the private origins of the private company

Ron Harris
The Private Origins of the Private Company: Britain 1862–1907

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Abstract—This article recalls the fact that until the mid-19th century neither company legislation, nor jurists, nor economists, envisioned companies to be private or small. Nevertheless, once freedom of incorporation and general limited liability were enacted, a new practice was set in motion in Britain. Smaller companies were formed in growing numbers, replacing partnerships, family firms and even sole proprietorships. They operated in sectors in which corporations had not been found before. These companies did not seek access to the stock markets. The article tracks the take-up pattern and changing characteristics of the corporate form in Britain between the enactment of free incorporation and general limited liability (1844–62) and the formal legal recognition of the private company (1907). It shows the dramatic increase in annual incorporation and the parallel decrease in the average capital and average number of shareholders in newly formed companies. The article then analyses the reasons for the decision of businesspersons to incorporate their small firms. The main motivations were the possibility to create asset partitioning between personal and business assets and the ability to use the floating charge. Finally, the article examines the legal reaction to the bottom up emergence of the private company. It examines the reactions of the courts (in the famous Salomon v Salomon case) and of the legislature to this unpredicted practice. It argues that incorporators and their lawyers used the available contractual flexibility to privately design Articles of Association and to adjust them to the specific needs of private and small companies, often by introducing partnership internal governance rules into company Articles. The present study relies on newly gathered data on the take-up of the company form and a newly produced sample of company files collected at Companies House and the National Archives.

Keywords: company law, legal history, private company, private ordering, contractual flexibility

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1. Introduction

Unlike living organisms, and contrary to a common misconception, business corporations did not begin small (and private) and only then grew bigger (and public). Shortly after 1600, the giant (public) English and Dutch East India Companies already dominated Eurasian trade. The most famous single-person company, ‘Aron Salomon and Company, Limited’, one of the earliest private companies, was not formed until 1892, almost 300 years later. This article explores the origins of the private company in Britain, which was first recognized by the Companies Act only in 1907. In the second half of the 19th century, it gradually developed from below, created by businesspersons and their lawyers (thus the ‘private origins’ in the title).¹ These first decades of the private company in Britain are a fascinating case study in private ordering and development of law from below.

In order to provide a multidimensional account of the development of the private company, the article approaches the private company from three directions and is organized accordingly in three parts. Following the introduction, Section 2 documents the emergence of the private company in the mid-19th century, at a time when the large public company was the paradigmatic company. The large public company continued to play an important role and justly received much attention in the legal, economic and business history literature of the second half of the century. Changes in the characteristics of the company in the period 1862–1907 are then described. The number of annual registrations increased dramatically; the average capital of companies dropped; the number of shareholders decreased; and incorporation became prevalent in services and manufacturing sectors in which the company form had been absent in the past. Section 3 aims to explain the causes for the trends documented in Section 2. It studies why the company form was attractive to businesspersons at the time, paying particular attention to asset partitioning, limited liability, entity shielding and legal capital that provided advantages to equity holders. It also notes that the invention of the floating charge benefitted equity investors and sophisticated lenders, and that this tool could not be used by non-corporate firms. The disclosure requirement, a major downside of the company form, became less stringent as the century progressed. This study is based on company records and company litigation and as such focuses on the demand side and on equity finance. Admittedly, such a study cannot provide a full explanation of the trend toward

¹ In this article, the term ‘corporation’ will be used for pre-1844 corporations created by charters or Acts of Parliament (as well as in non-British contexts) whereas the term ‘company’ will be used for post-1844 companies incorporated by way of registration (and for pre-1844 unincorporated companies). The term ‘private company’ will be used for the period after 1907 for companies classified by the Companies Act as private companies. For the period until 1907 the term refers to companies that were not listed in any stock exchange and did not offer their shares to the investing public.
incorporation. Existing and future studies of debt finance and of the banking system can provide complementary explanations.

In Section 4, the article analyses the legal reactions to the informal appearance of the private company. Legislative committees did not result in significant amendment of the Companies Acts with respect to private companies until 1907. The notable court response, *Salomon v Salomon*, decided by the House of Lords in 1897,\(^2\) is analysed in the context of the development of the private company, allowing new insights. This section then focuses on the adjustment of the internal governance rules of the company form, initially created for public companies, to the needs of small private firms. Contractual flexibility, i.e., laws that enable incorporators to freely draft their incorporation agreements and set the rules that governed the companies they formed, was the precondition and private ordering was the tool. The discussion examines the space created by the Companies Act; the contracting practices as reflected in a quantitative sample and a case study; and the court responses.

The article is based on three types of primary sources. First, the first dataset of its kind was formed of the take-up of organizational forms that require registration (public and private companies and limited partnerships) for the entire period, 1844–2003. In most of the years, the dataset is based on the annual reports of the Board of Trade, Department of Trade and Department of Trade and Industry as well as additional data on company characteristics at registration, such as nominal capital, taken from annual reports and ad hoc reports. Because such data were not reported on a regular and systematic basis, whatever information was available had to be used. The second source is a first of its kind sample of company registration files. The sample is of companies registered in 1892, when the turn to smaller companies was already apparent but before the effect of the statutory amendments of 1900 and 1907 had taken effect.\(^3\) Company files, held by the National Archive and Companies House, include information on capital, number of shareholders, and more, both at registration and later; information that is not available in the annual reports of the registrar or elsewhere. This source also contains the full text of the contractual instruments used for forming the company. The third source comprises more conventional legal sources, including court cases, legal treatises and parliamentary reports.

This article reports on part of a wider comparative project. The introduction of a new form, the Private Limited Liability Company (PLLC), is a widespread phenomenon. The form was first introduced in Germany in 1892 as the GmbH. After its introduction in Britain in 1907, it was introduced in France in 1925 as the SARL. The US is the outlier. Following an abortive attempt in the 1870s and 1880s to introduce the partnership association with most of the

\(^2\) [1897] AC 22 (HL).

\(^3\) The year 1892 was also selected because it allows comparison to other jurisdictions as the GmbH was introduced in Germany in that year.
features of PLLCs in several states, the successful introduction of a PLLC form, the LLC, occurred only a century later, in the 1980s. The project aims to shift some scholarly attention from the large public companies to small and medium-sized enterprises (SMEs).4

A. First they were all Public

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

In 1776, Adam Smith stated that the joint-stock company form should be used only by large companies in four sectors:

first, the banking trade; secondly, the trade of insurance from fire, and from sea risk and capture in time of war; thirdly, the trade of making and maintaining a navigable cut or canal; and, fourthly, the similar trade of bringing water for the supply of a great city.5

Interestingly, when 50 years later, the Committee of Privy Council for Trade announced its policy with respect to the granting of letters patents of incorporation based on the 1834 Companies Act, it related to the same sectors and envisioned the same scale.6 Single proprietor enterprises never sought incorporation. Small enterprises of two or more proprietors were, by default, common law partnerships.


6 R Harris, Industrializing English Law: Entrepreneurship and Business Organization, 1720-1844 (CUP 2000). The only difference being that railway companies, which Smith had not foreseen, were included in the Board of Trade guidelines.
The Registration, Incorporation and Regulation Act 1844 shuffled the cards. Now incorporated joint-stock companies could be created by mere registration with the Companies Registry Office, the forerunner of Companies House, established by the Act. Registration required filing a few documents and forms that provided the public with basic information about the company. The Act also made a clear distinction between companies and partnerships. The unincorporated company, a popular form used by some of the smaller firms to avoid the costs of incorporation, lost ground. Unincorporated companies could easily register and enjoy all the legal features of a corporation. On the other hand, they were obliged to register. The Act required partnerships with transferable shares and partnerships with more than 25 members to register in a manner similar to that required by joint-stock companies. The in-between space created from below by private ordering of lawyers and businesspersons, using contracts, partnership law and trust law, was eliminated by the 1844 Act.

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

2. The Emergence of the Private Company

A. More and Smaller Companies: Quantitative Trends

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

The first trend, the development of public companies, has received most of the attention of the literature in law, economics, finance and business. The attention given to this trend is justified. Michie and others pointed to the dramatic increase in the total number of securities and their paid up capital between 1853 and 1913. Much of the increase was in corporate stock. In 1853, British government bonds still dominated the market, comprising 70% of quoted securities (in nominal values), but by 1913, they comprised only 15%. Correspondingly, corporate securities increased from 20% to 75% of the nominal value; commercial and industrial securities were the fastest growing
sectors, rising from £22 m to £917 m.\footnote{RC Michie, \textit{The London Stock Exchange: A History} (OUP 1999) 70–142; William Arthur Thomas, \textit{The Provincial Stock Exchanges} (Frank Cass and Company Limited 1973).} Grossman, who also covered provincial exchanges and used market capitalization, showed that the number of companies listed in his markets rose from 520 to 1,100 and much of the increase was in industrial and commercial companies, mining and banking.\footnote{RS Grossman, ‘New Indices of British Equity Prices’ (2002) 62 JEH 121–46.} In their classic books, Leslie Hannah and Alfred Chandler analysed the rise of big business, often monopolistic, and of the corporate economy. They surveyed the transformation from entrepreneur and family controlled firms to hierarchical professional manager-controlled firms.\footnote{L Hannah, \textit{Rise of the Corporate Economy} (Methuen 1976); Alfred D. Chandler, \textit{Scale and Scope: The Dynamics of Industrial Capitalism} (Harvard University Press 1994). The debate in the literature is on the timing of the transition.} Another related issue that has attracted attention is the shift from controlling stockholder public companies to widely dispersed companies. It was assumed that the separation of ownership and control that, according to Berle and Means, took place in the United States in the early 20th century, took place in Britain only decades later. Franks, Mayer and Rossi, basing their analysis on samples of 20 companies incorporated around 1900 and 20 companies incorporated around 1960, concluded that the dispersed ownership that characterizes the UK corporate system today emerged early in the 20th century and replaced family ownership.\footnote{J Franks, Colin Mayer and Stefano Rossi, ‘Spending Less Time with the Family: The Decline of Family Ownership in the United Kingdom’ in Randall K Morck (ed), \textit{A History of Corporate Governance around the World: Family Business Groups to Professional Managers} (University of Chicago Press 2005). See also Julian Franks, Colin Mayer and Stefano Rossi, ‘Ownership: Evolution and Regulation’ (2009) 22 Rev Financ Stud 4009, which uses samples of 55 companies for 1920 and 1950 and reaches similar findings.} Cheffins presents a more nuanced picture. Separation of ownership and control in the UK took place early in only a few sectors, notably banking and railway companies. But in other sectors, including industrial companies, insurance companies, shipping companies and electric utilities, the separation of ownership and control began only in the interwar period and was completed only after the Second World War.\footnote{BR Cheffins, \textit{Corporate Ownership and Control: British Business Transformed} (OUP 2008) 221–51, 292–300, 350–70.}

The just attention given to public companies marginalized the second trend, which is the focus of this article. The appearance of smaller companies, with fewer shareholders, less capital and no intention to raise capital on the stock exchange in the second half of the 19th century, is not unknown to historians. But this trend was surveyed mainly in older articles and dissertations.\footnote{HA Shannon, ‘The First Five Thousands Limited Companies and their Duration’ (1932) 3 Econ Hist 421; G Todd, ‘Some Aspects of Joint Stock Companies, 1844–1900’ (1932) 4 Econ Hist Rev 46; JB Jefferys, ‘Trends in Business Organization in Great Britain since 1856: With Special Reference to the Financial Structure of Companies, the Mechanism of Investment and the Relations between the Shareholder and the Company’ (PhD thesis, London 1938).} This section will consolidate some of the findings of this literature and add new quantitative findings, based on two datasets produced as part of the current project. The section will show that the trend towards the incorporation of small
firms and the creation of informal private companies gathered momentum in the past three decades of the 19th century, and that eventually, a large majority of companies became small private companies.

(i) Annual registration of companies

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

For the period 1844 to 2003, a dataset was constructed of the take-up of the corporate form, which, for most of the period, is based on annual government reports. Unless otherwise noted, the following figures are based on that dataset, the first of its kind. The average annual number of incorporations in the years 1846–55, after the release of the bottleneck, was 245. In 1856, there were 956 completely registered companies. The passage of the Limited Liability Acts caused the re-registration of many companies as limited companies and a continued rise in the number of new registrations. The average number of registrations for the period 1856–69 was 445. In most years after 1872, the number was over 1,000. In each year after 1889, the number was more than 2,500. The annual average for the 1890s was 3,661. In 1907, the year in which the private company was formally introduced, the number of registrations reached 5,147 (see Figure 1).

As expected, the total net stock (registered minus dissolved) of companies grew as well. In 1907, on the eve of the introduction of the private company, and despite the downturn in annual incorporation that followed the harsh Companies Act 1900, the Boer War and the economic slowdown, the total net stock was 41,651 companies, about 40 times its number 50 years earlier.
The arrow in Figure 1 points to the era of dramatic growth in the number of annual registrations between 1862 and 1907. This article focuses on that period. It analyses the characteristics of the companies that composed that growth, the causes for the growth and the legal response to these new characteristics. It argues that despite the fact that the private company was formally introduced only in 1907, in fact it evolved informally from below after 1862 and was privately ordered by shrewd lawyers. The post-1907 rise in private companies and decline in public companies that is underscored by the logarithmic scale of Figure 1 is a continuation of a trend that began in 1862.

The diffusion and expansion figures are also impressive when adjusted for population or GDP growth. Annual registrations per 1,000 people rose by 13, from 0.009 in 1860 to 0.118 in 1900. Registration per million pounds of GDP rose by 8, from 0.004 in 1860 to 0.032 in 1900.\(^{17}\) This in itself may hint that more also means smaller, and that firms that were too small to incorporate during the era of incorporation under privilege, sought incorporation once the restrictions were removed, a process that continued for the rest of the 19th century.

Another indication of the incorporation of the new, smaller type of companies can be found in the average registered nominal capital per company. This average is taken from summaries in the annual reports. The average nominal capital per company declined from £170,188 in the years 1863–69 (average of annual averages in the range), to £82,093 in the 1870s, to £54,479 in the 1890s, to £33,519 in 1900–1907.\(^\text{18}\)

The trend towards smaller companies can be better captured by examining the distribution of companies with nominal capital in various brackets, ranging from less than £1,000 to more than £1,000,000. This method allows us to isolate the exceptionally large public companies that emerged in this period due to capital intensive technologies and economies of scale and may have offset the decline in the average, and to focus on the smaller companies. However, the distribution for the early years is not available as such in the annual reports. Table 1 is the result of going through the list of all companies registered in the years 1877 and 1882 and extracting the nominal capital of each company in order to provide the distribution.

Only 19 of the 817 companies registered in 1877 had capital of less than £1,000 (2.3% of all registered companies). In 1882, there were 43 out of 1,409 (3.1%). 34% of the companies in 1877 and 24% of the companies in 1882 had

\[\begin{array}{lcc} \text{Capital (in £)} & 1877 & 1882 \\ \hline <1000 & 2.3\% & 3.1\% \\ 1000–5000 & 18.6\% & 13.0\% \\ 5000–10,000 & 13.5\% & 7.8\% \\ 10,000–20,000 & 21.1\% & 13.8\% \\ 20,000–50,000 & 18.5\% & 22.6\% \\ 50,000–100,000 & 12.0\% & 12.6\% \\ 100,000–200,000 & 8.1\% & 12.3\% \\ 200,000–300,000 & 2.1\% & 6.4\% \\ 300,000–400,000 & 0.9\% & 1.6\% \\ 400,000–500,000 & 0.4\% & 0.6\% \\ 500,000–750,000 & 0.7\% & 2.9\% \\ 750,000–1,000,000 & 0.0\% & 0.3\% \\ >1,000,000 & 2.0\% & 3.1\% \\ \hline \text{Total} & 100.0\% & 100.0\% \end{array}\]

\(^{18}\) Average nominal capital figures are taken from annual reports.
nominal capital less than £10,000; 40% of the companies in 1877 and 36% of the companies in 1882 had capital of between £10,000 and £50,000.

For 1890, the distribution is available (in cruder categories) in the Companies Registrar’s testimony before the 1895 Departmental Committee Report (Davey Report). In that year, 17% of the companies had nominal capital less than £2,500; 46% of the companies had nominal capital less than £10,000 and 28% of the companies had capital in the range of £10,000–£50,000.

For 1892, our sample shows that exactly 46% of the companies had nominal capital less than £10,000 and 30% had nominal capital in the range of £10,000–£50,000 (and this is also a calibration of the sample).

For the years 1896–1905, the distribution is readily available in the Warmington Committee’s Appendix to the Company Law Committee Report of 1906.$^{19}$

Figure 3 shows that in the decade between 1896 and 1905, there was an increase in the percentage of companies registered with nominal capital of less than £1,000 from 3.8% to 8.3%; with nominal capital in the range of £1,000–£5,000 from 18.5% to 32.5%; and with nominal capital in the range of £5,000–£10,000 from 12.9% to 16.7%. Higher nominal capital ranges shrank correspondingly. In fact, the same trend of increases in the percentage of companies with less nominal capital continues from the 1877 and 1882

Table 2. Nominal Capital of Companies, 1892 Sample

<table>
<thead>
<tr>
<th>Capital (in £)</th>
<th>Registered</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;1000</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>1000–5000</td>
<td>14</td>
<td>25</td>
</tr>
<tr>
<td>5000–10,000</td>
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<td>16</td>
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<td>10,000–20,000</td>
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<td>18</td>
</tr>
<tr>
<td>20,000–50,000</td>
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<td>12</td>
</tr>
<tr>
<td>50,000–100,000</td>
<td>7</td>
<td>12</td>
</tr>
<tr>
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<td>6</td>
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</tr>
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<td>400,000–500,000</td>
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<td>500,000–750,000</td>
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<tr>
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<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>57</td>
<td></td>
</tr>
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</table>

Figure 3. Percentage of Nominal Capital of Companies at Registration in Various Capital Ranges (1896–1905).
samples, to the 1890 reported figures, to the 1892 sample and through the reported figures of 1896–1905.

The capital data analysed above has one major shortcoming. It relates to nominal capital at the time of incorporation, not called-up or paid-up capital over the years. Its main advantage is that it is more readily available because it can be extracted from the annual reports of the Board of Trade on the activities of the Companies Registrar. Nominal capital may not reflect much about the size of companies if it is fixed arbitrarily or at high levels, just in case. But there are good reasons to believe that incorporators deliberated before fixing the nominal capital. Trends in paid up capital could not be captured through the same sources. These will be analysed below, based on company files.

(iii) Number of shareholders

Another perspective regarding the size of companies is the number of shareholders. As seven was the minimum required by law, even one-person companies had seven nominal shareholders. But larger companies as well incorporated with only seven shareholders: the required signees of the memorandum. This became the standard practice of company lawyers. As a result, the number of shareholders at incorporation provides no valid information on the size of the company.

Our 1892 sample of company files allows a more apt approach. I followed the annual reports that included lists of shareholders to see how shares were dispersed over several years, beyond the initial formal number of seven shareholders. As many as 98% of the companies in the 1892 sample had seven shareholders at incorporation. Later, additional shareholders were added to the larger companies. By the end of the first year, only 22% of the companies had seven shareholders, but only 13% had 100 or more shareholders. Seventy-two per cent of the companies had fewer than 50 shareholders, a figure that 15 years later, in 1907, became the threshold between private and public companies. By the fifth year, only 11% of the companies had seven shareholders, 17% had 100 or more and 56% fewer than 50 shareholders (see Figure 4). The numbers are probably upward-biased because companies with few shareholders had higher representation among the non-reporting companies. But even without accounting for this bias, the figure suggests that less than 20% of the companies were widely held public companies, whereas more than half had fewer than 50 shareholders. The figure also demonstrates the advantages of a methodology that relies on company files.

In 1895, JS Purcell, the Registrar of Joint Stock Companies, delivered a memorandum to the Davey Committee, which was appointed in 1894 by James Bryce, President of the Board of Trade, to examine the need for amendments to

20 For one, not all companies inflated their capital. One reason for this was that fixing high nominal capital shifted control of the allocation of shares from the shareholders to the directors. An additional reason was that promoters paid stamp duty based on the level of registered capital.
the Companies Act. To prepare the memorandum, the Registrar surveyed incorporations in the first half of 1890. He concluded that of the 1,339 companies registered in the first six months of 1890, 415 were private in nature. Of these, 8% had one major shareholder, 12.9% had two shareholders, 15.3% had three, 8.9% had 4, 6.1% had five, 8% had six and only 9.2% had seven shareholders. This indicates that 59% of the private companies he surveyed had fewer real shareholders than the required minimum of seven. Unfortunately, Purcell did not explicate his methodology and did not explain his definition of ‘private company’ or ‘major shareholder’.

(iv) Conclusion
Several contemporaries observed this change and began to talk about a new type of company, the private company. In 1877, Francis B Palmer, an eminent company lawyer, published *Private Companies; Or How to Convert your Business into a Private Company, and the Benefit of So Doing*. This booklet was one of the first to respond to the changing reality. In the 1892 preface to its 10th edition (now titled *Private Companies and Syndicates, Their Formation and Advantages*), Palmer wrote:

> During the last ten years the conversion, under the Companies Act, 1862, of business concerns into private companies, i.e. companies started without any appeal to the public for capital has made extensive progress.²¹

²¹ FB Palmer, *Private Companies and Syndicates, Their Formation and Advantages* (Stevens and Sons 1892) 2. He attributed much of this progress to the guidance provided by his own book, *Private Companies; or How to Convert Your Business into a Private Company, and the Benefit of so Doing* (Stevens and Sons 1881), that had come out in yearly editions during the previous decade.
His testimony fits the trend observed quantitatively:

It took a good many years before the immense advantages of the Act of 1862 were fully understood. At first, the Act was almost exclusively used for public companies with numerous shareholders...it came to be understood that the Act...had freed the community at large from the tyranny of unlimited liability. Since this discovery, thousands of private companies have been formed and the number is rapidly increasing, as day by day the advantages of the system become more and more appreciated.22

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

B. Who were the Private Companies?

Until the Companies Act 1907, no formal legal distinction between public and private companies existed.23 There was a range of types of companies. The types in the upper part of this range could, in retrospect, be considered public companies, as they raised external equity finance from the public. The types in the lower part of the range could be considered (both in retrospect and by some contemporaries such as Palmer) private companies. But rather than this dichotomizing typology, a typology is suggested within each basic type, based on the extent to which each company resorted to the public for external finance (for public companies) and on the previous organizational form of the company (for private companies). While there is a link between the organizational type and the size of the firm, this link is not necessarily very strong. To be clear: though the two are linked and sometimes overlap, in this typology and the article as a whole, the focus is on organizational type and not on the size of the firm.

Located on the upper part of the typology range was the standard, large, publicly held, widely dispersed, stock exchange listed and actively traded company, which will not be dealt with here. Down from it were additional subtypes of public and semi-public companies. These include the publicly

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22 ibid 4–5.
23 The 1907 Act defined the private company as one whose articles of association prohibited inviting the public to subscribe to its share and debenture capital, restricted the transferability of its shares and limited the number of its shareholders to 50. Companies Act 1907 (7 Edw 7 c 50) s 37(1). This term was used by Palmer in his 1881 book. See FB Palmer, Company Precedents for Use in Relation to Companies Subject to the Companies Act 1862 to 1880: With Copious Notes (Stevens 1881) 32. Besides Palmer, in the literature I found no accurate description of a ‘private company’ as we know it today with this name, even though there was literature which described this ‘new phenomenon’. See JW Smith, A Compendium of Mercantile Law (Stevens 1859) 61.
traded company with controlling shareholder, the company that was traded only in provincial stock exchanges, the company that turned to the primary market at its initial public offering (IPO) but was traded irregularly, with low liquidity, or not listed and quoted at all in any formal secondary market. Public companies could be found in infrastructure, utilities and network sectors such as railway, canal, water supply, gas lighting and the developing telegraph and electricity sectors. They could also be found in second industrial revolution technology and capital intensive industries such as steel and chemical manufacturing, shipping, and the infant bike and automobile industries, and in first industrial revolution sectors: textile, mining and metal manufacturing, in which some firms adopted mass production and economies of scale and grew larger and public.

At the other end of the range were single-person companies (or in contemporary jargon, one-man companies). The Companies Act required a minimum of seven members in a company. The simple solution was to use six dummy members, the legality of which will be discussed below. One step up was a family company in which one of the family members, typically the patriarch, controlled and managed the company by himself.24 Other members could be employed by the company or receive some of the profits at the discretion of the manager. But governance was not an issue and was not regulated by law. The question of whether the famous Salomon v Salomon case,25 which is conventionally viewed as dealing with a company of the first subtype, indeed belongs to the first, or in fact, to the second subtype, will be discussed below.

Another step up was a company that was originally controlled by a patriarch but, by the second or third generation, its shares were held by several heirs, siblings, cousins, etc. Such companies could now encounter management and control conflicts. A further step up included companies with a small number of shareholders who were not members of the same family. These could be partnerships, which turned into companies once incorporation became more accessible and cheaper, or new firms that decided for the same reason to incorporate rather than be run as common law partnerships.

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

25 Salomon (n 2).
This article examines the emergence of the subtypes of the private company, as typified above, from the single-person company, to the family company, to the partnership-like company. Public and semi-public companies of the first type and its subtypes are not our subject.

What were all these private companies doing? The sectorial identity of the companies registered in any given year was not reported in their annual statistical reports. The registered names could be too vague or even misleading to allow classification. The registration documents had to be examined. The ‘objects’ clause of the Memorandum of Association was the best indication. In that clause, the more substantive and specifically tailored subsections, often the first subsection, carried the information, not the more standardized and general objects (to sell, borrow, rent, employ, carry on any related business, etc) that were listed in other subsections. In some cases, it was necessary to consider the objects together with the Articles of Association or a side agreement (for example, when the object was to buy firm XYZ and carry on its business). Our 1892 sample provides a good snapshot. For 58 of the companies, mostly private companies (based on the number of shareholders and nominal capital), it was possible to identify a major sector of activity. Table 3 shows the sectors of activity for these companies.

The largest group, manufacturing companies, besides traditional small-scale producers such as brick manufacturers and brewers, also included carriages and firefighter manufacturers, tool and machine engineering, and chemical manufacturers. Some of these companies vertically integrated production with wholesale or even retail. The entertainment sector features opera, theatre, club and baths. In addition to gas, the utilities sector also included the new network technologies of electricity and telephone. The financial companies included the traditional banking and insurance sectors but also included an agent for shareholders and a financial information company. The miscellaneous category includes a chemist, a florist and a grocer.

<table>
<thead>
<tr>
<th>Sector</th>
<th>% of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Colonial Natural Resources</td>
<td>12</td>
</tr>
<tr>
<td>Domestic Natural Resources</td>
<td>9</td>
</tr>
<tr>
<td>Entertainment</td>
<td>12</td>
</tr>
<tr>
<td>Finance</td>
<td>10</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>26</td>
</tr>
<tr>
<td>Publication</td>
<td>9</td>
</tr>
<tr>
<td>Utilities</td>
<td>9</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>14</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
</tr>
</tbody>
</table>
Diffusion of the company form to the core of traditional manufacturing was partly related to one of two trends. The first trend was of incorporation in order to turn to the stock market and raise external equity finance. This category included core first industrial revolution textile and iron and steel manufacturers, growing larger over time, second industrial revolution capital intensive firms such as those in the chemical industry, and at least some of the more capital intensive utilities, financial firms and colonial companies. The second trend was the turning of family firms and partnerships into private companies without the intention of raising capital in the equity market. In addition to those in our sample, family firms and partnerships producing finished consumer goods were in the process of conversion to the corporate form. So were wholesalers and some retailers. Machine engineering and production often remained small businesses because of individualized needs; these were converted to the corporate form not in order to raise equity finance. The service firms in our sample were in sectors that grew with the expansion of the middle class, literacy, leisure and new consumer technologies. Our sample seems to have mostly picked up this second trend, which, though less significant in terms of size of firms, represented many more newly formed companies.

Birmingham and London’s East End were the more typical locations for these types of smaller firms converting into private companies, than the industrial hubs of Manchester or Leeds. The firm of Aron Salomon, leather merchant and wholesale boot manufacturer from Whitechapel, East London, to which the article will soon turn, was prototypical of the sectors and scales to which the corporate form diffused in this period.

3. The Incentives to Incorporate

A. Asset Partitioning

(i) Limited liability

The debates in the 1840s and 1850s over the desirability of limited liability did not envision private companies. The response of English law to the newly appearing private companies resorting to limited liability was a non-response.

26 Producers of other types of finished goods, such as shoes, cloths, kitchenware, clocks, books and processed food, not in our 1892 sample, were also likely to be among those converted around that time. See MJ Daunton, Wealth and Welfare: An Economic and Social History of Britain 1851–1951 (OUP 2007) 76–165.

Private companies could benefit from this feature, though it was not designed for them.28

Another development that worked in the same direction was with respect to the procedures for the winding up of companies. The Bankruptcy Consolidation Act 1869 confirmed that company creditors could not seek execution of judgments against shareholders and could no longer bankrupt shareholders. This was a procedure that gave effect to the general limited liability that had already been introduced more than a decade earlier.29 It clarified the advantage of incorporation even when no resort to external equity capital was considered.

(ii) Entity shielding
While for public companies, the main benefit of limited liability was the access to a wider impersonal market of equity investors, for private companies the main benefit was the ability to create asset partitioning. Incorporation enabled the legal separation between two pools of assets: business assets and liabilities, and personal assets and liabilities. For private companies, the main issue was debt finance rather than equity finance. Limited liability shielded the personal assets of the shareholders from the creditors of the company. Its reverse entity shielding protected the assets of the company from the creditors of any of its shareholders.30

Entity shielding was not new in the mid-19th century. As Hansmann, Kraakman and Squire showed, entity shielding developed over the 17th and early 18th centuries with respect to partnerships, trusts and corporations.31 The regime created by the combined holdings in *Craven* (1683) and *Crowder* (1715) is known as the ‘jingle rule’. This rule gave partnership creditors priority over partnership assets, and personal creditors priority over personal assets, and brought about the weak entity shielding of partnerships.32 Further developments during the 18th and 19th centuries permitted the English partnership to add a degree of liquidation protection to the priority rule recognized in *Craven*, and thus to a transition from weak to strong entity shielding. During the 17th century, it likely became settled doctrine that a trustee’s personal creditors could not levy on trust assets even though the trustee held those assets in his own name. By the late 17th century, the trust

31 ibid 1374–87.
offered full liquidation protection; neither a beneficiary nor his creditors could force liquidation of trust assets. The 1844 general incorporation statute did not explicitly provide for strong entity shielding, apparently because by the 19th century, that attribute was understood to be inherent in the company form. So, unlike the case of limited liability, the development of entity shielding cannot explain the timing of the appearance and spread of private companies because it predated these companies by at least a century and a half. In addition, the advantages of the incorporated company in this respect narrowed and possibly even disappeared, as the partnership form acquired strong entity shielding.

(iii) Called up capital and reserve liability
The transition from a regime of unlimited liability to a regime of limited liability was not instantaneous. When general limited liability was introduced in 1855–56, most pre-existing companies had a significant balance of uncalled and unpaid capital. This balance had two main functions: raising additional capital according to investment needs from existing shareholders, and the creation of reserve liability for creditors.

Several scholars, studying public companies, suggest that a significant gap existed between nominal and paid-up capital of companies in the mid-19th century and that the gap narrowed as the century progressed. In most sectors, the practice of issuing fully paid shares replaced a practice in which initial calls were made for only a fraction of the nominal capital of each share. Jefferys, in a classic study, analysed the paid up capital of listed companies based on reports in Burdett's Official Intelligence (1882–98, succeeded by Stock Exchange Official Intelligence), and reached the conclusion that the ratio of paid up to nominal capital increased over time.33 While in the period 1856–65, unpaid shares were widely used, by 1885, 60% of the capital was paid up and the ratio continued to grow, though not evenly across sectors. Shannon, based on an unspecified 20% sample, argued that the gap in low denomination shares narrowed considerably between the 1860s and 1880s but that this was not the case with high denomination shares.34 In a recent study, Acheson, Turner and Ye found fluctuations in the percentage of fully paid stock between 1825 and 1869. For three sample years, 1825, 1845 and 1865, the paid up to nominal capital ratio was 58.1, 58.4 and 67.4%, respectively. The current study also relates only to listed companies, and makes calculations based on the Course of the Exchange. Variations among sectors, were also found, with banks, insurance companies and financial companies having the lowest ratio.

The lowering of share denominations and of total registered capital, as well as the use of more fully paid shares, closed the gap that had allowed company liquidators in the past to make substantial calls on shareholders’ personal assets for the unpaid portion of issued shares, on behalf of creditors. There are several reasons for these trends. The gradual calling of capital was used in large infrastructure projects such as canals and railways and as these were completed by the 1860s and 1870s, the gap between nominal and paid up capital in these sectors closed. The use of calls in instalments, in order to attract the middle classes to equity investment, was gradually abandoned as share denominations decreased and as the middle classes became wealthier. The adverse effects of uncalled capital became apparent with the failures of the bank of Overend, Gurney & Co in 1866 and of the Albert and European insurance companies in 1869 and 1871. Shareholders in these companies were forced by their liquidators to pay uncalled balances, in some cases, dozens of pounds per share and hundreds of pounds per shareholder, leading to the insolvency of hundreds of individuals. Though the practice of using uncalled capital did not disappear altogether in the 1880s and 1890s, it was confined to the financial sectors.

How did these trends affect private companies? Previous studies based on stock exchange reporting could not examine this question. In this study, the method for getting the paid-up ratio had to be different, as stock exchange information was not reported for most of the sampled companies. However, companies were required by the Companies Act to file annual reports as well as special reports with the Companies Registrar. As shares were not fully paid when the company was registered, the paid-up capital figures could not be taken from the original registration record but rather from the first few annual reports of companies that were filed with the Companies Registrar. A random sample was used of company files photocopied at the National Archive and

35 According to Jefferys, ‘The Denomination and Character of Shares’ (n 33), the nominal denomination of shares was reduced in the second half of the 19th century from tens or even hundreds of pounds to as low as one pound per share. See also Shannon, ibid 389. Cottrell, based on a different sample, asserted that mean share value fluctuated in the years 1856–82. But he too acknowledged that the issuing of £5 shares became more common from the mid-1870s and £1 from the end of that decade. PL Cottrell, Industrial Finance 1830–1914: The Finance and Organization of English Manufacturing Industry (Taylor & Francis 1980) 81–88. See also Rob McQueen, A Social History of Company Law: Great Britain and the Australian Colonies 1854–1920 (Ashgate Publishing Ltd 2009) 148–53 who supports Cottrell’s findings based on his own 10% sample of the two years 1856 and 1866. GG Acheson, JD Turner and Q Ye, ‘The Character and Denomination of Shares on the British Equity Market’ (2012) 65 Econ Hist Rev 862 recently concluded that in the period they sampled, 1825–70, high share denomination persisted in sectors such as utilities, railways banking and insurance. See also CR Hickson, JD Turner and Q Ye, ‘The Rate of Return on Equity Across Industrial Sectors on the British Stock Market, 1825–70’ (2011) 64 Econ Hist Rev 1218. But none of the studies contradict Jefferys’ conclusion that share denomination declined in the 1880s and 1890s.

Companies Registrar and coded. This allowed us to track the paid-up capital of private companies.

As can be seen from Table 4, not all companies filed all reports, thus only data on a subset of the full sample is available for each year. It is also clear from the table that shares were paid up over a few years from formation as more companies moved into the higher brackets. By 1897, 47% of the companies had paid-up capital of 60% or more. The average paid-up capital of the sampled companies (that reported) in 1897 was calculated as 70%, a higher ratio than the one reported in the above studies.

The trends that began in the 1860s in public companies legitimized and incentivized the registration of smaller private companies with low nominal capital and diminishing reserve liability in the following decades.

(iv) Legal capital
Legal capital is the par value of all of a company’s shares outstanding. Legal capital may not be distributed as dividends or in any other form. Once unlimited liability was replaced by a limited liability regime and the use of reserve liability was gradually replaced by fully paid par value, legal capital was the amount put at risk by shareholders at the formation of a company and the amount that serves as a cushion for the protection of creditors. Fixing significant minimum legal capital was widely used in Continental corporation law. It served as a threshold. Small firms could not meet this requirement.

Table 4. Paid-up Capital of the Sampled Companies

<table>
<thead>
<tr>
<th>% Paid-Up</th>
<th>1892 Report</th>
<th>1893 Report</th>
<th>1897 Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>1–20</td>
<td>19%</td>
<td>18%</td>
<td>6%</td>
</tr>
<tr>
<td>21–40</td>
<td>31%</td>
<td>24%</td>
<td>12%</td>
</tr>
<tr>
<td>41–60</td>
<td>31%</td>
<td>24%</td>
<td>35%</td>
</tr>
<tr>
<td>61–80</td>
<td>8%</td>
<td>24%</td>
<td>12%</td>
</tr>
<tr>
<td>81–100</td>
<td>12%</td>
<td>12%</td>
<td>35%</td>
</tr>
<tr>
<td>Number of Companies in Sample</td>
<td>26</td>
<td>17</td>
<td>17</td>
</tr>
</tbody>
</table>

A sample of 50 dissolved companies was drawn from National Archives BT 31 Board of Trade, Companies Registration Office, Files of Dissolved Companies 1855–1976 (45,987 boxes, files and volumes). Files in the National Archives are kept in boxes that were received from Companies House. These are organized based on date of dissolution, not date of registration. They are kept in this order because this is how they were shipped from Companies House after being held there for about 20 years after dissolution. In order to avoid biases that result from sampling based on date of dissolution, I sampled 1,892 companies based on their original running registration numbers, using a table titled ‘Last Company Number for each Calendar Year’. I then located the files of these companies in the various boxes sent over the years, and photocopied them. The sample is thus of companies that were registered with the Companies Registrar in England and Wales in 1892. This sample did not pose problems regarding active or recently dissolved companies or with destroyed files, as the numbers of these are insignificant for 1892. In samples for later years that will be used in future stages of the project, supplements and adjustments were made, insofar as feasible, to account for them.

Palmer, *Private Companies and Syndicates* (n 21) 25–29, advises incorporators to do just this.
England, the law allowed contractual flexibility with respect to the capital of the company. It was suggested to several of the committees that examined company law in England in the second half of the 19th century to fix minimum capital but the measure was never adopted.\(^39\) As shown above, as time passed, companies selected lower registered capital.

According to Geoffrey Miller, the par value system failed in America in the passage from the 19th to the 20th century.\(^40\) In various ways, such as by wage payment to themselves or self-dealing or simply by loss-making, shareowners could diminish the original legal capital of the company. Legal capital, as it functioned in England, did not reduce the incentive for the transformation of firms into private companies.

B. Floating Charges

The introduction of general limited liability was only the first of several developments that made incorporation more attractive to shareholders vis-à-vis creditors. By the 1860s, the expansion from railways to other sectors of the use of debentures as a form of long-term finance legitimized their use in smaller private companies as well. The development of the floating charge as a means for creating secured debt over working capital provided floating charge creditors with seniority over unsecured trade creditors.\(^41\) An ongoing debate discusses the demand side and supply side causes of the development of floating charges by lawyers, and their recognition by the courts.\(^42\) While resolution of the debate about the reasons for the creation of the floating charge and its effect on the financing of public companies is not essential to our needs, an analysis of its side effect on private companies is. The use of floating charges was legitimized in the 1870s. The 1882 Bills of Sale Act set a standard form of bills of sale that required the annexing of a schedule listing the affected personal chattels and by this curtailed the creation of floating charges. But this Act excluded debentures issued by incorporated companies, thus in fact disallowing the formation of floating charges by individuals and partnerships.\(^43\) Thus, while the company form ceased to provide an advantage

\(^{39}\) In Germany, even the private company, the GmbH, when introduced, was required to have an issued capital of at least 20,000 Marks (about £1,000). In France, when the SARL was introduced in 1925, its minimum capital requirement was 25,000 francs. See Guinnane and others, ‘Putting the Corporation in its Place’ (n 4); T Guinnane, ‘Using a New Legal Form: The GmbH from its Introduction to World War I’ (Department of Economics, Yale University, September 2008) <http://yale.academia.edu/TimothyGuinnane> accessed 21 December 2012.


\(^{43}\) Bills of Sale Act 1882, ss 4, 17.
over the partnership with respect to entity shielding, with respect to the use of the floating charge, the company form was preferable to the partnership, the family firm and the individual.

This advantage was manifest in two contexts: first, borrowing from informed lenders such as banks and financial institutions, and second, deceiving uninformed lenders such as suppliers, customers, employees and involuntary creditors. It was suggested that, until the third quarter of the 19th century, firms wishing to obtain debt finance could use informal reputational social networks. These included not only kin, neighbours and business associates but also country banks that relied on personal acquaintance in their creditworthiness and credit rationing decisions. As personal credit declined and was replaced by impersonal credit, personal reputation was replaced by secured assets as a primary consideration in the allocation of business loans by financial institutions. The company form, allowing asset partitioning and the use of floating charges, was the preferred organizational form from the perspective of suppliers of credit. Family firms and partnerships incorporated in order to gain access to impersonal external debt capital. This plausible explanation cannot be verified by the current research. Information on debt finance in company files is too scant and incomplete to allow us a thorough investigation of this hypothesis here. A study of the banking system and its records, as performed by other historians, is a more appropriate methodological approach to examining this argument.

The second use of floating charges was when promoters-turned-shareholders in small firms issued debentures to themselves, secured by floating charges in consideration of assets or firms that they sold to the newly formed company. These debentures placed them as senior creditors in the event of insolvency. Before the 1900 amendment to the Companies Act, such charges did not have to be registered with the Companies Registrar. Recording them in company books, to which unsophisticated would-be creditors had no access, was all that was needed. This is exactly what Aron Salomon did, as is evident in the famous *Salomon v Salomon* case. But his case was not exceptional. The Davey Committee found the use of floating charge debentures by incorporators to be a widespread practice. The Committee characterized this practice as a means ‘to escape the operation of the bankruptcy law’. Yet, it did not recommend prohibiting the practice; it only recommended the requirement of disclosure to other would-be creditors, by filing with the Registrar.

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44 For a critical survey of the literature that suggests the supply of debt finance as playing an important role, see JS Getzler, ‘The Role of Security’ in Getzler and Payne (eds) (n 42).
45 *Salomon* (n 2).
C. The Drawback of Incorporation: Disclosure

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

The General Incorporation Act 1844 was based on the rationale of registration and disclosure. Gladstone’s Act replaced traditional state inspection and discretion at the incorporation stage with freedom of incorporation, public information and investor discretion. Incorporators had to provide information to the Companies Registrar and that officer made the information publicly available. The information included the deed of settlement, the names of shareholders and directors, the prospectus issued to the public and annual accounts and balance sheets. The year 1844 was a highpoint in terms of disclosure. But, as it turned out, the requirements for disclosing the prospectus, the accounts and the balance sheet were soon bypassed and not enforced. They were officially abolished in 1847 and 1856, despite the fact that, at the same time, the introduction of general limited liability could have justified extended disclosure in order to protect creditors. The Companies Act 1862 retained only the more basic disclosure requirements.

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

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47 Partnership Act 1890 (53 & 54 Vict c 39).
48 Companies Act 1907 (7 Edw 7 c 24).
49 With one exception, which originated long before the Act: dissolution of partnerships had to be reported in the London Gazette in order to detach individuals from any new liabilities of their former partners.
51 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.
52 It imposed more significant requirements, including reporting of liabilities and assets on banking and insurance companies.
the prospectus requirement and a decrease in the number of company registrations. But they did not affect private companies. Even though these were not mentioned by name in the 1900 Act, they were in fact exempt from the requirements because they made no public offering of shares. One significant disclosure requirement placed on all companies including private companies in 1900 was the requirement to register all mortgages and charges. This was a response to the widespread use of floating charges by company promoters, making themselves senior creditors. The Companies Act 1907 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. This enhanced disclosure requirement created, for the first time, a distinction between private and public companies.

While between 1862 and 1907, the level of disclosure in companies was more significant than the level of disclosure in partnerships (where it was non-existent), it was nevertheless not substantial compared to earlier and later periods and other countries. By selecting the company form over the partnership form, promoters faced a trade-off. In order to gain what they perceived as the advantages of the company form, definitely with respect to limitation of liability, possibly with respect to longevity and to separation of ownership from management, incorporators had to give up some of their privacy. But once the disclosure requirement was expanded in 1900 and 1907, the trade-off was mitigated. In 1907, a menu of four options in terms of level of disclosure existed. The public company required the most disclosure, then the private company, then the limited partnership, and last, the general partnership.

D. Conclusion

All of these changes amounted to a dramatic transformation. Before 1844, small firms were not likely to obtain incorporation at all or, at best, had to invest much time and money in incorporation. By 1855, their shareholders enjoyed limited liability. By the 1870s, shareholders were relieved of the threat of calls on the unpaid balance of their shares. By the 1880s, they could become secured creditors of their companies, by investing in it in the form of a shareholders’ loan secured by floating charge, and being able to collect from the firm when it became insolvent before most other creditors. Firms that remained sole proprietorships, unincorporated family firms and partnerships

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

could not enjoy any of these privileges. Their partners remained liable, according to the famous phrase, attributed to Lord Eldon, to the last shilling of debt and to the last shilling of their assets.

4. The Legal Response to the Private Company

Until 1844, the state could control and prevent the formation of companies that, in the officials’ view, were too small. The Acts of 1844–62 sharpened the organizational decision. Firms could be organized as either companies or non-companies: sole proprietorships or partnerships. All were available, legal and cheap. One can presume that because the corporate form was created for public companies it did not suit smaller and more private firms. Were the rules that governed internal relationships in companies, which were tailored to public companies, unsuitable for private companies? There were at least three alternative modes for adjusting company law to the needs of small private firms: statutory amendments, common law holdings and incorporation contracts. Statutory company law was not amended until 1907 to better suit private companies. This section will first discuss the mere legality of small private companies, through the extreme case of a sole proprietorship turned into private company, then survey the general architecture of company law and will finally discuss the contracting practices as reflected in the tailoring of Articles of Association to the needs of private companies and the outer bounds of the contractual flexibility with respect to the governance of companies as determined by the courts.

A. Salomon v Salomon and the legality of private companies

The 1862 Act, the major consolidated Act in force until 1907, required that any association or partnership with more than 20 partners (10 in banking) be incorporated. It also required a minimum of seven members for the incorporation of a company. The Act did not include a minimum capital requirement for incorporation. Thus, it allowed for the formation of small, family firm-like and partnership-like companies, as long as they had seven shareholders. Could a company of less than seven shareholders be formed? What could incorporators and their attorneys do when they wanted to form companies of one to six shareholders in the period between 1862 and 1907? They used nominal shareholders. Was this legal? In other words, were

56 The Limited Liability Act 1855 (18 & 19 Vict c 133) set the minimum number for the formation of a Limited Liability Company at 25 but it remained in force only until the following year.
57 Sole proprietorships and single-person companies are not relevant to the discussion in this section. Nor are family firms in which full trust prevails among family members and as a result, the inter se relationship is not a consideration in selecting the organizational form.
58 Companies Act 1862 (25 & 26 Vict c 89).
59 ibid.
companies formed in this way recognized as companies for every purpose? The Davey Committee report, published in 1895, 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.60

It then discussed the need for a remedy:

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.61

How did the courts rule on this issue? Salomon v Salomon, arguably the most famous case in the 400-year history of English company law, deals, among other issues, with this very question.62 In this section, I will offer a new reading of Salomon as representing a range of responses to the emergence of the private company. Aron Salomon was a well to do boot and shoe manufacturer in July 1892. He traded as sole proprietor under the firm of ‘A Salomon & Co’. Beginning with little or no capital, over 30 years, he gradually built up a thriving business.

In July 1892, ‘Aron Salomon and Company, Limited’, was incorporated with liability limited by shares, and with nominal capital of £40,000 divided into 40,000 shares of £1 each. The memorandum of the company was signed by Aron Salomon, his wife, four sons and one of his daughters. They were each initially allocated one share. Then Salomon sold his sole proprietorship business to the company for 20,000 fully paid shares of £1 and a debenture of £10,000. In the following year, the company had difficulties due to external factors, such as strikes and changes in the government contracting policy with suppliers, became insolvent, and went into receivership and liquidation. As holder of the debenture, Salomon claimed a dividend as senior creditor, even though some of the unsecured creditors had not been paid.63 Salomon utilized, to the utmost, the shielding not only of his private assets but also of the business assets he had transferred from the sole proprietorship by combining

60 Davey Committee Report (n 46) vii, para 12.
61 ibid vii, para 20.
62 Salomon (n 2). In company law textbooks, the case 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 PL Davies, Gower and Davies Principles of Modern Company Law (Sweet & Maxwell 2008) 4, 5, 27, 28, 29, 32, 41, 44, 92, 177, 187, 191, 195, 306.
63 At some stage, the debentures were cancelled and reissued to a man named Broderip who lent money to the company via Salomon. The initial proceeding was accordingly titled Broderip v Salomon [1895] 2 Ch 323. But Broderip was fully paid and the debentures ended up with Salomon again. This aspect is irrelevant to our reading of the case.
fully paid shares, a debenture and floating charges, a common practice at
the time. He was protected not only by limited liability as shareholder but
also by a senior claim that he personally had as a creditor of the company. The
liquidator tried to invalidate Salomon’s claim and to obtain a judgment against
Salomon personally in order to pay the unsecured creditors.

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

I am perfectly convinced that the shareholders, who were all members of the family
of Mr Salomon, were nominees of Mr. Salomon, and that no real interest was ever
given to them in the company, and I do not believe that it was ever intended to give
them any real interest whatsoever in the company.\(^64\)

He then held:

Under the Companies Act of 1862 a man may become what is called a private
company so as to obtain the benefits of limited liability. I have already held, in a case
where the founder of such a company had become bankrupt and the company
claimed his assets, that the company was a mere fraud, and the Court of Appeal
supported that decision. In this case I propose to hold the same thing - that this
business was Mr. Salomon’s business and no one else’s; that he chose to employ as
agent a limited company; that he is bound to indemnify that agent, the company; and
that his agent, the company, has a lien on the assets which overrides his claims. The
creditors of the company could, in my opinion have sued Mr. Salomon.\(^65\)

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

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

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

\(^{64}\) ibid 329.
\(^{65}\) ibid 331–32.
the privileges conferred by the Act from those members of limited companies who allow such companies to carry on business with less than seven members; and by s. 79 the reduction of the number of members below seven is a ground for winding up the company. 66

Applying to Salomon, he concluded:

Although in the present case there were, and are, seven members, yet it is manifest that six of them are members simply in order to enable the seventh himself to carry on business with limited liability. The object of the whole arrangement is to do the very thing which the legislature intended not to be done; and, ingenious as the scheme is, it cannot have the effect desired so long as the law remains unaltered. 67

Lindley LJ was one of the most distinguished jurists of the time and a leading authority on company and partnership law. 68 He accordingly framed the case as a company law case, one that should be determined by a statutory interpretation of the 1862 Act. This was not an inconsequential bankruptcy case that should be determined by its exceptional facts as Vaughan Williams J understood it; on the contrary:

The appeal raises a question of very great importance, not only to the persons immediately affected by the decision, but also to a large number of persons who form what are called ‘one-man companies’. Such companies were unheard of until a comparatively recent period, but have become very common of late years. 69

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

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

I must pause here to point out that the statute enacts nothing as to the extent or degree of interest which may be held by each of the seven, or as to the proportion of interest or influence possessed by one or the majority of the share-holders over the others. One share is enough. Still less is it possible to contend that the motive of becoming

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66 ibid 337.
67 ibid.
68 N Lindley, A Treatise on the Law of Companies: Considered as a Branch of the Law of Partnership (Sweet and Maxwell 1889).
69 Broderip v Salomon (n 63) 336.
shareholders or of making them shareholders is a field of inquiry which the statute itself recognises as legitimate. If they are shareholders, they are shareholders for all purposes; and even if the statute was silent as to the recognition of trusts, I should be prepared to hold that if six of them were the cestui que trust of the seventh, whatever might be their rights inter se, the statute would have made them shareholders to all intents and purposes with their respective rights and liabilities, and, dealing with them in their relation to the company, the only relations which I believe the law would sanction would be that they were corporators of the corporate body.\textsuperscript{70}

The Lord Chancellor tells us that not only are nominal shareholders legitimate shareholders for the purposes of the Companies Act; even when all the other shareholders are trustees of a single shareholder, the company is legal. All the other Law Lords held, similarly, that the question is one of statutory interpretation and that the statute is very clear. Any seven members, whatever their interest in the company, even a single nominal share, and whatever the relationship between them, patriarchal subordination or entrustment, can constitute a company. One of the concurring lords was Lord Davey, who had chaired the committee appointed to consider amendment of the Companies Act and delivered its recommendations the year before.\textsuperscript{71}

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

Four of the sons were working with their father. The eldest, who was about thirty years of age, was practically the manager. But the sons were not partners: they were only servants. Not unnaturally, perhaps, they were dissatisfied with their position. They kept pressing their father to give them a share in the concern. ‘They troubled me,’ says Mr. Salomon, ‘all the while.’ So at length Mr. Salomon did what hundreds of others have done under similar circumstances. He turned his business into a limited company. He wanted, he says, to extend the business and make provision for his family.\textsuperscript{72}

Lord MacNaghten’s description is remarkable. Incorporation was the first step in changing the governance structure of the firm, in preparation for transferring this family firm to the second generation. The firm was in the process of transforming from a single-person or patriarchal family firm into a second-generation family firm that is more like a partnership among the

\textsuperscript{70} Salomon (n 2) 30.

\textsuperscript{71} Davey and his committee were appointed in November 1894, shortly after Salomon’s hearing in the High Court. The Committee delivered its report in June 1895, shortly after the Court of Appeal’s decision in Salomon and about a year before the case was argued before the House of Lords. The Court of Appeal decision in Salomon was the only court case listed among the 17 items of written evidence submitted to the Committee.

\textsuperscript{72} Salomon (n 2) 48.
siblings. Within the typology offered in this article, the incorporation was into a partnership-like company and not into a single-person company. The motivation for incorporation related to internal relationships, decision making, the father’s retirement, and the future exit of some of the children, more than with asset partitioning and protection against creditors. This motivation led hundreds of other family firms, moving from first-generation sole proprietorship to second-generation partnerships, to the corporate form. What was at stake was not the fortune of Aron Salomon, a Jew from Whitechapel, East London’s poor and crime-stricken immigrant district. What was at stake was a wide social-economic phenomenon. It is evident that the House of Lords, as the Court of Appeal before it, and unlike the High Court, realized that it was dealing with a major phenomenon and that the importance of the decision could not be overstated.

This narrative seems to portray the decision not as one that the Lords were compelled to deliver because it was determined in the province of legislation and forced upon the courts, or because the Lords were bound by a canon of interpretation requiring literal interpretation of statutes rather than one that followed the purpose of the legislation. It was not a question of yielding to the inevitable due to the incorporators’ ability to manipulate and bypass regulatory prohibitions by using nominal shareholders. The decision is not even motivated by equitable sympathy for Salomon personally because of his misfortunes, even though this is how the Lords viewed him. The Lords in Salomon v Salomon intended to facilitate a productive and advantageous social phenomenon—the conversion of under-legalized family firms into joint-stock companies with well-defined legal status.

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

B. Restructuring the Connexion between Company Law and Partnership Law

Company law could be adjusted to the needs of private companies by borrowing concepts and rules from partnership law. This was a natural move.

73 Companies Act 1907 (7 Edw 7 c 24) s 37(4).
for those firms that were converted from the partnership form of organization to the company form of organization in order to benefit from the asset partitioning features of the company while wishing to maintain a partnership-like, more consensual and closed, form of governance. In the 19th century, the relationship between partnership law and company law was perplexing. On one hand, the origins of partnership law and company law are different. Partnership law evolved in the vicinity of agency law, master and servant law, the law of private bailiffs, and generally in the field that in modern terms is called contract law, within the more general field of private law. Company law evolved within the realm of the law of the prerogative of the Crown, as an authority that was delegated to another body politic created by the King, an issue that in modern terms is part of constitutional law. Significant partnership litigation was through the writ of account in Chancery. Company law was litigated through the prerogative writs of quo warranto and scire facias, the procedure of visitation, and the doctrine of ultra vires, mostly in the court of King’s Bench. Several 19th-century jurists acknowledged this fundamental difference and reiterated its existence. Other 19th-century jurists stated that the rules governing internal relationships in both realms of law were similar. What can explain these conflicting statements is the dynamic and unsettled border between the governance rules of partnership law and company law.

Principles of partnership law entered company law through at least two routes. The first is the unincorporated company and the second is corporate personality theory. The restricted access to the corporate form, despite growing demand, in the century or so before 1844, gave rise to the development from below of the unincorporated company. Businessmen and their attorneys used existing building blocks in partnership law, trust law and contract law to create a substitute for the corporation, without full incorporation. Partnership law concepts that were first applied to unincorporated companies were then applied to incorporated companies. Foss v Harbottle is the prime example. By the

76 B Montagu, A Digest of the Law of Partnership: With a Collection of the Cases Decided in the Courts of Law and Equity upon that Subject (Butterworth 1815) 50–52.
77 Re Agriculturalist Cattle Insurance Company, Baird’s Case (1870) LR 5 Ch App 725, 733 (James LJ); Smith (n 23) 61; WD Edwards, Commercial Law (Methuan Commercial Series 1900); N Lindley (n 68) 61.
78 Smith (n 23) 66–67; H Thring, The Law and Practice of Joint-Stock Companies I–2 (Stevens & Sons 1861).
79 Harris (n 6) 137–67.
80 Foss v Harbottle (1843) 2 Hare 461, 67 ER 189.
early 19th century, a well-established equitable doctrine in partnership law provided partners with access to the remedy of account only upon the winding up of the partnership. This doctrine restricted the review by Chancery of the everyday internal affairs of partnerships.\textsuperscript{81} The doctrine was extended to the internal affairs of unincorporated companies that were viewed as partnerships. In 1843, only a year before the introduction of general incorporation, the doctrine was applied to a corporation incorporated by Parliament for the first time in \textit{Foss v Harbottle}. Once incorporation by mere registration became widespread, the doctrine was applied to all companies and became the cornerstone governing the internal affairs of companies.\textsuperscript{82} The oppressed minority in a company could not bring a claim against a corporate cause of action; instead, it had to turn to the internal forums in a company before turning to court, and these could ratify and rectify alleged misconduct. The effect of \textit{Foss v Harbottle} was that litigation about internal conflicts became almost impossible.\textsuperscript{83} Ironically, the main partnership doctrine that applied to companies only hindered the ability of minority shareholders to protect themselves against oppression by the majority.

C. The Rewriting of Corporate Personality Theory

The second route through which more private, partnership like, governance conceptions could enter company law was the theory of corporate personality. After the introduction of general incorporation the debate about the conceptualization of corporate personality was revitalized and reshaped. The traditional theory, which was called the grant, concession or hierarchical theory, viewed legal personality as public-law-created. It was challenged late in the 19th century by two other theories. The natural personality theory, originating with Gierke in Germany, viewed corporate personality as stemming from the extra-legal real or natural existence of associations of individuals.\textsuperscript{84} The aggregate or partnership theory of corporate personality, originating in the United States, viewed corporations, like partnerships, as created by mutual agreement among the shareholders, as a contractual private law creation.\textsuperscript{85} It

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\textsuperscript{81} Its rationale was that ‘since harmony between partners is not to be had by decree, equity would not act in vain’. A more cynical interpretation would say that Lord Eldon LC wished to ease the long delays in Chancery and his own overburdening.


\textsuperscript{83} Exceptions to the \textit{Foss} rule were gradually defined and litigation became possible in some circumstances.

\textsuperscript{84} DR Runciman and R Magnus (eds), \textit{Frederic William Maitland: State, Trust and Corporation} (CUP 2003) xi–xiv, 1–5; O Gierke, \textit{Political Theories of the Middle Ages} (first published 1913, Frederick William Maitland tr, The Lawbook Exchange Ltd 2002).

argued that in an era of free incorporation, the personality of corporations could no longer be justified by state grant. Registration with the state was merely technical and informative. The corporate personality was in fact formed by mutual agreement of the incorporators and was reflected in the Memorandum and Articles of Association that constituted a contract. This theory viewed company law as analogous to partnership law and justified similar rules for governing companies’ internal affairs. For example, it denounced majority dictatorship and justified consensual decision-making, particularly with respect to amending the basic contract—the Articles of Association.

The implication of the adherence to the partnership theory of corporate personality was that companies, at least fundamental aspects of their existence, should be managed by consensus and not by majority. This is the ultimate means against minority oppression. But taken with the locked-in feature of the company, which, contrary to partnership cannot be dissolved at will, this may lead to deadlocks.\(^{86}\) The theory did not directly affect company legislation. But the Companies Act 1862, which predated the articulation of the theory, reflects some similar notions. The capital structure of a company, as fixed in its Memorandum of Association, could be changed only by a special resolution that required a 75% majority.\(^{87}\) The Articles of Association could be altered only through a special resolution that required the same 75% majority.\(^{88}\) These two examples of the influence of partnership governance rules on company law did not go far in introducing rules that were particularly suitable for small private companies. One could argue that they only augmented the problem by preventing judicial review of majority dictatorship and by increasing the likelihood of a deadlock without an exit option, which is a major concern of modern private companies. They only placed an additional burden on the parties to make sure that the Articles of Association they drafted and agreed upon would foresee the possible future contingencies and problems, and prevent these as completely as possible. The third mode, contractual freedom, was essential for achieving this.

D. Contractual Flexibility as Organizing Principle

Contractual flexibility could allow different companies, large and small, public and private, to draft significantly different Articles of Association.\(^{89}\) Could entrepreneurs tailor the organizational form of their choice to the specific needs and concerns of their small and private firm? Could entrepreneurs who chose

\(^{86}\) For the easy dissolvability of partnerships compared to companies, see Lindley (n 68) ; J Collyer, *Wood's Collyer on the Law of Partnership* (WC Little & Co 1878); F Pollock, *A Digest of the Law of Partnership* (Stevens 1890) 179; Partnership Act 1890 (53 & 54 Vict).

\(^{87}\) The name could also be changed. Other components of the Memorandum, the type of liability and objects, could not be altered at all after incorporation, Companies Act 1862 (25 & 26 Vict c 89) ss 12.

\(^{88}\) Lamoreaux and Rosenthal, ‘Legal Regime and Contractual Flexibility’ (n 4).
the corporate form for organizing private companies select any partnership feature they wished and add it contractually to their company’s articles of incorporation? More specifically, could they opt into the high level of lock-in offered by the company form of organization but opt out of its governance by majority rules and into the level of protection against minority oppression offered by the governance rules of partnerships?

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

Whereas the American statutes tend to lay down mandatory rules, the British Companies Act relies far more on the technique of the Partnership Act, providing a standard form which applies only in the absence of contrary agreement by the parties. Much that in America is mandatory is in Britain included only in the optional model constitution - the famous table A. And this constitution, or whatever the parties substitute for it, is expressly declared by the act to bind the company and the members as if it were a contract under seal. 90

His main examples were contractual freedom in Britain with respect to the appointment of directors, the division of powers between directors and shareholders, the rules regulating meetings and votes, the pre-emptive right to take part in further issuing of shares, the right to inspect books and records, and the setting of restrictions on the transferability of shares. 91 Though most of Gower’s references are to the Companies Act 1948, the basic structure of Table A, and the setting of major rules in these fields as default rules both in Table A and in the act itself, originated in the Companies Act 1862. 92 Palmer, writing in 1892, echoed the notion of flexibility: ‘The private company is, in many cases, the simplest mode of constituting what is in substance, though not in point of law, a partnership arrangement.’ 93 Why did Britain resort to contractual flexibility based on standard default Articles of Association at this early stage? Gower does not explain. I hope to further address the question of why Britain allowed considerably more contractual flexibility than the United 90 Gower (n 82) 1376.
91 Gower was particularly puzzled by the fact that even the most liberal jurisdictions in the United States, such as Delaware, which did not provide mandatory safeguards to small shareholders in public corporations, nevertheless did not provide incorporators in close corporations contractual freedom in designing their bylaws. He mentioned a few issues in which the mandatory rules of American law better protected shareholders than the default British rules. The essence of the puzzle as I understand it is that, generally speaking, American law was less protective of small shareholders in public companies and less flexible for shareholders in private or close companies that needed less protection.
92 See the default rules in cls 8, 32, 44, 55, 61, 63, 66 of Table A of the 1862 Act that deal with most of the issues mentioned by Gower. For a recent study that focuses on shareholder governance and also includes a historical survey, see RC Nolan, ‘The Continuing Evolution of Shareholder Governance’ (2006) 65 CLJ 92. 93 Palmer, Private Companies and Syndicates (n 21).
States in the second half of the 19th century and the first two decades of the 20th century with a historian of US corporations in the near future.94

Harwell Wells studied the ways in which close corporations (the rough equivalent of British private companies) in the late 19th to mid-20th century US tried to overcome the mandatory rules of corporation law that were set to meet the needs and concerns of public corporations. The incorporators of close corporations and their lawyers had to resort not only to bylaws but also to private side-contracts in order to evade mandatory rules. While his study is not directly relevant to this study of Britain, one can learn from it what the distinct concerns of incorporators of small private companies were and which rules they wished to apply to their companies. These included restrictions on transferability of shares, supermajority voting requirements that would provide the minority with veto power at least on fundamental issues, entrenchment of minority shareholders on boards of directors, the fixing of employment and salary or of level of dividend, the right of shareholders to be bought out or to liquidate the company. In essence, many of these arrangements imitated partnership law rules or actual partnership agreements.95 Many of them appear in the British example as well.

E. Exercising Flexibility: A Quantitative Analysis

The sample of company files for 1892, created for this study, demonstrates the level of opting out of the default company law rules. Of the 45 companies in the sample for which Articles of Association were preserved, only 11% adopted Table A in full; 33% adopted it in part, and 56% rejected it altogether. Some of the clauses of Table A were opted out by as many as 80% of the companies.

In addition to opting out many companies wrote into their Articles of Association a large number of articles drafted to suit their needs. About half of the companies in the sample had Articles containing more than a hundred clauses. Companies used specially drafted clauses in their Articles that dealt with issues such as appointment of directors, borrowing powers, calls on shares, convening general meetings, voting, audit and arbitration. Many companies wrote in clauses that limited the transferability of shares, subjecting


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

Thus, contractual flexibility was not only an option offered by the structure of statutory company law, which included mostly default rules. It was an option that was exercised by most incorporators and their lawyers. Two factors that could explain the high opting out rate are the fact that the 1862 Act and its Table A did not envision private companies and that, by 1892, they were 30 years old. Table A’s default rules may have been outmoded, no longer reflecting what the majority of contracting parties would want. An analysis of the Articles of Association of sample alone provides an indication of contractual flexibility but does not indicate the exact bounds of that flexibility.

F. Court Imposed Restrictions on Flexibility

Incorporators and their attorneys must have had some sense of what they could definitely do, and what they could do and get away with on the margins of contractual flexibility. Yet the courts had the last word; they could strike down or not enforce arrangements that were fixed in Articles if these were, in the courts’ view, contrary to the Companies Act or the common law. A survey of court cases cannot provide a full map of the extent of contractual freedom because various contractual stipulations in Articles were never litigated, and concerning others, which were only mentioned, their validity was not directly determined. Let us examine a few examples that appeared.

One of the features that distinguish joint-stock companies from partnerships, and public companies from private companies, is the transferability of shares. In public companies, transferability is integral. When a multi-owner private company is incorporated, transferability is likely to be at the centre of negotiation and contracting. Weston’s Case is instructive. A shareholder transferred his shares to two other persons for low payment at a stage at which the company was in debt and shortly before it wound up. The directors refused to register the transfer. Thereafter, the liquidator sued the selling shareholder for the unpaid portion of the shares. It was clear from the fact that the transferees had no source of income or place of residence that the intention of the original shareholder was to avoid liability by transferring to judgment-proof persons. The main issue was whether the directors were authorized to refuse transfer in such circumstances. On appeal, the court distinguished between three levels. The first was the Companies Act. The court viewed section 22 of the Act as providing a default rule. The default was transferability. Then the court discussed the question of whether the general authority of the directors

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96 Preliminary data from samples of 1912 and 1927 indicate that the percentage of opting out from the 1908 Act Table A was considerably lower in those years.
97 It is conceivable that the incorporators and their attorneys would draft into the Articles an arrangement that they knew would not be enforced in order to mislead other less informed incorporators.
98 Weston’s Case (1868–69) 4 Ch App 20.
and their duty to act in the best interests of the company allowed them to refuse transfer on such grounds and held that it did not. Finally, the court read the Articles of Association and found in them grounds for refusal only when a shareholder is indebted to the company. Thus, the directors could not refuse transfer on the grounds of the identity of the transferee. The court mentioned that in other companies, the Articles established other more severe restrictions on transfer of shares. From the above analysis by the court, it is clear that there is significant contractual flexibility with respect to the rules fixed in Articles of Association concerning transferability of shares. There is every reason to think that Articles such as those of Ollersett, which provided the directors with full discretion to refuse transfer without giving any reason, would have been upheld by the courts. Contractual flexibility in this dimension allowed the use of a framework originally intended for public companies with freely transferable shares to be used for forming partnership-like private companies, in which membership was based on personal relationships and could be altered only by consensus.

Another important dimension of private companies is the agreement regarding the distribution of income and profits. The two main components of this dimension are dividends and employment. Shareholders in private companies, like partners in partnerships, are often also their employees. Minority shareholders in private companies are concerned over freeze-out, namely that the majority will ‘manage the company as it wishes; employ itself, but not the minority, at generous pay; not distribute dividends; and not offer to buy out the minority (which is not free to, or unable to, sell its shares) at a fair price. The doctrine of Foss v Harbottle,99 discussed above, which considerably restricted the ability of courts to intervene in majority-based decision making in companies, only increased the minority’s concern regarding freeze-out and oppression.

Entrenched employment with guaranteed salary was one of the solutions.100 In an 1875 case, Eley v The Positive Government Security Life Assurance Company, Article 118 in the Articles of a company stated that ‘Mr. William Eley…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.’101 The Article was probably included as consideration for services rendered at the stage of incorporation. The solicitor later became a minor shareholder in the company and the company at some stage resorted to other solicitors. Eley sued the company for breach of contract. In his judgment, Amphlett B held that Article 118 did not amount to a contract that bound the company vis-à-vis a solicitor as such. The Articles bind shareholders in that capacity and only inter se. Technically, the Articles were not made under the

99 Foss v Harbottle (n 80).
100 Another relevant issue that will not be discussed here: rules governing dividend decision making.
Kelly CB expressed doubt as to 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. However, this case does not determine the validity of all types of employment arrangements found in Articles, it does raise considerable doubts with respect to their validity.

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

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

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

102 ibid 30.
103 See eg Nelson v James Nelson & Sons Ltd [1914] 2 KB 770.
104 Companies Act 1862 (25 & 26 Vict c 89) s 79, 129.
105 A McNeil, Campbell’s Mercantile Law (W Green 1904) 242–43.
5. Conclusion

This article recalls the fact that in Britain (and elsewhere), until the mid-19th century, neither company legislation, nor jurists nor economists, envisioned companies to be private or small. Until the mid-19th century, the company was used exclusively for what was considered public purposes and for raising equity capital from the public. Once freedom of incorporation and general limited liability were enacted, a new practice was set in motion in Britain. Smaller companies were formed in growing numbers, replacing partnerships, family firms and even sole proprietorships. They operated in sectors in which corporations had not been found before. By 1907, most companies were small and did not resort to the stock market. They were family firms, sole proprietorships and partnerships, converted into joint-stock limited companies. As this article shows, the company form of organization was radically transformed between 1862 and 1907.

The private company as a term and a phenomenon was first found in the press and in legal literature. It was then discussed by legislation review committees, legitimized by the courts, and only in 1907, first defined by the Companies Act. Within a decade after its formal introduction in 1907, and the lessening of disclosure requirements applying to it, more than 41,000 new private companies were registered in (compared to fewer than 9,000 new public companies). By 1919, more than 90% of newly registered companies were registered as private companies. In addition, in the same decade, nearly 145,000 pre-existing companies, representing a majority of active companies in Britain, were converted into private companies. The transformation was complete.

The transformation did not rely on statutory amendments. It was privately ordered by incorporators and their attorneys by tailoring the basic contractual document of the company form, the Articles of Association, to the needs of private companies in general and to the specific concerns of each small company in particular. Such private ordering became possible because of the high degree of contractual flexibility available in Britain. This flexibility stemmed from the basic structure of the Companies Act, which included few mandatory rules and regulated much of the internal governance of companies through default rules, the famous Table A, from which people could opt out. It also resulted from the seminal Salomon case and several additional court cases that validated new types of rules fixed in the Articles. This research substantiates the argument that the legal system, due to high level of contractual flexibility offered by statute and common law, supplied ‘from below’ in a private ordering manner the demand for the use of the company form of organization by SMEs during the period 1862–1907 in which supply ‘from above’ through a formal statutory amendment was not yet made possible.