

# Corporation or Limited Liability Company

By

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## **Introduction**

As with a partnership, owners of a corporation pool their capital. In contrast to a partnership, a corporation has four distinctive legal characteristics: legal personality, transferability of ownership interests, a functional managerial hierarchy, and limited shareholder liability. Each one of these characteristics has added to the emerging economic dominance of the corporation.

The early corporation was a child of the state, and can be considered as an extension of its narrow mercantile interests, and, as such, it enjoyed monopoly privileges. Eventually this gave rise to state abuse of the corporation to extract wealth from its citizens. Consequently, the corporation evoked political and legal hostility that hindered its development. Once the corporation became associated with competition, companies gained freedom to incorporate.

## **Formative History**

Forms of partnership that had unlimited and limited liability, called *societas* and *commenda* respectively, were rooted in Roman law. (Limited liability has an advantage over unlimited liability in that capital suppliers can only lose the amount of capital advanced.) However, the advent of the corporation generally is associated with the granting of a royal charter to the Russia Company in 1557, giving to it exclusive trading privileges with Russia. This charter allowed it to constitute on a joint-stock basis with a functional management. But the novel feature of the Russia Company was its joint-stock with legal personality, which through the company seal enabled it to sue and to be sued. Exclusive trading charters had been granted previously to “regulated companies” as early as the thirteenth century. The first of these was called the Merchants of the Staple, organized to govern the wool-export industry, and the last, organized in

1505, was the Merchant Adventurers. Significantly, the regulated companies governed the actions of individual merchants and had no real legal personality.

The Russia Company innovation was copied in Holland with the establishment of the Dutch East India Company. In addition, Genoa chartered a slave-trading corporation (1580) and France chartered its Africa (1561), Coral (1600) and Canadian (1602) companies.

The idea of the juristic person, or personality under the law, is attributable to Roman jurists, coming into common law, for example, by way of canon law. But through the vehicle of royal charters, the idea of legal personality enabled both ecclesiastic and lay institutions to hold and administer property in perpetuity. Royal charters conferring legal personality continued to be granted to English companies, the most significant being English East India Company (1599). When receiving a new charter in 1654, this company won the right to perpetual existence, following the precedent set by the Dutch East India Company in 1623. Free transferability of East India Company shares soon followed, setting a precedent for future corporations.

### **The Mercantilist Corporation**

Despite the success of the early corporation, public opinion regarding exclusive trading privileges soured under James I (1566–1625). The king was a spendthrift and had accumulated unprecedented debts. To raise additional income he regularly sold exclusive charters and renegotiated existing ones, creating a climate of investment uncertainty that undermined the long-term interests of the state. That investment uncertainty was the root cause of an economic crisis in the 1620s, intensifying political resentment against exclusive privileges. Although the

attorney general, Sir Edward Coke (1552–1634), had earlier failed to restrict exclusive charters to those deemed in the public interest, Parliament was prompted to restrict royal prerogative. In 1624 it passed the Statute of Monopolies, which forbade the issuing of any further charters without its consent.

Opposition to the business corporation persisted through both the Commonwealth and Restoration eras, resulting in a decline in trading companies involved in European and the Levant trade. However, because of imperial rivalries, promotion of long-distance-trading corporations such as the East India and Hudson Bay Companies continued. Such companies were deemed essential to thwart foreign political and commercial ambitions. For example, France in 1664 chartered its own East India Company. In addition, monopoly corporations such as the East India Company were an important source of government income. For example, the need to raise additional income was an important reason behind the incorporation of the Bank of England in 1694. A notable feature of this period was the inclusion of the privilege of limited liability in company charters.

The reputation of the corporation received a further blow during the first quarter of the eighteenth century. War expenditure had led to unsustainable national debt levels, and schemes were developed to convert public debt into shares of companies, having as their primary asset the same government liabilities. The most infamous instances of these were the Mississippi Company in France (1718), and the South Sea Company in England (1720). The success of the debt conversions depended simultaneously on creditors receiving favorable terms and on government debt levels being greatly reduced. In both instances, company stock was

overpromoted and stock prices soared, drawing in many thousands of investors. Eventually, rationality prevailed and investors began to doubt the promises of outlandish dividends. Consequently, stock prices fell precipitously. The Mississippi and South Sea episodes, both classic financial bubbles, further deepened suspicions regarding corporations, particularly in regard to the propensity to overpromote stocks. Given this historical context, one can understand why the physiocrats in France and Adam Smith (1723–1790) in Britain expressed disapproval toward corporations.

### **Freedom of Incorporation**

Negative opinion regarding corporations persisted through to the turn of the eighteenth century, although in England chartered companies made significant inroads in the insurance and transportation industries due to the need to raise large amounts of capital and to diversify risk. Moreover, quasi-corporations existed in shipping and tin mining. These sectors were under the special jurisdiction of admiralty and stannary courts. Both court systems operated under the principle of customary law, where legal principles adapted to suit business practice instead of conforming to a set of abstract legal principles, as was characteristic of both civil and natural law.

In contrast, under the common law, many corporations had to constitute more circuitously, given the difficulty of obtaining a charter. Through the trust device, promoters hoped to establish joint-stock firms having transferable shares and the ability to sue and be sued. However, this device could not be used to attain limited liability. Beginning in the last quarter of the eighteenth century, such unincorporated companies appeared in the silk, wool, food, and beer industries, but

were notably absent in the cotton and metal industries. In this period the number of companies increased five-fold, and many of them were unincorporated.

The growth in unincorporated businesses occurred despite their illegality under the Bubble Act (1720). This act had been dormant but was resurrected in a number of court rulings in the period 1808 to 1812. The legal threat to the unincorporated companies dissipated only when the act was repealed in 1825. Under a strict interpretation of the common law they were still illegal, but a business-friendly regime at both the chancery- and common-law courts had ruled that such companies were in the public interest. However, continued uncertainty prompted Parliament to enact company legislation that had as its main tenet freedom of incorporation. A chief concern focused on whether freedom to incorporate should be constrained to guard against overpromotion and stock speculation. However, lessons from incorporation experiences in the United States and France ultimately resulted in the English Companies Act of 1844 granting freedom of incorporation, and leaving investors to protect themselves. However, corporations were required to accurately report half-yearly earnings to stockholders.

In the nascent United States, despite the legacy of the common law and the Bubble Act, some state legislatures had begun to freely issue charters to companies operating in many commercial sectors including banking, insurance, and manufacturing. Also, as early as 1817, Connecticut and Massachusetts had moved towards chartering corporations with limited liability. Competition among the states soon encouraged their neighbors to follow suit. Significantly, the region experienced increased economic growth.

In France hostility toward the corporation had peaked during the Revolution, when it had been outlawed for a time, but under Napoleon, corporations were accepted as a necessary evil. Although opposition to corporations eased in successive regimes, there remained reluctance to grant charters. Paradoxically, a form of limited partnership known as a *commandite par actions* was allowed to mutate into an unofficial corporation. Firms could easily register as *commandites*, and in contrast to the chartered corporation they were free from stringent capitalization requirements. Formally, only owners not engaged in management could enjoy limited liability and the right to transfer shares. In practice, however, managers were able to circumvent such constraints. Significantly, *commandite* firms were associated with the most dynamic part of the French economy.

Freedom to incorporate with limited liability in Britain did not come until 1856. Free incorporation with limited liability soon followed in France, and by 1860 most U.S. states had adopted it. Finally, by the last quarter of the nineteenth century many continental European nations had followed suit, ushering in the modern corporate era.

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