Contractual Flexibility within the Common Law: Organizing Private Companies in Britain and the United States

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Abstract: There is now a large literature arguing that shareholders are better protected against abuse by corporate insiders in common-law than in civil-law countries, especially those with legal systems modeled on the French code. There is also a growing literature critiquing this view, to which we have contributed. In this paper we continue that work of criticism by questioning the idea that common law countries followed broadly similar legal trajectories. In particular, we show that corporate law developed in a fundamentally different way in Britain than in the United States, so that founders of British corporations had much more contractual freedom than their counterparts in the U.S.

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There is now a large literature arguing that shareholders are better protected against abuse by corporate insiders in common-law than civil-law countries, especially those with legal systems modeled on the French code. There is also a growing literature critiquing this view.[1] In previous work with Timothy Guinnane and Jean-Laurent Rosenthal we contributed to this critique by showing that preoccupation of the so-called "law and finance" school with governance in large public corporations had obscured the wider menu of organizational forms available in civil-law countries. This wider menu is important if one looks beyond large public corporations to consider the problem of protecting investors in small- and medium-size enterprises (SMEs). Indeed, from the standpoint of SMEs, the most important innovation historically was the creation of the private limited liability company (PLLC). Germany passed enabling legislation for this form as early as 1892. Britain created its own version in 1907, and many civil-law countries followed suit in the early twentieth century, including France in 1925. Business people in the United States only gained access to the form at the very end of the twentieth century.[2]

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[1] This literature was sparked by two articles by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny: "Legal Determinants of External Finance," *Journal of Finance*, 52 (July 1997): 1131-50; and "Law and Finance," *Journal of Political Economy* 106 (Dec. 1998): 1113-55. For recent surveys, see Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, "The Economic Consequences of Legal Origins," *Journal of Economic Literature* 46 (June 2008): 285-332; and Mark J. Roe and Jordan I. Siegel, "Finance and Political: A Review Essay Based on Kenneth Dam's Analysis of Legal Traditions in *The Law-Growth Nexus*," *Journal of Economic Literature* 47 (Sept. 2009): 781-800.

[2] Timothy W. Guinnane, Ron Harris, Naomi R. Lamoreaux, and Jean-Laurent Rosenthal, "Pouvoir et propriété dans l'entreprise: pour une histoire internationale des sociétiés á responsabilité limitée," *Annales: Histoires, Sciences Sociales* 63 (janvier-février 2008): 73-110. (An English version available as "Ownership and Control in the Entrepreneurial Firm: An International History of Private Limited Companies," Yale University Economic Growth Center Discussion Paper #959 [December 2007], http://www.econ.yale.edu/growth_pdf/cdp959.pdf.)

The radically different histories of the PLLC in Britain and the U.S. spurred us to question the practice of treating these two common-law countries as essentially the same. Here we challenge this coupling further by examining the different ways in which the regulation of corporate governance has evolved in the two countries. A key assumption underpinning the law and finance literature is that there is an ideal, or efficient, set of legal rules that maximizes shareholders' protection. However, rules that optimally protect shareholders in large public corporations may have a different, perhaps even a harmful, effect on small private companies. Consider the index of "antidirector rights" compiled by Rafael La Porta, Florencio Lopez-de Silanes, Andrei Shleifer, and Robert W. Visny (hereafter LLSV) for their influential article, "Law and Finance." All of the variables in their index are weighted equally, yet their importance for SMEs can vary dramatically. On the one hand, whether the law allows proxy voting by mail may be irrelevant for the operation of small, partnership-like corporations. On the other, whether the law gives existing stockholders preemptive rights to new shares might be critical for maintaining the balance of power in such enterprises. Another component of the index measures whether corporations are forbidden by law to require shareholders to deposit their stock in advance of general meetings. LLSV consider such practices harmful because they block trading during periods when there may be contests for control. In small, closely held companies, however, members may have a vital interest in regulating the transferability of shares under any and all circumstances. Legal mechanisms that give oppressed minority shareholders access to the courts are clearly important for firms of all sizes, but in small enterprises their use might effectively force the dissolution and even the liquidation of an otherwise profitable business. Better to nip oppression in the bud by giving minority investors voice, as well as the ability to exit. Often the best way to accomplish this end, however, is to set up voting rules that deviate from the one-share-one-vote standard that LLSV code as pro-investor.

Our aim in this paper is not to correct LLSV's variables or construct an alternative index. To the contrary, we doubt that it is possible to put together a one-size-fits-all index of legal rules that captures the needs of investors in large, publicly traded enterprises as well as those in small, closely held private firms. Unlike investors in large public corporations, members of SMEs must typically balance a series of tradeoffs: the desire to have veto power over important decisions versus the risk of deadlock; the wish to keep one's job in the business versus the fear of entrenching incompetent employees; the need to be able to exit versus the risk of facilitating an untimely dissolution. Investors in SMEs are better served by laws that offer them flexibility to solve their contracting problems in unique ways—for example, by requiring supermajority votes for some but not all corporate decisions, or by regulating the transferability of shares under specific sets of circumstances.

It is our contention that, for most of modern history, British law afforded members of corporations a much greater degree of contractual freedom than did U.S. law. After spending a year at Harvard during the 1950s, the great scholar of British company law, L.C. B. Gower, concluded that general incorporation statutes in the U.S. were much more prescriptive than their British counterparts:

> Whereas the American statutes tend to lay down mandatory rules, the British Companies Act relies far more on the technique of the Partnership Act, providing a standard form which applies only in the absence of contrary agreement by the parties. Much that in America is mandatory is in Britain included only in the optional model constitution—the famous table A. And this constitution, or whatever the parties substitute for it, is expressly declared by the act to bind the company and the members as if it were a contract under seal.[3]

[3] L. C. B. Gower, "Some Contrasts Between British and American Corporation Law," Harvard Law Review 69 (June 1956): 1369-1402. The quote is from p. 1376.

Gower based his generalization largely on a comparison of the 1948 Companies Act with contemporaneous American statutes. In this paper we adopt a wider time frame and compare the evolution of British and U.S. law from the first introduction of general incorporation statutes in the middle of the nineteenth century to roughly the eve of the Great Depression. Corporate governance in the U.S. was largely a matter of state rather than federal law, and there was considerable variation in the content of general incorporation statutes across jurisdictions. We focus our study on a set of states that were important industrial centers, innovators in the area of corporate law, or both: Delaware, Illinois, Massachusetts, New Jersey, New York, Ohio, and Pennsylvania. We then complement our analysis of statute law in the two countries with a survey of the relevant case law. Our aim throughout is to explore the consequences of the legal rules for small private companies, not just large public ones. We are particularly interested in understanding the extent to which members of SMEs were able to adjust the corporate form to meet their particular contracting needs.

As we show, by the time Gower visited Harvard in the 1950s, the differences in corporate law in the two countries had actually narrowed considerably compared to where they had started a century earlier. General incorporation statutes in the two countries followed fundamentally different models from the very beginning. The first American statutes were highly restrictive in that they included a number of provisions limiting the size of firms and the types of businesses in which they could engage. They were also restrictive in the extent to which they prescribed a specific internal governance structure for corporations, mandating, for example, that corporations were to be managed a board of directors, setting the qualifications for those directors and their minimum and maximum number, and laying out the voting rules for their selection By contrast, British company law imposed no constraints on size and type of business and few on corporate governance. The path breaking 1862 Company Law included a set of default governance provisions in an appendix, allowing incorporators to opt out of any or all of them and write their own rules. The greater flexibility of the British statutes was a benefit to entrepreneurs associated with SMEs. Although in neither country was the law written with small firms in mind, the British rules could be more easily adapted to the needs of small businesses than could the more rigid U.S. statutes. Moreover, the British courts were willing to ratify those uses.

Small business people in the U.S. pushed back against the constraints of statute by adding novel provisions to their articles of association and bylaws or by writing side contracts. Although the impulse of the courts was to enforce statutory norms and find these innovations "contrary to public policy," over time the case law chipped away at these rigidities so that it became possible to a greater extent than before for members of SMEs to insure that they would retain a voice in running their enterprises and influence the identity of their business partners. Nonetheless, more than a century after the advent of general incorporation the differences in the degree of contractual flexibility in the two countries remained striking—so much so that when Gower visited the U.S. he could not help but "reflect on the contrasts and comparisons between the American law and the corporate law and practice of his native land."[4]

The Evolution of Statutory Law in Britain

The 1844 Registration, Incorporation and Regulation Act switched Britain from a regime of incorporation at the State's discretion by special charters and private acts to a regime of general incorporation by registration. The Act was drafted by a committee chaired by William Gladstone. Gladstone was at the time the young President of the Board of Trade in Robert Peel's

[4] Gower, "Some Contrasts between British and American Corporation Law," 1369.

liberal Tory administration, a conservative just turned into liberal, and a future Prime Minister.[5] The first years of Peel's administration were short lived heyday of free trade and *laissez-faire*. Gladstone's Act replaced traditional State inspection and discretion at the incorporation stage with freedom of incorporation, public information and investor discretion. Parliament already experimented with the concepts of registration and public disclosure in other contexts for a couple of decades before applying it in the General Incorporation Act of 1844.[6] Registration with the Companies Registry Office required filing a few documents and forms that provided the public with basic information about the company.[7] The information included a deed of settlement, names of shareholders and directors, a prospectus issued to the public, and annual accounts and balance sheets.

1844 was a highpoint in terms of disclosure. The Act of that year devoted many of its sections to that topic, distinguished between provisional registration and complete registration (allowing only those companies that completed the disclosure the later status), and authorized the Companies Registrar to refuse or annul registration of a company that did not meet the disclosure requirements. But, as it turned out, the requirements for disclosure of the prospectus, accounts and balance sheet were soon bypassed and not enforced. They were officially abolished in 1847 and 1856.[8] The 1855-56 Companies Acts provided general limited liability.[9] The consolidated

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[5] RON HARRIS, INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844 277-285 (2000); BISHOP CARLETON HUNT, THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND 1800-1867 90-115 (1936).
[6] RON HARRIS, INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844 274-277 (2000).
[7] The Joint Stock Companies Act, 1844, 7 & 8 Vict. C. 110. Some of the information had to be provided at the initial provisional registration stage and the rest was required in order to achieve full incorporation. Winding up of companies was regulated by a separate act The Joint Stock Companies Act, 1844, 7 & 8 Vict. C. 111.
[8]The Law imposed more significant requirements, including reporting of liabilities and assets, on banking and insurance companies.
[9]

1862 Act, which included general limited liability and minimal disclosure requirements, was the basis for statutory company law for the rest of the nineteenth century.

The new general incorporation by registration regime required the creation of new constitutional instruments. In the previous regime the constitution of the corporation was fixed in the royal charter or private act. It was made operational by the promulgation of bylaws that were issued by the corporation based on specific authority granted in that charter or act. These bylaws were inferior to the charter/act. The 1844 Act was the first to introduce the concept of two formative constitutional documents drafted and signed by the incorporators according to guidelines provided in the Act. The terminology in that Act was "Deed of Settlement" and "Bye Laws." The division of labor between the two documents allocated a lot to the Deed of Settlement. Schedule A to the Act listed the issues that had to be covered by the Deed, mostly internal governance issues. But it was drafted as a guideline or a template and not as default rules.[10] The act added that the Deed may contain "provisions for such other purposes (not inconsistent with Law) as the parties to such Deed shall think proper." The 1856 Act already used the terms adopted afterwards in the 1862 Act, a similar division of labor between the two documents, a template for the Memorandum in Schedule A and default Articles of Association in Schedule B.[11] As the 1856 Act was in force for just six years and the 1862 Act was in force until 1907, we will make references below, when examining the level of contractual flexibility offered in Britain, to the 1862 Act.

In the new regime, that was in the making in the 1844 Act and was fixed in the 1856 and 1862 Acts, the Memorandum of Association replaced the charter and the Articles of Association replaced the bylaws. The Memorandum was prescribed by the 1862 Act to settle five issues:

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[10] Companies Act 1844 Section VII and Schedules A & B.
[11] 1856 Act Sections V & IX and Schedules A & B.

Name of company, part of UK in which it was incorporated, objects of the company, limitation of liability of members and registered capital and its division to shares.

The Articles were to include "such regulations for the company as the subscribers to the memorandum of association deem expedient."[12] Both the memorandum and the articles had to be signed by the subscribers. The Act included as its first schedule a Table A entitled "Regulations for Management of a Company Limited by Shares." Section 15 of the Act set Table A as the default Articles of Association which were to apply unless the incorporators opted out of them in whole or in part. Section 16 of the Act said that the Articles "shall bind the company and the members thereof to the same extent as if each member had subscribed his name and affixed his seal thereto, and there were in such Articles contained a covenant on the part of himself … to conform to all the regulations contained in such Articles, subject to the provisions of this Act." This section was later interpreted as setting up the Articles as a contract, though as we will see below some jurists viewed the Articles as a contract only among the shareholders, while others viewed the Articles also as a contract between the shareholders and the company.[13]

The schematic normative hierarchy set by the Act was first the Act at the top, then the Memorandum, and finally the Articles that were subject to both. The Memorandum was more strongly entrenched than the Articles against future amendments. The rule was that a company could not alter its Memorandum, the two exceptions being that it could increase its capital or change name in a special resolution, which required a 75 percent super majority. Thus, its objects and type of shareholders' liability clauses were unalterable.[14] Articles of Association were as a

[12] 1862 Act section 14. The arrangements for companies limited by guaranty and for unlimited companies required the fixing of the liability regime. We will ignore here and thereafter such companies.
[13] Others read it more narrowly as aimed only at eliminating the expectation that future shareholders would actually sign the Articles.
[14] 1862 Act sec. 12, 13.

general rule alterable by a special resolution requiring a 75 percent majority.[15] It seems so far that the articles were a contractual instrument, which incorporators enjoyed a high level of contractual freedom in drafting at the incorporation stage and that down-the-stream amendments were more restricted. This level of contractual flexibility was achieved at the very early stages of general incorporation. As will be shown in the next section, U.S. general incorporation statutes during this period offered business people much less contractual freedom.

The Act itself was quite long: 212 sections. But only a few of them deal with internal governance. Most dealt with either the formation or winding up of companies and with the liability of the company and its shareholders towards creditors. Those that touched upon internal governance dealt mostly with voting rules and majority required for certain decisions. Voting rules were drafted as default rules. For example section 52 stated, “In default of any regulations as to voting every member shall have one vote.” Section 51 said, “In compounding the majority under this section, when poll is demanded, reference shall be had to the number of votes to which each member is entitled by the regulations of the company.”

The rest of the governance rules were set in Table A. Table A set issues such as capital and shares, meetings and votes, appointment, powers and meetings and resolutions of directors, dividends, accounts and audits. Table A was drafted with large public corporations in mind. It offered a full governance apparatus with strict formalities that did not suit a single person corporation, a family firm, or even a partnership-like close corporation. Table A included, as mentioned above, the default Articles of Association. Incorporators could opt out of these and replace them in whole or in part by Articles they drafted.[16] The division of labor between the Act

[15] Sec. 50.
[16] For actual opting out see Ron Harris, The Private Origins of the Private Company: Britain 1862-1907 (SSRN).

and Table A and within the Act between mandatory rules and default rules was made in a manner that left most of the issues for the incorporators to agree upon contractually.[17]

This division of labor was maintained in later amendments. New mandatory rules were added mostly in order to protect investors from the public at the primary market IPO stage by reviving and expanding the disclosure requirements.[18] Some of the new rules added in the amendments aimed at improving creditor protection. But with respect to internal affairs amendments mostly aimed at following common practices by adapting default rules to contractual patterns. This was most evident in the replacement of Table A of the 1862 Act with a somewhat reformed default articles of association in Table A the 1908 Act and again with minor alterations in the 1929 Act.[19]

The basic structure of Table A of 1908 followed that of 1862, and was somewhat longer—114 articles compared to 97. But there were some meaningful differences between the two. The 1908 Table A, unlike the 1862 Table A, devoted several articles to the regulation of different classes of shares having different attached rights, including preferred shares.[20] The 1862 Table A referred to the regulation of transfer of shares as a technical matter and mentioned only one cause for refusal of transfer—indebtedness on the shares. The 1908 Table had a more elaborate treatment and empowered the directors to decline transfer of shares that were not fully paid to "a person they do not approve," even when transfer was due to death.[21] The 1862 Table A fixed as default a scaled voting rights scheme on a poll in the General Meeting: 1 vote for every

[17] See also R.C. Nolan, "The Continuing Evolution of Shareholder Governance", Cambridge Law Journal 2006, 65 (1), 92-127.
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[20] Articles 3, 4.
[21] Articles 20-23.

share up to 10, 1 vote for every 5 shares between 10 and 100, and 1 vote for every 10 shares above 100.[22] The 1908 Table A default was 1 vote per share.[23]

The motivation for amending Table A was explained by the Committees that considered amendments to the Companies Act in 1895 (the Davey Committee) and 1906 (the Warmington Committee). The first recommended that it "would be of value to many new companies if Table A were amended so as to make it conform more closely to modern practice and business requirements."[24] It recommended that the Board of Trade amend Table A, but this recommendation was never followed. The second committee concluded, "The regulations in Table A having now been in force unaltered for more than forty years, it is found and have for many years been found that in practice they require considerable alteration to make them available for the usual requirements of a company."[25] This approach corresponded to what used to be the common wisdom among law-and-economics scholars: that default rules should follow what incorporators wanted.[26]

Until the end of the nineteenth century the flexibility built in to the Companies Acts generally met the needs of small enterprises as well as large, and many SMEs adopted the corporate form. Beginning around the turn of the century, however, the law increasingly distinguished large public companies from (usually) smaller private ones. In response to a series of scandals involving abuse of investors in large public companies, Parliament passed a new statute in 1900 that increased disclosure requirements for companies wishing to raise capital from the public and prescribed the content of the prospectus, which had to be registered. Companies had to provide information on the allotment of shares, particularly to promoters and

[22] Article 44
[23] Article 60.
[24] 1895 Report p. xviii sec. 61.
[25] 1906 Report p. 21 sec. 59.
[26] Easterbrook and Fischel but not Ayres and Gertner.

vendors, with special emphasis on shares not issued for cash. These requirements placed a considerable burden on public companies, reflected in the following years by both trying to work through loopholes in the prospectus requirement and a decrease in the number of company registrations. But they did not affect companies that did not wish to raise capital from the public, companies that were called in the contemporary jargon private companies.[27] One significant disclosure requirement placed on all companies including private companies in 1900 was the requirement to register all mortgages and charges. Another requirement of the 1900Act was the appointment of auditor for every company. The auditor had to review the balance sheet. The 1907 Companies Act added another significant requirement, but only relating to public companies: balance sheets had to be filed with the Companies Registrar and made available to the public.[28] This enhanced disclosure requirement sharpened the distinction between private and public companies. The 1907 Act introduced for the first time the private company as a legally recognized organizational form. A company that met three requirements, namely that its articles of association prohibited inviting the public to subscribe to its share and debenture capital, restricted the transferability of its shares, and limited the number of its shareholders to fifty, was qualified as a private company. A private company could be formed with only two shareholders compared to seven shareholders in the past and in the public company.[29]

Now the incentive for incorporating SMEs increased. The mandatory rules applying to IPOs and disclosure with respect to public companies were tightened in 1900 and 1907. Private companies could be formed legally with only two shareholders and enjoy limited liability and

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[27] But no requirement was yet made in 1900 to disclose the balance sheet to shareholders or to the public. See Leslie Hannah, *Pioneering Modern Corporate Governance: A View from London in 1900* 8 Enterprise and Society 653 (2007).

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

[29] Companies Act, 1907, 7 Edw.7 c.50, s. 37(1).

related advantages such as the ability to use floating charges.[30] The basic division in the Act between a few mandatory rules that protected creditors and investors in IPOs and a wealth of default rules that dealt with internal governance to be found in Table A was maintained through the 1907, 1908 and 1929 Acts. Default rules were amended in 1908 to suit common practices. The increased demand for incorporation, in its newly introduced private company form, also increased the demand for contractual flexibility that would allow incorporators of sole proprietorships, family firms and partnerships to tailor the articles of companies to their specific needs. Ambiguities remained only with respect to a few rules in the Act that were not clearly drafted as mandatory or default. These were typically rules that combined relationship with creditors and internal management affairs. To these rules and the ongoing process of their interpretation by courts as default or mandatory over the period discussed in this paper we will return when discussing the case law below.

The Evolution of Statutory Law in the United States

As in Britain, corporations could only be formed in the U.S. in the early nineteenth century by special legislative act. Although some of the American states chartered large numbers of corporations during this period, opposition quickly mounted to the practice. By their very nature, corporate charters were grants that enabled a small group of citizens to operate under advantages that their competitors did not possess. The most basic of these advantages, of course, was legal personhood—the right to hold property and sue or be sued in the corporate name. Many early charters also granted shareholders limited liability, and there were other potential boons whose extent and value varied from case to case. Bank charters, for example,

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[30] See Ron Harris, The Private Origins of the Private Company: Britain 1862-1907 (SSRN).

invariably included the right to issue currency in the form of bank notes. Similarly, charters for turnpike, bridge, and canal companies typically conveyed powers of eminent domain, as well as the right to levy tolls on a particular route.

Some critics proposed abolishing corporations entirely; others advocated the passage of general incorporation laws that would eliminate the element of privilege by enabling any group that wanted one to obtain a charter for their venture. Although both options were tried at different times and places and for different types of corporations, in the end the second policy won out—in part because there was broad interest in participating in corporate ventures, and in part because states that chartered large numbers of corporations earned fees that enabled them to reduce the property-tax burden on their citizens.[31]

The general incorporation acts passed during first wave of statutes typically applied only to a limited set of industries. For example, Ohio's 1846 law targeted companies engaged in mining or in the manufacture of an enumerated set of commodities that ranged from "iron from ore, bar or other iron, steel, or manufactures of wire" to "pins, buttons." Similarly, Pennsylvania's 1845 act specified companies "carrying on the manufacture of woolen, cotton, flax or silk goods, or of iron, paper, lumber or salt." Because the aim of these statutes was to level the economic playing field, they were full of restrictions on the scale of enterprise. Ohio's law put a ceiling on capitalization of $200,000. Massachusetts's 1851 statute imposed the same

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[31] On this latter point, see John Joseph Wallis,. Richard E. Sylla, and John B. Legler, "The Interaction of Taxation and Regulation in Nineteenth-Century U.S. Banking," in *The Regulated Economy: A Historical Approach to Political Economy*, eds. Claudia Goldin and Gary D. Libecap (Chicago: University of Chicago Press, 1994), 121-44. There is a large literature on the early history of American corporations, but see especially Louis Hartz, *Economic Policy and Democratic Thought: Pennsylvania, 1776-1860* (Chicago: Quadrangle Books, 1948); Oscar Handlin and Mary Flug Handlin, *Commonwealth: A Study of the Role of Government in the American Economy* (Rev. edn.; Cambridge: Harvard University Press, 1969); James Willard Hurst, *The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970* (Charlottesville: University Press of Virginia, 1970); Pauline Maier, "The Debate over Incorporations: Massachusetts in the Early Republic," in *Massachusetts and the New Nation*, ed. Conrad Edick Wright (Boston: Massachusetts Historical Society, 1992), 75-81; and Maier, "The Revolutionary Origins of the American Corporation," *William and Mary Quarterly* 50 (Jan. 1993): 51-84; and John Joseph Wallis, "Constitutions, Corporations, and Corruption: American States and Constitutional Change, 1842 to 1852," *Journal of Economic History* 65 (Mar. 2005): 211-56.

limit, and Illinois's 1857 law put it at $500,000. Pennsylvania prohibited corporations from owning more than 2,000 acres of real estate and specified that a company's liabilities could not exceed three times the amount of capital actually paid in. New York's statute of 1848 limited a company's debts to the amount of its paid-in capital, as did the 1849 laws of New Jersey and California. Most statutes also limited the duration of charters. Pennsylvania corporations had a maximum life of twenty years, Ohio forty years, and New York, Illinois, and California corporations fifty years. In addition, legislatures assured their continued control over corporations by embedding reservation clauses in charters that gave them the right to revise the rules at any time.[32]

In contrast to the British case, the general incorporation laws passed by the various U.S. states during this period retained the old hierarchical relationship between the constitution of the corporation, embodied in its charter, and the bylaws, which governed the day-to-day operations of the company. Moreover, because legislators were so intent on curbing the economic power of large enterprises, the statutes standardized the provisions of charters in a way that allowed for very little contractual freedom. For the most part incorporators had to adopt the governance provisions laid out in the acts exactly as written. In Pennsylvania, for example, a company's board of directors had to consist of five to thirteen members, a majority of whom must be citizens of the state; shareholders were entitled to one vote per share up to a maximum of one

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[32] California's law also imposed proportional unlimited liability on shareholders. See *Acts of a General Nature Passed by the Forty-Fourth General Assembly of the State of Ohio, Begun and Held in the City of Columbus, December 1, 1845* (Columbus: C. Scott and Co., 1846), 37-40; *Laws of the State of New-York Passed at the Seventy-First Session of the Legislature* (Albany: Charles Van Benthuysen, 1848), 54-61; *Laws of the General Assembly of the Commonwealth of Pennsylvania, Passed at the Session of 1849* (Harrisburg: J. M. G. Lescure, 1849), 563-69; Lucius Q. C. Elmer, *A Digest of the Laws of New Jersey: Containing All the Laws of General Application, Now in Force, from 1709 to 1855, Inclusive, with the Rules and Decisions of the Courts,* annotated by John T. Nixon (2nd edn.; Philadelphia: J. B. Lippincott & Co., 1855), 456-62; *Statutes of California, Passed at the First Session of the Legislature* (San Jose: J. Winchester, 1850), 347-76; *General Laws of the Commonwealth of Massachusetts Passed Subsequently to the Revised Statutes* (Boston: Dutton & Wentworth, 1854), Vol. 1, 660-64; *The Revised Statutes of the Commonwealth of Massachusetts, Passed November 4, 1835* (Boston: Dutton & Wentworth, 1836), 327-34, 362-66; *Laws of the State of Illinois, Passed by the Twentieth General Assembly Convened January 5, 1857* (Springfield: Lanphier & Walker, 1857), 161-65.

third of the total number of shares; and directors were elected by a plurality of the votes. The laws of most other states were similarly restrictive. All specified a minimum number of directors, and most specified a maximum number and also set their qualifications, requiring them to be stockholders and fixing the proportion that must be residents of the state. Most also prescribed the voting rules to be followed in elections for directors—usually one vote per share with a plurality deciding the outcome. Of the states surveyed for this paper, only Massachusetts and New Jersey allowed corporations to determine in their bylaws the number of votes each stockholder was allowed to cast.

Corporations chartered under these general laws had to file certificates in which they described their business and stated the amount of their authorized capital and the number and par value of their shares. The statutes sometimes specified a procedure for changing aspects of these filings. For example, it was common to require a vote of two-thirds of the shares to increase or decrease a company's authorized capital stock (within the permissible limits). However, the statutes were often silent on at least some types of changes, and most neglected to specify a procedure for voluntarily winding up the corporation's affairs, leaving such matters to the common law. At this time, the courts typically required unanimous consent to change a fundamental aspect of the firm's business or to dissolve a corporation, so these silences added to the statutes' inflexibility.[33]

In most states business people who wanted to escape the restrictions imposed by these laws or to organize under different governance provisions could still apply for special charters from their legislatures. A few states (Ohio is the most prominent example) enacted

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[33] Edwin Merrick Dodd, *American Business Corporations until 1860: With Special Reference to Massachusetts* (Cambridge: Harvard University Press, 1954), pp. 139-40, 184-85, 191-92, 361; William J. Carney, "Fundamental Corporate Changes, Minority Shareholders, and Business Purposes," *American Bar Foundation Research Journal* 1980, no. 1 (1980): 69-132.

constitutional provisions banning special charters at around the same time as they passed their first general incorporation laws, but most gave businesses the option of taking out charters under the general laws or securing special legislation.[34] During the middle decades of the nineteenth century state legislatures passed literally thousands of bills each year in response to applications for special charters. Very few of these charters went to the kinds of small, closely held companies whose contracting problems are the focus of this paper. Rather the vast majority were transportation companies, utilities, and financial institutions whose incorporators probably planned to raise at least some portion of their capital from outside investors. The special provisions in these charters dealt primarily with matters critical to the success of these kinds of business, such as the acquisition of land for right of ways or the specification of the kinds of assets in which it was permission to invest company funds. They rarely included governance clauses of the sort likely to be important for closely held companies, such as supermajority voting rules or restrictions on the transferability of shares. Indeed, the only provisions aimed at protecting shareholders' interests that one finds with any frequency in special charters were those important to investors in large firms, such as the requirement that directors provide shareholders with annual financial reports.[35]

Thus legislators' experience with special charters did little to educate them about the needs of investors in small, closely held corporations. To the contrary, because special charters continued mainly to be sought by firms operating in politically sensitive industries such as banking and transportation, these grants kept political discussion focused on the unfair advantages that the wealthy and powerful could secure by lobbying their legislators. The large numbers of special charters passed despite the enactment of general incorporation laws

[34] See Susan Pace Hamill, "From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations," *American University Law Review* 49 (Oct. 1999): 81-180.
[35] These generalizations are based on an ongoing analysis of a sample of special charters from the 1870s.

convinced critics that stronger medicine was needed to cure the body politic of this form of corruption. Beginning in the late 1840s and accelerating in the 1870s, they secured revisions to state constitutions that prohibited legislatures from granting special charters of incorporation. Two-thirds of the states had such provisions in place by the end of the century.[36]

The movement to ban special charters led to a second wave of general incorporation statutes in which legislators attempted to strike a delicate balance and accommodate the kinds of businesses that previously had sought private legislation without, at the same time, encouraging the growth of ever larger and more powerful corporations. Pennsylvania's 1874 general incorporation law is a good example. Following directly upon the ratification of a new constitution outlawing special charters, it imposed significant restrictions on firms adopting the corporate form as a way of limiting the economic power of large-scale enterprises.[37] Thus the statute retained clauses fixing the maximum amount of capital a firm could raise, the magnitude of its debt relative to its paid-in capital, and the extent of the real estate it could own. There was also a new provision prohibiting corporations chartered in the state from purchasing equity in other corporations. The statute no longer placed a ceiling on the number of shares large stockholders could vote, but it attempted to insure that minority owners would be represented on corporate boards by permitting them to cumulate their votes. Although the statute aimed to be comprehensive in its coverage and govern corporations "not for profit" as well as those formed for business purposes, it still listed the specific types of corporations that could organize under the law and included provisions that applied only to specific industries. For example, companies

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[36] Most of the New England states never adopted such provisions; nor did New York. But all the other leading industrial states did. Ohio adopted the provision in 1851; Illinois, Pennsylvania, and New Jersey during the 1870s; and Delaware in 1897. See Hamill, "From Special Privilege to General Utility," Appendix B, Chart 2.

[37] For the text of both the constitution and the statute, see *Constitution of the Commonwealth of Pennsylvania; Also Laws of the General Assembly of Said Commonwealth, Passed at the Session of 1874* (Harrisburg: Benjamin Singerly, 1874). See also Angelo T. Freedley, *The General Incorporation Law of Pennsylvania, Approved 29 April, 1874, and Supplementary Acts, with Notes, Forms and Index* (Philadelphia: T. & J. W. Johnson & Co., 1882).

governed by the section on "manufacture of iron or steel, or both, of any other metal, or of any article of commerce, from wood or metal, or both" had annually to "lay before the stockholders a full and complete statement of the business and affairs of the corporation for the preceding year," a requirement not imposed by the statute on most other types of corporation.

These restrictive provisions of the act coexisted uneasily, however, with others that pointed in the direction of the more permissive statutes that some states would pass later in the century—statutes that would shift the balance of power in favor of controlling shareholders. For example, although by default Pennsylvania's statute assigned the power to make bylaws to shareholders, it was now possible for a company to delegate this authority to its board of directors. There was also a trend toward voting rules that made it more difficult for minority shareholders to block important changes in policy. For example, a simple majority in interest of the stockholders was all that was required under the 1874 statute to increase or decrease the firm's capital (within the limits set by the act). It was also all that was needed to create a new class of preferred stock.

New Jersey's 1849 general incorporation statute had been the most permissive of the first wave, and the state continued to represent the upper bound of flexibility. In contrast to Pennsylvania's statute, New Jersey's new law (passed in 1875, the same year as a constitutional amendment barring special charters) allowed corporations to be formed for any lawful purpose and placed no restrictions on the amount of capital they could raise, the sums they could borrow, or the acreage of real estate they could own.[38] Incorporators also had more freedom to shape the governance structure of their companies. The act set certain default rules, but the incorporation

[38] On the constitutional amendment, see John W. Cadman, Jr., *The Corporation in New Jersey: Business and Politics, 1791-1875* (Cambridge, Mass.: Harvard University Press, 1949). For the statute, see *Revision of the Statutes of New Jersey. Published under the Authority of the Legislature by Virtue of an Act Approved April 4, 1871* (Clark, N.J.: Lawbook Exchange, 2005), 174-97. Neither Pennsylvania nor New Jersey imposed limits on the duration of charters.

certificate (or sometimes the bylaws) could specify alternatives. The quorum for stockholders' meetings was a majority of the shares, unless the bylaws indicated otherwise. Similarly, each member of the firm had one vote for each share owned, unless the certificate allocated voting rights differently. Although New Jersey law required a two-thirds vote to increase a corporation's capital beyond that specified in its certificate, issue a new class of preferred shares, or voluntarily dissolve the corporation, the certificate could specify a different voting threshold to move into a new line of business or decrease capitalization. More significantly, the certificate could include "any limitation upon the powers of the corporation, the directors, and the stockholders that the parties signing the same desire," so long as these limitations did not "attempt to exempt the corporation, the directors, or the stockholders, from the performance of any duty imposed by law."

New Jersey's 1875 law thus broke with previous American practice and instituted procedures that were much more like those inscribed in company law in the United Kingdom. Although the New Jersey legislature did not lay out anything like Britain's model Table A, a company's certificate of incorporation could now include deviations from those rules that the statute treated as defaults, as well as the types of information that British corporations recorded in their Memoranda of Association. As in the U.K., there was much more contractual flexibility at the time of incorporation than later on. Indeed, unlike later revisions of the statute, the 1875 act did not include procedures for amending the articles that had been written into the certificate. This silence meant that such matters were left to the common law, which the courts still generally interpreted as requiring unanimous consent.

The laws of most other state were closer to Pennsylvania's during this period than to New Jersey's. New York corporations could not have more than $2 million in capital, could not issue bonds beyond one-half the value of their property, and were limited in duration to fifty years. Stockholders could specify in their bylaws the quorum required for annual meetings and the manner in which the bylaws could be amended. But all other governance matters were set by statute or left to common-law rules. In elections for directors (who had to number between five and thirteen and be stockholders owning at least five shares apiece), each shareholder was "entitled to as many votes as shall equal the number of his shares multiplied by the number of directors to be elected and he may distribute his votes among those to be voted for as he sees fit; and the persons receiving the greatest number of votes shall be directors." A majority vote was sufficient to increase or decrease the corporation's capital within the limits of the act, but the owners of two-thirds of the shares had to approve changes in the principal place of business or an extension of the corporation's life (within the fifty-year limit of the act).[39] Illinois corporations no longer bumped up against limits on capitalization, but they could not owe debts exceeding the amount of their capital stock and could not be chartered for more than ninety-nine years. Voting rules for directors were the same in Illinois as in New York, though the law allowed corporations to create staggered boards and a majority of shareholders could increase or decrease the number of directors.[40] Ohio corporations faced no limits on capital or on duration, but voting rules for directors ("not less than five nor more than fifteen") were the same as in New York and Illinois. The law required stockholders owning at least two-thirds of the shares to adopt or change bylaws, which could determine the quorum needed for a stockholders' meeting. Although Ohio corporations could incur debts up to the amount of their capital, they could only secure a maximum of half that amount with mortgages, which required "the written asset of not less than

[39] *Laws of the State of New York Passed at the Ninety-Eighth Session of the Legislature* (Albany: Hugh J. Hastings, 1875), 755-65.
[40] *Public Laws of the State of Illinois, Passed by the Twenty-Seventh General Assembly* (Springfield: Illinois State Journal Printer, 1872), 296-307.

three-fourths of the stockholders, representing at least three-fourths of the capital stock of the company actually paid." A majority of the shareholders could increase or decrease the corporation's capitalization, but it required the written assent of three-fourths of the shareholders, both in number and value of shares, to create a new class of preferred stock. Ohio permitted corporations in a limited set of mining and manufacturing industries to consolidate upon the approval of stockholders owning at least two-thirds of the shares of each company involved.[41] Massachusetts imposed limits on capitalization that varied with the type of enterprise and restricted the debts of a corporation to the amount of its capital, but its statute appears to be more flexible in allowing the bylaws to fix the number of directors (above a minimum of three) and set the rules for their election. Shareholders could also increase or decrease capital within the limits set by the act and, by a three-fourths vote create a special class of stock with a fixed dividend (though regular shareholders would bear personal liability for the corporation's debts until the special stock was redeemed).[42]

Although for some types of enterprises New Jersey's more flexible law might have had advantages over the laws of Pennsylvania and other jurisdictions, it was not yet common for companies to secure charters from a state other than the one in which their principal place of business was located. Then, as now, large firms were much more likely than small firms to move their chartering homes, but at this point in time large firms were disproportionately in sectors (transportation, finance, utilities) where successful operation depended on local rights

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[41] *The Revised Statutes and Other Acts of a General Nature of the State of Ohio in Force January 1, 1880* (Columbus: H. W. Derby & Co., 1879), 836-977.

[42] *Acts and Resolves Passed by the General Court of Massachusetts in the Year 1870* (Boston: Wright & Potter, 1870), 154-71; For a state by state summary, see William W. Cook, *Corporations as Created and Regulated by the Statutes and Constitutions of the Various States and Territories, Also of the Federal Government, and of England, Canada, France, and Germany* (New York: L.K. Strouse & Co., 1889). See also Frederic Jesup Stimson, *American Statute Law, Vol. II: An Analytical and Compared Digest of the Statutes of All the States and Territories Related to General and Business and Private Corporations In Force July 1, 1892* (Boston: Boston Book Company, 1892); and E. Merrick Dodd, Jr., "Statutory Developments in Business Corporation Law, 186-1936," *Harvard Law Review* 50 (Nov. 1936): 27-59.

(such as access to land for rights of ways or the ability to issue currency) that states typically conferred in corporate charters.[43] Although New Jersey's 1875 law specifically allowed companies to carry on part of their business out of state, it seems from the wording of the statute that the legislature included this provision as a convenience to firms based there and did not expect New Jersey to become a home for corporations located elsewhere. In any event, it accompanied this provision by quite burdensome registration requirements, requiring companies to imbed in their certificates of incorporation information on the proportion of their business that would be carried on outside New Jersey and the locations of all their out-of- state operations.[44]

As manufacturing firms grew in size during the late nineteenth century and acquired operating units in different parts of the country, the benefits of securing a charter from a state with more permissive laws increased. New Jersey tapped into this latent market with a series of amendments to its general incorporation act beginning in 1888. At this time, the law generally prohibited corporations from buying stock in other corporations, so the only way one firm could be acquired by another was for its stockholders to dissolve it and sell off its assets to the acquiring firm.[45] New Jersey remedied this problem by allowing corporations to hold stock in other corporations and by creating a set of rules under which mergers could occur: Stockholders owning at least two-thirds of the shares of each of the affected corporations had to approve the merger, and any stockholder who objected could demand to be bought out. New Jersey

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[43] Charles M. Yablon has argued that states did compete by means of special charters to incorporate particularly important railroads which ran through multiple jurisdictions. See "The Historical Race: Competition for Corporate Charters and the Rise and Decline of New Jersey: 1880-1910," *Journal of Corporation Law* 32 (Winter 2007): 331-32.

[44] Yablon compares the numbers of firms incorporated in New Jersey in the 1880s with those incorporated in other industrial states and argues that New Jersey's relatively permissive law attracted to the state a disproportionate share. He does not, however, specify a clear counterfactual or collect the data needed to see whether significant numbers of firms located elsewhere were choosing to domicile in New Jersey. Yablon, "Historical Race," 332-35.

[45] A few states allowed companies to own stock in other companies under special circumstances, for example to facilitate the building of spur lines from railroads to manufacturing facilities. See William G. Roy, *Socializing Capital: The Rise of the Large Industrial Corporation in America* (Princeton: Princeton University Press, 1997), 151-52.

simultaneously moved to attract out-of-state corporations by relaxing its registration requirements so that it was no longer necessary to do more than indicate in the articles of association that there would be operations in other states.[46]

New Jersey's statutory revisions were a combined result of the state's search for new revenue sources, of efforts by lawyers for Standard Oil and other trusts formed during the 1880s to find a more secure legal framework for their enterprises, and of the realization by corporate attorney James Brooks Dill that there was money to be made from chartermongering. Dill helped to guide the changes through the legislature and then, after they were passed, actively promoted the advantages of a New Jersey charter, setting up a new firm, The Corporation Trust Company, to handle the paper work for companies headquartered outside the state and to serve as their legal representatives in New Jersey. Dill's efforts paid off handsomely both for himself and for the state of New Jersey. Mergers that had previously resorted to the trust device now took out New Jersey charters, as did virtually all of the giant combinations formed during the merger waves of the period. Much of this business, as well as that of other firms flocking to New Jersey, went through Dill's firm. At the same time, tax revenues soared. By the end of the so-called Great Merger Movement in 1904, fully 60 percent of New Jersey's revenues came from incorporation fees and franchise taxes. Not only did New Jersey's budget moved from deficit to surplus, but the state was able completely to pay off its bonded debt and abolish property taxes on its citizens.[47]

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[46] See Christopher Grandy, "New Jersey Corporate Chartermongering, 1875-1929," *Journal of Economic History* 49 (Sept. 1989): 677-92. For the first amendments in 1888 see *Acts of the One Hundred and Twelfth Legislature of the State of New Jersey* (Trenton: MacCrellish & Quigley, 1888), 441-46. These and subsequent amendments were embodied in a complete revision of the state's general incorporation statutes in 1896. See *Acts of the One Hundred and Twentieth Legislature of the State of New Jersey* (Trenton: MacCrellish & Quigley, 1896), 277-317.
[47] Grandy, "New Jersey Corporate Chartermongering," 678-83; Yablon, "The Historical Race," 337-49.

New Jersey's success stimulated a number of other states, including Delaware, Maine, New York, South Dakota, and West Virginia, to revise their general incorporation statutes in order to compete for the business of attracting out-of-state charters.[48] It also had a profound effect on the content of general incorporation statutes elsewhere because even states that did not enter the competition wanted to keep hold of the revenues they received from corporations operating within their boundaries.[49] The Massachusetts legislature, for example, created a special commission in 1902 charged with examining the effect of the state's corporation laws "upon trade, commerce and manufacturers, … especially in respect to matters of taxation" in comparison with the laws of other states. The commission's report, the bulk of which dealt with tax matters, concluded that Massachusetts's general incorporation statute was "unsuited to modern business conditions" and, as a result, "during the past ten or fifteen years … the possibilities of incorporation in other States have become well known and have been availed of to the detriment of this Commonwealth." The commissioners drafted a completely new statute, modeled on the laws of New Jersey and Delaware and other chartermongering states, which was adopted by the legislature in 1903 almost as proposed.[50] Some states (Pennsylvania is a good example) did not undertake a complete revision of their general incorporation statutes at this time but met New Jersey's challenge with a series of amendments that gradually moved the law in the

[48] Yablon, "The Historical Race," 358-71. This competition in turn stimulated strong opposition from critics of the growing power of large-scale enterprises that made headway even in New Jersey, where progressive reformers succeeded in toughening up the law in 1913. After suffering several years of corporate defections and falling tax revenues, New Jersey's legislature repealed the reforms, but by then Delaware had secured its place as "the mecca of corporations." Grandy, "New Jersey Corporate Chartermongering"; Henry N. Butler, "Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges," *Journal of Legal Studies* 14(Jan. 1985): 129-66.

[49] Yablon, "The Historical Race," 370-71.

[50] See Commonwealth of Massachusetts, *Report of the Committee on Corporation Laws, Created by Acts of 1902, Chapter 335* (Boston: Wright & Potter, 1903). The quotes are from pp. 7, 19, 20. For the statutes, see *Acts and Resolves by the General Court of Massachusetts in 1903*, 418-56; *The Consolidated Laws of the State of New York* (Official edn.; Albany: J. B. Lyon Co, 1909), Vol. 1, 439-49, and Vol. 2, 1315-98.

new direction.[51] Others revised their statutes with a significant lag. Illinois, for instance, enacted its new law in 1919, and there was a burst of legislation in other states in the late 1920s and early 1930s.[52]

Because the new general incorporation statutes passed during this third wave aimed either to attract charters for big businesses or keep large enterprises from moving their corporate domiciles out of state, they no longer included restrictions on size. Gone were the ceilings on capitalization, debt to capital ratios, and real estate holdings. Gone too were the limits on duration. Although not all the new laws followed New Jersey's in abolishing the prohibition on owning stock in other companies, most established procedures that facilitated mergers and, at the same time, made it easier to make other fundamental changes to a corporation's affairs, such as issuing additional classes of shares, entering new lines of business, and even dissolving the enterprise. Replacing the old common-law emphasis on unanimous consent were rules that required some standard vote (usually two-thirds of the number of shares) to approve the change and set up a procedure for buying out disapproving shareholders.

The new laws moved closer to British practice in that more of their provisions were default rules that incorporators could modify in their articles of association or sometimes even in their bylaws. For example, the statutes typically allowed incorporators to specify such matters as whether the directors or the stockholders would enact bylaws, which body would select corporate officers, and what proportion of stockholders constituted a quorum at annual meetings.

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[51] See John F. Whitworth and Clarence B. Miller, *Statutory Law of Corporations in Pennsylvania* (Philadelphia: T. & J. W. Johnson & Co., 1902); and Whitworth and Miller, *The Corporation Laws of Pennsylvania, 1903-1905* (Philadelphia: T. & J. W. Johnson & Co. 1905). ##other states

[52] *Laws of the State of Illinois by the Fifty-First General Assembly* (Springfield: Illinois State Journal Co., 1919), 312-51. ##other states. See E. Merrick Dodd, Jr., "Statutory Developments in Business Corporation Law, 1886-1936," *Harvard Law Review* 50 (Nov. 1936): 27-59; Wiley B. Rutledge, Jr., "Significant Trends in Modern Incorporation Statutes," *Washington University Law Review* 22 (April 1937): 305-43; and Harwell Wells, "The Modernization of Corporation Law, 1920-1940," *University of Pennsylvania Journal of Business Law* 11 (Spring 2009): 573-629.

Delaware, Massachusetts, and later other states followed New Jersey in permitting the articles to include additional provisions regulating the powers of the corporation, the directors, and the shareholders so long as they were not inconsistent with the law. Intriguingly, however, many of the statutes in this third wave still rigidly prescribed one-share, one-vote rules for elections for directors. New Jersey and Delaware allowed incorporators to specify other rules, but the rest of the states did not, though most gave shareholders the right to cumulate their votes.

If the contemporary literature is an accurate guide, the increase in contractual freedom that the third wave of statutes conferred on incorporators seems primarily to have benefited controlling interests in large firms. Adolf Berle and Gardiner Means were only the most famous of an increasing chorus of critics who decried changes in the law that had transformed the corporation into "an arrangement by which many men have delivered contributions of capital into the hands of a centralized control."[53] Certainly, incorporators could now more easily concentrate power in the boards of directors by modifying the default rules to give directors authorship of the bylaws and reduce the quorum required for shareholders' meetings. Most of the laws allowed directors to entrench themselves by staggering their terms of service so that only a few stood for election in any given year. To make matters worse, most states dropped whatever requirements there had previously been to provide shareholders (or the state) with annual financial reports (here Massachusetts's 1903 act is a significant exception), and the lower vote thresholds for approving fundamental changes to a corporation's business made it more difficult for minority shareholders to block directors' initiatives.

The increased flexibility granted by the statutes seems to have been much less valuable for business people involved in SMEs. For example, members of closely held companies had to

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[53] Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (1968 edn.; New Brunswick, N.J.: Transaction Publishers, 2003). The quote is from p. 119. See also Dodd, "Statutory Developments in Business Corporation Law"; and Rutledge, "Significant Trends in Modern Incorporation Statutes."

worry about the identity of their business partners. They needed to be able to control who could own shares, but only Massachusetts permitted the articles of association to specify "the restrictions, if any, imposed on" the transferability of stock. Other states treated shares of stock as personal property that, by definition, were transferable at will. Similarly, minority members of closely held corporations worried about how to insure that they would have an ongoing voice in business decisions and how to protect themselves against oppression by controlling shareholders. The best way to do accomplish these ends was by requiring directors to be elected by supermajority votes, but as we have seen, most states' statutes still prescribed standard voting rules in which stockholders had one vote per share and the candidates with the most votes won. As we will see, this situation would not change until the post-World War II period, when high personal income tax rates spurred more small businesses to incorporate and also to push for legislative reforms.

Britain and the U.S. Compared

As late as the 1930s, therefore, general incorporation statutes in the U.S. granted members of the SMEs much less contractual freedom than did statutes in Britain. This difference was to a large extent a consequence of the different political context within which the statutes in the two countries had evolved. In the U.S. general incorporation laws were initially responses to charges of political corruption. They were the work of democratic movements that wanted to prevent politically well-connected entrepreneurs from securing privileges through special legislative acts that were not available to all businesses. Because they aimed both to provide open access to the form and to insure that large firms did not gain disproportionate advantages from this access, they both imposed severe restrictions on the scale of corporate enterprises and allowed organizers very little flexibility. In Britain, by contrast, enactment of the early Companies Acts was propelled by businesses' pent-up demand for access to the corporate form. Parliament had granted relatively few special charters during the early nineteenth century, so there was no equivalent backlash against the advantages obtained by a favored few. Instead, the Acts were responses to businesses and their needs, and so were much more laissez faire in their initial conception.

Although in neither country was the legislation written with small enterprises in mind, the greater flexibility of the British statutes meant that from the very beginning incorporators of SMEs had much greater ability to modify the form to suit their needs. Over time, moreover, British law evolved in ways that made the form much more suitable for small, closely held corporations. The most important changes occurred during the early twentieth century. In response to abuses by promoters of large public corporations, the Companies Act of 1900 imposed a costly new set of reporting and auditing requirements. Although corporations that did not issue their stock publicly were exempted from some of these requirements, the law imposed new costs on them as well. Protests by owners of small closely held corporations led in 1907 to a revision of the law that formally distinguished private from public companies, giving the former all the organizational tools they needed to resolve their contracting problems.

U.S. law, ironically, changed during the same period in ways that better met the needs of big business rather than SMEs. By the end of the nineteenth century the number of large manufacturing enterprises had grown sufficiently that chartermongering was a lucrative proposition for states in search of new revenue sources. As New Jersey, Delaware, and a few other states competed for the business of chartering corporations, they spurred other jurisdictions to revise their general incorporation statutes in ways that made them more friendly to large-scale-enterprises. Although these changes reduced some of the inflexibility that had long characterized corporate law in the U.S., they did little to improve the contracting environment for SMEs. Indeed, they may even have worsened things for minority interests in closely held companies by making it easier for majority shareholders to entrench themselves in positions of control.

Contractual Flexibility: The Minimum Number of Shareholders in Britain

Even in Britain there were aspects of company law that were not well suited to the needs of SMEs. Probably the most obvious were provisions that required there to be at least a specified number of incorporators. The 1856 Act and the 1862 Act required a minimum of seven members for the incorporation of a company.[54] The Act did not include a minimum capital requirement for the company as a whole or per member. Thus it allowed for the formation of small, family firm-like and partnership-like companies, so long as they had seven shareholders. As time passed, more promoters wished to incorporate family firms and partnerships and even single person proprietorships. They used nominal shareholders to reach the minimum number of seven.

This resort to nominal shareholders became a contested issue. The Davey Committee report, published in 1895, dealt among other things with this phenomenon. It first described the problem:

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

[54] The 1844 Act did not mention a minimum number, presumably because its drafters did not foresee the possibility of forming small companies. The Limited Liability Act, 1855, 18 &19 Vict. *C.* 133 set the minimum number for the formation of Limited Liability Company at 25. But it remained in force only until the following year. The Companies Act, 1862, 25 & 26 Vict. c. 89

It then discussed the need for a remedy, considering two conflicting options, one to reduce the minimum number and the other not to count nominal shareholders:

> There is **no magic it has been said in the number of seven**, and it must be admitted that to require that number of subscribers to the Memorandum to form a company, or that number of shareholders to maintain a company, **does not secure seven substantial or real shareholders.** But your Committee are **not disposed to disturb the present practice** in the registration of companies, or to recommend any alteration of the law **either as regards the number of seven or the amount of their subscription**.[55] [Our emphasize R.H. & N.L.]

The reduction in the minimum number of members had to await the next committee.

How did the courts rule on this issue in the meantime? Were they willing to allow such a practice, or should we say fiction, and permit small businesses to adopt the corporate form to their needs? *Salomon v. Salomon*, arguably the most famous case in the 400-year history of English company law, dealt, among other issues, with this very question.[56] In July 1892, Aron Salomon and Company, Limited, was incorporated. The memorandum of the company was signed by Aron Salomon, his wife, four sons and one of his daughters.[57] They were each initially allocated one £1 share. Then Salomon sold his sole proprietorship business to the company for 20,000 fully paid shares of £1 and a debenture of £10,000. At this stage the company had one shareholder with 20,001 fully paid shares and six shareholders with 1 share each. The six were all family members of the major shareholders.

In the following year, the company had difficulties due to external factors, such as strikes and changes in the government contracting policy with suppliers. It became insolvent and went into receivership and liquidation. One of the creditors wished to sue Aron Salomon personally. In

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

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

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

the Chancery Division of the High Court it was held by Vaughan Williams that the company was not legally formed because six of its shareholders were nominal and should be ignored. In the Court of Appeal Lindley, a leading company law jurist, reached a similar outcome using a somewhat different argument. The House of Lords on Appeal reversed the decision. Lord Chancellor Hulsbury held that "the statute enacts nothing as to the extent or degree of interest which may be held by each of the seven, or as to the proportion of interest or influence possessed by one or the majority of the share-holders over the others. One share is enough."[58] The bottom line was that Salomon was not held personally liable to debts owed to other creditors as was even allowed to claim dividend as a senior creditor of his own company. The level of flexibility allowed by the use of nominal shareholders that was in flux before 1895 was clearly settled by the House of Lords in 1897 in *Salomon.*

The 1907 Act made redundant the use of nominal shareholders by permitting the formation of private companies with only two shareholders. One of the features that distinguished this new type of company from the public company was that the public company still required the magical number of seven. Private company was defined, as mentioned above, as a company that, in its Articles of Association, commits not to raise capital from the public, to have restrictions on share transferability and to have no more than fifty shareholders.[59] After 1907, a single person company did not need more than two shareholders, one of them nominal, if all it wanted was the shield of limited liability.

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59 Companies Act, 1907, 7 Edw.7 c.24, s. 37(4)

Contractual Flexibility: The Minimum Number of Shareholders in Britain

Although, as we will see, U.S. courts were generally much less willing than their British counterparts to allow members of small, closely held corporations to deviate from statutory norms, they do not seem to have thrown up any significant roadblocks to companies made up of fewer than the minimum number of incorporators fixed by statute, including those consisting of only one person.[60] To begin with, the statutes were generally more lenient than Britain's: most states set the minimum number at three in the nineteenth century.[61] Moreover, U.S. courts never seemed to worry much about whether the shareholders' interests were purely nominal. Rather their concern was what to do when one person acquired all the shares so that the number of stockholders, fictional as well as real, fell below the minimum required to incorporate. Some early decisions treated a corporation as "in suspense" until the single owner transferred shares enough to others (they could be family members) to make up the minimum number of stockholders. This treatment does not seem to have had any real consequence, however, because the courts enforced actions taken by corporations in a suspended condition and generally did not hold their lone shareholders personally liable for company debts.[62] Other courts considered the corporation to be an artificial entity that, once it was created, existed independently of its stockholders whatever their number. Hence a Wisconsin judge ruled that "the owner of all the

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[60] See Harwell Wells, "The Rise of the Close Corporation and the Making of Corporation Law," *Berkeley Business Law Journal* 5 (Fall 2008): 263-316.

[61] Iowa required only one incorporator and South Carolina, and Washington only two. Manufacturing corporations in Alabama needed only two and in Nebraska they could be formed with any number. Frederic Jesup Stimson, *American Statute Law,* Vol. II, 10, 23, 540. By the mid-twentieth century, one-man corporations

[62] *Louisville Banking Company v. Eisenman, &c.,* 94 Ky. 83 (1894). See also *William H. Swift v. Smith, Dixon & Co.*, 65 Md. 428 (1886). I. Maurice Wormser has observed that courts were "more apt to pierce the veil of corporate entity where one person owns all the stock," but he submitted that these piercings were not objections in and of themselves to the ownership structure of the corporation—that "the same result would have followed had there been a thousand stockholders, or ten thousand." See "Piercing the Veil of Corporate Entity," *Columbia Law Review* 12 (June 1912): 497-518. See also "Judicial Supervision of the One Man Corporation," *Harvard Law Review* 45 (April 1932): 1084-89; and Warner Fuller, "The Incorporated Individual: A Study of the One-Man Company," *Harvard Law Review* 51 (June 1938): 1373-1406.

capital stock of a corporation does not therefore own its property, or any of it, and does not himself become the corporation."[63] Although there were a few contrary opinions, this latter view quickly became dominant.[64]

Contractual Flexibility: Internal Governance in the U.S.

U.S. courts were also fairly indulgent when corporations with one or just a few members failed to follow all the legal niceties associated with stockholders' and directors meetings.[65] They were not so indulgent, however, when members of closely held companies made formal agreements at odds with the statutory provisions on corporate governance. This propensity to strict construction of the statutory norms was a serious problem for minority investors in closely held corporations. For example, one way they could protect themselves against oppression by controlling shareholders was to write voting rules that gave them veto power in the selection of directors. But in states with laws mandating that directors be chosen by a plurality of the votes cast, courts overturned agreements setting higher voting thresholds. As late as 1945, the New York Court of Appeals invalidated a bylaw requiring stockholders' unanimous consent to elect a director,[66] and another New York appeals court had earlier struck down a similar provision

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[63] *Button v. Hoffman*, 61 Wis. 20 (1884).
[64] Compare *Newton Manufacturing Co. v. H. & T. M. White*, 42 Ga. 148 (1871); *R. W. Millsaps v. Merchants' & Planters' Bank of Greenville*, 71 Miss. 361 (1893); *Irvine Co. v. Bond et al.*, 74 F. 849 (1896); *First National Bank of Gadsden v. Winchester*, 119 Ala. 168 (1898); and *Frederica M. Poillon v. John J. H. Poillon and Liberty Realty Co.*, 85 N.Y.S. 689 (1904); with *James Pott & Co. and others v. Samuel D. Schmucker, Trustee*, 84 Md. 535 (1897); and *First National Bank of Chicago et al. v. Trebein Co. et al.*, 59 Ohio St. 316 (1898). By the mid-twentieth century, one-person corporations were valid in every state except Louisiana. See George D. Hornstein, "Judicial Tolerance of the Incorporated Partnership," *Law and Contemporary Problems* 18 (Autumn 1953): 435-50.
[65] On this point see "Judicial Supervision of the One Man Corporation," 1084-85.
[66] *James Benintendi et al. v. Kenton Hotel, Inc., and John B. Dondero et al.*, 294 N.Y. 112 (1945). See also *Eisenstadt Bros., Inc., et al. v. Eisenstadt et al.*, 89 N.Y.S. 2d 12 (1949); *Henry I. Christal v. Edward Petry*, 90 N.Y.S. 2d 620 (1949); *Christal v. Petry*, 301 N. Y. 562 (1950).

imbedded in a company's articles of association.[67] Judges were equally strict about bylaw or charter provisions that altered the quorum mandated by statute for shareholders' meetings.[68]

Even in states where the general incorporation laws allowed more flexibility in setting voting rules, shareholders could run into difficulties if they entered into agreements to run their companies effectively as partnerships. In an often cited case the New Jersey Court of Appeals refused to enforce a contract between the two stockholders of a corporation formed to publish and distribute the *Encyclopedia Britannica*. The two men had promised to make all decisions by mutual assent, effectively bypassing the additional directors that the law required them to elect, and the court found the agreement in contravention of the statutes. Justice Dill, the corporate lawyer turned judge who had earlier played an important role in drafting New Jersey's innovative general incorporation statute, wrote the opinion for the court, 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 their joint enterprise may from time to time require."[69] Stockholders who disregarded the statutory norms in this way risked more than the possibility that their agreement would not be enforced. As Dill wrote, "If the

[67] *In the Matter of the Election of Directors of the Boulevard Theatre and Realty Company*, 186 N.Y.S. 430 (1921). See also *Reiss v. Levy et al.*, 161 N.Y.S. 1048 (1916); *Harry Kaplan and E. J. Willett v. Ellis P. Block*, 183 Va. 327 (1944).

[68] *In the Matter of the Election of Directors of the Rapid Transit Ferry Company*, 44 N.Y.S. 539 (1897); *In the Matter of the Election of Directors of P. F. Keogh, Inc.*, 183 N.Y.S. 408 (1920). For more general discussion of courts insistence on adherence to statutory norms, see George D. Hornstein, "Stockholders' Agreements in the Closely Held Corporation," *Yale Law Journal* 59 (May 1950): 1040-56; Hornstein, "Judicial Tolerance of the Incorporated Partnership"; and O'Neal, "Giving Shareholders Power to Veto Corporate Decisions." See also Naomi R. Lamoreaux, "Partnerships, Corporations, and the Limits on Contractual Freedom in U.S. History: An Essay in Economics, Law, and Culture," in *Constructing Corporate America: History, Politics, and Culture*, eds. Kenneth Lipartito and David B. Sicilia (New York: Oxford University Press, 2004), 29-65; Naomi R. Lamoreaux and Jean-Laurent Rosenthal, "Legal Regime and Contractual Flexibility: A Comparison of Business's Organizational Choices in France and the United States during the Era of Industrialization," *American Law and Economics Review* 7 (Spring 2005): 28-61; and Wells, "Rise of the Close Corporation."

[69] *Walter M. Jackson, v. Horace E. Hooper, Harris B. Burrows, Charles C. Whinery and Franklin H. Hooper*, 76 N.J. Eq. 592 (1910) at 599.

parties have the rights of partners they have the duties and liabilities imposed by law and are responsible in solido to all creditors." In other words, they faced the prospect that the courts would pierce the corporate veil and hold them unlimitedly liable for their enterprise's debts.[70]

At least in theory, there were ways shareholders in closely held corporations could get around such problems. The more flexible general incorporation statutes passed during the third wave of legislation allowed shareholders to create multiple classes of stock and to assign those classes different voting rights. By creating more than one class of common stock, giving each class representation on the board of directors, and requiring all classes to approve decisions that fundamentally affected the corporation's business, shareholders in closely held companies could insure that they all had an equal say in the enterprise's affairs. Although it is difficult to gather data on the extent to which incorporators made use of this option, multiple classes of common stock do not seem in fact to have been a very popular way to solve corporate governance problems. A random sample of nearly five hundred firms from *Moody's Manual of Industrial Securities* for 1924 yielded only twelve with more than one class of common stock. Of course, *Moody's* disproportionately covered large companies, but the vast majority of the companies in the sample were not publicly traded. In fact, only 8 percent had common stock that was listed or traded on any exchange, including regional exchanges and secondary markets like the New York Curb.[71]

Shareholders in closely held companies could also enter into voting agreements or trusts to insure that they acted in concert and voted their shares in pre-specified ways. Judges in most

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[70] *Jackson, v. Hooper*, 76 N.J. Eq. 592 at 599.

[71] It was much more common to add a class of preferred stock than a second class of common. About two-thirds of the firms in the sample had at least one issue of preferred stock. Such issues could benefit minority shareholders by guaranteeing them a minimum dividend. They might also confer important voting rights under special circumstances—for example, if the firm failed to pay the specified dividend within a specified period of time.

states displayed a willingness to uphold such agreements from early on,[72] but they were of only limited utility to minority shareholders seeking to insure themselves an ongoing voice in the corporation's affairs. In the first place, because they were of finite duration, there was no way to prevent agreements from being renegotiated or even repudiated by controlling shareholders when their term expired. Second, courts would not uphold such agreements if they constrained the decision-making power of the board of directors. As a New York judge put the matter, "Corporations are the creatures of the state and must comply with the exactions and regulations it imposes." Any agreement to bypass the board of the directors or "to create a sterilized board" was "illegal and void."[73] Because it was usually the responsibility of the board to choose corporate officers and other important employees, agreements that aimed to entrench minority shareholders in positions of responsibility were particularly unlikely to be enforced. In one Minnesota case, for example, a controlling shareholder in a brass works promised a minority investor lifetime employment as the firm's general manager and later reneged on the agreement. When the dismissed shareholder sued, the court ruled the agreement contrary to public policy. The selection of officers was a power given by statute to the board of directors, and no director could "bargain away in advance the judgment the law contemplates he shall exercise at

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[72] See *John Faulds v. William Yates et al.*, 57 Ill. 416 (1870); *Sidney V. Smith et al. v. San Francisco & North Pacific Railway Co. et al.*, 115 Cal. 584 (1897); *Frank W. Brightman v. Lot B. Bates*, 175 Mass. 105 (1900); *Thompson-Starrett Co. v. E. B. Ellis Granite Co.*, 86 Vt. 282 (1912); *Clarence H. Venner v. The Chicago Railway Co. et al.*, 258 Ill. 523 (1913). There were, however, some contrary cases, in which stockholders entering into agreements were held to have violated their fiduciary duties toward other members of the firm. See, for example, *Thomas J. Creed v. Edward M. Copps, et al.*, 193 Vt. 162 (1930). In some states, moreover, courts tended to view such arrangements with hostility. See, for example, *Shepaug Voting Trust Cases*, 60 Conn. 553 (1890); *W. S. Harvey, Trustee v. The Linville Improvement Co.*, et a., 118 N.C. 693 (1896); *Morel et al. v. Hoge et al.*, 130 Ga. 625 (1908).

[73] *Philip Manson v. F. Kingsbury Curtis*, 223 N.&. 313 (1918) at 323. See also *Ernest J. Seitz v. Theodore Michel*, 148 Minn. 80 (1921); *Schuster v. Largman et al.*, 308 Pa. 520 (1932).

subsequent official meetings of the board."[74] It was simply not permissible to tie the hands of directors, who were charged by law with acting in the interests of the corporation as a whole.[75]

In 1936, a decision by the New York Court of Appeals to enforce an agreement promising a minority shareholder employment as the corporation's general manager "so long as he should be 'faithful, efficient and competent'" signaled that the courts might be shifting toward a more flexible interpretation of the statutes in cases involving close corporations. Two years earlier in *McQuade v. Stoneham* the same court had found an attempt to entrench a stockholder in such a position to be contrary to public policy. Now, however, in *Clark v. Dodge* the judges questioned whether they were "committed by the *McQuade* case to the doctrine that there may be no variation, however slight or innocuous," from the statutory norms. The answer, they concluded, was no. The broad interpretation of *McQuade* was dicta, not law, and the precedent "should be confined" to the particular facts of that case. "There was no attempt to sterilize the board of directors" in the present case, and the agreement to "continue Clark as general manager, so long as he proved faithful, efficient and competent" was so minor an infringement on the powers of the board of directors "as to be negligible." "If the enforcement of a particular contract damages nobody," there is "no reason for holding it illegal, even though it impinges slightly" on the statutory requirement that "the business of a corporation shall be managed by its board of directors."[76]

Clark v. Dodge notwithstanding, on the eve of World War II there was still considerable uncertainty surrounding the status of side contracts that aimed to guarantee minority investors in

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[74] *Seitz v. Michel*, 148 Minn. 80 (1921) at 85.
[75] See also *West v. Camden*, 135 U.S. 507 (1890); *Manson v. Curtis*, 223 N.Y. 313 (1918); *Noah Fells v. Martin Katz et al.*, 256 N.Y. 67 (1931); *Francis X. McQuade v. Charles A. Stoneham et al.*, 263 N.Y. 323 (1934).
[76] *David H. Clark v. John L. Dodge*, 269 N.Y. 410 (1936) at 415-17. See also *McQuade v. Stoneham*, 263 N.Y. 323 (1934). For a similar trend in Illinois, see Carlos L. Israels, "The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution," *University of Chicago Law Review* 19 (Summer 1952): 778-93.

closely held corporations an ongoing voice in decision-making. The courts were now willing to enforce at least some such agreements, but they were still reluctant to allow directors to contract away their powers to any significant degree. This situation became increasingly untenable when high personal income tax rates during and after the Second World War pushed more and more small-scale enterprises to incorporate. Scholars scrambled to provide business people (and their lawyers) with advice about how to navigate this legal minefield.[77] They also pushed for new legislation that would "fit the characteristics which obviously distinguish the close corporation from the public one."[78] New York revised its laws to allow supermajority voting rules in response to the *Benintendi* decision in 1948, but the first significant break with past statutes occurred in North Carolina in 1955. Imbedded in that state's new Business Corporation Act were several provisions aimed specifically at small, closely held firms, including one declaring that agreements among all the shareholders of such corporations shall not, regardless of their form or purpose, "be invalidated on the ground that [their] effect is to make the parties partners among themselves."[79] About a dozen other states passed similar statutes over the next several decades. Still others modified their general incorporation laws in ways that increased the flexibility of the corporate form.[80] Nonetheless, as late as the 1980s legal scholars were still voicing the opinion that much more needed to be done in the U.S. to free "close corporations

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[77] See Hornstein, "Stockholders' Agreements in the Closely Held Corporation" and "Judicial Tolerance of the Incorporated Partnership"; Kurt F. Pantzer and F. Hodge O'Neal, *The Drafting of Corporate Charters and By-Laws* (Philadelphia: Committee on Continuing Legal Education of the American Law Institute and the American Bar Foundation, 1951); F. Hodge O'Neal, *Close Corporations: Law and Practice* (Chicago: Callaghan, 1958), 2 vols.; O'Neal, "Giving Shareholders Power to Veto Corporate Decisions: Use of Special Charter and By-Law Provisions"; William L. Cary, "How Illinois Corporations May Enjoy Partnership Advantages: Planning for the Closely Held Firm," *Northwestern University Law Review* 48 (Sept.-Oct. 1953): 427-41.

[78] Norman Winer, "Proposing a New York 'Close Corporation Law,'" *Cornell Law Quarterly* 28 (Mar. 1943): 313-43 (the quote is from p. 313); F. Hodge O'Neal, "Developments in the Regulation of the Close Corporation," *Cornell Law Quarterly* 50 (Summer 1965): 641-62; and O'Neal, "Close Corporations: Existing Legislation and Recommended Reform," *Business Lawyer* 33 (Jan. 1978): 873-88.

[79] O'Neal, "Developments in the Regulation of the Close Corporation," 647-48.

[80] See Lamoreaux, "Partnerships, Corporations, and the Limits on Contractual Freedom"; Lamoreaux and Rosenthal, "Legal Regime and Contractual Flexibility"; and Wells, "Rise of the Close Corporation."

from the restraints of rigid corporate norms" and give members of these firms more ability to intermix attributes of the partnership and corporate forms in structuring their enterprises.[81]

Contractual Flexibility: Internal Governance in Britain

In Britain, of course, the various Companies Acts took the issue of voting rights, and decision-making rules more generally, off the table. Incorporators for the most part could arrange such matters any way they wanted by modifying the default rules laid out in Table A. Nonetheless, or because of this, shareholders sometimes wanted to secure their controlling positions, or their ability despite being in a minority position to veto decisions, by entrenching themselves as directors. In addition they sometimes sought to guarantee themselves employment at the company and protect their level of remuneration.

Shareholders could be named as directors or employees in the Articles of Association. The basic problem was that the Act determined (section 50 of the 1862 Act) that the General Meeting of any company could alter its articles of association by a Special Resolution, that is by a supermajority of 75 percent of the votes in the meeting. At an early stage the courts held that companies could not opt out of the alteration allowed by that section and could not entrench the articles as a whole or in part. A coalition of shareholders holding more than 75 percent of the votes could alter the articles at will. A minority shareholder holding less than 25 percent of the votes was exposed to alteration of articles that seemed to entrench him as director or employee. Shareholders who wanted to secure their position in the company, often shareholders in SMEs,

[81] Kelvin H. Dickinson, "Partners in a Corporate Cloak: The Emergence and Legitimacy of the Incorporated Partnership," *American University Law Review* 33 (Spring 1984): 559-600. See also Robert W. Hillman, "The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations," *Minnesota Law Review* 67 (Oct. 1982): 1-88; and Mark R. von Sternberg, "The Close Corporation's Counterparts in France, Germany, and the United Kingdom: A Comparative Study," *Hastings International and Comparative Law Review* 5 (Winter 1982): 291-322.

resorted to side contracts. The question was whether side contracts afforded stronger or weaker entrenchment than articles. Most pertinently, to what extent would courts enforce them on the company in addition to forcing them on the shareholders? Only enforcement on the company by way on injunction or invalidating its acts would amount to strong, property rights like (to use terminology borrowed from Calabresi and Melamed), entrenchment, one that is stronger than the limited entrenchment in articles.

In *Browne v. La Trinidad* the possible ways for entrenching directors, in the articles or in side contracts, were examined. An agreement was made in 1884 between a vendor and two others according to which the vendor would sell mining property in Mexico to a newly formed company in return for fully paid shares in that company.[82] In that agreement the vendor was also entrenched as director in the company for four years. The articles of the company allowed removal of directors by special shareholder resolution. The vendor was initially invited to join the board but two years later a meeting was summoned to remove him. The Court of Appeals declined his petition for an injunction. He was entrenched in a side contract between him and the other promoters, soon to be shareholders in the company. The company was not a party to the contract. Though the memorandum and the articles of the company made reference to that contract, they did not entrench him and, to the contrary, provided a mechanism for the removal of directors. One can infer from this case that entrenchment of directors can be binding on the company when done expressly in the articles. It is not binding when made in a side contract. Yet, one has to bear in mind that entrenching in the articles is subject to the mandatory rule in the Act that permitted alteration of the articles themselves by a 75 percent majority.

The following cases demonstrate that when directors were named and entrenched properly in the articles the courts respected the entrenchment. In *In Re Dale and Plant, Limited*

[82] (1888) L.R. 37 Ch.D. 1, 11-16 per Cotton and Lindley.

(1889) a company having two real shareholders was formed three years earlier in the business of dryslaters. The two shareholders were named and entrenched in the articles as the managing directors for ten year with annual remuneration of £300 each. Holding of ten shares was a qualification requirement for directors. Termination of employment for the company was not a cause for annulment of appointment as directors. The dispute in this case was between the liquidator and the managing directors, the former claiming that the money owed by the company to the directors was in their capacity as shareholders and as such should be paid only once all creditors were fully paid. The court rejected the claim. It held that the money was owed to directors in their capacity as directors. Clearly the court recognized the contractual freedom to fix employment as well as pay in the articles of association.[83]

The status of the articles as part of an entrenchment contract between the company and its with directors was even more clearly stated in 1898 in a case which again involved a company that set remuneration of directors in its article: "The article is not in itself a contract between the company and the directors; it is only part of the contract constituted by the articles of association between the members of the company inter se. But where on the footing of that article the directors are employed by the company and accept office the terms of art. 62 [the remuneration article] are embodied in and form part of the contract between the company and the directors."[84] This view of the articles and the side contract as two elements of the same contract made the entrenchment of the directors binding upon the company in a manner that would invalidate, not only compensate for, any breach in the form of termination of office or decision to reduce pay.

We did not find many reported cases in which the validity of employment contracts that were entrenched in articles was litigated. In a 1875 case, *Eley v. The Positive Government*

[83] (1890) LR 43 Ch. D. 255.
[84] New British Iron Co Ex p. Beckwith, Re [1898] 1 Ch. 324, 326.

Security Life Assurance Company (Limited), the issue was the entrenchment of a lawyer, apparently a minority shareholder. Article 118 in the Articles of a company stated that “Mr. W.E. shall be the solicitor of the company and shall transact all the legal business of the company, including parliamentary business, for the usual and accustomed fees, and shall not be removed from his office unless for misconduct.” The article was probably included as consideration for services rendered at the stage of incorporation. The company at some stage resorted to other solicitors. Eley sued the company for breach of contract. The case raised the fundamental question of the status of the articles as an employment contract with a named shareholder. In his judgment, Amphlett B. held that article 118 did not amount to a contract that binds the company vis-a-vis a solicitor as such. The articles bind the shareholders in that capacity and only inter se. He reasoned that technically the articles were not made under the seal of the company or by the directors under authority of the company. Kelly C.B. expressed the doubt whether, even if approved by the board of directors, the board had the power to bind the company in an employment contract for all time to come.[85] The Court of Appeal per Cairns approved the decision.[86] The grounds were again that the articles were not an agreement under the seal of the company.

The holding in this case can be read widely or narrowly. A wide reading would conclude that articles do not constitute enforceable employment contracts. A narrow reading would conclude that this was a very peculiar case and the holding is limited to its circumstances. This narrow reading would mention the specific circumstances that led to the court’s decision. The board did not approve the articles. Eley was not an original shareholder and received his shares only a while later and thus was not viewed as a party to the contract. Many people purchased

[85] Eley v. The Positive Government Security Life Assurance Company (Limited) LTR 33 (1876. 743, 747-749.
[86] (1875-76) LR Ex. D. 88.

shares based on a circular which did not mention the commitment to employ Eley. The articles set only his pay but not the services he had to provide. Most of these specific circumstances would not apply to original shareholders in private companies. The narrow reading would recommend following the proper technicalities and by this giving the articles a binding effect as employment contract.

These cases raise three conceptual issues that are relevant for us in understanding the status of articles and side contracts as entrenchment devices: the legal status of the articles as contract; the ability to entrench articles that name directors and employees against further amendments; and the effect of incorporation into the articles of side contracts. I will discuss them one by one.

Company law treatise writers and judges were divided over the question whether the articles of association were a contract only among the shareholders, as held by Buckley and Lindley, or also between the shareholders and the company, as held by Palmer and Gore-Brown. Only the latter interpretation meant that the company was bound by them. In 1915 in Hickman v. Kent Astbury summarized the state of law:

> It is difficult to reconcile these two classes of decisions and the judicial opinions therein expressed, but I think this much is clear, first, that no article can constitute a contract between the company and a third person; secondly, that no right merely purporting to be given by an article to a person, whether a member or not, in a capacity other than that of a member, as, for instance, as solicitor, promoter, director, can be enforced against the company; and, thirdly, that articles regulating the rights and obligations of the members generally as such do create rights and obligations between them and the company respectively.[87]

It is clear from this statement that for a long while this conceptual issue was in a flux. The value of the holding itself should be taken as limited because Astbury was a trial court judge. Anyway, he recognized that the company along with the shareholders could possibly be

[87] (1915) 1 Ch. 881, 900.

viewed as a party to the contract embodied in the articles. But the articles were not a contract with third party, were not a contract with the shareholders in other capacities, and those articles that regulated the shareholders as such did not bind the company contractually. This case shows that some aspects of the contractual status of articles, including its lack of contractual status as an employment contract, were gradually settled between *Eley* (1875) and *Hickman* (1915). But the core of the conceptual issue was still unsettled and a level of vagueness prevailed.

The entrenchment of directors and employees and the fixing of their remuneration in the articles had a drawback. The articles were subject to amendment. Could the articles as a whole or the employment sections of them be entrenched against amendments? P*unt v. Symons & Co. Limited* (1903) nicely demonstrates the circumstances under which the issue arises. The company was incorporated in 1898 with the purpose of buying a furnishing business from Symons. Symons was entrenched in the articles as governing director with full powers of management and of appointment and removal of other directors. In the vending contract between Symons and the company it was agreed that the company would not alter the clauses in its articles that entrenched Symons as managing director. After his death a dispute arose between the executors of his bequeath and some of the other shareholders as to the validity of that agreement. Those shareholders argued that the agreement could not prevent the company from exercising its statutory power under section 50 of the Companies Act, 1862, to amend its articles by passing Special Resolution in its General Meeting. Byrne for the court held: “the company cannot contract itself out of the right to alter its articles, though it cannot, by altering its articles, commit a breach of contract.” How did he square the circle? “When dealing with contracts referring to revocable articles … care must be taken not to assume that the contract involves as one of its terms an article which is not to be altered."[88]

This case repeated decisions made in earlier cases that already held unequivocally that the articles themselves could not validly prohibit their amendment.[89] It also alluded to a common practice of incorporating into the articles of association of a newly formed company an agreement made with promoters or vendors. It echoed Lindley's holding three years earlier in the classic case of *Allen v Gold Reefs of West Africa Ltd* that made the full connection between the contractual effect of the articles, the mandatory power granted by the Act to alter the articles and the common law and equitable doctrines that prohibit companies from breaching their contracts or oppressing minorities by altering their articles.[90]

As time passed there was an attempt by the courts to conceptualize the issues coherently and to decide specific cases based on first principles, such as a clear definition of the contractual status of the articles of association. But these attempts did not mature and pragmatic resolution of disputes was still the first resort of many judges. The nature of the development of case law was such that on the practical level attorneys could advise their clients which contractual governance terms could be validly entrenched in the articles, which could more likely be held valid when fixed in side contracts, which were unsettled, and which could not be validly contracted because of mandatory rules in the Act or common law and equity doctrines.

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[88] Punt v. Symons & Co. Limited (1903) 2 Ch. 506.

[89] In an early case Walker v. London Tramyays Company XII 705 (1879) Jessel M.R. held similarly in single sentence in a briefly reported case. More substantial discussion can be found in Malleson v. National Insurance & Guarantee Corp. [1894] 1 Ch. 200 and reiterated by Lindley in the Court of Appeal in Andrews v Gas Meter Co. [1897] 1 Ch. 361.

[90] [1900] 1 Ch. 656, 671, 673.

Britain and the U.S. Compared

The statutory platform that the courts had to apply with respect to internal governance was fundamentally different in Britain and the U.S. As a result court cases in the two countries dealt with different issues. In the U.S., not only did statutes often set the duration of the company and its capital, but also voting rules at general meetings and the functioning of the board of directors,. Attempts to dodge the rules through side contracts that dealt with voting, appointment of directors, restrictions on the decision-making by directors, and other similar matters gave rise to much litigation. The courts gradually determined which side contracts and which arrangements were valid and which were not, but there was still large areas of uncertainty as late as the mid-twentieth century.

Because of the more flexible and default rules based nature of British statutory law, most of the issues that in the U.S. were experimented with in side-contracts could in Britain be done in the articles themselves. Resort to side contracts was mainly of second order. Shareholders aimed at providing stronger entrenchment in the side contracts to issues that were entrenchable only against majority of up to 75 percent. The courts had to deal with the consequences of such entrenchment and the remedies that could be provided upon its breach. Incorporators and their lawyers in Britain dodged with the secondary rule of change, which set how articles could be altered. In the U.S., because of the more limited contractual flexibility, incorporators and their lawyers, and as a result also the courts, still dealt with the primary rules that dealt with the substance of internal management.

Contractual Flexibility: Exit in Britain

In mid-nineteenth century Britain joint-stock companies were thought to be fundamentally different from partnerships. "Ordinary partnerships are by the law assumed and presumed to be based on the mutual trust and confidence of each partner in the skill, knowledge, and integrity of every other partner." As a result courts held that partners could not transfer their interest during their lives or at death without the consent of all other partners. It was "to escape from these that joint stock companies were invented." In light of the different nature of the company the presumption was that shares in joint-stock companies were transferable.[91] This presumption could, however, be negated by a shareholders' agreement. Even public companies might wish to maintain some level of supervision over the transfer of shares to ensure that new shareholders were able to meet calls on shares that were not fully paid.[92]

In *Weston's Case* (1868) the relationship between transferability restricting articles in the articles of a company and the Companies Act was examined. Here discretion was given in the articles to the Board to refuse to register share transfers to ensure the resources of transferees. Section 22 of the 1862 Companies Act stated: "The shares … of any Member in a Company … shall be personal assets, capable of being transferred in manner provided by the Regulations of the Company…". In appeal Chancery rejected the argument that shares were not transferable unless the articles made these shares transferable. The court held to the contrary that shares by virtue of section 22 were by default transferable. Importantly, it is held in *Weston's Case*, at a

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[91] Baird's Case In re Agricultural Cattle Insurance Company 5 L.R. Chancery Appeals 725 (1870), 733-35. This was a case of a company formed by a deed of settlement in 1845, before the 1862 Companies Act. The dispute here, as in several other contemporary cases, was between a liquidator who wished to widen the circle of shareholders upon which calls could be made in winding up of a company in order to increase dividend to creditors and an alleged shareholder who claimed that the transfer of shares to her was not executed because it contradicted restrictions in the articles.

[92] Turner, John D., Wider Share Ownership?: Investors in English and Welsh Bank Shares in the Nineteenth Century. The Economic History Review, Vol. 62, No. S1, pp. 167-192, August 2009

very early stage in the development of private companies, that section 22 is a default rule and not a mandatory rule. Incorporators acquired by this holding a contractual freedom to devise their own restrictions upon transferability.[93]

As time passed, the incorporators of small companies who wished to maintain their close and personal, partnership-like, nature were concerned with devising articles that would restrict transferability of shares. As reflected in litigation reports of the last third of the nineteenth century, such articles were common and their sophistication grew. Articles were included in articles of association with more specifically tailored restrictions on transferability. Consent of the other shareholders was required upon an exit of a shareholder due to sale, bankruptcy, marriage of a female shareholder, or death. Then, upon declining approval, a right of first refusal was given in the articles to existing shareholders. At the next stage a mechanism was designed according to which the company was to purchase the shares of departing shareholders at either market price or price offered by a potential outside buyer. This mechanism was to apply either at the company’s discretion or when the company refused to approve share transfer under triggering circumstances. What these cases reveal is the upholding of terms set in the articles of companies. Courts dealt routinely with interpretation and application of such terms.[94]

The question whether a company can empower itself to purchase its own shares is particularly instructive with respect to contractual flexibility. On the one hand, as we have seen above, the purchase of shares by companies was a preferable exit mechanism in close companies as it allowed the exit of a shareholder without forcing any of the remaining shareholders individually to purchase his shares and without the need to locate an agreeable third party purchaser of the shares. On the one hand, the concept of irreducible legal capital is central to the

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

[94] See for example: Stewart Erskine v. Thomas Duff & Co. Ltd (1900) 7 S.L.T. 367; Stewart v. James Kellier & Son Ltd (1901) 9 S.L.T. 184; Burland's Trustee v. Steel Brothers & Co. Ltd 1 Ch. 279.

protection of creditors and potential creditors of limited liability companies. The general rule was clear. A company cannot reduce its capital contrary to the Companies Act. Once the memorandum limits the liability of shareholders and puts the capital at the disposal of creditors, an article cannot deviate and allow the reduction of capital.[95] But the courts made exceptions from time to time when creditors' rights did not seem to be in peril. In *In Re Dronfield Silkstone Coal Company* a company was authorized by its articles to purchase its own shares. Following a deadlock over management issues, the company purchased the shares of its largest shareholder. While Chancery Division ruled that the article that allowed the purchase was void, the Court of Appeal reversed the decision. This is a case of surrender of shares that is just one step removed from forfeiture of shares. The surrender of shares in this case was a domestic matter that did not undermine creditors and thus was held valid.[96] Despite the general rule against a company's purchase of its own shares, the contracting for this method of buyout and exit could be upheld by courts when creditors are not at risk.

A similarly instructive issue is that of contracting over winding up rules. This too involved the relationship among shareholders, which is inherently more contractual, and the relationship between shareholders and creditors which is governed by the Act. The Act included detailed winding up rules. The rules that applied to involuntary dissolution initiated by creditors due to insolvency are not relevant for our purpose here. The relevant question was whether shareholders can opt out in the articles from the statutory rules that applied to shareholders' initiated winding up. The pertinent rules are the rule that required a 75% majority resolution by

[95] See Trevor v. Whitworth (1887) L.R. 12 App. Cas. 409 in which the House of Lords held outright that an article to such effect is void.
[96] C. A. 1880 17 Ch. D. 77. For another example see Cree v. Somervail (1878-79) L.R. 4 App. Cas. 648. In that case the House of Lords had no problem applying an article that allowed the company to purchase the shares of three of its shareholders.

shareholders and the rule that allowed the court to wind up a company when it is of the opininon that it is "just and equitable" to do so.

In *Perevil Gold Mines* an article set the conditions under which shareholders could petition for winding up: consent of two members of the board, permission by majority resolution in the general meeting or holding of 20 percent of fully paid capital. When shareholders petitioned for winding up without meeting any of these conditions, a motion was made by other shareholders to stay the winding up proceedings. They argued that the articles constituted a contract among the shareholders and that the contract did not contradict the Companies Act. They read the article as a waiver of rights rather than a contradiction of the act and interpreted the Act as not prohibiting waiver of rights as long as it does not say so expressly. The court per Lindley M.R., a leading company law authority, rejected this approach:

> I do not say that a valid bargain may not be made between a company and an individual contributory or creditor … but to say that the company was formed on the terms that its existence should not be terminated upon the circumstances … provided by the Act is contrary to what the Legislature has enacted… This article is contrary to the Act and is invalid.[97]

Lindley rejected the distinction between setting of rules and waiver of rights in articles. Both were invalid when they contradicted the Companies Act. He upheld a distinction between the articles of association and side agreements. Waiver of right to petition for winding up in a side agreement is not void as such, but it does not constitute part of the constitution of the company. In a practical sense, a breach of the side agreement can render a remedy of damages but cannot serve as reason for staying the winding up proceedings.

Another popular means for opting out of the winding up rules of the Act was by providing in the articles for the reference of disputes to arbitration. Shareholders were required

[97] [1898] 1 Ch 122 (CA)

by the articles to refer their internal disputes to arbitration rather than resort to court liquidation and untimely dissolution. Was such opting out valid and binding? In *Re Yenidje Tobacco Co Ltd.*, it was held in 1916 based on the 1908 Act that a private company composed of two traders-shareholders is analogous the partnership in the sense that its shareholders cannot be locked in.[98] Thus the arbitration clause was not valid. A year earlier, in *Hickman v. Kent or Romney Marsh Sheepbreeders Association,* the arbitration clause was included in the articles of an association not for profit for sheep breeding. In this case the clause was upheld by the court as valid.[99] The differences between the two firms may explain the different outcome. Anyway, the ability to contract for arbitration in contradiction to the Act was unsettled for a while. Only in *Beattie v E&F Beattie Ltd.*, a 1938 case was it decided clearly that companies cannot contract for arbitration and directors can resort to courts for liquidation in disregard of arbitration clauses.[100]

Contractual Flexibility: Exit in the U.S.

In cases involving dissolution, U.S. courts also tended inflexibly to enforce statutory norms. By the end of the nineteenth century more and more states had included provisions for voluntary dissolution in their general incorporation statutes. These provisions typically allowed shareholders to end their corporation's existence by some specified supermajority vote, usually two-thirds of the value of the stock outstanding. Under the common-law, voluntary dissolution had required unanimous consent, so the change meant that minority shareholders could no longer so easily block dissolutions that were contrary to their interests. At the same time, however, the threshold was too high to provide them with a workable means of exiting the business if they

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[98] [1916] 2 Ch. 426.
[99] [1915] 1 Ch. 881.
[100] [1938] Ch. 708.

were unhappy with the way controlling shareholders were running it. Although the courts provided minority shareholders with some degree of protection—they would intervene to prevent dissolutions that were thinly disguised freeze-outs, and they could be enlisted to force a dissolution where controlling shareholders were clearly behaving oppressively—there was a large middle ground where unhappy minority shareholders were unable to convince the majority to dissolve, or not, as the case might be.[101] In Britain incorporators could build rules into their articles of association that provided investors with escape hatches, but it was difficult to anticipate problems in this way in the U.S. American courts generally would not allow incorporators to set different voting thresholds in their articles of association from those specified in the statutes (in Illinois they could impose a higher voting requirement but not a lower one) or write provisions allowing them to waive the right to dissolve voluntarily in accordance with statute (though in New York the law allowed such waivers).[102] Nor could they enter into agreements that would compel dissolution or the disposal of corporate property under pre-specified circumstances, such as the death of an important member of the firm. The courts interpreted such agreements as impermissible attempts to treat members of a corporation as if they were partners rather than shareholders.[103]

Of course, if they could find a buyer for their shares, disgruntled minority shareholders could exit by selling off their stock. The general incorporation laws enacted by the various state legislatures during the nineteenth century typically included a provision deeming corporate shares to be personal property and transferable at the pleasure of the holder. This freedom of

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[101] Winer, "Proposing a New York 'Close Corporation Law,'" 323, 331-33; George D. Hornstein, "A Remedy for Corporate Abuse—Judicial Power to Wind Up a Corporation at the Suit of a Minority Stockholder," Columbia Law Review 49 (Feb. 1940): 220-51; and Hornstein, "Voluntary Dissolution—A New Development in Intracorporate Abuse," *Yale Law Journal* 51 (Nov. 1941): 64-84.

[102] Hornstein, "Stockholders' Agreements in the Closely Held Corporation" and "Volutary Dissolution"; Cary, "How Illinois Corporations May Enjoy Partnership Advantages," 438.

[103] Hornstein, "Stockholders' Agreements in the Closely Held Corporation," 1046-47.

transfer, however, was as much a problem for closely held companies as was the difficulty of exit. It was important for members of such enterprises to be able to control the identity of their business partners, but they found it difficult to write enforceable contracts that accomplished this end. Although the statutes specified that a corporation's bylaws could prescribe the manner of transferring the shares, in most cases the courts refused to uphold rules that limited in any way shareholders' ability to sell their property, including those that required stockholders to give the their business associates a first right of refusal.[104] As the Maryland Court of Appeals asserted in 1896, such provisions constituted "an unreasonable and a palpable restraint upon the alienation of property."[105]

During the early twentieth century courts began to relax this position somewhat. Although judges still invalidated provisions in corporate charters and by-laws that posed significant restrictions on the transfer of shares, they were increasingly willing to uphold those that required stockholders first to offer their shares to other members of the company or to the corporation itself (most state statutes by this time allowed corporations to acquire their own shares). It is apparent from their references to the frequency of such arrangements that incorporators were increasingly writing them into their bylaws, despite earlier decisions declaring them unenforceable. The worst thing that could happen to stockholders who entered into these agreements was that the courts would not uphold them, but they were a way that they

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[104] *Bank of Atchison County v. Durfee et al.*, 118 Mo. 431 (1893); *John McNulta v. The Corn Belt Bank*, 164 Ill. 427 (1896); *Victor G. Bloede Co. v. Victor G. Bloede*, 84 Md. 129 (1896); *Charles A. Miller v. Farmers Milling & Elevator Company et al.*, 78 Neb. 441 (1907).There were a few contrary cases. A Massachusetts court required an executor to transfer shares in the New England Trust Company to the company in conformity with a bylaw. The court did not rule on validity of the bylaw but rather treated the provision as a contract with the corporation to which the testator had explicitly agreed. Intriguingly, the court relied mainly on English precedents in this case. It also cited special charters granted by the Massachusetts legislature that had included such provisions, even though the special charter for this particular company did not have such a clause.

[105] *Bloede Co. v. Bloede*, 84 Md. 129 (1896) at 141.

could express their commitment to the closed nature of their company.[106] It is also apparent that judges were coming around to the view that such agreements were eminently reasonable. As one wrote, "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."[107] In the words of another, "there seems to be no reason in principle why [incorporators] should not be permitted to retain the control of the corporation in which they have embarked their fortunes among themselves. … It is *their* business and *their* money which is involved."[108]

The problem judges faced was how to square such sentiments with earlier decisions that had overturned these provisions as invalid restrictions on transferability. In some cases one can see them struggling for grounds on which to enforce the agreements. Thus in one case they determined that an officer of a corporation who purchased stock that had not first been offered to the corporation as required by its bylaws had violated his fiduciary duty.[109] A more common justification, where there were only a small number of stockholders, all of whom had originally agreed to the bylaw at issue, was that the provision was a contract that the members of the firm

[106] In his advice to incorporators Thomas Conyngton argued that such provisions probably had desireable results even if they were technically unenforceable. See his *Manual of Corporate Organization Containing Information, Directions and Suggestions Relating to the Incorporation of Enterprises* (New York: Ronald Press Co., 1913), 337-39.

[107] *Casper v. Kalt-Zimmers Manufacturing Company*, 159 Wis. 517 (1915) at 522. Some judges, however, still expressed the contrary view. New Jersey Vice Chancellor Emery wrote 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." *Edwin J. Morris v. Hussong Dyeing Machine Company et al.*, 81 N.J. Eq. 256 (1913) at 261. *Thomas J. Prindiville v. Johnson & Higgins*, 92 N.J. Eq. 515 (1921). Similarly Vice Chancellor Backes doubted "that a partnership may be perpetuated in the garb of a corporation" and the law countenanced "corporate existence with copartnership privileges of choosing one's associates."

[108] *Maurice D. Baumohl and Harold W. Danser and the Long Branch Steamboat Company v. Milton J. Goldstein and Marguerite D. Eisner*, 95 N.J. Eq. 597 (1924) at 602.

[109] *Baumohl v. Goldstein*, 95 N.J. Eq. 597 (1924) .

had entered into with each other, as well as with the corporation, and was enforceable as such and not because it was a valid bylaw.[110] In some cases judges explicitly recognized that they were modifying precedents and declared such bylaws enforceable.[111] In other cases, they simply ignored contrary decisions.[112]

Changes in statutory authority offered the most important justification for enforcing these kinds of provisions. In some of the earlier cases, judges had overturned similar bylaws on the grounds that they were not included in the list of provisions that the statutes indicated could be included in bylaws. Maine's general incorporation law, for example, specified that "corporations may determine by their by-laws the manner of calling and conducting meetings; the number of members that constitute a quorum; the number of votes to be given by the shareholders; the tenure of office of the several officers; the mode of voting by proxy, and of selling shares for neglect to pay assessments; and may enforce such by-laws by penalties not exceeding twenty dollars." Strictly construing this statute, a Rhode Island court ruled that the corporation had "no power" to enact a bylaw requiring stockholders first to offer their shares to the corporation before transferring them to another party.[113] The more liberal general incorporation statutes passed at the end of the nineteenth century were more easily construed as allowing such regulations. Thus, 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 upheld in 1910 a bylaw requiring a shareholder to notify the corporation "in writing, stating the amount of stock he

[110] *Garrett v. Philadelphia Lawn Mower Company*, 39 Pa. Super. 78 (1909).
[111] See, for example, *Farmers' Mercantile and Supply Company v. Laun*, 146 Wis. 252 (1911).
[112] See, for example, *Casper v. Kalt-Zimmers Manufacturing Co.*, 159 Wis. 517 (1915).
[113] *William H. Ireland v. Globe Milling and Reduction Company*, 19 R.I. 180 (1895).

desires to sell and the market value of same" and giving the company "an option on said stock for thirty days following such notice."[114]

Nonetheless, incorporators who wrote provisions into their bylaws requiring stockholders to give the corporation or its members first right of refusal before selling their shares still faced considerable uncertainty about whether the courts would allow them. For example, the incorporators of the Household Finance Corporation (a Delaware company) had such a provision written into both the company's articles of association and its bylaws and also printed the provision on each share of its stock. A stockholder who objected filed suit and lost, lost again on appeal, and lost a third time in 1930 in Delaware's chancery court.[115] Although the stockholder's challenge failed, that the issue would be so persistently litigated, even in Delaware and as late as 1930, is a good indication that restraints on transferability remained problematic. As the chancery justices admitted in their opinion, there was "a conflict of decisions as to the validity of a by-law of that character, requiring a stockholder before selling his stock, to give the corporation or other stockholders an opportunity to purchase it."[116] Not until the second half of the twentieth century would this uncertainty be completely eliminated by a new wave of statutes that explicitly allowed close corporations to restrict the transferability of their shares.

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[114] *Nicholson v. Franklin Brewing Company*, 82 Ohio St. 84 (1910). This position received additional support after 1909 by the passage in a number of states of the Uniform Stock Transfer Act. Section 15 of this act declared, "There 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." The implication of this section, which the courts seemed to accept, was that bylaw provisions restricting transfer could be held valid if they were written on the certificates. See *Baumohl v. Long Branch Steamboat Co.*, 95 N. J. Eq. 597 (1924). Commissioners on Uniform State Laws, *American Uniform Commercial Acts* (Cincinnati: Gibson & Perin, 1910), 128-29.
[115] *John H. Lawson v. Household Finance Corporation*, 17 Del.Ch. 343 (1930).
[116] *Lawson v. Household Finance Corp.*, 17 Del. Ch. 343 at 350.

Britain and the U.S. Compared

In conflicts over exit, as in other controversies related to corporate governance, the first impulse of courts in the United States was to enforce statutory norms. The various states' general incorporation laws all declared that stock in corporations was personal property and, as such, transferable. As a result, the courts had a great deal of difficulty allowing incorporators to impose restrictions on the transferability of shares, even when the terms of the restrictions seemed eminently reasonable. As statutes became more flexible during the early twentieth century, courts found ways to justify a more liberal stance. But even at mid-century, they were unwilling to enforce agreements that did not guarantee stockholders seeking to exit a just price for their shares. Not until states revised their general incorporations statutes again in the third quarter of the twentieth century did members of SMEs obtain the ability to control the identity of their business associates. In Britain, where company law was more flexible to begin with, such agreements were never really an issue, and as more and more SMEs took out corporate charters, came to be seen as routine. Indeed, the 1907 Act creating a separate status for private companies *required* firms registering under the act to impose restrictions on the transferability of their shares in exchange for exemption from the reporting requirements imposed on public companies.

Litigation over contracts that modified the statutory rules governing dissolution and winding up was more similar in the two countries. In Britain, these rules were not defaults—that is, they were not among the provisions in Model Table A that could be accepted, modified, or bypassed at will. Rather they were positioned in the body of the statute, as they were in the U.S., and the courts came to treat them as mandates, as did courts in the U.S. The similar practices of British and U.S. courts in this area of law is evidence that differences in what incorporators could and could not do in the two countries were driven largely by the structure of statutory law rather than the behavior of the courts. Where the rules were similarly prescriptive, the courts were similarly inflexible. As a general matter, however, British Company Law was much less prescriptive than were general incorporation statutes in the U.S., and the courts were correspondingly more permissive.

Conclusion

Both Britain and the U.S. dealt during the State chartering era with similar concerns. In both countries corporations were associated with interest groups, privileges, and even monopoly. In both the task of exercising informed and consistent discretion with respect to a growing number of incorporation petitions became burdensome. In both, on the other hand, corporations seemed to be economically valuable, attractive outlets to a widening circle of middle class investors, and taxable entities. Both countries resorted to free incorporation and general limited liability at about the same time. Yet the process of transformation from chartering to free incorporation gave rise in Britain to a notion that the new companies statute should be based on the principle of disclosure of information to potential investors. In the U.S., on the other hand, the basic principle was one of supervision of corporate affairs, including internal affairs, by the state. As a result in Britain, from the start, general incorporation legislation was based mostly on default rules. In the U.S. it was based on mandatory rules.

The confines of our research allow us only to conjecture about the causes of this divergence. In the U.S., due to the larger number of chartered corporations, which resulted at least partly from the multiplicity of incorporating jurisdictions, the antagonism and suspicion towards corporations had stronger effect on the restricting content of the ensuing legislation. In Britain a long experience with unincorporated companies, that enjoy significant contractual flexibility, made the application of such flexibility in the companies legislation conceivable. In Britain the unitary system gave rise only to a single company act. Such singular act could be more prone to influence by personal and contingent factors.

The similar common law legal origins do not seem to have much explanatory power. The divergence was created by legislation and not by judge made law. Indigenous factors at the relevant time were more important than legal traditions. Legislation in France and Germany, examined in a companion study by Guinnane and Rosenthal, was not radically different from legislation in Britain and the U.S.

Once the starting point was different, the dynamics worked differently. In the U.S. there were three distinct waves of legislation. Contractual flexibility grew slowly and cautiously over time as some initial concerns eased. Competitive pressures among jurisdictions, with New Jersey as a leader, caused flexibility to tilt towards the needs of big public corporations that were the subject of the competition. In Britain the basic statutory structure of Table A default rules and minimum statutory intervention in internal governance remained similar throughout the period 1856 – 1929 and beyond. A gradual statutory convergence did take place. Much of it resulted from the dynamics of legislative waves in the U.S. But even in the 1920s, and according to Gower even in the 1950, differences persisted and Britain still offered more flexibility.

The courts played their role in the province determined for them by the different statutes. In the U.S. they dealt with the immediate concerns of private companies: restriction of transferability of shares, allocation of voting rights, structure and functioning of the board of directors. In Britain, as flexibility with respect to these issues was secured, litigation concentrated on other issues, such as entrenchment of employment and offices and the opting out of winding up rules. A notable exception was the basic issue of the formation and perseverance of companies with fewer shareholders than the statutory minimum or with nominal shareholders. U.S. courts were more liberal in recognizing such companies while British courts were until 1897 hostile to them. In other areas, however, courts in the U.S. played a more restrictive role, striking down attempts at contractual flexibility. The divergence in contractual flexibility resulted initially from legislatures and was augmented by courts. Britain offered SMEs more flexibility at an earlier stage despite LLSVs' stipulation that the US and Britain were quite similar.

This paper offered a close reading of statutes and cases in search for the boundaries of contractual flexibility. It focused attention on flexibilities in companies' regulation that are relevant for SMEs. It followed the changes in the level of flexibility from the introduction of general incorporation until roughly the Great Depression. Further research can examine the level of flexibility in partnerships. Such a study is important because only interplay between the organizational menu and the flexibility in any given form reveals rigidities and frictions. Further research should aim at going beyond our conjunctions in explaining the causes of the initial divergence and the persistent differences between U.S. and Britain. Lastly, as in other pieces of our larger project and in other studies that focus on the law and the immediate choices made in a response to it, understanding the implications for economic performance is a continued challenge.