores some implications of the study for the current effort to reregulate the market for corporate privileges.

I. Methodology and Hypotheses

A. *The Framework*

The framework for this study combines the approach of political economists with that of legal and economic historians. Specifically, the law and legal institutions at any one time are not viewed as a historical accident or the outcome of autonomous evolution, but rather as the result of political and economic forces that manifest themselves in the competition among interest groups for favorable legislation.[1] This approach to change in legal institutions harkens back to the economists' version of the interest group theory of government.[2] In a market for special interest legislation, legislation is "sold" by legislators and "bought" by winning coalitions that outbid their rival seekers.[3] By this approach to government, it is critical to identify the major winners and losers under a given government program before attempting to explain how the program emerged.

It may be necessary, moreover, to examine the supply side of the market for legislation, where the legislature has monopoly power over the

[1] See Lawrence M. Friedman, A History of American Law 10–14 (1973) for an outline of the framework.

[2] See George J. Stigler, The Theory of Economic Regulation, 2 Bell J. Econ. 3 (1971); Richard A. Posner, Theories of Economic Regulation, 5 Bell J. Econ. 335 (1974); and Sam Peltzman, Toward a More General Theory of Economic Regulation, 19 J. Law & Econ. 211 (1976). Also see Gordon Tullock, The Welfare Costs of Tariffs, Monopolies, and Theft, 5 West. Econ. J. 224 (1967) and Anne O. Krueger, The Political Economy of the Rent-seeking Society, 64 Am. Econ. Rev. 291 (1974).

[3] See Robert McCormick & Robert D. Tollison, Politicians, Legislation, and the Economy: An Inquiry into the Interest-Group Theory of Government (1981), for theoretical formulation and empirical tests of this view using cross-sectional data on state governments in the United States.

production and supply of legislation, including corporate charters, within its jurisdiction. The legislature, however, is not a classical monopolist because it has to contend with several sources of competitive pressures. First, its monopoly power is controlled by the majority political party, which is always faced with internal competition for the right to control legislative output. In this regard, it is useful to view political parties as maximizing firms that are confronted by competitive market forces within the legislature that hamper their efforts to gain control of the supply side of the market for legislation.[4] Second, the legislature's monopoly position may also suffer from foreign competition if the political boundaries delineating the legislature's jurisdiction do not create effective entry barriers against intrusion by other legislatures or if legal constraints on the exit of economic resources are relaxed.[5] Third, the legislature's monopoly position is further constrained because private parties had imperfect contractual substitutes for the corporate form. A complete analysis of the political and economic constraints on legislative behavior is sharpened by using the useful dichotomy between "exit" and "voice" elaborated by Albert Hirschman.[6] In this model individual residents of a given state choose some mix between internal political activity ("voice") and departure from the state ("exit") to express their dissatisfaction with the then current legal order. As the opportunities for movement beyond the state were limited, participation in the political process had relatively greater appeal during the nineteenth century; but over time exit became a more viable alternative as jurisdictional barriers were weakened by legal and technological changes. Nonetheless in the early part of the nineteenth century it seems fair to say that, within certain boundaries, it is proper to treat state legislatures as the possessors of substantial monopoly power within their respective jurisdictions.

[4] The majority party faces many production and organizational problems common to conventional firms. See W. Mark Crain & Robert D. Tollison, The Sizes of Majorities, 46 S. Econ. J. 726 (1980).

[5] For a brief summary of the economics of jurisdictional competition as it relates to corporate chartering in the United States, see Frank H. Easterbrook, Antitrust and the Economics of Federalism, 26 J. Law & Econ. 23, 34–35 (1983). Jurisdictional competition has been found to play an important role in other law and economics contexts; see, for example, Charles M. Tiebout, A Pure Theory of Local Expenditure, 64 J. Pol. Econ. 416 (1956); Susan Rose-Ackerman, Does Federalism Matter? Political Choice in a Federal Republic, 89 J. Pol. Econ. 152 (1981); Richard E. Wagner & Warren E. Weber, Competition, Monopoly, and the Organization of Government in Metropolitan Areas, 18 J. Law & Econ. 661 (1975); and Charles D. Kolstad & Frank A. Wolak, Competition in Interregional Taxation: The Case of Western Coal, 91 J. Pol. Econ. 443 (1983).

[6] Albert O. Hirschman, Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States (1970).

This interest group approach to legal institutional change is similar, in some aspects, to the property rights framework in which "the emergence of new property rights takes place in response to the desires of the interacting persons for adjustment to new benefit-cost possibilities."[7] The property rights framework is based on the hypothesis that institutions develop in response to changing private needs or profit potentials, and that new institutional arrangements will not be set up unless the private benefits of their creation exceed the costs: "It is the possibility of profits that cannot be captured within the existing arrangemental structure that leads to the formation of new (or the mutation of old) institutional arrangements."[8] Accordingly, the major characteristic of the methodology of these models is an emphasis on the identification of exogenous changes in order to explain why property rights which cannot be established profitably at one point in time will later be justified economically.

A combination of these perspectives and methodologies helps explain the timing of legislative actions by identifying those changes in exogenous economic variables that alter the costs and benefits of existing property rights and thus encourage interest groups to seek favorable legislative changes from legislators, who react to the pressures of competing interest groups.[9] The law will not change unless the legislators perceive the possibility of net gains to themselves from changing the law. That is, legislators are maximizers whose marginal trade-offs determine the nature of the law at any given time.

The evidence analyzed in this paper is qualitative in nature and is not amenable to hypothesis testing that relies on large samples and econometric methods. In applying the property rights methodology, however, it is not necessary to measure directly the legislators' net gains from changes in the law in order to understand the incentives for legal change. Instead, one can follow exogenous economic and legal events that would tend to alter the legislators' costs and benefits and then determine if the predicted changes occurred. In summary, the model of legal change used in this paper employs the interest group perspective to explain *why* the method of incorporation was changed and the property rights methodology to help explain *when* it was changed.

[7] On the property rights framework, see generally Harold Demsetz, Toward a Theory of Property Rights, 57 Am. Econ. Rev. 347 (1967); Lance E. Davis & Douglass C. North, Institutional Change and American Economic Growth (1971); and Douglass C. North & Robert P. Thomas, The Rise of the Western World: A New Economic History (1973). The quotation is from Demsetz, at 350.

[8] Davis & North, *supra* note 7, at 39.

[9] A similar framework was utilized by Gary D. Libecap, Economic Variables and the Development of the Law: The Case of Western Mineral Rights, 38 J. Econ. Hist. 338 (1978).

In this framework, the passage of general incorporation laws was a voluntary reduction in monopoly power by the legislators (that is, by the suppliers in the market for corporate charters). Because of the public benefits of a general incorporation law, it is doubtful that any politically effective coalitions could have "bought" their passage. At first blush, the voluntary reduction in monopoly power appears to be incompatible with the interest group perspective by suggesting that the firms (political parties) were not maximizing profits. This paper, however, identifies exogenous economic and legal events that decreased the rents from the legislators' spatial monopolies in corporate charters and thus paved the way to general incorporation laws. The specific exogenous changes are the growth of an interstate railroad network, which led to an increase in interstate commerce, and the Supreme Court decision, *Paul v. Virginia,*[10] forbidding states to exclude corporations chartered in other states. These changes resulted in a national "free market" for corporate privileges that was quickly dominated by small states eager to capture the revenues from fees and taxes on the national corporations they were able to charter under their own liberal general incorporation laws. Spatial monopolies over corporate privileges were destroyed, and the market value of the special charter legislation was reduced. In consequence, legislators stopped producing special charters. Nationwide competition transformed the corporate form from a special privilege to a routine occurrence.

B. Alternative Hypotheses for the Emergence of General Incorporation Laws

Although the history of the passage of general incorporation laws has received considerable attention in both the legal and economic literature,[11] there have been few explanations for their passage. Lawrence Friedman has suggested that the method of incorporation changed chiefly because the passage, and subsequent amendments, of special acts of in-

[10] 75 U.S. (8 Wall.) 168 (1869).

[11] See, for example, S. Samuel Arsht, A History of Delaware Corporation Law, 1 Del. J. Corp. Law 1 (1976); Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (rev. ed. 1968); John W. Cadman, Jr., The Corporation in New Jersey; Business and Politics, 1791–1875 (1949); Joseph E. Davis, Essays in the Earlier History of American Corporations (1917); Edwin Merrick Dodd, American Business Corporations until 1860: With Special Reference to Massachusetts (1954); Oscar Handlin & Mary F. Handlin, Origins of the American Business Corporation, 5 J. Econ. Hist. 1 (1945); William C. Kessler, Incorporation in New England: A Statistical Study, 1800–1875, & J. Econ. Hist. 43 (1948); George J. Kuehnl, The Wisconsin Business Corporation (1959); Russel C. Larcom, The Delaware Corporation (1937); Shaw Livermore, Early American Land Companies: Their Influence on Corporate Development (1939); and Hugh L. Sowards & James S. Mofsky, Factors Affecting the Development of Corporation Law, 23 U. Miami L. Rev. 467 (1969).

corporation took up too much of the legislatures' time.[12] Thus, in an interest group perspective, Friedman seems to be claiming that general corporate privileges were not important, that there were no rents to be captured from the marketing of special corporate charters, and that there were no rents to be captured from making corporate privileges available to all. This is clearly contrary to the evidence presented in Section II. Throughout the early nineteenth century, state legislators retained control over special charters in the face of constant political pressures—sometimes based on charges that special charters took too much time—for divesting themselves of chartering activity. This legislative preservation of prerogatives is, of course, consistent with the interest group perspective of this paper. No legislature, prior to the exogenous changes identified, had ever voluntarily relinquished its control over the special charter.[13] In several states, however, this power was taken from the legislatures when the states revised their constitutions as the result of provisions adopted at state constitutional conventions and approved by the electorate.[14] It appears, therefore, that the Friedman hypothesis might help explain the passage of general incorporation laws at the constitutional level. For example, the public objections to the waste of legislative time and money in the special chartering system were more vulnerable to destruction in a forum not dominated by legislators. Yet by implication the constitutional activity reconfirms the central prediction about legislative behavior. When monopoly rents were positive, no legislature voluntarily relinquished monopoly control over the special charter.

Anderson and Tollison have suggested that the unincorporated joint stock company flourished as a substitute for the specially chartered corporation during the late eighteenth and early nineteenth centuries, both in England and the United States.[15] Under their interpretation, the passage of state general incorporation laws was the second best method for legislators to take advantage of the emergence of large firms as a substantial source of revenue. Regulation-inclined state legislators encouraged unincorporated firms to take advantage of the new laws so that the legislators could keep track of potential customers. The Anderson-Tollison interpretation is complementary to the thesis of this paper, yet it appears to be unable to explain the timing of the passage of general incorporation laws,

[12] Friedman, *supra* note 1, at 172, 447.

[13] See text accompanying notes 83–84 *infra*.

[14] See text accompanying notes 92–96 *infra*.

[15] Gary M. Anderson & Robert D. Tollison, The Myth of the Corporation as a Creation of the State, Internat. Rev. Law & Econ., forthcoming. See also Livermore, *supra* note 11.

as their interpretation does not rely on an exogenous event, such as *Paul v. Virginia,* to explain the eminent decline of the special charter.

Shughart and Tollison, however, do address the timing of the passage of general incorporation laws.[16] Their interpretation and empirical results indicate that the deregulation of the market for corporate privileges followed the same S-shaped growth curve that describes the diffusion process for many technological innovations.[17] In their view, the identification of exogenous changes is not as important as it is in the analysis presented in this paper. Explaining the adoption of general incorporation laws, however, does not explain the end of special chartering, since special chartering continued under the dual system in many states after the passage of those states' initial general laws.[18] The Shughart-Tollison interpretation only complements, but does not refute, the thesis offered in this paper.

It is possible to construct several efficiency-based explanations for the passage of general incorporation laws. A general incorporation law, for example, may be viewed as a quasi-public good intended to reduce transaction costs and to promote general economic activity by providing a more efficient way of organizing business associations.[19] The major difficulty with this explanation, however, is that no economic theory explains what motivates legislators to make economically efficient decisions. Implicit in this public interest framework is the notion that the legislators are responsive to broad-based demands that produce the highest total bids for changes in the law which benevolently will allow resources to flow to their highest valued uses. Public choice theory, however, predicts that it is the distribution of the bids, not just their total size, that determines the passage of legislation. That is, because of the costly nature of political participation and the publicness of its benefits, the likely result is that broad-based demands would be overwhelmed by the more intense and narrowly based demands of special interest groups. The evidence presented in this study confirms this view by showing that states continued to pass special charters long after the broad-based demands for liberal general incorporation laws were clearly recognized.

A second efficiency explanation might view general incorporation laws as the survivor of an evolutionary process that selects the most efficient

[16] William Shughart & Robert D. Tollison, Corporate Chartering: An Exploration in the Economics of Legal Change (June 1983) (unpublished manuscript, Clemson Univ., Econ. Dept.).

[17] See Zvi Griliches, Hybrid Corn: An Exploration in the Economics of Technological Change, 25 Econometrica 501 (1957).

[18] See text accompanying notes 40–84 *infra*.

[19] Richard A. Posner, Economic Analysis of Law 292–96 (2d ed. 1977).

laws. Thus the Demsetz, North-Davis, and North-Thomas models of institutional changes contemplate a slow drift to efficient systems of property rights. But this model seems inappropriate here for several reasons. First, it cannot explain how the parties are able to overcome the traditional Prisoner's Dilemma, which can block the emergence of the desired corporate form. That is, even if the net benefits to individual firms from jointly procuring the passage of a general law were greater than the net benefits to individual firms when all firms sought special charters, the latter strategy would dominate if the cooperation of all firms (which would be necessary for the passage of the general law) could not be guaranteed.[20] Second, those institutional changes that appear efficient in isolation (in the small) may prove to be undesirable as part of a general equilibrium framework (in the large). Thus any change in incorporation standards could lead to the more efficient organization of business organizations, but this result need not be efficient if the corporations proved effective in forming powerful "rent-seeking" coalitions that seize legislative intervention to obtain private wealth. Third, these models do not explain how the preferences of the public at large, which are some measure of net social benefits, are transformed into legislative action as there is no voting model that gives individual legislators an incentive to adopt an economically efficient property rights structure.[21] Explanations of this sort therefore may possibly explain the spontaneous evolution of property rights through individual interaction and common-law adjudication,[22] but they seem less able to explain what legislated property rights approach the efficient solution, either at the time of its passage or thereafter.

In spite of these concerns, an efficiency explanation may be consistent with the facts. If the constitutional status of the corporation operating in interstate commerce was inefficient prior to *Paul v. Virginia,* then *Paul* can best be explained as the result of continuing pressures on the federal court system to change the constitutional rules. The *Paul* decision changed the legislative market for corporate privileges from one of localized monopolies into a competitive, national free market in corporate

[20] For a discussion of the Prisoner's Dilemma, see Charles J. Goetz, Law and Economics 8–31 (1984). For a discussion of the distinction between free riding behavior with large numbers of economic actors and strategic behavior with small numbers of actors, see James M. Buchanan, The Limits of Liberty: Between Anarchy and Leviathan 36–38 (1975).

[21] The seminal works on voting models are Anthony Downs, An Economic Theory of Democracy (1957); Duncan Black, Theory of Committees and Elections (1958); and James M. Buchanan & Gordon Tullock, The Calculus of Consent: Logical Foundations of Constitutional Democracy (1962).

[22] See generally Frederick Hayek, 1 Law, Legislation, and Liberty: Rules and Order (1973).

privileges. The firms (state legislatures) that prospered in the competitive market were the firms that could produce the best product at the lowest cost. Since the marginal cost of producing corporate charters by special legislative acts was most likely greater than by general law, the general incorporation law was chosen as the most desirable means of production. Moreover, competition between the producers forced the states to offer the most efficient set of corporate laws. It should be noted that both the interest group and efficiency hypotheses suggest the same scenario following the *Paul v. Virginia* decision. The interest group hypothesis, however, is supported regardless of the motivation for the *Paul* decision.

Another explanation is to treat general incorporation laws as revenue measures designed to capitalize on the increased demand for corporate privileges by larger firms that developed with the Industrial Revolution. In this scenario, the revenues of a state derived from the business of incorporating firms would increase as the state trade in corporate charters changed from a high-price, high markup, low-volume business to a low-price, low markup, high-volume business.[23] Even if state revenues from corporate taxes and fees did increase after this change in the law, this alternative theory by itself does not appear to be consistent with either the facts or the competing interest group theory. In the interest group perspective, legislators would capture a portion of the rents generated by special acts. In contrast, under general incorporation acts, the increased state revenues go directly to the state treasury, leaving little opportunity for the legislators to capture the revenues generated. Although it may be argued that legislators as a group benefit from having control over greater revenues, the interest group theory suggests that legislators would be better off by creating rents through special acts, which they could then capture in the market for legislation. However, the revenues-generating explanation has increased plausibility once the legislators are no longer creating rents by passing special charters, as reduced revenues are better than no revenues at all.

The evidence presented in Section II offers strong support for the thesis of this paper. The alternative hypotheses offered are consistent with isolated aspects of the change in method of incorporation but do not explain the overall picture. The interest group hypothesis, however, is

[23] This hypothesis is suggested by Ames's interpretation of why the method of conveying government-owned frontier land to private individuals changed from grants through individual charters to selling plots at a uniform price. This change took place in the United States in the late 1780s and Ames claims that it was motivated by fiscal considerations. See Edward Ames, Public Land Offices as an Institutional Innovation, presentation at the Public Choice Seminar, V.P.I. & State Univ. (July 1981).

much richer than the alternatives and offers a perspective that is extremely helpful in identifying relevant explanatory variables.

II. Jurisdictional Competition and the End of Special Chartering

The individual states of the United States did not change their method of incorporation from special charters to general incorporation laws either suddenly or at the same time. These important changes, which took place throughout the nineteenth century, developed in three overlapping stages: first, the era of special charters; second, the dual system under which some companies incorporated under restrictive general incorporation laws while others continued to incorporate through special legislative acts; and third, interstate incorporation competition, which led to the adoption of liberal general incorporation laws. These three stages provide the organization for this section.

A. *The Special Chartering System*

Following the American Revolution, there was almost universal assent to the proposition that the power to form corporations was vested in the state legislatures.[24] All corporate charters were issued one by one by individual legislative acts, and the overwhelming majority of the corporations chartered in the late 1700s were banks, insurance companies, water companies, and companies organized to build or run canals, turnpikes, and bridges. Many of the public utility or transportation corporations were awarded monopoly privileges and police powers of the state (for example, eminent domain) in exchange for the financing and construction of quasi-public goods by the private firms.[25]

It was not until the second decade of the nineteenth century that the technology available to United States firms was sufficiently advanced to require large-scale enterprises.[26] The preamble of most early New Jersey manufacturing company charters, for example, justified the acts of incor-

[24] See Cadman, *supra* note 11, at 3; and Dodd, *supra* note 11, at 196.

[25] See Davis, *supra* note 11, for a thorough discussion of eighteenth-century corporations. His study is very enlightening with regard to the origins of the American business corporation as a device for engaging in banking, insurance, and the improvement of communications. It tells us very little, however, of the development of the corporation as an industrial organization, since that development did not occur on a substantial scale until after 1800.

[26] The power loom was the major technological development. See Victor S. Clark, 1 History of Manufacturers in the United States 449 (1949); and Oscar Handlin & Mary F. Handlin, Commonwealth: A Study of Government in the American Economy, 1774–1961, at 490 (rev. ed. 1969), for discussions of the importance of the power loom with respect to the use of the corporate form.

poration on the grounds that the enterprises required more capital than could be obtained by more traditional means.[27] Entrepreneurs demanded access to the corporate form as an efficient way to structure and finance business ventures of all types.

Although interested in using the corporate form to promote industrial independence from England,[28] state governments in the first third of the nineteenth century were conservative in their initial granting of the corporate form to industrial and business organizations. The result of these conflicting considerations was an interesting combination of relative generosity in granting special charters and a fairly restrictive policy with respect to their terms.[29] The usual corporate privileges denied by these early charters were perpetual succession and limited liability.[30] Thus, it

[27] Cadman, *supra* note 11, at 39–40.

[28] The increasing utilization of the corporate form beginning in 1809 was a significant by-product of the limitations on the importation of European goods which were imposed by the Embargo Act of 1807 and the Non-Intercourse Act of 1809. See Handlin & Handlin, *supra* note 26, for an examination of the effects of the embargo on the demand for Massachusetts manufacturing charters. Also, see Dodd, *supra* note 11, at 367–68. It was not merely coincidental that "it was not until 1809 that the corporate device, already common in transportation and finance, became anything other than exceptional in manufacturing." *Id.* at 368. Also see Kessler, *supra* note 11, at 52; and Caroline F. Ware, The Early New England Cotton Manufacture, A Study in Industrial Beginnings 44 (1931).

[29] See Dodd, *supra* note 11, at 365–66, 391–92, for the conflicting considerations underlying New England legislative policy.

[30] It was not clear whether a corporation necessarily included limited liability under the common law when the charter was silent with respect to shareholders' obligations to creditors. This issue was not affirmatively settled until 1824 when a federal circuit court, in a case where there was no express exemption from liability in the company's charter, stated: "The individual shareholders are not liable for the debts of the bank in their private capacity. The charter relieves them of personal liability and substitutes the capital stock in its stead." Wood v. Dummer, 3 Mason 308, 311 (C.C.D. Me., 1824). See Dodd, *supra* note 11, at 370–73. There is some dispute between legal scholars as to the importance of limited liability at this early stage in the development of the corporate form. Compare Handlin & Handlin, *supra* note 11, and Livermore, *infra* note 31, with Dodd, *supra* note 11, at 390. However, there seems to have been very little dispute between incorporators. See, for example, Joseph K. Angell & Samuel Ames, A Treatise on the Law of Private Corporations Aggregate, 23 (1st ed. 1832). In order to understand the value of limited liability at this early stage in the development of the corporate form, it is necessary first to understand the dominant method of financing a corporation in the first half of the nineteenth century; see Dodd, *supra* note 11, at 74–84. The usual practice was for the incorporators to obtain stock subscriptions on which only a small percentage of the par value of the stock was paid at the outset and then to assess the subscribers up to the amount of the subscription in order to meet future needs of the company. (The common practice today is to use shares which are fully paid at the time of issue.) A stock subscription was an enforceable contract, and the failure of shareholders to meet assessment calls generated considerable litigation. Even after it was established that shareholders were not liable for corporate debts, a shareholder's liability extended beyond his initial contribution to embrace the unpaid portion of the subscription. Samuel Williston, History of the Law of Business Corporations Before 1800, 2 Harv. L. Rev. 105–24 and 149–

has been said that "[t]he recipients of many charters had to rest content with the doubtful legal privileges of suing and being sued as an entity, a different tax status, and the pomp of a corporate seal."[31] Although the basic theory of the special charter was that individual legislative sanction provided the necessary control and regulation of a new form of business association, state legislatures granted special charters with less restrictive terms to favored groups.[32]

The passage of special charters and supplementary acts occupied increasingly large portions of legislative sessions in the first third of the nineteenth century.[33] In order to ease this burden, many legislatures passed general regulating statutes. These acts did not provide for incorporation by procedure; instead they merely established the powers and restrictions applying to corporations created by special charter. By referring to the general regulating statutes, the special charter did not have to include the general powers and restrictions. In effect, the passage of a special charter subject to the general regulating statute involved the legislature filling out a form, adding a few details such as the name of the corporation, names of the incorporators, and the capital stock pertaining to the particular case.[34]

General regulating statutes were an advancement in legal technology, and they appear to have reduced the legislators' time devoted to each special charter. However, in this paper's perspective, the general regulating statutes would not necessarily lead to less total time spent by legislators on special chartering. The general regulating statutes were a move

66, at 160 (1888). At any rate, limited liability is important solely on the question whether it actually encouraged the formation of corporations. From the perspective of this paper, it is also important to know whether the presence of limited liability affected the legislators' behavior with respect to the granting of corporate privileges. The early availability of limited liability in the market for corporate privileges was eventually influenced by jurisdictional competition through capital markets.

[31] Shaw Livermore, Unlimited Liability in Early American Corporations, 43 J. Pol. Econ. 674, 677 (1935).

[32] See Berle & Means, *supra* note 11, at 127–28; and Harold W. Stoke, Economic Influences upon the Corporation Laws of New Jersey, 38 J. Pol. Econ. 551, 551–52 (1930).

[33] See Cadman, *supra* note 11, at 14.

[34] *Id.* at 15–16. It has been argued that general regulating statutes were passed in order to save legislators' time—see Joseph G. Blandi, Maryland Business Corporations, 1783–1852, at 11–12 (1934); and Dodd, *supra* note 11, at 375–76—and to restrict the abuses of the special charter system; see Cadman, *supra* note 11, at 17–18. General regulating statutes were also needed to correct a more technical legal problem. In the absence of these statutes, the kinds of provisions included in special corporate charters varied widely. Consequently, the uncertainty as to the exact privileges and immunities of individual corporations led to large amounts of litigation. Cadman at 9–18; Blandi at 11–12; and Stoke, *supra* note 32, at 558–59. For an analysis of the substantive provisions regulating corporations in the first half of the nineteenth century, see Berle & Means, *supra* note 11, at 122–24.

toward a standardized product with a lower production cost. This move did not necessarily mean lower prices for the purchasers of special charters because perfect price discrimination was still possible as each special charter continued to be marketed individually. Furthermore, the legislators of many of the states that enacted general regulating statutes continued to grant customized special charters to firms willing and able to put in the extra effort necessary to secure more favorable privileges. Thus, since the general regulating statutes did not affect the demand for special charters and did not lower the marginal cost of production of many special charters, the expected increase in the quantity of special charters (which did in fact occur after the passage of general regulating statutes) leads one to speculate that the real purpose of these statutes might have been to enable legislators to capture additional rents from the production of additional special charters.

Each corporate charter, therefore, was adopted for the benefit of a specific group and, initially, each was unique with respect to its provisions for powers, duration, limited liability, voting rights, and other incidents. In fact, some of the special chartering bills provided specific relief from taxation. Lobbying, logrolling, and bribery—all symptoms of a market for special interest legislation—appeared early and developed rapidly in connection with bills for special charters. The special chartering system inherently possessed the potential for rent-seeking behavior, and many examples show how charter applicants strained to get more generous terms from their legislators than those obtained by rival groups already in the field. Of course, corporations already in existence were not likely to rest content while the legislature granted more favorable terms to their potential competitors.[35] In discussing the manifestations of these competing pressures and demands for legislative favors, one author has remarked that it is appropriate to describe the legislature as "the 'clearing house' for [these] competing demands and projects."[36] The special chartering system was, as its name suggests, a system of special interest legislation.[37]

[35] The effects of this systematic competition for legislative favors were evident in every state and in the territories as well; see, for example, Kuehnl, *supra* note 11, at 3; and Cadman, *supra* note 11, at 171.

[36] Kuehnl, *supra* note 11, at 190.

[37] Stoke, *supra* note 32, at 557–58, noted: "If every proposed corporation must obtain the consent of the legislature, then it must make friends of the legislators. Incorporation for many companies, of course, was purely perfunctory, but for the larger enterprises, whose stock would become marketable securities, the legislature often had to be persuaded in various ways. Lobbies and personal pressure were methods known to the privilege-seeker even of that early day, and in some instances darker and more sinister methods must be called upon to explain the inconsistency and vacillation which the legislature displayed." In

One feature helped stabilize the system of special charters. There were very few interstate corporations during the early development of the general business corporation. Incorporation in a state implied that the corporation would locate and operate in that state.[38] Because of these considerations, it would appear that each state had a complete spatial monopoly with respect to the market for corporate privileges within its political boundaries. This was not entirely true, however, because a state's political boundaries were ineffective exit barriers with respect to the capital accumulated by its citizens. Thus, the legislators of any particular state did not have complete control over the corporate privileges that could be purchased by its capitalist citizens. In the special charter era, much of the public interest rhetoric surrounding the passage of special charters dealt with this competition in capital markets—the state's desire to attract outside capital or prevent the flight of local capital. Success in the capital markets translated into the chartering of firms that would build factories and increase the wealth of the state.[39]

Prior to the emergence of capital market jurisdictional competition, the major influence on the terms of corporate charters had been the use of voice in the political process. The impact of the availability of the exit option on the market for corporate privileges at that early stage was slight, however, as it was offset by a change in the political status of special charters—jurisdictional competition had provided a public interest rationale for granting increasingly valuable privileges. Nevertheless, the early jurisdictional competition presaged the total demise of the voice option as a viable means for affecting the acquisition of corporate privileges. Voice became irrelevant as jurisdictional competition became

many states the special chartering system was rocked by scandals and charges of corruption. See, for example, Cadman, *supra* note 11, at 10–11, 139–40, & 163; Friedman, *supra* note 1, at 173; Harry G. Henn, Handbook of the Law of Corporations and Other Business Enterprises 18 (1970); and Kuehnl, *supra* note 11, at 190–91. Also see Louis Hartz, Economic Policy and Democratic Thought: Pennsylvania, 1776–1860, at 62–69 (1948) and Cadman, at 11, for discussions of logrolling. It has been suggested that logrolling forces would not have been as strong with respect to the granting of corporate charters for industrial purposes because of the suspicion that there would have been relatively less importance placed on sectional considerations. See Hartz at 64–65. However, there is no apparent reason why votes for canal charters would have to be exchanged for votes for other canal charters. Also, in general, it is expected that profit-maximizing legislators would organize their firms in a manner which would allow legislators from nonindustrial areas to receive some of the benefits from the passage of corporate charters for industrial organizations.

[38] In fact, manufacturing company charters of this period usually required that the enterprise be located not only in the state but also in a particular town. Dodd, *supra* note 11, at 178–80, 400.

[39] For discussion and examples of the effects of capital markets on the markets for corporate privileges, see Cadman, *supra* note 11, at 35–37; Dodd, *supra* note 11, at 232–33, 378–89; Ware, *supra* note 28, at 91; and Blandi, *supra* note 32, at 91–92.

concerned with the flow of corporate privileges, and not just capital, across state lines.

B. The Dual System of Incorporation: Market Segmentation and Price Discrimination

Under the dual system of incorporation, it was possible to incorporate either by a simple procedure under a general incorporation statute or by special act. The system developed after the passage of the first general incorporation act of wide coverage in the United States—the New York Act of 1811.[40] The act was popular,[41] and the major difference between the corporations formed by special charter and those formed under the general law was that the general law companies were smaller on average.[42] In effect, the legislators gave inferior privileges to smaller firms while continuing to sell the superior privileges (in the form of a special charter) to the firms that valued the privileges more highly. This market segmentation and price discrimination were the essence of the dual system of incorporation when viewed in the interest group perspective. General incorporation laws of widespread applicability were passed by only three states (New York, New Jersey, and Connecticut) prior to 1845,[43] and the dual system was functional in only eleven of thirty-seven states during its peak between 1846 and 1875.[44] The fully fledged development of the dual system began in 1846 with two events: the ratification of a new New York State constitution and the passage of a New Jersey manufacturing general incorporation law.

The New York constitution of 1846 restricted the granting of special charters to "cases where, in the judgment of the Legislature, the objects of the corporation cannot be attained under general laws."[45] It is not clear

[40] The passage of the New York Act of 1811 was closely connected with national Democratic policies of the period and the patriotic movement to stimulate home manufacture. See generally William C. Kessler, A Statistical Study of the New York Incorporation Act of 1811, 48 J. Pol. Econ. 877, 878–79 (1940); Livermore, *supra* note 31, at 684–85; and Larcom, *supra* note 11, at 1. Monopolistic legislators, it seems, can be influenced by patriotic notions. The patriotic legislators, however, did not relinquish control over several important corporate privileges. The terms of the New York Act of 1811 included a low maximum capitalization of $100,000, a short life of only twenty years, and a strange shareholders' liability provision. See Stanley E. Howard, Stockholders' Liability under the New York Act of March 22, 1811, 46 J. Pol. Econ. 499 (1938).

[41] Kessler, *supra* note 40. Contra Berle & Means, *supra* note 11, at 136; Livermore, *supra* note 31, and Dodd, *supra* note 11, at 388.

[42] Kessler, *supra* note 40, at 882.

[43] Cadman, *supra* note 11, at 118–19.

[44] Kessler, *supra* note 11, at 43–44.

[45] B. P. Poore, Clerk of Printing Records, The Federal and State Constitutions, Colonial Charters, and Other Organic Laws of the United States 1363 (1878).

why this provision was added to the new constitution. It surely was not added because the legislature was overburdened with special charter applications—as would have been suggested by the Friedman hypothesis.[46] For example, for the years 1840–45, there were sixty-nine manufacturing company incorporations under the Act of 1811; during that time there were only nine by special act.[47] Even after passing a more comprehensive general incorporation law for manufacturing firms, the New York legislature was quite accommodating in making the judgment that the general incorporation law was suitable for a particular firm: "By 1872 . . . the pressure for private acts of incorporation was still so strong that the governor declared in his annual message: 'There should be more specific constitutional restraints upon legislative power to grant special charters for private corporations. . . .' "[48] Thus, the constitutionally imposed dual system in New York was not a major deterrent to special charter legislation.

Four other states, following the lead of New York, added qualified constitutional prohibitions against special corporation chartering between 1845 and 1875: Illinois and Wisconsin in 1848,[49] Maryland in 1851,[50] and North Carolina in 1868.[51] Of these, the dual system created by the Wisconsin constitutionally mandated statute is the best documented. Between 1848 and 1871, only 143 business corporations were created under Wisconsin general incorporation laws while 1,130 were created by special acts—a ratio of almost eight to one.[52] Thus, in Wisconsin as in New York, the constitutionally mandated, dual system did not significantly alter the legislators' behavior toward special charters. In general, it appears that the constitutionally mandated, dual system failed to have a negative impact on the market for special corporate charters.

The first general incorporation law in the dual incorporation era that was not constitutionally mandated was the New Jersey manufacturing law of 1846.[53] It was immediately clear that the 1846 act was not a suitable alternative to incorporation by special act, and in 1849 the Democrat-dominated legislature passed a revised general incorporation law designed

[46] See text accompanying notes 12–14, *supra*.

[47] Kessler, *supra* note 40.

[48] Cadman, *supra* note 11, at 173. Also, see Friedman, *supra* note 1, at 172–73.

[49] Poore, *supra* note 45, at 465, and 2039.

[50] *Id.* at 1431.

[51] *Id.*

[52] Kuehnl, *supra* note 11, at 143, 146.

[53] Cadman, *supra* note 11, at 118–19.

to increase the relative desirability of the general law corporations.[54] Democrats were ambivalent toward the corporation. Jacksonian Democrats, while concerned about alleged abuses of the special charter system such as bribery and logrolling, also attacked the basic concept of the general business corporation.[55] They were fundamentally opposed to the granting of limited liability, which they viewed as an unjust and illegitimate creation of the state, and they feared that widespread use of the corporate form would lead to increased concentration of wealth and economic power. Nevertheless, the pressures for special charters continued, and even the Democrats succumbed to those pressures while they controlled the legislature.[56] Here, as under the special chartering system, the dual system witnessed the overpowering of ideology and party policies by interest groups.[57]

During the dual incorporation era, 1845–75, six states—other than New York, Connecticut, and New Jersey—passed general incorporation laws that had no constitutional mandate: Michigan in 1846,[58] Pennsylvania in

[54] *Id.* at 127.

[55] Schlesinger summarized the Jacksonians' concerns: "For a people still yearning for an economy dominated by individual responsibility, still under the Jeffersonian dream, the corporation had one outstanding characteristic: its moral irresponsibility. Corporations have neither bodies to be kicked, nor souls to be damned, went a favorite aphorism." Arthur M. Schlesinger, Jr., The Age of Jackson 335 (1948). See also Dodd, *supra* note 11, at 392–96; Cadman, *supra* note 11, at 72–79; and Hartz, *supra* note 37, at 91–92. General law corporations were viewed as the lesser of two evils.

[56] Hartz, *supra* note 38, at 147–48.

[57] The New Jersey manufacturing general incorporation laws of 1846 and 1849 were employed fairly frequently in their early years. Between 1847 and 1857, inclusive, sixty-four corporations were formed under general laws, while sixty-eight were formed by special act (Cadman, *supra* note 11, at 207–8). Beginning in 1856 with the conversion of three general law manufacturing company charters into specially chartered corporations (*id.* at 143–44), there emerged a new trend toward more frequent use of the special charter for almost every category of business—manufacturing and mining, transportation and communication, public utility, and finance. Special charters between 1858 and 1875 totaled 1,455 while only 361 corporations were formed under the general laws. These figures can be broken down to reveal that 702 corporations organized for general business purposes (including 398 manufacturing and mining) were chartered by special act and only 358 (including 156 manufacturing and mining) by virtue of the general laws (*id.* at 207–8). After consideration of these facts, there can be little doubt as to the correctness of the following statement:

"Altogether the period of 1858 to 1875 was the heyday of special chartering in New Jersey. This situation arose in spite of the availability of general incorporation laws and in spite of the fact that the final decade of the period was marked by a revived public and legislative interest in the potentialities of incorporation by procedure. . . .

The most significant fact about these years is that the legislature did not manifest the slightest disposition to cease chartering by special act. . . . Special charters were the order of the day." (*Id.* at 160.)

[58] *Id.* at 119.

1849,[59] Massachusetts in 1851,[60] Vermont in 1853,[61] Maine in 1862,[62] and New Hampshire in 1866.[63] Of these, the New England states—the only ones for which more than sketchy data are available—present an interesting picture. For 1863–75, a period when all of the New England states except Rhode Island had general incorporation laws, those states incorporated a total of 4,575 companies: 2,390 by special act and 2,185 by general law. Of these, almost all of the general law corporations can be attributed to Connecticut and Massachusetts, with both showing more general law than special act companies. Manufacturing and mining charters accounted for 3,136 (about 69 percent) of the 4,575 total. Of the 3,136 corporations, almost 65 percent (2,016) were organized under general laws.[64] Thus, it appears that the New England states, while showing greater proclivity to use their general corporation laws than the other states studied, maintained a functioning market for special charters.

1. *Reasons for the Continued Popularity of Special Charters.* The privilege of incorporation under the early general acts was circumscribed with limitations and requirements that could be avoided by procurement of a special corporate charter.[65] A major, and perhaps the most important, difference between the terms of general and special law charters related to the rules affecting the liability of the corporations' directors, who were concerned with their individual exposure to suit. Some of the general incorporation laws in dual-system states contained very strict rules for directors' liability.[66] Almost all special corporate charters, on the other hand, were silent with respect to directors' liability, and the common law did not hold directors personally liable to creditors.[67] Special charters thus enabled directors to avoid personal liability for their mistakes.[68]

[59] William Miller, A Note on the History of Business Corporations in Pennsylvania, 1800–1860, 55 Q. J. Econ. 150, 158 (1940).

[60] Dodd, *supra* note 11, at 314–18.

[61] *Id.* at 410.

[62] *Id.* at 428.

[63] *Id.* at 407.

[64] Kessler, *supra* note 11, at 46–47. It has been suggested that the utilization of the general laws, under the dual system, was even less significant than indicated by the statistics because it is probable that many of the corporations initially chartered under the general laws used the general law as a temporary convenience or as a testing ground prior to attempting to procure a special charter. See Cadman, *supra* note 11, at 166–67.

[65] Although no complete study of restrictions included in the general incorporation laws adopted by the various states in the middle decades of the nineteenth century is available, a broad sample can be found in Justice Brandeis's dissent in Liggett Co. v. Lee, 288 U.S. 517, 541–80 (1932).

[66] Cadman, *supra* note 11, at 169; and Kuehnl, *supra* note 11, at 125–26, 151.

[67] Kuehnl, *supra* note 11, at 151.

[68] There were only minor differences between the terms of the two types of corporations with respect to shareholders' limited liability. *Id.* at 123–24 & 150–51; Cadman, *supra* note 11, at 169; and Dodd, *supra* note 11, at 418–19.

The low limits on capitalization found in some of the general incorporation laws were another reason for preferring a special charter, as for example under the dual systems in both Connecticut and Massachusetts.[69] Many of the general incorporation laws also required annual reports to be submitted not only to the stockholders but also to a government agency. These publicity requirements, which were often unpopular because of their cost and because shareholders wished to keep their identity confidential, could be avoided by securing special acts of incorporation.[70] Several other important exemptions and positive rights were included in the terms of special charters. Special charters allowed a company to escape the overall debt limits established in the general laws and to obtain the rarely granted powers of mortgaging property and issuing bonds,[71] where the ability to leverage the firm's capital structure improved the prospects for a larger return to equity interests.[72] Special charters even gave an outright exemption of specially chartered companies from state and local taxes that were payable by firms that incorporated under general laws.[73] Also, many of the special charters included the rare privilege of being able to issue stock in exchange for property other than money.[74]

Moreover, the gains conferred by special charters tended to increase over time. These charters could be modified and amended to reflect the new opportunities in business and finance, while the general incorporation law continued to reflect outmoded limitations that became ever more costly as the nineteenth century progressed.[75] In other words, business practice—as reflected in the terms of special charters secured from legislatures by entrepreneurs—led the way in developing the modern law of incorporation.[76] The businessmen who secured special charters from the legislature at great expense converted them to a competitive advantage that gave them an above normal net rate of return on their investments. In addition, two other conditions predisposed business groups in favor of special charters, even when they contained nothing more than the same privileges as general incorporation charters. First, the controversial

[69] Kessler, *supra* note 11, at 48–49, 62; and Dodd, *supra* note 11, at 418–19. See Kuehnl, *supra* note 11, at 124 for support of the same proposition in Wisconsin.

[70] Kuehnl, *supra* note 11, at 124; Cadman, *supra* note 11, at 169; and Dodd, *supra* note 11, at 319–20.

[71] Cadman, *supra* note 11, at 169.

[72] The allowable degree of leverage would have been relevant to the value of the firm at this time because capital markets were underdeveloped and far from perfect.

[73] Cadman, *supra* note 11, at 169.

[74] *Id.*; and Kuehnl, *supra* note 11, at 125.

[75] Cadman, *supra* note 11, at 170–71; and Kuehnl, *supra* note 11, at 146–47, 192.

[76] Friedman, *supra* note 1, at 168–69.

status of the corporation raised fears that future legislatures would alter the general laws to further restrict the rights and privileges of all corporations formed under the general law, while it seemed less likely that the legislature would pass the many individual pieces of legislation necessary to restrict the rights of all specially chartered corporations.[77] Second, a charter granted by special act of the legislature was important to business promoters because it gave added prestige to the company and aided in marketing the initial stock issue.[78] The "voice" mechanism in the political process, so often associated with a socially wasteful allocation of resources, appears to have fostered a more efficient set of substantive corporation laws.

2. *The Dual System and Segmented Markets for Corporate Privileges*. The initiation and passage of a general incorporation law appears, at first glance, to be inconsistent with the legislature's monopoly position. However, under the dual system, the legislators retained much of the market for corporate privileges, which in turn suggests that their behavior was consistent with their politically constrained monopoly position. Thus legislators behaved like monopolists faced with a real and continuous threat of regulation, typically in the form of a constitutional prohibition against the granting of special charters. Under this "threat effect," legislators gave away substitute, yet inferior, products—the right to a restrictive corporate charter under a general law—as the price for preserving the right to sell the superior, customized special charters. Some state legislatures were literally swamped with bills for special corporate privileges, yet the surging popularity of the corporate form made it politically impossible to restrict the corporate form to only the highest bidders. The legislative response to this dilemma was, in effect, to segment the market for corporate privileges into two categories according to elasticity of demand. The business associations with the greater elasticity were granted restricted corporate privileges through a simple administrative procedure and uniform fees, that is, a general incorporation law. Those with relatively inelastic demands were sold customized liberal corporate privileges at whatever price the legislators could extract.

The most straightforward example of this market segmentation and price discrimination concerned the conservative capitalization limitations contained in dual system general incorporation laws. If, as seems plausible, the corporate form became more desirable as firms increased in size, then it is readily apparent that the general law capitalization limitations forced the firms with relatively inelastic demands for corporate privileges

[77] See Cadman, *supra* note 11, at 169–70.

[78] *Id.* at 170; Dodd, *supra* note 11, at 320; and Kuehnl, *supra* note 11, at 146.

to seek special charters from legislators. Thus legislators were able to continue creating and extracting monopoly rents while at the same time satisfying the political challenges to the special charter by giving up some control over the market for corporate privileges. In this context, the Friedman hypothesis may be valid in explaining the passage of the dual system general laws, but clearly it does not explain the continued use of the special charters.[79]

Constitutional restraints on the passage of special charters were the result of the same forces that led some legislatures to initiate independently the passage of general incorporation laws. The Industrial Revolution and the increasing amount of legislative time devoted to satisfying the accompanying increase in demand for corporate privileges motivated both legislative and constitutional developments. Between the late 1840s and 1870, all state constitutional conventions, called for whatever reasons, addressed the burden special chartering legislation placed on the legislators' time and on the state's budget by prolonging legislative sessions. The opportunities for lobbying, logrolling, and bribery had multiplied as the volume of special chartering legislation increased, and it is apparent that the constitutional conventions were more articulate than the voting public in expressing their objections to the abuses of the special chartering system. Market segmentation forestalled more massive reform while allowing legislators to capture rents where the demand for corporate charters was relatively inelastic.

Although the dual system general incorporation laws decreased the rate of increase in the annual number of special charters, in most years the number of special charters issued exceeded the number of general law corporations in most dual system states.[80] Dual system special chartering is basically consistent with the expected behavior of a price-discriminating monopolist faced with a constantly increasing demand for its products. Although the availability of incorporation by general law might have deterred some marginal firms (that is, marginal on the decision to seek a special charter) from seeking special charters, it is likely that the marginal cases were overwhelmed by the overall increased demand for corporate privileges. Nevertheless, the growing number of special charters created considerable political costs.[81] The public's objections to the expense of the system,[82] its alleged corruption, the inequality of privileges

[79] See text accompanying notes 12–14 *supra*.

[80] See Kessler, *supra* note 11, at 48–50, for a detailed study of incorporation trends in New England.

[81] See Cadman, *supra* note 11, at 154–64.

[82] See, for example, Cadman, *supra* note 11, at 63–64; and Kuehnl, *supra* note 11, at 161.

contained in the special charters, and the granting of special tax exemptions are additional evidence that price discrimination existed under the dual system.

The typical legislative response to political pressure and criticisms of the special chartering systems was to pass an act aimed at "purifying the procedure of special chartering rather than . . . ending the practice altogether."[83] Furthermore, although state legislators recognized that liberal general incorporation laws could both relieve the legislative workload and reduce the scope for granting special favors, they made no significant attempts to modernize the existing general laws to meet business needs better.[84] Legislators maintained their segmented markets for corporate privileges until they faced a constitutional prohibition of special corporate charters.

3. *Early Exportation of Corporate Privileges.* The rise of the dual system of incorporation coincided with subtle changes in the competition between jurisdictions. The competition among states had always influenced the flow of capital across state lines. Most of the capital market type of jurisdictional competition involved the granting of liberal special charters to out-of-state capitalists in order to attract capital into the state. States that retained their systems of special chartering had a comparative advantage. Whether a state could increase its wealth by adopting a policy of granting liberal corporate privileges was a much debated issue when states were formulating their initial policies with respect to the terms of business corporation charters.[85] In addition, jurisdictional competition raised the question of whether a corporation under special charter could do business outside the state of incorporation. Prior to the 1850s, it was

[83] Cadman, *supra* note 11, at 140. Also, see Friedman, *supra* note 1, at 173. For example, some state constitutions required a two-thirds vote of the legislature for granting special charters. Provisions of this type became less common as the general law movement progressed, possibly because experience had indicated that they were ineffective in stemming the tide of special charters. See 2 James Kent, Commentaries on American Law 340–41 (12th ed., Oliver Wendell Holmes, Jr. ed. 1873). One commentator's view of the two-thirds requirement was that it "led to greater scandals in the legislature, since more money was required to secure the necessary two-thirds vote." J. H. Dougherty, Constitutional History of the State of New York, at 167, quoted in Cadman, *supra* note 11, at 108, n. 90.

[84] Cadman, *supra* note 11, at 165; and Kuehnl, *supra* note 11, at 115–16.

[85] New Jersey's success in attracting numerous industries to a state with few natural resources appears to have settled the issue. See Cadman, *supra* note 11, at 177. Although it appears that New Jersey was able to increase its wealth by passing favorable legislation, it is not readily apparent that this was the necessary result of its policies. The real reason behind New Jersey's long-term success in this form of capital market competition was the failure of other states to adopt the same policies when they appear to be successful. That is, it is not clear why New Jersey was able to capture monopoly profits over a long period in the absence of entry barriers.

either assumed or required that the operations of corporations—both special and general law—would be confined to their chartering state.[86] Beginning in the mid-1850s, the articles of special charters usually included a provision authorizing the corporation to carry on a part of its business outside the state—the intention being that the corporation's primary place of business would remain the chartering state.[87] These provisions, coupled with the rules of comity, allowed corporations chartered in the state of their primary place of business to exercise their corporate privileges in another political jurisdiction subject to the regulation in the foreign state. The status of "foreign" corporations—corporations operating outside their state of origin—was uncertain at this time, and corporations were hesitant to take a large portion of their operation outside their state of incorporation.[88]

The practice of incorporating in a state other than the state of the primary place of business had its origins in the dual incorporation era. In most instances, the shareholders behind the incorporation were residents of the incorporating state.[89] In other instances, more similar to the modern practice, the shareholders sought the most liberal special charters without regard to their residences or the location of the corporation's operations.[90] The development of this form of jurisdictional competition reduced each state's control over the market for corporate privileges within its jurisdiction. However, the states' spatial monopolies were still secure because (1) the great majority of firms were engaged in intrastate commerce and were not large enough to warrant entering the interstate market for corporate privileges; (2) the tax breaks which were important in many special charters could not be granted to corporations operating outside the incorporating state; and (3) the constitutional status of foreign corporations was still in doubt.[91] Nevertheless, this method of incorpora-

[86] Stoke, *supra* note 32, at 561.

[87] Kessler, *supra* note 11, at 48–49, has suggested that such a provision was a major reason for the continued use of special charters under the dual system in the New England states. Cadman, *supra* note 11, at 170, makes the same suggestion, albeit less enthusiastically, for New Jersey.

[88] See text accompanying notes 100–108 *infra* for a consideration of the constitutional protections of foreign corporations engaged in interstate commerce.

[89] This was particularly true of western mining operations financed by eastern capitalists. Kessler, *supra* note 11, at 60. The legislators of western states would not have been jealous of this activity since most of those states had constitutional prohibitions against special corporate charters in their initial constitutions. See notes 94–95 *infra*. Furthermore, the western legislators most likely viewed the infusion of eastern capital as an important impetus to growth and development.

[90] See Cadman, *supra* note 12, at 179–80, for examples.

[91] See text accompanying notes 100–108 *infra*.

tion was the beginning of the type of interstate incorporation competition that eventually destroyed the states' spatial monopolies and thus the special chartering system.

C. *The Death of the Special Charter: Interstate Incorporation Competition and Liberal General Incorporation Laws*

It has been shown that special charters were allocated through the legislative market for corporate privileges that survived adamant criticisms of the corporate form and the negative attributes of the rent-seeking activity surrounding the special chartering system. Beginning in 1845, however, constitutional provisions relating to incorporation were concerned to a large extent with eliminating all private acts of incorporation. The corollary of the absolute prohibition of special acts was the duty of the legislatures to pass general incorporation laws.

The first state to adopt an absolute prohibition of special acts of incorporation for business organizations was Louisiana in its 1845 constitution.[92] By 1875, as indicated by Table 1,[93] eighteen of the thirty-seven states then in the union had followed Louisiana's example and had made all special acts of incorporation unconstitutional. Of these, Illinois and Wisconsin had tried qualified constitution prohibitions of special charters (that is, they had adopted the dual system) and found them to be inadequate. Both states adopted absolute constitutional prohibitions in 1870 and 1871, respectively.[94] When coupled with the three dual-system states with qualified constitutional prohibitions—New York, Maryland, and North Carolina—and Florida, where the 1868 constitution required the passage of general incorporation laws but did not limit the passage of special charters,[95] there were twenty-three states with a constitutional mandate for general incorporation laws by 1875. Thus it appears that the trend inaugurated by Louisiana was on course to put an end to the special chartering of corporations.

The tenacity of legislators in the other states, on the other hand, is quite impressive. By 1875, thirty years after Louisiana first prohibited special acts of incorporation, the special charter was still an accepted incorporation procedure for almost half the states (eighteen of thirty-seven). Furthermore, the fact that nineteen states no longer allowed their legislatures to grant special charters should not be interpreted as evidence of a volun-

[92] Poore, *supra* note 45, at 721.

[93] *Id.*, various pages.

[94] *Id.* at 488 and 1050.

[95] *Id.* at 350.

TABLE 1
CHRONOLOGY OF PRE-1875 STATE CONSTITUTIONAL PROVISIONS THAT ABSOLUTELY PROHIBITED SPECIAL ACTS OF INCORPORATION

State	Date
Louisiana	1845
Iowa	1846*
California	1849*
Michigan	1850
Ohio	1851
Indiana	1851
Minnesota	1857*
Oregon	1857*
Kansas	1861*
Nevada	1864*
Missouri	1865
Nebraska	1866*
Alabama	1867
Arkansas	1868
Illinois	1870
Tennessee	1870
Wisconsin	1871
West Virginia	1872
Pennsylvania	1873

* State's first constitution.

tary relinquishment of monopoly power by those legislatures, as all of the absolute prohibitions of special charters were adopted in constitutional conventions that were called to revise the state's entire constitution—seven of the constitutions containing absolute prohibitions were the original constitutions of the states. Because it is reasonable to assume that legislators are apt to have a somewhat greater influence in the amending process, a presumption of voluntary relinquishment of monopoly power might be justified only when the prohibition was the result of an amendment to the constitution as opposed to a general revision.[96] The remainder of this section is devoted to explaining the demise of the special charters in the last quarter of the nineteenth century, even though it was not constitutionally prohibited in many states.

1. *Exogenous Economic Changes Affecting the Market for Corporate Privileges.* In the early nineteenth century, entry barriers created by geographic isolation resulted in spatial monopolies for many local producers. As the century progressed, technological breakthroughs in transpor-

[96] The basis of this presumption is a belief that, in general, legislators are more likely to exert a dominant influence with respect to the procedure for amending a constitution vis-à-vis a general revision at a constitutional convention.

tation and communication overcame the geographic entry barriers in goods markets and led to the development of a national economy of integrated markets. In particular, the period from 1815 to 1860 has been identified as the period of major innovations in rail and canal transportation,[97] as well as telegraph communications.[98] The increased speed and certainty of distant transactions made possible by the telegraph network improved the functioning of extralocal markets and increased the feasibility of an integrated national economy. These exogenous economic changes, aided by the commerce clause of the Constitution,[99] eroded local monopolies in goods markets.

The spatial monopolies in the state legislative markets for corporate privileges, however, appear to have withstood the economic shocks in spite of the fact that foreign corporations engaged in interstate commerce reduced the individual states' control over the market for corporate privileges within their own boundaries. Because the special chartering and dual incorporation systems continued after the development of a national economy, it appears that the growth of interstate commerce, standing alone, was not a sufficient condition for the emergence of a national market for corporate privileges. The missing condition was a change in the legal environment in the form of a constitutional guarantee that a state had no power to exclude a foreign corporation—a corporation operating outside the jurisdiction in which it was created—from conducting business within the state.

2. *The Constitutional Basis of Jurisdictional Competition.* From its beginnings, the American law of corporations has wrestled with the legal status of foreign corporations.[100] The earliest issues surrounding foreign corporations related to the basic question of legal existence outside the state of incorporation. In this regard, the federal and state courts addressed questions concerning access to courts and the enforceability of

[97] See, for example, George R. Taylor, The Transportation Revolution, 1815–1860 (1962).

[98] See Richard B. Du Boff, Business Demand and the Development of the Telegraph in the United States, 1844–1860, 54 Bus. Hist. Rev. 459 (1980).

[99] See Sidney Ratner, James H. Soltow & Richard Sylla, The Evolution of the American Economy: Growth, Welfare, and Decision Making 123 (1979) ("The Constitution had created the possibility of a great common market throughout the United States").

[100] See generally Gerard C. Henderson, The Position of Foreign Corporations in American Constitutional Law (1918); H. A. Haring, Corporations Doing Business in Other States; A Contribution to the History and Theory of Juristic Persons in Anglo-American Law (1927); Cadman, *supra* note 11; Dodd, *supra* note 11; Henn, *supra* note 37; and Congressional Research Service, Library of Congress, The Constitution of the United States of America: Analysis and Interpretation—Annotations of Cases Decided by the Supreme Court of the United States to June 29, 1972 (Lester S. Jayson supervising ed. 1973).

contracts.[101] These and other related issues necessarily became intertwined with the status of the corporation under the United States Constitution. The question of whether a corporation is a citizen with constitutional rights and guarantees was a major problem for the United States Supreme Court in the early nineteenth century. As late as the 1860s, the status of operating a corporation in a foreign jurisdiction was uncertain.[102]

It was not until 1869 that decisions of the Supreme Court began to clarify the privileges of foreign corporations. In *Paul v. Virginia,*[103] the question before the court was whether the Commonwealth of Virginia could impose restrictions on foreign corporations that sought to sell insurance in its domestic markets when parallel restrictions were not imposed on local corporations. The Supreme Court upheld the power of the state to do so on two grounds. First, a corporation was not a citizen of any state and therefore was not entitled to the nondiscriminatory treatment that the privileges and immunities clause of the Fourteenth Amendment guaranteed to citizens. Second, it held that the sale of insurance was not a transaction involved in interstate commerce. While on its face the decision looked as though it preserved the power of local governments, its effect was the opposite, for, as Henn notes, the "corollary" of *Paul* "was that a state had no power to exclude a foreign corporation from doing interstate business."[104] In other words, the effect of the decision was that a state could exclude a foreign corporation from engaging in intrastate commerce within its jurisdiction or could attach reasonable conditions to the permission given such corporations to carry on such business,[105] but that a state could not exclude a foreign corporation from doing interstate business.

The impact of *Paul v. Virginia* on the legislative market for corporate privileges was enormous: "With the denial of the right to exclude, there fell to the ground, as to these corporations, the whole traditional theory

[101] On the first question, see Bank of the United States v. Deveaux, 9 U.S. (5 Cranch) 61 (1809). On the second, see Bank of Augusta v. Earle, 38 U.S. (13 Pet.) 519 (1839).

[102] Dodd, *supra* note 12, at 152, 179–81.

[103] 75 U.S. (8 Wall.) 168 (1869).

[104] See Henn, *supra* note 37, at 19.

[105] See Conrad Reno, A Treatise on the Law of Non-residents and Foreign Corporations as Administered in the State and Federal Courts of the United States (1892) for early state regulation of foreign corporations. The bulk of the regulations were aimed at insuring service of process of foreign corporations and prohibiting foreign corporations from removing cases to the federal courts. The Supreme Court has limited the discretion of states in this regard. See, for example, Insurance Co. v. Morse, 87 U.S. (20 Wall.) 445 (1874) (a state could not, as a condition of admission of a foreign corporation, require the corporation to agree not to resort to the federal courts).

by which state regulation of foreign corporations had been justified. For if the right to exclude is denied, the right to admit on condition necessarily falls with it. *Thenceforth, if the state was to regulate foreign corporations engaged in interstate commerce, it must be as a lawmaker with qualified legislative jurisdiction, not as a person making a bargain, who may exact whatever price he can get.*"[106] As Henn says: "[I]nterstate enterprises could [now] shop for the most favorable state of incorporation. . . ."[107]

3. *The National Free Market in Corporate Privileges.* Once the spatial monopolies for corporate privileges had fallen away after *Paul,* legislators faced both new challenges and new opportunities in the changed legal environment. One opportunity open to states was to pass liberal general laws to attract incorporators from across the nation and to increase the revenues of the legislators' home states with taxes and franchise fees on the firms chartered under their laws but operating in other states. In essence, state legislators were presented with the opportunity to export some of the costs of their state government.

New Jersey was the first state to take advantage of the opportunities presented by the exogenous legal and economic changes. New Jersey had long been aware of the revenue-generating aspects of corporate chartering as indicated by her selling of monopoly privileges to the Camden and Amboy Railroad.[108] The revenues from the Camden and Amboy monopoly made it possible for the state to avoid direct taxes in several years between 1831 and 1848 and unnecessary to levy any direct taxes in any year between 1848 and the Civil War.[109] Furthermore, New Jersey legislators had shown a special proclivity toward the granting of special charters from 1857 to 1875, and they had been less hesitant than other states to grant charters to firms operating outside their jurisdiction. Finally, one should not be surprised at New Jersey's early entry into the national free market for corporate privileges because a liberal law would tend to raise a larger proportion of total state revenues for smaller states vis-à-vis larger states (assuming a liberal law would generate a fixed amount of revenue regardless of the size of the state passing the law), which helps explain why the most active states in the jurisdictional competition tended to be small (for example, Delaware, Maine, and West Virginia). In any event,

[106] Henderson, *supra* note 100, at 116 (emphasis added).

[107] Henn, *supra* note 37, at 19.

[108] See Stoke, *supra* note 32, at 554–55; and Cadman, *supra* note 11, at 54–59.

[109] Cadman, *supra* note 11, at 59. New Jersey's experience with the Camden and Amboy is the closest approximation to aboveboard competition for the field uncovered in the course of research for this paper. See Gordon Tullock, Entry Barriers in Politics, 55 Am. Econ. Rev. 458 (1965); and Harold Demsetz, Why Regulate Utilities? 11 J. Law & Econ. 55 (1968), for the development of the principle of "competition for the field."

the New Jersey legislature passed the nation's first modern general incorporation law in 1875.[110]

Although the law was passed before the electorate approved a pending absolute constitutional prohibition of special charters, New Jersey's experience with the constitutional prohibition of special charters differed from the previous experiences of any other states in two important aspects. First, it was the first state in which the constitutional provision prohibiting special acts had been adopted as an amendment to an existing constitution. All previous constitutional prohibitions had been included in the complete revision of state constitutions or the adoption of a state's first constitution.[111] The New Jersey prohibition was the result of an amending process in which the legislators played a significant role in the instigation of the change, whereas in the other states the legislators most likely had less control over a general constitutional convention. The New Jersey legislators appear to have relinquished their power over special charters voluntarily, whereas earlier prohibitions of special charters had been constitutional. Second, with the prohibition of special charters the new mandate for a general incorporation law was not burdened by many of the restrictions on general charters granted elsewhere: "[T]he legislature of New Jersey was at an advantage as compared with the legislatures of many states, for it was permitted an almost free hand in deciding on the terms of charters to be granted under general laws."[112] This aspect of the New Jersey constitution was undoubtedly related to the legislature's role in the amendment process and is best understood as a manifestation of a desire to enter the national market for corporate privileges with a comparative advantage over its constitutionally constrained competitors.

The New Jersey general incorporation act of 1875, when enacted, was the broadest and most enabling general law ever passed. The procedure for incorporating under the law was very simple—clearly the dominant ancestor of modern incorporation procedure.[113] An important provision allowed corporations to be formed without regard to the residency of the incorporators or the corporation's primary place of business. In conjunction with these provisions "[t]he act declared that, if the by-laws should so provide, the directors of any company might hold their meetings, have

[110] See Cadman, *supra* note 11, at 155–60 and 196–200; and Edward Q. Keasby, New Jersey and the Great Corporations, 13 Harv. L. Rev. 198, 205–7 (1899), for discussions of the events leading to the 1875 changes in the New Jersey law.

[111] George H. Evans, Business Incorporations in the United States, 1800–1943, at 11 (1948).

[112] Cadman, *supra* note 11, at 200.

[113] See Keasby, *supra* note 110, at 205–6.

an office and keep the books, except the stock and transfer books, outside the state, on condition, however, that they should always maintain a principal office within the state and have an agent in charge thereof. . . ."[114] The 1875 act provided that the tax status of corporations would be the same as that of individuals. However, within a few years the legislators imposed additional filing fees and annual franchise taxes on corporations formed under the 1875 act. These rates were low and the tax base was the amount of capital stock. The use of the capital stock as the tax base was particularly attractive to foreign incorporators in that it was certain and left nothing to the discretion of tax assessors.[115] As a result of these favorable provisions, New Jersey dominated the national market for corporate privileges for over forty years.[116]

4. *The Effects of Interstate Incorporation Competition on the Market for Special Corporate Charters.* The most important effect of the interstate incorporation competition spurred by the decision in *Paul v. Virginia* was the drastic reduction in the legislators' rates of return from the

[114] *Id.* at 206–7.

[115] *Id.* The same point was stressed in testimony before the U.S. Industrial Commission in 1899; see, for example, 1 U.S. Industrial Commission, Preliminary Report on Trusts and Combinations, Pt. II, at 971, 975, 996, 1035–37, 1081, 1986 (1900).

[116] New Jersey's early entry did not prevent the entry of competitors into the national market for corporate privileges. In the 1880s, it faced active competition from West Virginia and Maine. In 1876, Maine adopted an amendment to its constitution prohibiting the granting of special charters. The resulting general incorporation law was fairly liberal in its terms except for a relatively low capitalization of $500,000. The New Jersey law of 1875 contained no limitation on maximum capitalization. In an effort to become more competitive, Maine increased the amount to $2 million in 1883. Dodd, *supra* note 12, at 428. However, a decision by the state supreme court, Libby v. Tobey, 82 Me. 397, 19 A. 904 (1890) (cited and discussed in Larcom, *supra* note 11, at 14–15), holding stockholders liable on the stock issued for property where the court found the property was not worth the par value of the stock, rendered Maine an undesirable place to incorporate. Although it increased the capitalization limit to $10 million in 1891 and removed it altogether in 1901, Maine was not successful in regaining its competitiveness. Dodd at 428. West Virginia was more successful in challenging New Jersey's preeminence, but its potential was limited by two major defects from the point of view of promoters. The first of these was a limitation on capitalization to $5 million—a relatively small amount which undoubtedly made West Virginia unacceptable to most large companies. Also, the corporation laws did not provide for the maintaining of any records or agents in West Virginia, and this resulted in "roving" or "tramp" corporations over which even the state of incorporation could not guarantee jurisdiction. Obviously, this created opportunities for fraud and thus increased the difficulty of marketing the corporations' stocks and bonds. U.S. Industrial Commission, *supra* note 115, at 1077–79, 1119, 1125. Also, see Larcom, *supra* note 11, at 14–15. In spite of these defects, West Virginia was the second most popular state of incorporation because its taxes and fees on foreign corporations were extremely low. These factors combined to make West Virginia a "snug harbor for roaming and piratical corporations"—"the tramp and bubble companies of the country"—and "the Mecca of irresponsible corporations." William W. Cook, A Treatise on Stock and Stockholders, Bonds, Mortgages and General Corporation Law 1603–5 (3d ed. 1894), cited in Friedman, *supra* note 1, at 458.

passage of generous special corporate charters brought on by the cheap substitute of foreign general incorporation laws. In consequence, the demand for special charters in all jurisdictions fell sharply. The development of interstate incorporation competition evidently shifted the legislators' marginal trade-off between the passage of special charters or the production of other forms of special interest legislation in favor of abandoning altogether the production of special charters.

The most convincing evidence of the effect of *Paul v. Virginia* on the marketability of special charters is the experience of the New England states after 1875. In a region where state economies were thoroughly integrated and general incorporation laws were available (except in Rhode Island), special charters nonetheless still accounted for approximately one-third of the mining and manufacturing incorporations in New England in the decade before 1875.[117] The *Paul* decision, however, drastically altered the market for corporate privileges in New England. Kessler, who conducted an extensive study of incorporation by special act in New England, chose to conclude his study in 1875, only six years after the *Paul* decision, because "[a]nother decade was to pass before general incorporation dominated the . . . scene. . . . With the appearance of general incorporation and of corporations chiefly for out-of-state operations, the stage was set for the next important event in the relations of the state to the private corporation; interstate rivalry for the lucrative charter business."[118] The demise of the special charter in New England in the decade beginning with 1875 is even more impressive support for the thesis of this paper, given that Maine was the only New England state in the nineteenth century to adopt a constitutional prohibition of special acts of incorporation.[119] Massachusetts, for example, which had been singled out for its particularly strict general incorporation law and low capitalization limitation throughout the latter part of the nineteenth century,[120] abandoned the practice of granting special charters shortly after 1875 without being forced to do so by constitutional authority. Evidently, the legislators in Massachusetts and the other New England states halted the production of special charters because the market for them had been undermined by an inexpensive—and, in many instances, superior—alternative product.

[117] Kessler, *supra* note 11, at 47.

[118] *Id.* at 62.

[119] Evans, *supra* note 111, at 11. Vermont enacted a constitutional amendment requiring general incorporation laws in 1913. Connecticut, Massachusetts, New Hampshire, and Rhode Island do not have constitutional provisions mandating general incorporation laws.

[120] See Friedman, *supra* note 1, at 456–57.

The central thesis of this paper is also confirmed by the experiences of dual incorporation states. It will be recalled that prior to 1875 several states had adopted general incorporation laws in response to qualified constitutional prohibitions of special charters.[121] In spite of the constitutional prohibitions, however, legislators of those states continued to find "loopholes" that allowed them to grant special charters to favored groups. For example, two of those states, Wisconsin and Illinois, abandoned their constitutionally mandated dual incorporation systems in favor of an absolute constitutional prohibition of special charters because the legislators' practice of granting special charters continued even after the privileges were available under general laws.[122] New York, which had adopted the first qualified constitutional prohibition of special charters in 1846,[123] found that the pressure for special charters was still so strong in 1872 that the governor declared in his annual message: "There should be more specific constitutional restraints upon legislative power to grant special charters for private corporations. . . ."[124] Additional constitutional restraints on the legislators' behavior, however, were not necessary, as evidenced by the fact that they stopped granting special charters shortly after 1875.[125] Apparently, the restraint on the legislators' behavior that ended their practice of granting special charters was competition in the form of New Jersey's exportation of corporate privileges into the New York segment of the national market for corporate privileges. The removal of barriers to entry by the decision in *Paul v. Virginia,* coupled with the enterprising behavior of New Jersey, was much more effective in limiting the New York legislators' discretion with respect to the granting of special charters than was the 1846 qualified constitutional prohibition of special charters.

The evidence presented supports the thesis that the development of jurisdictional competition for revenues in the market for corporate privileges led to the demise of special charters. This interpretation, however, should not be taken to suggest that the states lost complete control of the incorporation process within their jurisdictions. In Delaware, for

[121] See text accompanying notes 46–53 *supra.*

[122] See text accompanying notes 46–65 *supra.*

[123] See text accompanying note 46 *supra.*

[124] State of New York, 4 Messages from the Governors 402, quoted in Cadman, *supra* note 11, at 173.

[125] In 1892, New York did what had become an unusual practice: it granted a special charter to General Electric in order to prevent GE's migration to New Jersey. See Henn, *supra* note 37, at 20. This explanation for the granting of the special charter, however, does appear reasonable since GE would not have had to physically move its headquarters from New York in order to incorporate in New Jersey.

example, the special charter remained the most popular incorporating procedure (for the few firms that chose to incorporate there) until the late 1890s.[126] Moreover, for many smaller firms, the relatively higher added expense (as a proportion of their revenues or assets) of incorporating in a foreign jurisdiction led them to incorporate domestically. In this matter, it has been suggested that "the burden of strict statutes fell only on those small corporations which could not afford to escape to some faraway haven."[127] A more precise statement would stress that the costs of operating under a strict statute were less than the costs of geopolitical migration. Exit was not a viable option. In any event, the small domestic corporations would have been similar to the firms that selected the unpopular general laws under the dual system. That is, the firms that did not find foreign incorporation worthwhile were similar to the firms that occupied the market segment that the legislators abandoned under the dual system. In consequence, it is not surprising that most legislatures did not attempt to exploit that small segment of the market over which they still maintained some control. Evidently, legislators found other activities more profitable than the production of special charters.

5. *The Beginnings of the "Race to the Bottom."* New Jersey, in spite of its position as the favorite state of incorporation, did not receive a substantial portion of its revenues from foreign corporation fees until it embarked on a second liberalization program in 1888.[128] The first step in this program was the amendment of the New Jersey constitution to allow corporations to hold and dispose of the stock of other corporations—that is, to legalize holding companies or the "trust organization."[129] The following year, James B. Dill, a young corporation lawyer from New York who clearly had his own interest at heart, and Leon Abbett, a former governor of New Jersey, lobbied the New Jersey legislature to amend the 1875 corporation law to clarify and elaborate the 1888 amendment. Under the plan, New Jersey would benefit from a substantial increase in revenues, and Dill and his associates would benefit from the profits of the Corporation Trust Company of New Jersey—a company organized by Dill to advertise the advantages of incorporating in New Jersey and to act as agents and handle the incorporation formalities for out-of-state incor-

[126] See Larcom, *supra* note 11, and Arsht, *supra* note 11, for thorough treatments of the evolution of Delaware incorporation law.

[127] Friedman, *supra* note 1, at 457.

[128] For discussion of this movement, see Stoke, *supra* note 32, at 570–72; Keasby, *supra* note 110, at 207–9; and Robert Hessen, In Defense of the Corporation 68–71 (1979).

[129] James C. Bonbright & Gardner C. Means, The Holding Company 57 (1932).

porators.[130] Dill's recommendations were adopted in 1889,[131] and in 1894 it was estimated that almost all of New Jersey's state budget was funded by fees and taxes on firms incorporated in New Jersey but primarily conducting business in New York.[132] Thus, the entrepreneurial efforts of a lawyer and a receptive legislature led to New Jersey's early dominance in the national market for corporate privileges.

Eventually New Jersey yielded its position to Delaware. Due primarily to the efforts of entrepreneurs cast in the mold of James Dill, Delaware became an aggressive competitor in the national market for corporate privileges in 1899. The drafters of the Delaware Corporation Act of 1899 looked to the laws of New Jersey, the most popular state of incorporation at that time, for the principal features of the Delaware law. In fact, several clauses of New Jersey's law were copied, almost word for word, into the Delaware statute.[133] Delaware's competitive position was also improved by a decision of the Court of Chancery of Delaware in 1900. In *Wilmington City Ry. Co. v. People's Ry. Co.*,[134] the court reasoned that the legislature, in adopting the language of the New Jersey statute, had intended that the courts of Delaware adopt the New Jersey courts' construction of the statute. The effect of this interpretation was to confer a level of certainty on a new statute that normally would have taken years of local litigation to develop. Thus, by adopting New Jersey's judicial precedents, the expected benefits of organizing and operating under the new Delaware law were brought into line with the expected benefits under the older New Jersey statute.[135]

Delaware, nevertheless, was not immediately successful in attracting large numbers of corporations even though it had lower taxes than New Jersey. Apparently, in order to be successful in the market for corporate privileges, a new entrant must do more than just meet the terms of the

[130] See the testimony of Howard K. Wood, Assistant Secretary of the Corporation Trust Company of New Jersey, 1 U.S. Industrial Commission, *supra* note 115, Pt. II, at 1089–94, for a description of the subsequent activities and services performed by Dill's company.

[131] 1889 N.J. Laws 265.

[132] Cook, *supra* note 116, at 1604–5, cited in Liggett Co. v. Lee, 288 U.S. 517, 557 (1932).

[133] Archibald H. Stockder, Business Ownership Organization 162–63 (1922); and Larcom, *supra* note 11, at 29–30.

[134] Wilmington City Ry. v. People's Ry., 47 A. 245 (Del. Ch. 1900), cited in Larcom, *supra* note 11, at 25–26.

[135] Even today, the preeminence of Delaware, in spite of the fact that several states have statutes at least as liberal as Delaware's, is attributed to Delaware's well-developed body of judicial decisions on the meaning of virtually every point that might be the subject of litigation. See Hugh L. Sowards, Corporation Law Cases and Materials 2–10 (1974); and Hessen, *supra* note 128, at 74.

corporation laws of the leading states. Firms will not change their state of incorporation unless either the expected tax savings or the expected cost savings associated with a more suitable corporate law are greater than the transaction costs involved in changing chartering states. Thus, a new competitor must make a substantial change in its laws to induce existing corporations to change their state of incorporation. Delaware, however, managed to capture the market without further altering its 1899 law when Governor Woodrow Wilson of New Jersey engineered the 1913 passage of the "Seven Sisters Acts"—antitrust measures that severely restricted permissible corporate activities in New Jersey.[136] "Corporations flocked to Delaware, and the phrase 'Delaware corporation' passed into the bloodstream of the English language."[137] The "Seven Sisters Acts" were repealed in 1917, but New Jersey had lost its advantage. Just as firms saw no reason to shift from New Jersey to Delaware in 1899, corporate officials saw no reason to switch back to New Jersey in 1917.[138] Today Delaware is undeniably the leader in the marketing of corporate privileges.

III. Implications and Concluding Comments

The decline and fall of the special charter has been explained as the direct result of two changes beyond the control of state legislators: the growth of interstate commerce and the Supreme Court decision in *Paul v. Virginia*. The passage of liberal general incorporation laws by small states eager to capture the revenues from fees and taxes destroyed the legislatures' spatial monopolies and greatly reduced the value of the special charter as a marketable piece of special interest legislation. As a result, legislators stopped producing special charters and all states enacted general incorporation laws (some more liberal than others). Thus, the availability of the corporate form in the United States had completed its evolution from a special privilege to a right. The importance of understanding this historical episode is magnified by its suggestion of the implications of current proposals for changes in incorporation laws.

[136] Henn, *supra* note 36, at 20. Since the beginning of the national market for corporate privileges, it had been clear that state action could not be effective in providing a "responsible" corporate statute. In discussing the late nineteenth-century differences between state incorporation laws, Friedman said, "[T]his was a moral division of labor, quite similar to the evolving case of divorce law. . . . Business simply went elsewhere to be chartered. . . ." Friedman, *supra* note 1, at 457. Thus, it appears that Woodrow Wilson—the great reformer—had a greater impact on New Jersey's main source of revenue than on corporate practices within New Jersey.

[137] Friedman, *supra* note 1, at 458.

[138] Hessen, *supra* note 128, at 73.

In the 1970s legal commentators and consumer advocates called for federal chartering legislation to replace the current system of state corporation laws.[139] These critics, who appear to have been influenced by the Berle and Means thesis that the separation of ownership and control spawns corporate abuse, fear that competition among the states for the lucrative charter business has allowed corporate managers to use their new-found freedom from shareholder or public controls to exploit shareholders.[140] Furthermore, the prestigious American Law Institute's project on corporate governance is motivated by a concern that the current regulatory structure has failed to produce a satisfactory corporate legal system.[141] Frustrated at the success of Delaware in the infamous "race for the bottom," and aware that individual state action cannot generate a "responsible" corporation law,[142] all of these corporate critics, either explicitly or implicitly, want to replace the current decentralized system with either a federal incorporation law or federally enforced minimum standards of management conduct.[143]

[139] Legal commentators included William L. Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 Yale L. J. 663 (1974); Donald E. Schwartz, A Case for Federal Chartering of Corporations, 31 Bus. Law. 1125 (1976); and Melvin A. Eisenberg, The Structure of the Corporations: A Legal Analysis (1976). Among consumer advocates were Ralph Nader, Mark Green, & Joel J. Seligman, Taming the Giant Corporation (1976); and The Big Business Reader: Essays on Corporate America (Mark Green & Robert Massie, Jr. eds. 1980).

[140] One of the earliest attacks on the competition among the states was by Mr. Justice Brandeis. The following statement is often cited by proponents of federal regulation: "Companies were early formed to provide charters for corporations in states where the cost was lowest and the laws least restrictive. The states joined in advertising their wares. The race was one not of diligence but of laxity." Liggett Co. v. Lee, 288 U.S. 517, 558–59 (1932) (dissenting opinion). Ralph Winter, however, has suggested that the modern corporate critics should not find much comfort in Brandeis's statement since he was referring to "the elimination of restrictions on the life of a corporation, total capital, corporate purposes, and the holding of stock in other corporations—all of which we are well rid of— . . . " Ralph K. Winter, Government and the Corporation (1978) at 7 n. 6. See Henry Manne, Our Two Corporation Systems: Law and Economics, 53 Va. L. Rev. 259, 269 n. 20 (1967) for discussion of some additional benefits for jurisdictional competition including, inter alia, the minimization of undesirable state regulation and the evolution toward similar laws across states.

[141] American Law Institute, Principles of Corporate Governance and Structure: Restatement and Recommendations (Council Draft No. 1, Spring 1982) at iii. The ALI's project has spurred a large amount of commentary; see, for example, Daniel R. Fischel, The Corporate Governance Movement, 35 Vand. L. Rev. 1259 (1982); James D. Cox, Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project, 1982 Duke L. J. 959; Statement of the Business Roundtable on the American Law Institute's Proposed "Principles of Corporate Governance and Structure: Restatement and Recommendations" (1983).

[142] Recall Governor Woodrow Wilson's disastrous attempt at reform in New Jersey in 1913; see text accompanying notes 135–38 *supra*.

[143] One corporate critic has distinguished the two approaches to corporate reform in terms of the goals of the reformers: The minimum standards approach is concerned with

The critics, however, have not gone unanswered—in fact, they have spurred much economic, legal, and historical scholarship in the field of corporate theory.[144] Hessen has explored the historical foundations of the corporate form to argue that, normatively speaking, the corporation itself does not depend on a government grant or a special privilege, so that political interference with an essentially private activity is thereby unjustified. In addition, he advances the thesis that the corporation is the product of purely private contracts and market forces and that general incorporation laws are merely enabling.[145] In his view, the Delaware corporation law, contrary to the critics of the "race for the bottom," was the most popular law because the competitive process had fostered a desirable set of substantive laws and clear legal precedents resulting in an enormous economic benefit for shareholders of Delaware corporations.[146] A recent empirical study has provided support for this thesis by demonstrating that management's decision to reincorporate in Delaware does not reduce, and may even increase, stockholders' wealth.[147] This finding undercuts the assertion, made by proponents of federal intervention, that the existing competition among states for corporate charters enables management to exploit shareholders.

The most obvious implication of this paper with respect to proposed uniform legislation relates to the return to monopoly control in the market for corporate privileges. Prior to the exogenous changes that led to interstate incorporation competition, state legislatures had monopoly control over the use of corporate privileges within their jurisdictions. A direct result of this monopoly control was the granting of special privileges via the special corporate charter to a favored few at the expense of the public.

protecting the interests of shareholders, whereas the federal incorporation approach is concerned with constraining the power of the corporation as a social institution in dealing with the public. See Neil W. Chamberlain, Social Strategy and Corporate Structure (1982) at 125–35.

[144] Representative contributions to this literature include Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977); Fischel, *supra* note 141; Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U. L. Rev. 913 (1982); J. A. C. Hetherington, When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights, 8 Hofstra L. Rev. 183 (1979); Nicholas Wolfson, A Critique of Corporate Law, 34 U. Miami L. Rev. 959 (1980); and G. D. Keim, Barry D. Baysinger, & Roger E. Meiners, The Corporate Democracy Act: Would the Majority Rule? 24 Bus. Horizons 30 (1981).

[145] Hessen, *supra* note 128. Also see Anderson & Tollison, *supra* note 15.

[146] Fischel suggests that: "Delaware's preeminence, in short, is in all probability attributable to success in a 'climb to the top' rather than a 'race to the bottom.' " Fischel, *supra* note 144, at 920.

[147] Peter Dodd & Richard Leftwich, The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation, 53 J. Bus. 259 (1980).

Times have changed, but businesses still demand, and all levels of government still supply, regulation, monopoly, and special privileges. Federal chartering would open the door to monopoly in the market for corporate privileges, which in turn could lead to the same types of abuses that occurred prior to the demise of special chartering at the state level. Certainly there is no reason to believe that the federal government, as sole provider of corporate privileges, would be immune to the pressures that influenced state legislators in the nineteenth century.[148]

The evidence presented in this paper also supports the proposition that jurisdictional competition leads to a more efficient set of substantive laws. The discussion of the continued popularity of special charters under the dual incorporation system suggests that early general incorporation laws were unpopular because they did not change to reflect trends in corporation finance, organization, and management,[149] as monopolistic legislators put their energies into liberal and up-to-date special charters without removing the evident limitations found in general incorporation laws. In contrast, the existence of competition among states for the lucrative chartering business since 1875 has assured that corporation laws are constantly adjusted to meet the needs of business organizations in a dynamic economy. Thus the historical evidence suggests that federal minimum standards, or a federal chartering system, could yield substantive laws that lag behind the changing needs of the business community.[150]

[148] In fact, the historical record indicates that the federal government can be an extremely effective cartelizing agent. See, for example, Gabriel Kolko, Railroads and Regulation: 1877–1916 (1965); and Robert M. Spann & Edward W. Erickson, The Economics of Railroading: The Beginning of Cartelization and Regulation, 1 Bell J. Econ. 227 (1970); and Robert B. Ekelund, Have State Regulations Led to Corporate Monopoly Power? in The Attack on Corporate America (M. Bruce Johnson ed. 1978) at 139–40.

[149] See text accompanying notes 74–78 *supra*.

[150] This suggestion is reinforced by the English experience. In England, corporation laws have been subject to review and revision at intervals of about twenty years since the 1860s. See L. C. B. Gower, Principles of Modern Company Law 53–57 (4th ed. 1979). It seems clear that the business environment undergoes considerable changes in the course of twenty years and that the lag in legislative response would lead to unnecessary constraints on business behavior. Furthermore, there is no reason to expect the changes, when they do occur under a national incorporation system, to be in the most efficient direction. On a similar note, England's recent entry into the European Economic Community presents the opportunity for jurisdictional competition in an international market for corporation privileges. The "harmonization" of corporation laws, however, appears to be a goal of the EEC Commission. The preeminent authority on English companies law, L. C. B. Gower, warns against this development because he believes that it will be difficult to get multinational agreement on reforms once the uniform code is established. *Id.* at 93. Because of this, he prefers "the comfortable old pattern of a major reform every 20 years or so." *Id.* On the other hand, this paper also suggests that England's autonomy should be maintained, not because the comfortable old pattern is superior, but because of the potential benefits of the recently available possibility of jurisdiction competition from the EEC market for corporate privileges.