

**Opening the Black Box of the Common-Law Legal Regime:
Contrasts in the Development of Corporate Law in Britain and the United States
in the Late Nineteenth and Early Twentieth Centuries**

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Abstract: The general incorporation laws enacted in Britain and the U.S. in the nineteenth century had strikingly different structures. Whereas British law was laissez-faire in spirit, the American statutes were highly regulatory. The literature on the efficiency of the common law might lead one to expect that these statutory differences would become less salient over time, as businesses litigated their disputes and courts in the two countries came to similar resolutions. However, we find that the case law tended, if anything, to accentuate the differences in the statutes. British courts typically enforced whatever arrangements shareholders wrote into their articles of association or otherwise contracted among themselves, so long as the agreements were not contrary to law. In the U.S., by contrast, courts generally refused to enforce shareholders' agreements that deviated in any significant way from statutory norms. Although by the 1920s judges in some states were beginning to rethink this position and argue that members of corporations should have greater flexibility to arrange their affairs contractually, they were limited in their ability to act on this rethinking by decades of contrary precedents. U.S. law would not really begin to converge on British law until the second half of the twentieth century, when states began to enact more flexible general incorporation statutes. By that time, British company law was also becoming more regulatory.

Acknowledgments: It is with a tremendous sense of gratitude that we prepared this paper in honor of Leslie Hannah, a great business historian with deep knowledge of the subject about which we write who has made important contributions to the comparative study of business institutions. We have benefited enormously from Les's comments on our papers over the years, including this one. We are also grateful for the comments and suggestions of Brian Cheffins, Giuseppe Dari-Mattiacci, James Foreman-Peck, Timothy Guinnane, Jean-Laurent Rosenthal, Francesca Trivellato, John Turner, Harwell Wells, two anonymous referees, and participants at the Festschrift Conference for Les at the Henley Business School, University of Reading, the conference on "Firm Governance: Law in History" at Tel Aviv University Law School, the Colloquium on Law, Behavior, and Social Science at the University of Illinois College of Law, and the Canadian Network for Economic History. We would also like to thank our research assistants Gali Gazit, Rotem Ehrenreich, Thao Nguyen, and Nimrod Shimoni.

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There is an extensive literature debating the differences between the common-law legal regimes found in Anglo-American countries and the code-based legal regimes on the European continent.¹ This paper contributes to that discussion by examining the laws governing corporations in two common-law countries, Britain and the United States. It is part of a larger effort in which we are engaged to show that the differences in the law of organizations within common-law and code-law countries have historically been as large as the often remarked upon differences between the two groups.² It is also part of an effort to shift attention from the large public companies on which much of the literature has focused to the generally smaller, often privately held concerns that populated the most technologically dynamic parts of the economy. Our goal is to compare the legal rules that governed these less studied entities in Britain and the United States during the late nineteenth and early twentieth centuries—the period of the Second Industrial Revolution. We go beyond a simple comparison of the statutes to study the different ways in which the courts in these two common-law countries interpreted the law.

At the start of the nineteenth century, in both Britain and the United States, corporations could only be chartered by special legislative act, and companies continued to be formed in this way in both countries through the middle of the century. Beginning in the late 1840s, almost all the U.S. states enacted constitutional provisions prohibiting legislatures from granting special

¹ Recent contributions include La Porta, Lopez-de-Silanes, Shleifer, and Vishny, “Legal Determinants” and “Law and Finance”; La Porta, Lopez-de-Silanes, and Shleifer, “Economic Consequences of Legal Origins”; and Morck, ed., *History of Corporate Governance*; Roe and Siegel, “Finance and Politics”; and Milhaupt and Pistor, *Law and Capitalism*.

²Guinnane, Harris, Lamoreaux, and Rosenthal, “Putting the Corporation in Its Place” and “Pouvoir et propriété dans l’entreprise”; Lamoreaux, “Corporate Governance.”

charters and bringing most corporations under the jurisdiction of general laws.³ In Britain, the number of corporations created by special legislation also declined over time, but as late as the early twentieth century, many of the largest businesses in the country—mainly railroads, trams, utilities, and other similar types of enterprises—were still “statutory companies.” These, as James Foreman-Peck and Leslie Hannah have shown, came under a set of legal rules imposed by the Companies Clauses Consolidation Act (CCCA) of 1845.⁴ By the early twentieth century, however, statutory companies were increasingly outnumbered, even on the London Stock Exchange, by companies registered under a series of general laws, called the Companies Acts, first enacted in the middle decades of the nineteenth century.⁵ It is these “registered companies” that are the focus of this paper.

Unlike the CCCA, which imposed a number of restrictions on companies’ internal governance, the Companies Acts were *laissez faire* in spirit, giving incorporators almost complete freedom to set up the governance structures of their businesses as they saw fit.⁶ In this way, the Companies Acts were also very unlike the general incorporation statutes passed by the various U.S. states, which were highly regulatory in their content and often prescribed in detail the governance rules that corporations had to adopt.⁷ One of the most striking manifestations of this difference was that British registered companies could write articles of association that entrenched specifically named directors for life, something that was not possible in the United

³ Evans, *Business Incorporations*, 11; Hennessey and Wallis, “Corporations and Organizations,” 98-99.

⁴ Foreman-Peck and Hannah, “UK Corporate Law,” and “Some Consequences.”

⁵ We are grateful to Hannah for information about how he and Foreman-Peck classified large companies that came under the CCCA versus the Companies Acts.

⁶ We focus this paper on the *internal* governance of corporations. Both the CCCA and the Companies Acts imposed stringent regulations on companies’ relations with creditors, particularly in the context of winding up a company’s business.

⁷ This difference has also been noted by Kershaw, “Path of Corporate Fiduciary Law.” Kershaw, however, takes a more deterministic view of the statutes’ effect on the case law than we do and also focuses more narrowly on the problem of self-dealing.

States. This practice became increasingly common among newly formed British companies in the early twentieth century. Indeed, almost half (46 percent) of the companies selected in a random sample of registrations from 1927 entrenched directors in this way, as opposed to 19 percent in 1892 and 24 percent in 1912.⁸

In the next section of this paper we describe the differences in the British and U.S. statutes, starting with the first wave of general incorporation laws enacted in the mid-nineteenth-century and continuing into the 1930s. The rest of the paper is devoted to exploring the ways in which courts in the two countries applied and interpreted the law. The literature on the efficiency of the common law might lead one to expect that the initial differences in statutes would become less salient over time as courts in the two countries confronted similar types of lawsuits.⁹ However, we find that the case law tended, if anything, to accentuate the differences in the statutes. In keeping with the *laissez-faire* spirit of the Companies Acts, British courts typically enforced whatever arrangements shareholders wrote into their articles of association or otherwise contracted among themselves, so long as the agreements were not directly contrary to law. In the U.S., by contrast, courts generally refused to enforce shareholders' agreements that deviated in any significant way from statutory norms. Although by the 1920s judges in some states were beginning to rethink this position and argue that members of corporations should have greater flexibility to arrange their affairs contractually, they were limited in their ability to act on this rethinking by decades of contrary precedents. U.S. law would not really begin to

⁸ These figures do not include managing directors, even if specifically named in the articles. Firms whose securities traded on public markets were less likely to have such provisions. Only 8 percent of the companies in a random sample of industrial enterprises taken from *Burdett's Stock Exchange Official Intelligence* for 1892 entrenched directors in their articles. For details on these samples and additional results, see Guinnane, Harris, and Lamoreaux, "Contractual Freedom."

⁹ On the efficiency of the common law, see Posner, *Economic Analysis of Law*; Rubin "Why is the Common Law Efficient"; Priest, "Common Law Process"; La Porta, Lopez-de-Silanes, and Shleifer, "Economic Consequences of Legal Origins."

converge on British law until the second half of the twentieth century, beyond the period we cover in this paper, when states began to enact more flexible general incorporation statutes. At about same time, British company law was also becoming increasingly regulatory.

Because this paper only examines cases related to internal corporate governance, we make no claim that the differences we observe in the courts' decisions in Britain and the U.S. carried over to other areas of law, for example those treating creditors' rights and insolvency procedures, and especially those that were more exclusively the domain of judge-made common law, such as the fiduciary duties of officers and directors. However, our findings are consistent with the work of scholars who have noted that British courts historically restricted themselves to interpreting the letter of the statute whereas American courts were more likely to base decisions on their assessments of legislative intent and public policy.¹⁰ Ironically, in the case of corporate law, the more formalistic approach of the British courts reinforced the laissez-faire character of that country's statutes, whereas the more instrumental approach of the American courts led to less contractual flexibility. It may be that the pervasive suspicion of corporate privileges in the U.S. accounted for both the restrictive nature of the American statutes and the courts' insistence on enforcing them rigidly.

The British and American Statutes Compared

Before the passage of the first general incorporation law in Britain in 1844, business rivals found it relatively easy to block applications for charters in Parliament, and so relatively few were granted.¹¹ In the United States, charters were much easier to secure, but the privileges

¹⁰ Healy, "Legislative Intent"; Bennion, *Understanding Common Law Legislation*. For a more general comparison of the two legal cultures, see Atiyah and Summers, *Form and Substance in Anglo-American Law*.

¹¹ Harris, *Industrializing English Law*.

that typically accompanied them provoked widespread outrage, not just among competitors but also among the public more generally. In both countries, the result was mounting pressure to adopt procedures for chartering corporations that were less subject to political manipulation. In the U.S., however, the concern was as much to level the playing field as it was to open up access to the corporate form, the main goal in Britain.¹²

This difference in the underlying politics shaped the content of the statutes enacted in the two countries. In Britain, the rising power of commercial and industrial interests, relative to the landed elite but also relative to the general population, led to an incorporation regime characterized by the principle of *laissez faire*. Although the 1844 law did not include limited liability and imposed a number of conditions on companies that registered under its terms, it was replaced in 1856 by a much more permissive statute that imposed virtually no restrictions on how companies could be run. Governance arrangements were henceforth to be set by each company in its articles of association. The 1856 act included in an appendix a model set of articles that applied if companies did not write their own rules, but incorporators could (and often did) reject the model articles as a whole or in part, and the provisions they wrote in their place could be (and again often were) completely different from the ones in the model table.¹³

This practice of marrying a liberal general incorporation statute with a default set of governance rules was reiterated in the Companies Consolidation Act of 1862 (with the model articles relabeled as “Table A”), and it continued to characterize British company law deep into the twentieth century. The only major reform during this period, the Companies Act of 1900, passed in the wake of a series of scandalous stock-market promotions, required companies issuing shares to the public to publish detailed information about their financial condition but

¹² Lamoreaux, “Corporate Governance.”

¹³ See Guinnane, Harris, and Lamoreaux, “Contractual Freedom.”

imposed only modest changes in internal governance rules.¹⁴ In 1907, moreover, Parliament exempted from the disclosure requirements companies that declared themselves to be private in the sense that they would not make public offerings of their securities.¹⁵ Over the next decade, more than 15,000 companies a year converted to private status, and the proportion of new companies choosing to be private rose until the latter accounted for more than 90 percent of new registrations in the 1920s. At the same time as Parliament offered companies the choice to be public or private, it enacted a new Table A that watered down many of the protections for shareholders included in the 1862 version.¹⁶ Parliament revised the Companies Act in 1929 but again did not take the opportunity to impose any significant new internal governance rules, except that the Act voided articles or side contracts protecting officers, directors, or auditors from liability for breach of their duties.¹⁷

In the United States, by contrast, egalitarian pressures to insure that corporations did not gain advantages over businesses organized in other ways led to the enactment of statutes that were highly regulatory in their content. For this study we collected the general incorporation statutes for manufacturing enterprises enacted by seven important states: Massachusetts, New York, New Jersey, Pennsylvania, Ohio, Illinois, and California.¹⁸ During the first major wave of general incorporation laws in the 1840s and 1850s, these statutes placed limits on how big

¹⁴ The statute moved procedures for auditing financial statements and calling extraordinary general meetings from Table A into the body of the act. Companies Act of 1900 (63 & 64 Vict. c. 48).

¹⁵ They could still sell their securities through private channels, and many announced their intention to do so by including in their articles a provision offering a commission to anyone who secured buyers for their shares. See Guinnane, Harris, and Lamoreaux, “Contractual Freedom.”

¹⁶ For example, although the 1900 law required companies to hire auditors who would report annually to shareholders, the new Table A reduced the information to be included in those reports and restricted shareholders’ access to the corporation’s books. For more information about these and other changes, see Guinnane, Harris, and Lamoreaux, “Contractual Freedom.”

¹⁷ 19&20 Geo. 5, Ch. 23 (1929), sec. 152.

¹⁸ See the online appendix. We did not include Delaware in this exercise because it did not enact a true general incorporation law until 1899, when it entered the chartermongering competition by passing what was essentially New Jersey’s law.

corporations could grow, how much they could borrow, and/or how long they could live. The laws also mandated specific governance structures and voting rules. These could vary enormously from state to state, but Pennsylvania's 1849 statute provides a sense of the kinds of provisions that might be included. Corporations in Pennsylvania were to be managed by a board of 5 to 13 directors, a majority of whom had to be citizens of the United States. The president of the corporation had to be a director, but the secretary and treasurer could not be. Shareholders had one vote per share, but no individual shareholder could cast votes amounting to more than one-third of issued shares. Directors' power to make bylaws was subject to revision and approval by a majority of the shareholders. Moreover, there were elaborate rules governing voting by proxy, the powers of directors, and the procedures for increasing or decreasing the capital stock (within the limits allowed by the statute).¹⁹ These provisions, it should be emphasized, were all imbedded in the statute, whereas in Britain such matters were left to the discretion of incorporators to write into articles.

Most states rewrote their general incorporation statutes in the 1870s and at least once more in the late nineteenth or early twentieth century. Although the revisions first relaxed and then ultimately eliminated ceilings on corporations' size and duration, they continued to impose significant restrictions on their internal governance. In the 1870s, for example, many states (including New York, Pennsylvania, Ohio, and Illinois) stepped up protections for minority shareholders by mandating cumulative voting in elections for directors. Thus if shareholders were electing five directors to the board, they had a choice of casting one vote for each of five different candidates, five votes for one candidate, or anything in between. Neither the

¹⁹ Pennsylvania General Assembly, "AN ACT to encourage manufacturing operations in this commonwealth," approved 7 April 1849. All citations to state statutes are from the Session Laws Library at <http://www.heinonline.org/HOL/Index?index=sslusstate&collection=ssl>.

chartermongering competition sparked by New Jersey's liberal 1888-89 amendments, nor Delaware's entrance into the competition a decade later, had much effect on these aspects of corporate law. Most general incorporation statutes still included detailed rules that structured corporations' internal governance, and most states that had mandated cumulative voting in the 1870s still continued to require it.²⁰ For example, Pennsylvania's 1933 general law required corporations to have at least three directors, a majority of whom constituted a quorum. Every corporation had to have a president, secretary, and treasurer. Stockholders had to be able to cumulate their votes in elections, and could remove directors by simple majority vote. As in 1849, moreover, there were there were elaborate (though somewhat different) rules governing such matters as voting by proxy, the powers of directors, and the procedures for increasing or decreasing the capital stock.²¹ By contrast, in Britain all these kinds of details were still up to incorporators to decide.

As we have shown in this section, there were stark differences in the general incorporation laws enacted in Britain and the U.S. in the mid-nineteenth century, and these differences persisted to a remarkable extent into the 1930s. In the remainder of this paper we investigate how judges in each country interpreted the law. We begin with a topic, the

²⁰ After the 1890s, the largest firms in the economy generally took out New Jersey or Delaware charters, but the most corporations continued to be domiciled in their home states. For example, of the companies obtaining assignments at issue of a random sample of patents, more than two thirds (68.7 percent) were chartered in their states of operation. Only 23.5 percent were other states (10.0 percent in Delaware, 4.8 percent in NJ, and the other 8.7 percent in a number of states). The same was taken using the patent search in LexisNexis Academic, <http://www.lexisnexis.com/hottopics/lnacademic/>?, and information on the location and state of incorporation is from the U.S. Patent and Trademarks Office, <http://patft.uspto.gov/netahtml/PTO/srchnum.htm>. For total numbers of incorporations in the various states, see Evans, *Business Incorporations*, Appendix 3.

²¹ Pennsylvania, General Assembly, "AN ACT Relating to business corporations," approved 5 May 1933. For other states, see the online appendix. Even in states where the laws were permissive on their face, the courts often limited their flexibility. For example, a provision in New Jersey's 1898 law allowing incorporators to write provisions on their certificates "creating, defining, limiting and regulating the powers of the corporation, the directors and the stockholders; *provided*, such provision be not inconsistent with this act" was interpreted by the courts as requiring conformity to the specific rules laid down in the statute. Delaware courts adopted a similar interpretation. See Kershaw, "Path of Corporate Fiduciary Law," 421-27.

transferability of shares, in which the wording of the statutes in the two countries was essentially the same and show that the American courts nonetheless construed the law more restrictively, basing their interpretations on broad notions of public policy rather than, as in Britain, on the letter of the law. We next look at cases where the American statutes were stricter than the British laws, and then at cases where the British statutes were more restrictive, and in both sections come to essentially the same conclusions. That is, judges' decisions in the two countries tended to reinforce the basic differences in spirit of the two sets of statutes. In the final section of the paper we look at litigation involving amendments to British companies' articles of association. In these cases, British judges' commitment to contractual principles clashed with their commitments to applying the statute literally and to respecting the basic corporate principle of majority-based decision making, and we discuss the ways in which they balanced these conflicting imperatives.

The Transferability of Shares: A Case Where British and American Statutes Were Similar

Although American incorporation statutes were generally more prescriptive than British company law, there were a few instances where the text of the legislation was virtually identical. A good example is the transferability of shares. Section 22 of the British Companies Act of 1862 declared that shares "of any Member in a company under this Act shall be Personal Estate, capable of being transferred in manner provided by the Regulations of the Company." The laws of many of the American states contained very similar wording. For example, California's 1853 general incorporation act specified that "[t]he stock of the company shall be deemed personal estate, and shall be transferable in such manner as shall be prescribed by the by-laws of the

company.”²² Sometimes the American statutes included provisions allowing directors to restrict the transferability of shares that had not yet been fully paid in or that belonged to shareholders who owed money to the company.²³ British law permitted comparable restrictions to be written into the articles of association, and the model appended to the 1862 statute empowered directors to decline to transfer shares owned by members indebted to the company.²⁴

British courts interpreted the phrase “in manner provided by the Regulations of the Company” as permitting incorporators to write additional restrictions on transferability into their articles of association. Just six years after the enactment of the 1862 Companies Act, the Court of Appeal in Britain ruled in *Weston’s Case* that the declaration that shares were transferable should be considered a default rule that could be modified by a company in its articles. As Lord Justice Wood explained, “I think it is perfectly plain that the Companies Act, 1862, in the 22nd section, gives a power of transferring shares.” But, he held, the section also made transfers subject to regulation by the articles. “[I]f it is desired by a company that such unlimited power of assignment shall not exist,” incorporators could insert a clause “in the articles by which the directors have powers of rejection of members.”²⁵ Writers of advice manuals on company law took the decision in *Weston’s Case* as settling the issue, and many companies wrote restrictions on the transferability of their shares into their articles.²⁶ Although the London Stock Exchange refused to list securities that limited shareholders’ ability to sell fully paid shares, companies that did not seek listing (the vast majority by the late nineteenth century) increasingly adopted such

²² “An Act to provide for the formation of corporations for certain purposes” (1853), §9. See the online appendix for additional examples.

²³ See, for example, New York’s 1875 law and Pennsylvania’s 1849 and 1874 laws in the online appendix. It was common in the nineteenth and early-twentieth centuries in an initial offering for shareholders to pay in only part of the par value of the shares and then make additional payments in installments as called for by the directors.

²⁴ 1862 Table A, §10.

²⁵ In re *Smith Knight & Co* [*Weston’s Case*] 4 L.R. Chancery Appeals 20 (1868), at 27, 30.

²⁶ Palmer, *Company Precedents*, 102. See also Chadwyck-Healey, *Law of Joint Stock Companies*, 57-61; and Jordan and Gore-Browne, *Handy Book*, 69.

constraints.²⁷ Sometimes the provisions gave some or all members of the company a first right of refusal on shares offered for sale.²⁸ More commonly, they simply allowed directors to refuse to allow a transfer to anyone of whom they did not approve.²⁹

American courts, by contrast, construed the phrase “in such manner as shall be prescribed by the by-laws of the company” much more restrictively. They generally refused to countenance rules that did more than facilitate the routine transfer of shares, declaring that the “right of a stockholder to sell and transfer his stock cannot be restrained by a by-law of the corporation.”³⁰ The first important application of this principle occurred in disputes involving banks and insurance companies, where directors sought to prevent the sale of shares by stockholders who were indebted to the institution, and such restrictions were not explicitly authorized by the chartering statutes. Thus a New York Appeals Court in 1859 invalidated a bylaw giving the directors the right to refuse to transfer shares until the shareholder “discharge[d] all debts and demands due or contracted by him or her to the bank.”³¹ The justices who made these decisions justified their reading of the statutes by invoking general principles of public policy. Restrictions on transferability, they declared, were illegal restraints on trade that abrogated the rights of creditors by putting property out of their reach.³² In one case, the court even allowed a transfer of a share that had not been fully paid for, contrary to a statute that permitted directors to refuse

²⁷ Jordan and Gore-Browne, *Handy Book*, 182; Harris, “Private Origins.” These provisions were common in the random samples of articles collected by Guinnane, Harris, and Lamoreaux for “Contractual Freedom.”

²⁸ For example, §8 of the articles of the Burlington Carriage Company, Limited, formed in 1892, stipulated that during the life of Patrick Ness, the dominant shareholder, no transfers could be made “to any person other than the said Patrick Ness without first offering such shares to him” at the same price as the buyer had been willing to pay.

²⁹ See, for example, §19 of the articles of association of the Pontypool Electric Light & Power Company, Limited, formed in 1892: “The Directors may decline to register any transfer of shares (1) where the Company has a lien thereon; (2) where the Directors are of opinion that the transferee is not a desirable person to admit to membership, and that without being under any obligation to assign any reason for such opinion.”

³⁰ Cook, *Stock and Stockholders*, Vol. 1, 447.

³¹ *Bank of Attica v. Manufacturers’ and Traders’ Bank*, 20 N.Y. 501 (1859).

³² See *Sargent v. Franklin Insurance Co.*, 25 Mass. 90 (1829); *Moore v. Bank of Commerce*, 52 Mo. 377 (1873); *Farmers’ and Merchants’ Bank of Lineville v. Wasson*, 48 Iowa 336 (1878); *Bank of Atchison County v. Durfee*, 118 Mo. 431 (1893).

transfers in such cases, on the grounds that the legislature could not possibly have meant to undermine the rights of legitimate creditors but only “to prevent speculation in the scrip.”³³

As time went on, the courts extended these pronouncements about public policy to cases where shareholders in close corporations were seeking to control the identity of their associates. In an 1886 case involving a manufacturer of wooden ware whose bylaws prohibited transfers without the approval of all the stockholders, Wisconsin’s high court declared that the restriction was “against public policy and unlawful” because it put property “beyond the reach of the creditors” of the shareholder. There could be no exception to the strict rule of transferability even for closely held companies. “The incorporators have secured the advantages of a corporation, and they should be governed by all the other incidents of a corporation.”³⁴ The Maryland Court of Appeals similarly ruled in 1896 that a bylaw requiring members of a dye-manufacturing corporation to give each other first right of refusal before selling shares to an outsider constituted “an unreasonable and a palpable restraint upon the alienation of property.”³⁵ Nor were courts in the liberal chartermongering states any different. As late as 1921, a New Jersey vice chancellor “seriously question[ed]” whether the state’s corporation act “countenance[d] corporate existence with copartnership privileges of choosing one’s associates.”³⁶

Despite these rulings, the practice of writing restrictions on the transferability of shares into corporate bylaws seems to have grown over time.³⁷ Incorporators realized that such provisions could serve a useful function, even if they were unenforceable. As Thomas Conynton

³³ *Quiner v. Marblehead Social Insurance Co.*, 10 Mass 476 (1813) at 483.

³⁴ *In Re Klaus*, 67 Wis. 401 (1886) at 406.

³⁵ *Bloede Co. v. Bloede*, 84 Md. 129 (1896) at 141-142.

³⁶ *Prindiville v. Johnson & Higgins*, 92 N.J. Eq. 515 (1921) at 520. See also *Ireland v. Globe Milling and Reduction Co.*, 19 R.I. 180 (1895); *McNulta v. Corn Belt Bank*, 164 Ill. 427 (1896); *Miller v. Farmers Milling & Elevator Co.*, 78 Neb. 441 (1907); *Morris v. Hussong Dyeing Machine Co.*, 81 N.J. Eq. 256 (1913).

³⁷ A Wisconsin court acknowledged as much in *Farmers’ Mercantile and Supply Company v. Laun*, 146 Wis. 252 (1911).

pointed out in his *Manual of Corporate Organization*, if the provision were printed on the stock certificate, “it would, regardless of its legal force, make the stock extremely difficult to sell, and would thus indirectly accomplish the desired end.”³⁸ As the practice became more widespread, moreover, some courts began to rethink the emphasis on transferability and acknowledge that there might be good reasons to allow shareholders in close corporations to vet new members of their company. Thus a Wisconsin judge wrote in 1915, “The personal element is as important in the make-up and management of a corporation as it is in almost every other undertaking. Restrictions, therefore, reasonably protecting incorporators or stockholders in their interests by permitting them first to purchase stock offered for sale, should be held lawful as promotive of good management and sound business enterprise.”³⁹ Other courts, however, continued to resist this trend toward greater contractual flexibility. A New Jersey vice chancellor admitted in 1913 that some authorities now sustained “provisions in charters or by-laws, expressly providing for a prior offer of sale to the company, or submitting to directors the name of the transferee for approval,” but he asserted that “the weight of authority and—in my judgment—the better rule, seems to be against the validity of such provisions, as being an unreasonable restraint of alienation.”⁴⁰ Coming from the state that started the chartermongering competition and whose general incorporation statutes were among the most liberal in the country, this opinion is telling to say the least.

Judges seeking to allow more contractual flexibility faced the problem of squaring their decisions with earlier holdings finding all restrictions on transferability invalid.⁴¹ Overturning

³⁸ See Conyngton, *Manual of Corporate Organization*, 337-39.

³⁹ *Casper v. Kalt-Zimmers Manufacturing Co.*, 159 Wis. 517 (1915) at 522. See also *Farmers’ Mercantile and Supply Co. v. Laun*, 146 Wis. 252 (1911); *Garrett v. Philadelphia Lawn Mower Co.*, 39 Pa. Super. 78 (1909); *Nicholson v. Franklin Brewing Company*, 82 Ohio St. 94 (1910).

⁴⁰ *Morris v. Hussong Dyeing Machine Co.*, 81 N.J. Eq. 256 (1913) at 261.

⁴¹ Where there were only a small number of stockholders, all of whom had originally agreed to the bylaw at issue, judges sometimes ruled that the provision was a contract that the members of the firm had entered into with each

well-established precedents was easier where revisions in the general statutes permitted the courts more leeway. On the grounds that Delaware law “expressly authorized [a corporation] to make by-laws ‘for the management of its property, the regulation and government of its affairs, and for the certification and transfer of its stock,’” an Ohio court in 1910 upheld a bylaw requiring a shareholder to notify the corporation “in writing, stating the amount of stock he desires to sell and the market value of same” and giving the company “an option on said stock for thirty days following such notice.”⁴² This position received additional support after the National Conference of Commissioners on Uniform State Laws adopted the Uniform Stock Transfer Act in 1909 and fourteen states enacted it within the next decade. Section 15 of this act declared, “[T]here shall be no restriction upon the transfer of shares ... by virtue of any by-law ..., or otherwise, unless ... the restriction is stated upon the certificate.”⁴³ The implication of this section, which the courts seemed to accept, was that bylaw provisions restricting transfers could be held valid if they were written on the certificates.⁴⁴ Such modifications were even more likely to be upheld if they were written into the corporation’s articles of association: “The charter of a corporation is a legislative grant—just as much so when incorporated under a general law as by special act.” Therefore, an amendment to a charter was also “a legislative act.”⁴⁵

Nonetheless a great deal of uncertainty remained. Incorporators of the Household Finance Corporation (a Delaware company) wrote such a restriction into both their company’s articles of association and bylaws, and also printed it on each share of stock. A stockholder who

other, as well as with the corporation, and was enforceable as such and not because it was a valid bylaw. See, for examples, *New England Trust Co. v. Abbott*, 162 Mass. 148 (1894); and *Garrett v. Philadelphia Lawn Mower Co.*, 39 Pa. Super. 78 (1909).

⁴² *Nicholson v. Franklin Brewing Co.*, 82 Ohio St. 94 (1910).

⁴³ National Conference, *American Uniform Commercial Acts*, 128-129; Dunham, “History of the National Conference”; Ehrle, “Uniform Stock Transfer Act.”

⁴⁴ See *Baumohl v. Goldstein*, 95 N. J. Eq. 597 (1924).

⁴⁵ *Casper v. Kalt-Zimmers Manufacturing Co.*, 159 Wis. 517 (1915) at 522.

objected filed suit and lost, lost again on appeal, and lost a third time in 1930 in Delaware's chancery court.⁴⁶ Although the stockholder's challenge failed, that the issue would be so persistently litigated, even in permissive Delaware as late as 1930, is a good indication that restraints on transferability remained problematic. As Delaware's chancery justices admitted, "[i]t cannot be denied that as a general proposition, ... a corporate by-law which unreasonably restrains the power of a stockholder to transfer his stock, has been held invalid as against public policy," and they felt compelled to devote the better part of six pages to justifying their finding that the restriction in this case was enforceable.⁴⁷

Entrenchment: A Case Where the American Statutes Were More Restrictive

One of the most striking consequences of the differences between the British and American general incorporation statutes was that it was much easier for incorporators in Britain to maintain control over the enterprises they created. Section 49 of the British Companies Act of 1862 required corporations to hold at least one general shareholders' meeting each year, but it did not specify what had to happen at those meetings. It did not even require that there be elections for directors. The default articles of association laid out in Table A in 1862 provided for an initial board of directors, chosen by the incorporators. That board was to step down at the first annual meeting, and the shareholders would then elect a full board whose members would serve staggered three-year terms.⁴⁸ These provisions were merely default rules, however, and companies that wrote their own articles could adopt different practices, including provisions that

⁴⁶ *Lawson v. Household Finance Corp.*, 17 Del. Ch. 343 (1930).

⁴⁷ *Lawson v. Household Finance Corp.*, 17 Del. Ch. 343 (1930) at 349-355.

⁴⁸ Table A, sections 52, 53, 58, and 59. We base our discussion on the 1862 model because it was in force from 1862 to 1906. In the latter year the Board of Trade made a modest set of revisions that carried through with little further modification until 1948. See Guinnane, Harris, and Lamoreaux, "Contractual Freedom."

protected some or all directors from ever having to face shareholders' scrutiny. Indeed, by the end of the century most companies were including a clause in their articles (that did not exist in Table A) that enabled the directors to name one or more of their number to be "managing directors," set their terms of service, and exempt them from having to stand for reelection during their terms.⁴⁹ As already indicated, an increasing proportion went even further and used their articles to entrench specifically named directors for extended periods of time, for life, or sometimes even into the next generation.⁵⁰ These provisions could only be abrogated if the articles of association were amended, an action that required a three quarters vote of the shareholders attending a meeting called for that purpose, followed by a majority vote at a second meeting to confirm the result. To guarantee they would maintain their positions, therefore, entrenched directors needed only to own a quarter of the shares plus one.⁵¹

The American statutes required directors to stand regularly for election and, as we have seen, often mandated specific election rules, such as cumulative voting, designed to increase the clout of minority shareholders. These laws made it difficult for large stockholders who did not individually own a majority of the shares to guarantee that they would be able to control their company over the long term. Therefore, to protect themselves, shareholders experimented with

⁴⁹ Sixty-four percent of the companies in our 1892 registration sample had this clause and 92 percent of the firms in our 1892 *Burdett's* sample of traded companies. The figures for the 1912 and 1927 samples were 98 and 100 percent respectively. See Guinnane, Harris, and Lamoreaux, "Contractual Freedom."

⁵⁰ For example, the articles of association of Ranken Ellis & Company, Limited, registered in 1892, declared Charles Gilbert Ellis to be the "Permanent Governing Director" (§81) of the company so long as he held at least half of the issued capital (§83) and gave him the power to appoint the other directors, define and limit their powers, and set their remuneration (§82). The articles of the Dymock's Patent Twine Company, Limited, registered in 1912, named three permanent directors and, in the event of their death, gave their executors the power to nominate their successors (§22).

⁵¹ See sections 50 and 51 of the 1862 Companies Act. Because incorporators set voting rules in the articles, if a company privileged large shareholders (for example, by disenfranchising shareholders who owned less than some minimum number of shares), control could be achieved with less than a quarter of the shares. As was always the case in British companies, voting was in the first instance by a show of hands, with each shareholder casting one vote. But the chairman of the meeting (or the number of shareholders specified in the articles) could demand a poll, at which point the company's voting rule prevailed.

various kinds of side contracts, reserving for themselves key managerial positions in the company, or agreeing to some kind of supermajority decision rule that gave them veto power. The courts generally regarded these arrangements as contrary to statute or accepted notions of public policy, however, and were unwilling to enforce them with injunctions or even to award damages for their abrogation. As a result, large shareholders in American corporations were not able to secure anything like the certainty of control that was possible in British corporations.

Judges were particularly hostile to agreements promising specific shareholders positions as directors or officers. In their view, it simply was not permissible to deprive shareholders of the power to elect directors or take away from directors the authority to choose other officers. As the Georgia supreme court declared in 1908, every person who buys a share in the stock of a corporation “has a right to believe that the corporation will, and to insist that it shall, be managed by the majority.” A contract guaranteeing a group of minority shareholders the right to select three of the five directors of a company was “against public policy and, therefore, void” because it took from the majority “the power to exercise their right as well as their duty to the other stockholders, present or future, and to the public”⁵² Similarly, agreements that entrenched individual shareholders as officers or managers interfered with the decision-making powers of the board of directors and might even require members “to act contrary to the duty” they owed to the “company and to the stockholders other than the plaintiff.”⁵³ The New York Court of Appeals summarized the case law on this point in 1934, “Directors may not by agreements entered into as stockholders abrogate their independent judgment.” Their duty is “to the

⁵² *Morel v. Hoge*, 130 Ga. 625 (1908) at 632. See also *Gage v. Fisher*, 5 N.D. 297 (1895); *Creed v. Copps*, 103 Vt. 164 (1930); and *McQuade v. Stoneham*, 263 N.Y. 323 (1934).

⁵³ *West v. Camden*, 135 U.S. 507 (1890) at 520. See also *Guernsey v. Cook*, 117 Mass. 548 (1875); *Woodruff v. Wentworth*, 133 Mass. 309 (1882); *Cone v. Russell & Mason*, 48 N.J. Eq. 208 (1891); *Abbott v. Harbeson Textile Co.*, 162 A.D. 405 (N.Y. 1914); *Cuppy v. Ward*, 187 A.D. 625 (N.Y. 1919).

corporation and its stockholders, to be exercised according to their unrestricted lawful judgment.” Thus, “a contract is illegal and void so far as it precludes the board of directors ... from changing officers, salaries or policies ... except by consent of the contracting parties.”⁵⁴

For analogous reasons, judges refused to allow members of closely held corporations to agree to make decisions by unanimous consent or any other rule that gave them veto power. As New York’s high court opined, “Corporations are the creatures of the state and must comply with the exactions and regulations it imposes.” Boards of directors were mandated by statute, which also granted them managerial authority over corporate affairs, and any agreement to bypass them or “to create a sterilized board” was “illegal and void.”⁵⁵ New Jersey Justice James Brook Dill agreed. In his earlier career as a corporate lawyer, Dill had helped to draft New Jersey’s liberal general incorporation statute, but now he overturned an agreement according to which the two main shareholders of the corporation formed to publish and distribute the *Encyclopedia Britannica* would make all decisions by mutual assent, effectively bypassing the additional directors that the law required them to elect. Dill found the agreement contrary to statute, declaring that “the law never contemplated that persons engaged in business as partners may incorporate, with intent to obtain the advantages and immunities of a corporate form and then, Proteus-like, become at will a copartnership or a corporation, as the exigencies or purposes of

⁵⁴ *McQuade v. Stoneham*, 263 N.Y. 323 (1934) at 328-330. In 1936, in *Clark v. Dodge*, the New York court signaled that it was willing marginally to rethink its position in a case where a minority shareholder had been promised employment as the corporation’s general manager “so long as he should remain ‘faithful, efficient and competent.’” In the court’s view, this particular contract was not an “attempt to sterilize the board of directors,” and the commitment to continue the shareholder so long as he proved competent was so minor an infringement on the powers of the board of directors “as to be negligible.” But the general principle that it was not permissible to constrain the author of the board remained intact. *Clark v. Dodge*, 269 N.Y. 410 (1936) at 414, 417.

⁵⁵ *Manson v. Curtis*, 223 N.Y. 313 (1918) at 323-324. For other examples, see *West v. Camden*, 135 U.S. 507 (1890); *Seitz v. Michel*, 148 Minn. 80 (1921); *Schuster v. Largman*, 308 Pa. 520 (1932).

their joint enterprise may from time to time require.”⁵⁶ As late as 1945, the New York Appeals Court struck down a similar arrangement in a hotel company: The state grants “to individuals the privilege of limiting their individual liabilities for business debts by forming themselves into an entity separate and distinct from the persons who own it.” In exchange, it demands “that the entity take a prescribed form and conduct itself, procedurally, according to fixed rules.” The agreement, a corporate bylaw, to make decisions by unanimous consent was invalid, the court ruled, because it was “obnoxious to the statutory scheme of stock corporation management.”⁵⁷

Stockholders had somewhat more success when they used the device of the voting trust to secure control, until judges began to view these arrangements with suspicion in the late nineteenth and early twentieth centuries. Voting trusts were agreements by which stockholders transferred their shares in a corporation to one or more trustees who would then vote them on behalf of the transferees. Before the late 1880s, judges generally found nothing wrong with stockholders combining their interests in this way so as to exercise their control more effectively.⁵⁸ Over the next couple of decades, however, they became increasingly likely to invalidate them, illustrating American courts’ willingness to ground their judgments on novel interpretations of public policy rather than relying, as did their British counterparts, on the meaning of the statute.⁵⁹

⁵⁶ *Jackson, v. Hooper*, 76 N.J. Eq. 592 (1910) at 599. Dill went on to warn that members of corporations who entered into such agreements risked being held unlimitedly liable as partners: “If the parties have the rights of partners they have the duties and liabilities imposed by law and are responsible in solido to all creditors” (599).

⁵⁷ *Benintendi v. Kenton Hotel*, 294 N.Y. 112 (1945) at 118. By this time, however, ideas about corporate governance were beginning to change, particularly in the case of closely held companies. The New York legislature responded to the decision by enacting legislation that ratified the dissenting judges’ view, granting stockholders liberty to set high voting and quorum requirements for corporate decisions. Over the next couple of decades about a dozen other states followed suit by passing similar laws. O’Neal, “Close Corporations” and “Regulation of the Close Corporation”; Wells, “Rise of the Close Corporation.”

⁵⁸ Beach, *Law of Private Corporations*, Vol. 1, 501. The most frequently cited case was *Faulds v. Yates*, 57 Ill. 416 (1870), which enforced a partnership agreement that three shareholders had organized to control a majority of the shares in a coal mining company.

⁵⁹ See Wormser, “Legality of Corporate Voting Trusts”; and Cushing, *Voting Trusts*, Ch. 3.

In the first of the new cases, an Ohio court refused in 1886 to enforce a voting trust against a shareholder who wished to withdraw. Making such agreements revocable at will rendered them useless for purposes of control, so this decision had the potential to undermine the utility of the device. Although the court found nothing illegal about the agreement in and of itself, it ruled that shareholders could not be prevented from withdrawing from it if they so desired, else “it may come to pass that the ownership of a majority of the stock of a company may be vested in one set of persons, and the control of the company irrevocably invested in others.” Such a state of affairs, the court declared, would be “intolerable” and contrary to the “universal policy” of law that “the right to vote is an incident to the ownership of stock, and cannot exist apart from it.”⁶⁰

What made such a separation intolerable was that it raised the possibility that the interests of the trustees voting the stock would no longer be aligned with the interests of the stockholders more generally. As a New Jersey vice chancellor explained a few years later, so long as the majority of shares in a corporation are owned by one person or by a “set of men, acting in concert,” minority shareholders “are, to some extent, protected by the natural interest of the majority to promote the real interest of the corporation.” But if voting power is vested in a person “who has little or no actual ownership, ... the minority loses this protection.” The court went on to assert that the motive for such arrangements are usually “some consideration of person gain.” The agreement under adjudication was a case in point, for its goal was to assure to one of the signatories the position as “manager for a fixed term and at a fixed salary,” an arrangement that, as we have already seen, the courts generally disallowed.⁶¹ Others cases involved more nefarious arrangements, as, for example, when shareholders in a Connecticut

⁶⁰ *Griffith v. Jewett*, 9 Ohio Dec. Reprint 627 (1886).

⁶¹ *Cone v. Russell & Mason*, 48 N.J. Eq. 208 (1891) at 214.

railroad company used a voting trust to award themselves construction contracts and profit personally at the expense of other shareholders.⁶²

When judges asserted that voting trusts had to be revocable, they were relying on general principles about public policy, not statutory interpretation. Although they started from the premise that voting trusts were essentially formalizations of the right to vote by proxy, a right conferred by statute,⁶³ they did not base their decisions on the statutory rules even in cases where the statutes could have been interpreted as dispositive. In the New Jersey case cited above, for example, the vice chancellor mentioned that state law limited the duration of proxies to periods shorter than the term specified by the voting trust agreement. However, his ruling did not hinge on that fact but rather on his judgment that the trust was “void as against public policy.”⁶⁴ Similarly, the judge in the Connecticut railroad case noted that the voting trust violated a provision of the statute limiting the duration of proxies. However, the act said nothing about whether the power of attorney had to be revocable, and the judge devoted a considerable part of his opinion to his assertion that it must be, citing no statutory authority for this claim but instead “the policy of our law.”⁶⁵ Moreover, it was precisely his assertions about policy that found their way into subsequent decisions. For example, when the Illinois Supreme Court invalidated a voting trust formed by shareholders of the Peru Plow and Wheel Company in 1915, it quoted extensively from the parts of the Connecticut decision declaring it “the policy of our law” that voting trusts had to be revocable.⁶⁶

⁶² *Shepaug Voting Trust Cases*, 60 Conn. 553 (1890).

⁶³ Shareholders had no common-law right to vote by proxy, but most statutes conferred it. See *Cone v. Russell & Mason*, 48 N.J. Eq. 208 (1891) at 213. The case cited as precedent was *Taylor v. Griswold*, 14 N.J.L. 222 (1834).

⁶⁴ *Cone v. Russell & Mason*, 48 N.J. Eq. 208 (1891) at 215.

⁶⁵ *Shepaug Voting Trust Cases*, 60 Conn. 553 (1890) at 578-80.

⁶⁶ *Luthy v. Ream*, 270 Ill. 170 (1915) at 178, quoting *Shepaug Voting Trust Cases*, 60 Conn. 553 (1890) at 579. . . For other cases similarly invoking public policy, see *White v. Thomas Inflatable Tire Co.*, 52 N.J. Eq. 178 (1893); *Harvey v. Linville Improvement Co.*, 118 N.C. 693 (1896); *Kreissl v. Distilling Co. of America*, 61 N.J. Eq. 5 (1900); *Bridgers v. First National Bank*, 152 N.C. 293 (1910).

Not all judges agreed with this position, and a few even challenged the propriety of grounding decisions in statements about public policy. In one of the earliest examples, the California Supreme Court in 1897 decried “public policy” as “a term of vague and uncertain meaning” that encouraged judges “to encroach” upon the domain of the legislature. The court found nothing contrary to statute or otherwise illegal in a railroad voting trust and, reversing a lower court decision to the contrary, enforced its terms against a shareholder seeking to pull out of the agreement.⁶⁷ California legislators apparently thought the decision was wrong because they subsequently enacted a clarifying amendment requiring agreements delegating the right to vote shares in a corporation to have a specified term of no more than seven years, and more importantly, insisting that such arrangements must always be revocable at the will of the shareholder.⁶⁸

The New York legislature, however, moved in the opposite direction around the same time and explicitly authorized shareholders to form voting trusts. The state’s general incorporation statute had specified that every proxy had to be limited in duration “revocable at the pleasure of the person executing it,”⁶⁹ but in 1901 the legislature changed the law to allow a shareholder to “transfer his stock to any person or persons for the purpose of vesting in him or them the right to vote thereon.”⁷⁰ Initially the right was for five years, but it was later extended to ten. A number of other states subsequently enacted similar legislation. Although these laws,

⁶⁷ *Smith v. San Francisco & North Pacific Railway Co.*, 115 Cal. 584 (1897) at 600. The court’s chief justice, William Henry Beatty, dissented on grounds of public policy (at 609-610). For other decisions upholding irrevocable voting trusts, see *Brightman v. Bates*, 175 Mass. 105 (1900); and *Carnegie Trust Co. v. Security Life Insurance Co. of America*, 111 Va. 1 (1910). According to Smith, “Validity of Voting Trusts,” this position was distinctly in the minority.

⁶⁸ California legislature, “An act ... regulating the giving and use of proxies to vote corporate stock...” approved February 27, 1905. For a case invalidating a voting trust on the basis of that act, see *Simpson v. Nielson*, 77 Cal. App. 297 (1926).

⁶⁹ New York Legislature, “AN ACT to amend the general corporation law,” approved 18 May 1892, §21.

⁷⁰ New York Legislature, “AN ACT to amend the general corporation law,” approved 16 April 1901, §20.

unlike California's, usually did not insist that the agreements be revocable, by fixing their maximum duration they still limited the time horizon over which shareholders could be certain they could insure control.⁷¹

The judicial record is silent on the issues that drove judges' increasing suspicion of voting trusts, but disquiet about the use of the device by Standard Oil and other large-scale enterprises for the purpose of horizontal combination may have played an important role. After the New York Senate completed its investigation of trusts in 1888, William W. Cook, a prominent treatise writer on corporate law, published a short volume describing the "assortment of schemes and devices" the hearings had "unearthed." Among them was the voting trust, and Cook suggested that recent court decisions insisting that such agreements be revocable offered considerable protection against their use for the purpose of industrial consolidation, encouraging judges to continue this line of precedents.⁷² Although most legal experts thought voting trusts could be a valuable tool for securing creditors' assent to reorganizations of bankrupt corporations, here again use of the device by financial titans like J. P. Morgan raised concerns, especially after Congressman Arsène Pujo held hearings to investigate the reach of the "money trust" in 1912-13. The Pujo committee's report highlighted the ways in which bankers exploited the device to consolidate their control over railroads and other large enterprises and recounted instances in which minority shareholders were disadvantaged by the trusts.⁷³ Legal writers blamed the Pujo report for a surge of court decisions invalidating voting trusts.⁷⁴ Their claims

⁷¹ For a table of the states' provisions, see Dougherty and Berry, "Voting Trust," 1123-25. California reversed course in 1931 and enacted a general incorporation law that legalized irrevocable voting trusts for a term of twenty-one years. See the online appendix.

⁷² Cook, *Trusts*, 32-33. Similarly, Simeon Baldwin was motivated by the case of Standard Oil and other "trusts" to write an important law review article, "Voting-Trusts," objecting to the idea of irrevocable trusts.

⁷³ U.S. House of Representatives, "Report of the Committee."

⁷⁴ See, for examples, Wormser, "Legality of Corporate Voting Trusts," 127-32, and Dougherty and Berry, "Voting Trust," 1122.

are difficult to assess, but there is no question that the end result was to reduce the utility of the device for stockholders who sought ways of insuring their ongoing control.⁷⁵

Number of Shareholders: A Case Where the British Statutes Were More Restrictive

In only rare instances was British company law more restrictive than the typical American general incorporation statute. One example was the requirement that corporations have a minimum number of shareholders. Although the various U.S. states set different thresholds (some five, some three, some less than three), the emphasis was on making it easy to form a corporation. Thus Illinois's 1857 statute began, "Any three or more persons, who may desire to form a company for the purpose of carrying on any kind of manufacturing, mining, mechanical or chemical business," may register it as a corporation by filing a certificate with basic information such as the name, objects, and amount of capital of the company.⁷⁶ The laws did not say anything about the number of shareholders a company must have once it went into operation, though typically they required companies to have a minimum number of directors. In the absence of a statutory requirement that directors also be shareholders, the courts seem not have cared how many shareholders a company maintained after its formation. Indeed, there were many lawsuits involving sales of property by a corporation in which one stockholder had acquired all the outstanding shares. The courts took it for granted that the corporation continued to exist; their main concern was to distinguish acts taken by the legal entity of the corporation from the personal acts of its sole remaining shareholder.⁷⁷

⁷⁵ See Lamoreaux and Phillips Sawyer, "Voting Trusts and Antitrust," for evidence on the declining use of voting trusts for purposes of long-term control.

⁷⁶ Illinois legislature, "An ACT to authorize the formation of corporations...", approved 18 Feb. 1857. For other examples, see the online appendix.

⁷⁷ See, for examples, *Newton Manufacturing Co. v. White*, 42 Ga. 148 (1871); *Button v. Hoffman*, 61 Wis. 20 (1884); *Millsaps v. Merchants' and Planters' Bank of Greenville*, 71 Miss. 361 (1893); *Louisville Banking Co. v.*

British law was much stricter on this issue. Section 6 of the 1862 Companies Act specified that “[a]ny Seven or more Persons associated for any lawful Purpose may ... form an incorporated Company,” and the courts interpreted this provision as requiring companies to have at least seven shareholders to preserve their corporate status. Unlike most governance provisions in the act, moreover, this rule was not a default that could be altered or rejected. It was a mandate, and the only question was whether the requirement could be satisfied by shareholders with merely nominal holdings. There was a great deal of uncertainty surrounding this issue until the House of Lords finally decided the question in the affirmative in the case of *Salomon v. Salomon* in 1897.⁷⁸ The suit involved a corporation, Aron Salomon and Company Limited, formed in 1892 to acquire Salomon’s sole proprietorship. In exchange for his business, Salomon received 20,000 fully paid shares of £1 each in the new company and a debenture of £10,000. The corporation’s other six shareholders were family members, each of whom held only one share. The year after its formation, the company became insolvent and went into receivership and liquidation. One of the creditors sued Aron Salomon personally for what he was owed, arguing that the company had not been legally formed because six of its shareholders were purely nominal.

Salomon lost the first two rounds of the case. The Chancery Division of the High Court sided with the creditor, and the Court of Appeal upheld the decision. Writing for the latter court, Lord Justice Nathaniel Lindley, an expert on company law, ruled that Salomon had attempted “to use the machinery of the Companies Act, 1862, for a purpose for which it never was intended.”

Eisenman, 94 Ky. 83 (1894). See also Wormser, “Piercing the Veil,” 516. But see also *Swift v. Smith, Dixon & Co.*, 65 Md. 428 (1886), where the court ruled that acquisition of stock in a corporation by a single person resulted in a suspension of the corporation’s existence until the owner transferred enough shares to others to reconstitute the board of directors.

⁷⁸ *Salomon v. A. Salomon and Co. Ltd* [1897] AC 22.

Parliament, he asserted, had “contemplated the encouragement of trade by enabling a comparatively small number of persons—namely, not less than seven—to carry on business with a limited joint stock or capital, and without the risk of liability beyond the loss of such joint stock or capital. But the legislature never contemplated an extension of limited liability to sole traders or to a fewer number than seven.”⁷⁹ Intriguingly, Lindley’s reliance on legislative intent led to much the same outcome as similar reasoning by justices in the United States—that is, to limits on the contractual flexibility of the corporate form.

The House of Lords, however, rejected this interpretive approach, ruling that judges were not supposed to attribute intentions to legislators but instead must base their decisions on the literal wording of the statute. Lord Halsbury reminded his fellow lords of this duty when he asserted, “I have no right to add to the requirements of the statute, nor to take from the requirements thus enacted. The sole guide must be the statute itself.” Deciding in favor of *Salomon*, he declared himself “wholly unable to follow the proposition that this [arrangement of shares] was contrary to the true intent and meaning of the Companies Act. I can only find the true intent and meaning of the Act from the Act itself.”⁸⁰ The renowned company-law jurist Lord Davey, agreed: “My Lords, it is possible, and (I think) probable, that the conclusion to which I feel constrained to come in this case may not have been contemplated by the Legislature, and may be due to some defect in the machinery of the Act. But, after all, the intention of the Legislature must be collected from the language of its enactments.”⁸¹

The body of lords approved this line of argument and overturned the decision of the Court of Appeal. *Aron Salomon and Company Limited* was held to be a legally constituted

⁷⁹ *Broderip v Salomon* [1895] 2 Ch. 323, 337.

⁸⁰ *Salomon v. A. Salomon and Co. Ltd* [1897] AC 22, 31.

⁸¹ *Salomon v. A. Salomon and Co. Ltd* [1897] AC 22, 54.

corporation, and Aron Salomon the person owed nothing to the company's creditors. The uncertainty that had previously prevailed about the use of nominal shareholders was now clearly settled in favor of a contractual flexibility that encouraged the conversion of partnerships, family firms, and even sole proprietorships into limited companies. Whatever the policy preferences of each of the judges might have been, the Lords took pains to ground their decision in a literal reading of the statute, rejecting the interpretative license taken by the Court of Appeal.

Amending the Articles of Association

British law treated a company's articles of association as a contract whose terms bound the shareholders and were enforceable in court so long as they were not directly contrary to statute. But the Companies Acts also stipulated that shareholders could amend their company's articles by a three-quarters vote. This provision for amendment brought corporate law into direct conflict with contract law, a central principle of which was that contracts could only be renegotiated and amended by consensus, not by some form of majority, or even supermajority, vote. How would the courts balance this conflict? Would they allow new interests to buy control of a company and change its governance rules to suit their own purposes, regardless of the preferences of minority shareholders? For example, could the new interests amend the articles to oust entrenched directors who did not hold enough shares to block the amendment? Or could the entrenched directors argue that such an amendment would amount to a breach of contract? That is, would the contractual principle of unanimous consent hold in such cases?

This problem did not pose itself with the same urgency in the United States because state general incorporation laws mandated most of the key governance provisions that British corporations could freely set in their articles, especially those involving the election of directors.

Indeed, the nineteenth-century American statutes typically did not include any provision for amending the articles. In the twentieth century states began to allow companies to amend their articles, but most of the changes they permitted were to the basic characteristics of the business—not to governance rules, which were still largely set by statute.⁸²

In Britain, however, shareholders could, by the requisite three-quarters vote, alter almost any aspect of a company's governance structure, including provisions entrenching specific individuals as directors. British courts for the most part upheld such amendments against legal challenges, but they might treat them as breaches of contract and impose damages as a remedy.⁸³ A key precedent was the 1904 case of *Baily v. British Equitable Assurance Company*. The company had a mutual department that distributed all of its profits to policy holders. An amendment to the articles changed this distribution by specifying that five percent of the profits would be allocated instead to a reserve fund. A policyholder/shareholder objected that the amendment amounted to a breach of his contract for a share of the full profits. In adjudicating the case, the court distinguished between contracts with shareholders and contracts with outsiders. The amendment itself was valid because shareholders, when they bought into a company, accepted its articles of association, including the procedure for amending them in the future. However, outsiders did not similarly acquiesce to future changes, and shareholders should be treated as outsiders when they entered into contracts with their company in their capacity as consumers (of insurance, for example) rather than as shareholders. The Court of Appeal held

⁸² See the online appendix. In some states, the language about the permissible scope of amendments was ambiguous, but the courts tended to disallow governance rules that deviated from statutory norms. See Kershaw, "Path of Corporate Fiduciary Law," 421-27. The twentieth-century U.S. statutes allowed corporations, by specific supermajority votes, to change basic aspects of the business, such as the location of the enterprise or the corporate purpose, that in Britain were not part of the Articles, but rather were inscribed in a company's Memorandum of Association. Some of aspects of the Memorandum (the business name and amount of capital) were amendable by a three-quarters vote, while others (the business's objects, whether liability was limited, the part of the UK where the company was incorporated) were not amendable.

⁸³ Palmer, *Company Law*, 30-32.

that a “company cannot, by altering its articles, justify a breach of contract” with outsiders and assessed damages accordingly.⁸⁴

The Lords subsequently applied this precedent to a case involving the entrenchment of a managing director in a lawsuit against Southern Foundries Limited. The company’s articles had empowered the directors to appoint a member of the board to the position of managing director for such period and upon such terms as they thought fit. In 1933 they appointed a director named Shirlaw to this office for a term of ten years. In 1936, however, the company merged into a corporate group and its articles of association were amended in a manner that allowed new owners to remove Shirlaw from his position. Shirlaw filed suit after he was dismissed the following year. The majority in the House of Lords held that even though the amendment to the articles was valid, the company breached Shirlaw’s contract by removing him from the position of managing director, and he was entitled as a result to damages.⁸⁵

In extreme cases, the courts were willing to invalidate an amendment to the articles—not because it violated a preexisting contract but rather because it was contrary to core principles of company law. For example, amendments might be invalidated if they were not to the benefit of the company or had been done in bad faith. The landmark precedent was the 1900 case of *Allen v. Gold Reefs of West Africa*, the starting point for all subsequent cases concerning changes to the articles.⁸⁶ At stake was an amendment empowering the company to place a lien (and eventually foreclose) on shares of members indebted to the company. The original article had restricted such actions to shares that had not been fully paid in; the amendment applied to fully paid shares

⁸⁴ *Baily v. British Equitable Assurance Co.* [1904] 1 Ch. 374, 385. Note that in this case the court was not asked to rule that the amendment was void or to issue injunction, but the court’s rationale suggests that such a request would not have been granted.

⁸⁵ *Southern Foundries (1926), Limited v. Shirlaw*, [1940] A.C. 701, 740.

⁸⁶ *Allen v. Gold Reefs of West Africa, Limited* [1900] 1 Ch. 656. See Satish, “Alteration of the Articles of Association.”

whose owners had overdue debts to the company. Lord Justice Vaughan Williams, one of the leading company law jurists of the era, explained that there were limits to the changes that companies could make to their articles:

I think that we are all agreed that cases might occur in which a member might have acquired, by contract or otherwise, special rights against the company which would exclude him from the operation of the altered article... A resolution may alter the regulations of a company but cannot retrospectively affect existing rights. I also take it to be clear that the alteration must be made in good faith; and I take it that an alteration in the articles which involved oppression of one shareholder would not be made in good faith.⁸⁷

In other words, if shareholders used the amendment process to advance their self-interest, the courts would invalidate their action, even if the shareholders had followed appropriate statutory procedures.

As the case of *Shuttleworth v. Cox Brothers and Company (Maidenhead), Limited* (1927) would demonstrate, moreover, the *Gold Reefs* precedent could apply even in cases where the majority moved to oust an entrenched director. Cox Brothers and Company's articles had named several individuals as permanent directors. Following a dispute involving one of them, the shareholders voted to amend the articles to enable him to be dismissed, and he was subsequently removed from office. The lower court, the jury, and the minority on the Court of Appeal all saw the amendment as a product of bad faith. The majority on the Court agreed that the test of good faith articulated in *Allen v. Gold Reefs of West Africa* applied, but it held that the plaintiff had not

⁸⁷ *Allen v Gold Reefs of West Africa, Limited* [1900] 1 Ch. 656. In this case Justices Lindley and Romer accepted the principle stated by Vaughan Williams, but whereas Vaughan Williams viewed the amendment as enacted in bad faith, the majority held it to be in good faith and valid.

met the burden of proof in this particular case. If the plaintiff had met the test—that is, if he had demonstrated that the majority had acted in bad faith or to the detriment of the company—the remedy could have gone beyond assessing damages for breach of contract to invalidating the amendment and enjoining the shareholders from removing the entrenched director from office.⁸⁸

In sum, British courts maintained their commitment to enforce the literal words of the statute by refusing as a general rule to issue injunctions against legally enacted amendments. If the amendments reneged on contracts embedded in the original articles, the courts were willing to provide parties harmed by them with monetary remedies. Only if the amendments violated central principles of company law, were the courts willing to go further and specifically enforce the preexisting contract.

Conclusion

The differences between British and American corporate law that were so strikingly apparent in the first wave of general incorporation statutes narrowed over time. Nonetheless, they were remarkably persistent as late as the 1930s and even beyond. When the noted British company-law jurist L. C. B. Gower visited the United States during the 1950s, for example, he was stunned to observe the extent of the restrictions still embodied in state incorporation laws. “To an Englishman,” he noted, “it seems strange that corporate codes, such as that of Delaware, which are notoriously lax in failing to provide important safeguards against abuses, should nevertheless be strict in matters which seem to us to be essentially for the parties themselves to settle.” British law, he remarked, was fundamentally contractual. It provided incorporators with “a standard form which applies only in the absence of contrary agreement by the parties.” The

⁸⁸ *Shuttleworth v Cox Brothers and Company (Maidenhead), Limited, and Others* [1927] 2 K.B. 9.

American statutes, by contrast, tended “to lay down mandatory rules” and, as a result, were “much less flexible.”⁸⁹

The legal origins literature has attributed much economic significance to the common-law tradition that Britain and the United States shared, connecting it causally with successful economic development. Contrary to the expectation one might derive from this scholarship, however, we find that this shared tradition did little to shape corporation law in Britain and the United States. Rather, corporation law was for the most part a matter of statute. Moreover, the formative general incorporation laws enacted in the two countries in the middle of the nineteenth century were fundamentally different. As much as one might have expected, given the literature on the efficiency of the common law, to find that the courts in the two countries reduced the areas of dissimilarity once they took over responsibility for interpreting and applying the law, such convergence as there was resulted more from the enactment of new statutes than from the judicial decision-making. Dispute resolution based on statutory interpretation is a different exercise from adjudication based on common-law principles, and by the middle of the nineteenth century, the theories, methods and canons of statutory interpretation in the two countries had diverged sharply. Why they diverged is beyond the scope of the article, but the literature on statutory interpretation suggests that the divergence was exogenous to the development of corporate law.⁹⁰ Regardless, once the very different incorporation acts were subjected to these divergent methods of statutory interpretation, the outcome was anything but convergence.

Although courts in the United States felt much freer to decide cases involving corporations on

⁸⁹ Gower, “Some Contrasts,” 1372, 1376-1377. As late as 1989 corporate law specialists in the United States were debating the extent to which the statutes should be modified to allow incorporators to write articles of association that differed from the standard rules. See Bebchuk, “Debate on Contractual Freedom,” his foreword to a special issue of the *Columbia Law Review* devoted to that subject.

⁹⁰ Again, see Healy, “Legislative Intent a”; and Bennion, *Understanding Common Law Legislation*.

the basis of their own assertions about public policy, their decisions generally reinforced the restrictive character of the various U.S. statutes, perhaps because judges shared many of the same larger political concerns about corporations that drove legislative enactments. In Britain, by contrast, the courts' greater adherence to the letter of the statutes led judges to bolster the contractual character of British law. Although some British judges too may have had ideological commitments to notions of contract that made this outcome more likely, their strict rules of statutory interpretation meant that they generally upheld modifications to the articles that conformed to statutory rules, even when doing so undermined contractual principles, unless the amendments violated a central tenet of company law.

One important consequence of these differences in legal rules was that incorporators of registered companies in Britain had much greater ability to ensure ongoing control over their enterprises than did their counterparts in the United States. They also had much greater ability to determine the identity of those with whom they were associated in business. More research is needed to understand the implications of these differences for the operation of the two economies. It is possible that British legal rules facilitated innovation by giving entrepreneurs access to capital without threatening their ability to control their businesses. But it is also possible that British legal rules protected stodginess. Such matters can only be resolved by detailed comparative work on the demography of companies in the two countries. Because it is likely that the differences in rules had their greatest impact on small- and medium-sized companies whose shares tended to be closely held, answering such questions will require

scholars to find move beyond the large, publicly traded firms for which information is most readily available and find ways of measuring the performance of smaller enterprises.⁹¹

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⁹¹ Again it is important to emphasize that this degree of contractual flexibility did not apply to the statutory companies covered by the CCCA. The performance of these large, publicly traded companies is comparatively easy to follow.

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