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**THE EVOLUTION OF THE JOINT STOCK COMPANY TO 1800:
A STUDY OF INSTITUTIONAL CHANGE**

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The Workplace and Corporate Law Research Group (WCLRG) is a research concentration within the Department of Business Law & Taxation, Faculty of Business & Economics, at Monash University. It has been in operation since March 2008, having previously operated as the Corporate Law and Accountability Research Group (CLARG) since November 2005.

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THE EVOLUTION OF THE JOINT STOCK COMPANY TO 1800: A STUDY OF INSTITUTIONAL CHANGE

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I Introduction

This paper traces the evolution of the joint stock company from its origins to the end of the eighteenth century and presents an historical analysis of the evolution of the joint stock company from the perspective of institutional change.¹ The related theoretical concepts of institutions, institutional evolution and path dependency, which describes the mechanism by which institutional change occurs, are discussed in Parts II and III. The paper then provides a narrative of the historical development of the joint stock company from its origins to 1800 in Part IV. Part V seeks to interpret the evolution of the joint stock company in the light of theories of institutional evolution and change. The discussion in this Part considers the economic context in which the joint stock company evolved and the relationship between this evolution and economic developments which were taking place.

The history of the early joint stock company reveals that there were several critical developments. These were the creation of the joint stock concept, most notably in the case of the East India Company in the early seventeenth century, the boom in company formations and the related development of stock markets after 1688, the Bubble Act and the development and proliferation of unincorporated joint stock companies after the Bubble Act and the share booms associated with canal companies in the late eighteenth century. The traditional narrative of the history of the joint stock company focuses on legal developments and emphasises two significant legislative turning points: the Bubble Act of 1720 and the first Companies Act of 1844. It is a contention of this paper that this emphasis on the “law in the books” presents a misleading impression which over-emphasises the importance of statutory developments. The paper suggests that in order to better understand the evolution of the joint stock company, it is more important to examine institutional change and commercial developments, as in fact many of the important features of the modern listed public company were already apparent by the early seventeenth century and most of the central characteristics of companies had evolved during the period examined in this paper.

¹ The concepts of institutions and institutional change are central to the perspectives developed by the school of New Institutional Economics. The term ‘new institutional economics’ was coined by Oliver Williamson, *Markets and Hierarchies. Analysis and Antitrust Implications* (1975) 1. The origins of the new institutional economics are usually traced back to R H Coase, ‘The Nature of the Firm’ (1937) 4 *Economica* 386 and ‘The Problem of Social Cost’ (1960) 3 *Journal of Law and Economics* 1. For a discussion of the evolution of new institutional economics and its various schools of thought see Rudolph Richter, ‘The New Institutional Economics: Its Start, its Meaning, its Prospects’ (2005) 6 *European Business Organization Law Review* 161, 163-174. One of the leading proponents of this school is Douglass C North who has applied its perspectives to the study of economic history and to the question of why some countries are wealthy and others poor. See for example *Institutions, Institutional Change and Economic Performance* (1990). For an overview of Douglass C North’s institutional view of economic history see Johan Myhrman and Barry R Weingast, ‘Douglass C North’s Contributions to Economics and Economic History’ (1994) 96 *Scandinavian Journal of Economics* 185.

The relationship of economic and legal change is complex and does not lend itself to a linear explanation. An analysis of this relationship requires consideration of the particular dynamics at work at different historical stages. The development of the joint stock company during the period under consideration occurred largely outside the law, which had little engagement with companies and where the law sought to regulate companies and share trading, most notably by the enactment of the Bubble Act, it appeared to do so in a discouraging and restrictive manner. The Bubble Act sought to prohibit unincorporated joint stock companies, yet during the century it was in operation, such companies often continued to be used and played an important role in certain sectors of the economy such as insurance, shipping and some manufacturing. Overall, almost despite the law, the joint stock company proved to be successful in both its incorporated and unincorporated forms over a long period of time as a mechanism for allowing large amounts of capital to be raised in certain key industries which were suited to joint stock enterprise.

During this period there were a number of alternative legal forms which business enterprises could adopt. To a large extent, these forms of business organisation were not so much in competition with each other across the economy, but rather various sectors of the economy tended to choose the form which best served the needs of entrepreneurs and capital providers. In some sectors such as those involving the construction of canals, docks and roads, entrepreneurs were able to successfully apply for incorporation Acts. In other sectors where vested interest groups strongly opposed incorporation applications, it was difficult or highly unlikely that an incorporation Act could be obtained, resulting in the frequent use of unincorporated companies. Other sectors were able to finance their capital needs from internal sources, networks or by borrowing. These businesses were mainly family controlled and did not have a need for the formation of joint stock companies.

The historical narrative in Part IV raises the question of whether law matters and if so, to what extent, in encouraging (or discouraging) the development and path of economic institutions. The analysis set out in Part V indicates that social norms played a more significant role than the law in the institutional development of joint stock companies. At a time when the court system and company law were undeveloped and there was little real prospect of contracts being enforced or wrongdoers being punished, a central question is why did investors have the trust to hand over cash in return for necessarily vague promises that they would ultimately receive a return on their investments if the venture they invested in turned out to be successful? From this point of view the early joint stock company was highly successful as an institution which, to a significant extent, overcame the ‘fundamental problem of exchange’² and mitigated investor concerns that company insiders would in some way exploit their positions and engage in misappropriating or improper rent-extracting conduct. Once this level of trust between outsider investors and company

² As discussed in Part II, the fundamental role of institutions is to provide incentives for economic players to enter into mutually beneficial exchange relationships. The concern that other parties will not commit to or adhere to their fulfilling of contractual obligations has been described as the ‘fundamental problem of exchange’. For a discussion of this concept from the perspective of historical analysis see Avner Greif, ‘The Fundamental Problem of Exchange: A Research Agenda in Historical Institutional Analysis’ (2000) 4 *European Review of Economic History* 251.

insiders was established, a path dependency³ was created which enabled the institution of the joint stock company to become a mechanism conducive to capital raising from large numbers of investors, and which played a significant role in the emergence of new commercial classes and the establishment of necessary infrastructure for the industrialisation of Britain.

The period covered by this paper concludes at the end of the eighteenth century, when the Bubble Act was still on the statute books even though it had not been invoked for many decades. The Bubble Act was a vestige of mercantilism which sought to entrench traditional vested interests and exclude competing commercial interests. These emerging commercial interests were the main users of joint stock companies, both as entrepreneurs and investors so they sought the freeing up of the law dealing with companies and eventually brought this about by the repeal of the Bubble Act in 1825.

II Institutions

The inter-relationship of law and society is complex and does not allow for a simple linear relationship of cause and effect. This relationship may operate equally in two ways: legal change is capable of affecting social and economic outcomes in an instrumental way and legal evolution may also be driven by changes in the broader social and economic context. Fögen claims that this “co-evolutionary” model is useful for describing the relationship between law and its environment. Societies are based on a balance of social systems which include the economy, legal system and political institutions. Each relies on and is linked to the others and so in modern sophisticated societies, these structural relationships generally facilitate co-evolution.⁴

The evolution of institutions is of direct relevance to legal evolution because law is itself one form of institution. Douglass North explained the purpose of institutions as being to create order and reduce uncertainty in economic activity by providing a stable, but not necessarily efficient, structure to everyday activities. It is in this role that they help determine transaction and production costs and profitability and so provide the incentive structure of the economy. Political and economic institutions are necessary where personal co-operation between players becomes difficult or impossible as the transactions become depersonalised and more complex and there are

³ The concept of path dependency is discussed in Part III. It is the process by which institutional change occurs. Previous steps in the process become established and determine change down a particular path so institutions can be described as ‘the carriers of history’. This expression was used by Paul A David, ‘Why are Institutions the ‘Carriers of History’?: Path Dependence and the Evolution of Conventions, Organizations and Institutions’ (1994) 5 *Structural Change and Economic Dynamics* 205.

⁴ Marie Theres Fögen, ‘Legal History – History of the Evolution of a Social System. A Proposal.’ (2002) <http://rg.mpiet.uni-frankfurt.de/?id=146>, para [15] and Simon Deakin and Frank Wilkinson *The Law of the Labour Market: Industrialization, Employment and Legal Evolution* (2005) 32. For a survey of the application of evolutionary theory to law see E Donald Elliott, ‘The Evolutionary Tradition in Jurisprudence’ (1985) 85 *Columbia Law Review* 38. For examples of theoretical applications of evolutionary theory see Deakin and Wilkinson, *The Law of the Labour Market* where the development of labour law in Britain is traced from an evolutionary perspective. Robert C Clark considered a number of examples of legal evolution in corporate and commercial law in ‘The Interdisciplinary Study of Legal Evolution’ (1981) 90 *Yale Law Journal* 1238.

large numbers of players who are largely unknown to each other. These factors drive up transaction costs and make monitoring performance and enforcement problematic.⁵

Institutions are “the rules of the game in a society, or, more formally, are the humanly devised constraints that shape human interaction”.⁶ Institutions can be further defined as a system of social factors comprising various interrelating elements such as rules, beliefs, norms and organisations that provide incentives to maintain a regularity of behaviour in social situations involving a transaction.⁷ The extent to which economic players will enter into mutually beneficial exchange relationships depends on the degree to which the parties commit to fulfilling their contractual obligations. A shareholder will not invest in a company without assurance that the directors will not run away with the money, the business of the company will be well run, proper information will be provided to the investor and if the business turns out to be profitable, profits will be fairly distributed among the investors. These types of concerns are the “fundamental problems of exchange” and institutions are formed to structure relationships in order to mitigate these concerns and encourage exchange to take place. Institutions do this by fostering the ability of the parties to commit to respect their obligations and to reveal that they will do so by linking past conduct with future reward. This reduces the benefits of misrepresenting information and renegeing on obligations.⁸

Institutions include formal constraints such as laws which are externally imposed by the state, and informal constraints such as social norms and conventions and codes of behaviour which are self enforcing.⁹ There has been considerable academic discussion on the relative importance of external constraints such as legal rules compared with internal constraints such as social norms and trust and the interrelation of law and social norms.¹⁰

The law and economics literature in corporate law assumes that the corporation is a “nexus of contracts”, being a collection of express and implied agreements voluntarily negotiated by the rational and selfish actors in the corporate enterprise such as shareholders, directors, creditors and employees who are each concerned only with maximising their own gains. They are discouraged from acting improperly and disregarding others’ interests by various market incentives and legal rules.¹¹

⁵ Douglass C North, ‘Institutions’ (1991) 5 *Journal of Economic Perspectives* 97, 97-98 and David, above n 3, 206.

⁶ North, above n 1, 3-4.

⁷ Avner Greif, *Institutions and the Path to the Modern Economy: Lessons from Medieval Trade* (2006), 30 and ‘Historical and Comparative Institutional Analysis’ (1998) 88 *American Economic Review* 80, at 80.

⁸ Greif, above n 2, 255-256.

⁹ Melvin A Eisenberg, ‘Corporate Law and Social Norms’ (1999) 99 *Columbia Law Review* 1253 examines the interrelationship of social norms and corporate law.

¹⁰ *Ibid* 1254, footnote 2 contains an extensive reading list on the operation of social norms in various legal contexts.

¹¹ This formulation was first articulated by Michael Jensen and William Meckling, ‘The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure’ (1976) 3 *Journal of Financial Economics* 305. For a critique of the nexus of contract conception see Melvin A Eisenberg, ‘The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm’ (1998) 24 *Journal of Corporations Law* 819.

Margaret Blair and Lynn Stout argue that the law and economics view is an incomplete explanation and does not reflect reality because co-operation between corporate participants occurs not just due to external constraints such as threat of legal or social sanctions (which includes loss of reputation) but also because of internalised trust and trustworthiness. These play important roles in discouraging opportunistic behaviour as people often behave with consideration for others' interests. This explains why co-operative behaviour in firms persists where legal and market sanctions are absent or ineffective.¹²

John Coffee also makes the argument that corporate behaviour is more likely to be shaped by social norms than by legal rules. He uses the term "norms" to mean "informal rules of conduct that constrain self-interested behaviour but are not enforced by any authoritative body that can impose a sanction".¹³ The more significant the role played by social norms, the less the corporation looks like a nexus of contracts. Coffee puts forward the tentative generalisation "...norms may matter most when the law is weakest. When formal law does not adequately protect shareholders, the strength of social norms becomes more important, because they could provide a functional substitute for law."¹⁴

In determining the institutional constraints which operate in particular historical situations, Avner Greif studied the commercial practices of the eleventh century Maghribi traders and concluded that a multilateral reputation mechanism rather than legal contracts and recourse to the courts provided the main constraint in curtailing opportunistic behaviour by overseas agents in long distance trade.¹⁵ Greif noted that the Maghribi traders adopted institutional foundations different from their European counterparts, indicating that cultural and institutional factors are dynamically intertwined in the processes of economic development.¹⁶

¹² Margaret Blair and Lynn Stout, 'Trust, Trustworthiness, and the Behavioural Foundations of Corporate Law' (2001) 149 *University of Pennsylvania Law Review* 1735. The writers argue at 1738 that the importance of internalised trust in fostering co-operation is contrary to the neoclassical *homo economicus* portrayal of the rational and selfish participant; however it is borne out by a large amount of empirical evidence in behavioural studies in 'social dilemmas'. These studies indicate that humans do behave in ways that are co-operative and considerate of others. See 1741-1742 for a summary of results which have emerged from social dilemma experiments and 1747-1753 for reasons why someone may trust another and why someone may act in a trustworthy manner.

¹³ John C Coffee, 'Do Norms Matter? A Cross-Country Evaluation' (2001) *University of Pennsylvania Law Review* 2151, 2171.

¹⁴ *Ibid* 2175.

¹⁵ Greif, *Institutions and the Path to the Modern Economy*, above n 7; and 'Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders' (1989) 49 *Journal of Economic History* 857, 865-866. Greif has written a number of further analyses of the institutions of Medieval traders: see 'Contract Enforcement and Institutions Among Maghribi Traders: Refuting Edwards and Ogilvie' at SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1153826, 30. Jeremy Edwards and Sheilagh Ogilvie dispute Greif's analysis and conclusions arguing that the relationship between the Maghribi traders and their agents was law based. Greif's rejoinder is the paper 'Contract Enforcement and Institutions among Maghribi Traders: Refuting Edwards and Ogilvie'. See also Amalia Kessler, 'Enforcing Virtue: Social Norms and Self-Interest in an Eighteenth-Century Merchant Court' (2004) 22 *Law and History Review* 71, for a discussion of how a Parisian merchant court enforced religion-based norms in order to promote long-term trust-based commercial relationships.

¹⁶ Greif, *Institutions and the Path to the Modern Economy* above n 8, 388-400. Greif provides an example of how cultural factors may influence economic institutions in his explanation of why corporations appeared specifically in Western Europe and were not transplanted in Asian societies. Greif argues that due to religious and cultural factors concerning marriage and inheritance, Western European society was based on the nuclear family structure rather than extended families. This created

Douglass C North described the importance of institutional evolution in economic history in the following terms:

History matters. It matters not just because we can learn from the past, but because the present and future are connected to the past by the continuity of a society's institutions. Today's and tomorrow's choices are shaped by the past. And the past can only be made intelligible as a story of institutional evolution. Integrating institutions into economic theory and economic history is an essential step in improving that theory and history.¹⁷

Institutional economists take issue with the neo-classical economics conception of the economy which assumes instrumental rationality and efficient markets which are organised and guided by the operation of automatic mechanisms.¹⁸ They see a wider range of explanatory variables and consider that the allocation of resources is determined by the organisational structures or institutions of a society. Markets, rather than being the driving force, are organised by and give effect to the institutions which formed them. The market economy is itself a system of social control.¹⁹

Institutionalists also oppose the neoclassical paradigm of determinate, optimum equilibrium solutions derived from static models and automatic mechanisms which lead to Panglossian²⁰ conclusions of "whatever is, is optimal". They see the economy as dynamic and evolutionary and are concerned with issues such as the distribution of power in society, the causes and consequences of individual and collective psychology, the interrelationship of the individual to culture and the evolution of the economy which is dynamic and not static. In addressing these issues, institutional economists generally take a multi-disciplinary approach and this includes recognition of the law as an important institution and that there is an interrelationship between the evolution of the economy and legal evolution.²¹

The "New Institutional" economists assert that institutions matter. If institutions play an important role in economic growth, rates of technological change, distribution of wealth and other related matters, it is likely that changes in these external environmental factors will influence future institutional change. Institutions constantly evolve in a complex process. This leads to further questions such as, 'why have institutions in different societies adopted widely divergent paths of historical change?', 'why are societies not converging with efficient institutions competing with

an institutional vacuum that was receptive to the development of impersonal economic and legal institutions such as corporations that substituted for the extended families, clans and social networks that prevailed elsewhere. See Avner Greif, 'Family Structure, Institutions, and Growth: The Origins and Implications of Western Corporations' (2006) 96 *American Economic Review* 308.

¹⁷ North, above n 1, vii.

¹⁸ Douglass C North, 'Institutions and Economic Theory' (1992) 36 *American Economist*, 3-6.

¹⁹ Clarence E Ayres, 'Institutional Economics: Discussion' (1957) 47 *American Economic Review, Papers and Proceedings* 26, 27.

²⁰ Pangloss was the tutor of Candide in Voltaire's *Candide: or the Optimist*. Pangloss represented the extreme optimist whose mantra was 'all is for the best in the best of all possible worlds'.

²¹ Warren J Samuels, 'The Present State of Institutional Economics' (1995) 19 *Cambridge Journal of Economics* 569, 571-575 presents eight principal facets of institutional economics and explains how these depart from neoclassical economic thought. The 'transaction cost' approach to assessing institutions in Oliver Williamson, 'Corporate Finance and Corporate Governance' (1988) *Journal of Finance* 567 is perhaps the best known example of institutionalist analysis.

and replacing inefficient ones?’ and, ‘why do inefficient institutions persist?’ These questions are significant because their answers help explain why different economies exhibit greatly different performance.²² An institutional perspective of the joint stock company raises the questions, ‘how important is law relative to other “rules of the game”’ and, ‘how do legal and economic change inter-relate with each other?’.

III Institutional Evolution and Path Dependence

The process of institutional change has been explained by the concept of path dependence which has been expressed as a process which moves in a direction that is influenced by previous steps in the process.²³ In considering institutional evolution, North believes that the concept of path dependency has considerable explanatory power. This results in the creation of an institutional matrix comprising an interdependent web of institutions.²⁴ Even small events and chance circumstances can determine solutions that, once established, can lead down a particular path and in some cases, a small event may have a considerable effect on later outcomes.²⁵ Through the process of path dependence, New Institutionalists place importance on history which they see in terms of the evolution of institutions which link the past to the present and future, so that institutions can be described as the “carriers of history”.²⁶ Paul A David perceived that institutions evolve in a way which shares attributes of biological evolution. There are a number of implications which stem from the use of this comparison. The biological mechanisms of selection are constrained by the materials that are on hand, in that the gene pool is carrying a large number of mutations. Rather than evolution moving towards ever greater efficiency as suggested by neoclassical economics, it is more accurate to see an institution as a “serviceable but inelegant resultant of a path-dependent process of evolutionary improvisation, a structure whose obvious functional limitations stem from its remote accidental origins.”²⁷

The notion that the evolution of institutions is best explained by the concept of path dependence was first developed by economists who sought to explain the process of

²² North, above n 1, 6-9.

²³ Bradley A Hansen and Mary Eschelbach Hansen, ‘The Role of Path Dependence in the Development of US Bankruptcy Law, 1880-1938’ (2007) 3 *Journal of Institutional Economics* 203, 206.

²⁴ North, above n 5, 109-111 uses a path dependence analysis to explain the divergent paths established by England and Spain in the New World. North America is characterised as having an institutional framework which evolved to permit complex impersonal exchange suited to political stability and the capture of the economic benefits of modern technology. In Latin America, political and economic exchange is dominated by ‘personalistic’ relationships which are the consequence of an evolving institutional framework that has not been conducive to political and economic stability and utilising modern technology.

²⁵ North, above n 1, ch 11. If the state of a system turns out to be very sensitive to its earlier states, that system is described as ‘chaotic’. This means that small differences among initial conditions produce very great differences in the final states. This makes prediction of cause and effect in chaotic systems very difficult if not impossible. See George A Reisch, ‘Chaos, History and Narrative’ (1991) 30 *History and Theory* 1, 4-6. Reisch claims that history is chaotic (6-9).

²⁶ David, above n 3, 205.

²⁷ *Ibid* 217, where David refers to Stephen Jay Gould’s metaphor of the Panda’s thumb in *The Panda’s Thumb* (1980) which is not anatomically a finger but an enlargement of bone previously part of the Panda’s predecessor’s wrist described as a ‘contraption not a lovely contrivance’.

technological change²⁸ and was later used to explain legal change.²⁹ A central question which may be answered by applying the concept of path dependency is ‘why do inefficient institutions persist despite more efficient alternatives?’. The answer to this question may also explain why legal evolution may not always be towards efficient laws and why legislation regulating joint stock companies may have unintended consequences.

The efficiency of institutional arrangements changes over time and a once efficient arrangement may later become inefficient. Whether it is worthwhile changing the inefficient institutional arrangement depends upon whether the benefit of the efficiency gain is greater than the costs of adjustment or switching costs in making the change. These costs may include a range of processes including sunk costs, social or human capital costs and entrenched rights of interest groups. It may therefore be rational to keep the inefficient institution rather than attempt to change it to a more efficient one. The concept of path dependence is used to explain the persistence of institutional arrangements, including legal rules and practices, which appear to be inefficient or not the most efficient possibility. Neo-classical economic theory has been used to argue that there are mechanisms at work which cause inefficient institutional arrangements to change towards more efficient arrangements, and ultimately to the most efficient or best arrangement through the survival of the fittest.³⁰ Path dependence explains why this adjustment process towards efficiency may never take place.³¹

The evolution of common law provides an example of institutional change. The common law is explicitly based on precedent and functions in a continuous and

²⁸ North, above n 5, 97 and *Understanding the Process of Economic Change* (2005); David, above n 3; and W Brian Arthur, ‘Competing Technologies, Increasing Returns and Lock-In by Historical Events’ (1989) 99 *Economic Journal* 116.

²⁹ See for example Mark J Roe, ‘Chaos and Evolution in Law and Economics’ (1996) 109 *Harvard Law Review* 641; Lucien Bebchuk and Mark J Roe, ‘A Theory of Path Dependence in Corporate Ownership and Governance’ (1999) 52 *Stanford Law Review* 127; Oona A Hathaway, ‘Path Dependence in the Law: The Course and Pattern of Legal Change in a Common Law System’ (2001) 86 *Iowa Law Review* 601; and Hansen and Hansen, above n 23.

³⁰ See for example Paul Rubin, ‘Why is the Common Law Efficient?’ (1977) 6 *Journal of Legal Studies* 51; Robert Cooter and Lewis Kornhauser, ‘Can Litigation Improve the Law Without the Help of Judges?’ (1980) 9 *Journal of Legal Studies* 139; and George L Priest, ‘The Common Law Process and the Selection of Efficient Rules’ (1977) 6 *Journal of Legal Studies* 65. This analysis is based upon judges making decisions on the basis of complete information and lack of bias: Ronald Heiner, ‘Imperfect Decisions and the Law: On the Evolution of Legal Precedent and Rules’ (1986) 15 *Journal of Legal Studies* 227. Henry B Hansmann and Reiner H Kraakman, ‘The End of History for Corporate Law’ (2001) 89 *Georgetown Law Journal* 439 argue that there has been convergence to the most efficient model in relation to corporate law and corporate governance; Raghuram Rajan and Luigi Zingales, ‘The Great Reversals: The Politics of Financial Development in the Twentieth Century’ (2003) 69 *Journal of Financial Economics* 5 make the same point in the context of financial systems.

³¹ Roe, above n 29 noted that the evolution of law in other countries did not always converge with the American model, yet a number of foreign systems were of comparable efficiency. He suggests that this indicates that there is more than one path to efficiency, and the law and economics perspective needed refinement to better explain legal evolution because what survives is not fully determined by evolution towards efficiency. He added three related paradigms to show that what survives also depends on initial, often accidental conditions (chaos theory), on the history of problems that had to be solved in the past but may be irrelevant today (path dependence) and on evolutionary accidents resulting in sudden adaptations followed by long periods of stability (punctuated equilibrium). See also Reinhard H Schmidt and Gerald Spindler, ‘Path Dependence, Corporate Governance and Complementarity’ (2002) 5 *International Finance* 311, 314.

predictable way so as to reduce uncertainty among actual and prospective litigants. The common law evolves as decisions become embedded in the law and new cases which reconsider old decisions or address new circumstances cause the law to change incrementally. Path dependency does not suggest that evolutionary paths are inevitable or preordained, nor does it predict the future as there are many choices to be made along the way. It is just that these choices are made within a constrained path.

Mark Roe uses an example to illustrate how path dependency operates.³² A winding road which exists today was formed many years earlier by a fur trader who was the first to enter the area and was intent on avoiding a wolves' den and so chose a winding indirect path to avoid the wolves. Had he been a better hunter of wolves, the trader would have killed the wolves and chosen a straight path but by chance, he chose to avoid the wolves rather than kill them. Over time other travellers followed the same path chosen by the trader because this was convenient, clearing trees and establishing a road. Over a long period of time, the road was widened and surfaced to be suitable for modern traffic and housing and industry was established along the bend in the road which followed the path taken by the trader many years ago.

When the time came to resurface the road, the question arose whether the road should also be straightened. To do so would involve removing many buildings which stood along the winding road. Even though the path of the road would not have been chosen today, society has invested in the road and the adjoining infrastructure and so it may be better to keep the winding road on its current path rather than building a straight road with the resultant dislocation. While the winding road may be inefficient in presenting dangers, causing more noise and causing tyres and brakes to wear out more quickly, sound walls and new technologies can overcome some of these problems so the transportation along the road adapts to the inefficiency caused by the bend.

This path dependent history overlaps with chaos analysis³³ because the present road is sensitive to the trader's original determination to avoid danger spots even though fur trading and wolf hunting are no longer important or even relevant today. Evolutionary analysis sees the trader as at an adaptive peak at a time of fur trade and fearsome wolves. In order to reach the next evolutionary hill, that is, a straight road better suited to modern travel, society must go down the first hill in order to remake the road. The winding road was best suited to the old environment but a straight road would be best suited to today's environment. There is no evolutionary competition between a straight and winding road in today's environment, rather we are in a local equilibrium. When there is a major shift, the equilibrium is punctuated. Persistence of the winding road does not imply present day superiority to untried alternatives.³⁴ Path dependence

³² Roe, above n 29, 643-644.

³³ For a discussion of the chaotic nature of history see Reisch, above n 25, 4-9.

³⁴ In *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (1994), Roe illustrates these concepts by analysing the relationships within corporate structures which in the United States are characterised by dispersed share ownership and relatively strong managers and weak share owners. He argues that this can be traced to path dependence stemming from the 1830s when President Andrew Jackson vetoed the re-charter of the Second Bank of the United States on the grounds that it engaged in political corruption. This was due to political reasons as the American public historically abhorred private concentrations of economic power. The response in the 1830s was to destroy this concentration of power in a financial institution. This is the equivalent to building a winding road to avoid wolves. Had the American government been stronger, in the same way as had the trader been an

helps provide an understanding of why a number of solutions are possible rather than driving to the most efficient, determinate outcome, why inefficiencies are not eliminated but are locked in, and how apparently unimportant, chance events can determine a particular path. This explanation is compatible with biological evolution theory which does not see evolution as a relentless drive towards efficiency, but as adaptation to survive a crisis and then stay stable. This may also help explain why legal evolution usually occurs in fits and starts, interspersed with long periods of stability.³⁵

The law and economics perspective sees evolution as slowly and continuously drifting towards efficiency. Recent evolutionary theory perceives evolution as occurring in rapid bursts which are then followed by long periods of stability, until a crisis occurs after which a species either mutates and adapts to the new environment or becomes extinct. There is then a further period of genetic drift and incremental change with little creativity or adaptation. This is described as “punctuated equilibrium”. This is an apt metaphor for legal evolution which is also marked by long periods of stability until an environment-changing crisis occurs, such as an economic depression or a major change in government or public opinion. The survivors of the crisis may be efficient in some respects and inefficient in others, but overall they are capable enough to survive. These long periods of stability or stagnation which occur in the biological world have also been noticed in relation to legal evolution. Klaus Heine and Wolfgang Kerber analysed the role of path dependence in the evolution of corporate law by applying the concept of technological paradigms and trajectories to corporate law.³⁶ They note that the corporate laws of various countries have remained markedly different and national systems persist despite more efficient systems existing elsewhere. They attribute this variance of corporate law systems to path dependence. They suggest that there are a number of factors, which also operate in the context of technological evolution, that stabilise legal rules and strengthen path dependence. These include:

- Uncertainty. The effects and consequences of adopting a new rule are uncertain because it is unpredictable as to how the new rule will operate in practice.

effective wolf hunter, strong financial institutions may have been allowed which would have been regulated by a strong government. As a result, the US had weak fragmented financial institutions and lacked a national financial system until near the end of the twentieth century. Over time various legal and economic institutions developed to undertake the tasks that strong financial institutions perform elsewhere. The rise of large scale industry at the end of the nineteenth century required large amounts of capital, which was provided by effective securities markets which became bigger and better as a result of the relative weakness of banks and other financial institutions.

³⁵ Roe, above n 29, 646, footnote 8 refers to Stephen J Gould, ‘Is a New and General Theory of Evolution Emerging?’ (1980) 6 *Paleobiology* 119, 125. Roe makes the point that many biological ‘decisions’ did not result from direct contests between alternatives. The dinosaurs were not defeated by mammals in a head to head struggle for survival. A change in the environment destroyed dinosaurs and mammals took the opportunity to fill the newly created space.

³⁶ Klaus Heine and Wolfgang Kerber, ‘European Corporate Laws, Regulatory Competition and Path Dependence’ (2002) 13 *European Journal of Law and Economics* 47, 54-60.

- Sunk costs and switching costs.³⁷ Lawyers, judges and other practitioners make considerable investments in human capital to become specialists. A fundamental change in the law may devalue their legal knowledge.
- Complementarities. The effect of one legal rule also depends on other legal rules and it is the working of the mixture of rules that is more important than the individual rules themselves. To change some legal rules requires consideration of how the new rules will fit in with other rules and institutions. This may be difficult to predict and therefore discourages change.

Schmidt and Spindler developed the idea that path dependence is strengthened by the development of complementarities. Elements of a system such as a legal system, corporate governance system, financial system or organisational system are complementary to each other if there is the potential that they fit well together. If these elements fit together well, the system is described as consistent. It is more important that the elements of a system fit together well than how good the individual elements are perceived to be or what type of system it is described as being.³⁸

This discussion of institutions and how institutions change is a useful perspective from which to consider the evolution of the joint stock company. Part IV sets out an historical narrative of this evolution. This historical analysis covers several centuries during which there was little legal regulation and the evolution of the joint stock company can be seen as an example of institutional change. This institutional perspective is discussed in Part V.

IV The Evolution of the Joint Stock Company

Origins

The origins of the joint stock company can be traced to the medieval guilds and other early corporations which were established by the Crown with their own legal status for purposes such as universities, local government, guilds and overseas trade. The fundamental attribute of a corporation was that it was recognised as a separate legal entity distinct from its members.³⁹ The evolution of joint stock involved the internal

³⁷ Schmidt and Spindler, above n 31, 314-315 discuss path dependence as a consequence of switching costs.

³⁸ Ibid 321 onwards discuss complementarity and corporate governance. In considering the effect of path dependence on American corporate governance, Roe, above n 29, 657 argued that when one means of control such as strong financial institutions is absent, other means (which can be described as complementarities) will develop to overcome the perceived problem of weak corporate governance. In the US, the control techniques which developed include strong boards of independent directors and monitoring committees, incentive compensation, threat of litigation, hostile takeovers and strong competitive product and capital markets. In Germany and Japan, financial institutions have relatively greater influence and boards therefore are weaker and play a lesser role. Roe suggests that each system performs about as well as the other and each system has solved basic corporate governance problems by modifying its own path-dependent institutions: 'The solutions are not usually beautiful and are often imperfect. Biological evolution is similarly imperfect, based on pre-existing structures that adapt to survive, not be perfect.' See also Heine and Kerber, above n 36, 57-59.

³⁹ A brief summary of various views regarding the origin of corporations can be found in Ron Harris 'The Institutional Dynamics of Early Modern Eurasian Trade: The *Commenda* and the Corporation' http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1294095 at 20-21. The predominant common law view considered the corporation as an abstract fiction: *Sutton's Hospital Case* (1612) 10 ER 22. See

establishment of a structure whereby members, described as “adventurers”, contributed capital and derived profits from the activities of the company on the basis of the number of shares held, in a similar way as was the case with partnerships.⁴⁰ The emergence of the joint stock company during the sixteenth century occurred as foreign trade expanded to newly discovered parts of the world, and incorporation and trade monopolies were granted by Royal charter to those who furthered government policy by equipping the navy, establishing colonies or discovering new trading routes.⁴¹ At first these were granted to individuals but it soon became apparent that the risks involved were best borne by collective endeavours. The joint stock concept was first used by regulated companies.⁴² Its evolution can be seen in the early years of the East India Company, which was granted a charter in 1600. At first, it was more a loose association of merchants than a company in the modern sense. The members could also privately carry on trade with the East Indies which was a characteristic of regulated companies. Members could later subscribe to joint stock in separate subordinate organisations or syndicates within the company, which was divided up and any profits distributed after each voyage undertaken by the syndicate. The use of syndicates within regulated companies was the usual way by which the joint stock principle was first applied.⁴³ In early joint stock companies, profits were divided after each voyage and members could choose whether or not to invest in a particular voyage.⁴⁴ This was later extended to a number of voyages over a specified period of years until eventually, during the mid-seventeenth century, it became usual for joint stock to become permanent.⁴⁵

Harold J Laski, ‘The Early History of the Corporation in England’ (1916) 30 *Harvard Law Review* 561; William R Scott, *The Constitution and Finance of English, Scottish and Irish Joint Stock Corporations to 1720* (1910-1912), 1-10; Clive M Schmitthoff, ‘The Origin of the Joint Stock Company’ (1939) 3 *University of Toronto Law Journal* 74; and Charles Sumner Lobingier, ‘The Natural History of the Private Artificial Person: A Comparative Study in Corporate Origins’ (1938) 13 *Tulsa Law Review* 41 especially 63-67.

⁴⁰ Paul L Davies, *Gower’s Principles of Modern Company Law* (6th ed, 1997) 20, footnote 9 suggests that the term ‘joint stock’ derives from ‘stock in trade’ rather than as a reference to the synonym of shares. For discussion on the evolution of the joint stock concept see Schmitthoff, above n 39, 88-91; and Ron Harris, ‘The Formation of the East India Company as a Cooperation-Enhancing Institution’ (2005), 26-27, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=874406.

⁴¹ The Russia Company (also known as the Muscovy Company) is generally regarded as the first joint stock company. It was chartered in 1555 with a monopoly over trade routes to Russia and was able to raise capital by issuing tradable shares. Other early companies formed around this time were the Guinea Adventurers (1553) and the Levant Company (1581). See Schmitthoff, above n 39, 91; Harris, above n 40, 24; and J Micklethwait and A Wooldridge, *The Company: A Short History of a Revolutionary Idea* (2003) 26.

⁴² These early companies evolved from guilds, from which they were adapted for trading purposes. They were known as ‘regulated companies’ because they were established by Crown charter giving them monopoly rights and separate legal entity status. They were regulated or governed by extensive rules set out in their charters. Membership of regulated companies was confined to those who were members of particular merchant organisations and were skilled in the particular activities of the company. A feature of regulated companies was that they operated as umbrella organisations facilitating the trading activities of their merchant members, so that members traded privately on their own accounts or in syndicates.

⁴³ Schmitthoff, above n 39, 91-92.

⁴⁴ Harris, above n 40, 32-33 and 45-46 argues that this feature of per-voyage stock encouraged investment and co-operation between insiders and outsiders when there were no established stock exchanges.

⁴⁵ In the case of the East India Company, per-voyage joint stock was used between 1600-1613, and term of years joint stock was used between 1613-1657, after which joint stock became permanent. For some time during the seventeenth century, several of these practices coexisted within different syndicates whereby the entire capital was divided at the end of a voyage, or the initial investment was

The early chartered joint stock companies can be seen as instruments of state foreign policy during the heyday of mercantilism.⁴⁶ The state provided the monopolist framework and corporate personality to enable these enterprises to be financed by a growing merchant class. The success of these “public-private” enterprises was considerably enhanced by the development of an innovative institution based upon the joint stock concept. Ron Harris argues that in the early years of the East India Company the development of joint stock facilitated cooperation between insider entrepreneurs and outsider providers of capital by providing for participatory governance, ensuring information flow and enabling investors to opt out of investing in particular voyages through the initial use of per-voyage joint stock. This mechanism required directors to establish reputation with investors through repeated transactions and extended the pool of investment capital beyond personal relationships and merchant groups and networks.⁴⁷ The high risk, long distances and large transaction volumes in foreign trade and colonisation, and the need to monitor and control distant managers, necessitated the development of skilled management hierarchies which combined the skills of specialist managers with the detailed knowledge of merchants in the particular trade.⁴⁸ It also necessitated a broader investment base beyond the membership of a particular trade or merchant group.⁴⁹

returned and the profits reinvested in the next voyage or the profits were divided and the capital retained by the company for the term of the joint stock. Private trading within the East India Company lasted for nearly the entire seventeenth century before being prohibited: Scott, above n 39, 45-46. See also Ron Harris, *Industrializing English Law: Entrepreneurship and Business Organization 1720-1844* (2000) 25; Harris, above n 40, 45; and Micklethwait and Wooldridge, above n 41, 31.

⁴⁶ K N Chaudhuri, *The Trading World of Asia and the English East India Company, 1660-1760* (1978) at 455. Mercantilism was not a cohesive and unified economic theory, but rather encompassed a broad range of policies; however, a common thread was that they involved the relationship between the state and various favoured mercantile or commercial groupings. These groups furthered government policy such as engaging in expansion of trade and settlement overseas and building a shipping fleet that could be used in time of war and, in return, the state bestowed monopoly powers through the grant of exclusivity in a particular region as well as the grant of a charter of incorporation which conferred advantages in capital raising. The granting of charters and monopolies to the ‘moneyed companies’ can be seen in this light. R B Ekelund, and R D. Tollison, *Mercantilism as a Rent-Seeking Society: Economic Regulation in Historical Perspective* (1981) argue that mercantilism was a logical system for those rent seeking merchants and organisations that benefited from it.

⁴⁷ Harris, above n 40, 32-33. Ron Harris, ‘Law, Finance and the First Corporations’, World Justice Project 2008 http://www.econ.duke.edu/~staff/wrkshop_papers/2008_2009_Papers/Harris.pdf at 29-31 argues that the provision of democratic governance structures and information to members and the right to choose whether or not to invest in a particular voyage were important at a time when there was no established share market as it conferred a form of exit option. In the absence of a share market, an investor wishing to sell shares and exit the company entirely had to find a buyer through personal contacts and have the transaction approved by the company. Harris (at 30) estimates that there were around 40 such transactions approved each year during the early years of the East India Company.

⁴⁸ Ann M Carlos and Stephen Nicholas, “‘Giants of an Earlier Capitalism’: The Chartered Trading Companies as Modern Multinationals’ (1988) 62 *Business History Review* 398 analysed the rise of managerial hierarchies in the early trading companies from a transaction cost approach. At 402-3 they claim that the development of large managerial hierarchies, in some cases of more than 350 head office administrators, by the mid eighteenth-century, indicates that the early trading companies were evolutionary predecessors of modern multinationals.

⁴⁹ The East India Company was highly successful in raising capital almost from its inception. In 1613 it raised £429,000 to finance four voyages and in 1617 it raised £1.7 million to finance seven voyages. At this time it had 934 shareholders and 36 ships; Charles P Kindleberger, *A Financial History of Western Europe* (2nd ed, 1993) 191. Scott, above n 39, 444.

By the mid-seventeenth century the main characteristics of the modern company such as raising share capital, limited liability, distribution of profits by payment of dividends, transferability of shares, the internal structures of director and shareholder meetings, the appointment of directors by shareholders, the establishment of managerial hierarchies and the keeping of accounts on a permanent basis and their disclosure to shareholders, had largely developed through inclusion in charters or by commercial practice.⁵⁰

Fiscal Revolution after 1688

Before 1688, incorporation was mainly granted by royal charter for the purpose of carrying out foreign trade and colonising activities. After 1688, Parliamentary constitutional supremacy was confirmed and Parliament rather than the Crown became the prime source for conferring corporate status, particularly in relation to business organisations. Parliament granted incorporation charters to encourage the carrying out of a wide range of public benefit works or governmental functions and policies. Corporations therefore played an important public role at a time when Government was undeveloped and poorly funded. Many private Acts of Parliament were passed which formed corporations or Commissioners to carry out public works such as road construction, water supply facilities and river navigation improvements – which would now be regarded as Government services – with the power given to the corporation to acquire property rights if necessary or charge users for the use of the facilities they established and managed. They were generally incorporated on the initiative of their promoters who sought authorisation to carry on a particular activity for which they could charge users, usually in conjunction with the conferral of a monopoly power which made the activity more lucrative.⁵¹ Parliament had wider powers of incorporation than the Crown and only it could provide for limited liability.

Apart from corporations created by charter or act of Parliament, some joint stock companies were formed without a charter or act. These unincorporated joint stock companies adapted partnership law and made their own provisions to deal with large numbers of shareholders and to bear many of the characteristics of incorporated companies despite the lack of legal recognition.⁵² Unincorporated joint stock companies, like partnerships, were conceptualised as aggregates of individuals without a separate existence from their shareholders. Under this conceptualisation, the relationship of the shareholders of an unincorporated company to the company itself was characterised in much the same way as partners in relation to their partnership.

⁵⁰ Harris, above n 45, 25 and above n 40, 28-31.

⁵¹ Margaret Patterson and David Reiffen, 'The Effect of the Bubble Act on the Market for Joint Stock Shares' (1990) 50 *The Journal of Economic History* 163, 164 claim that the granting of incorporation was often in return for some payment or benefit which raised government revenue and could also include exchange of favours, bribes or giving shares to Members of Parliament or exchanging government debt for shares in the newly created corporation which, as described below, happened in the case of the South Sea Company.

⁵² The law of partnership developed from the *societas*, an early form of trading association which became part of the law merchant. Its main features were that it involved some permanency of association; each partner had capacity to bind the others in contracts made for the firm and had unlimited liability to creditors of the firm. Partnership law had to be adapted because it did not provide for large numbers of shareholders, the separation of membership and management and transferability of shares. For a history of early partnership law see William S Holdsworth, *History of English Law* (2nd ed, 1937) vol 8, 193-199.

The characteristics of the unincorporated joint stock company which differentiated it from the “ordinary” or private partnership stemmed from the number of shareholders, the more ambitious scale of its operations and the more sophisticated financial requirements that were necessary to accommodate a relatively large number of passive or *rentier* investors who did not participate in management and who could readily transfer their shares without reference to other shareholders.

After the 1688 Revolution there was a boom in joint stock company formations, both incorporated and unincorporated, in a wide range of industries including treasure salvaging,⁵³ mining, fire insurance, water suppliers, banks and manufacturers of arms, textiles, soap, sugar, paper and glass.⁵⁴ This boom was closely interrelated to the development of stock markets and the growth of trading in the shares of both incorporated and unincorporated joint stock companies.⁵⁵ An indication of widespread share trading was the first publication of stock market prices in 1692.⁵⁶ All the institutional structures which characterise an effective modern share market such as professional brokers, established brokerage fees, available price information and a variety of tradable securities evolved through commercial practice with little or no legal encouragement.⁵⁷ The growing importance of joint stock companies as a form of business enterprise can be seen in the development of stock markets which, in turn, made the company form more popular by enhancing the transferability of shares. The evolution of companies and stock exchanges are closely linked in this interactive way. The corporate attribute of freely transferable shares is only attractive to investors if the shares can be easily traded. Equally, stock exchanges can only flourish if the

⁵³ Scott, above n 39, 326-327 refers to ten companies formed between 1687 and 1702 to recover treasure from wrecks. The best known of these companies was The Adventurers in the Expeditions of William Phipps formed in 1688 to salvage treasure by means of a newly invented diving bell from a Spanish ship which sank in 1646 near Hispaniola. The investors made a profit of one hundred times their initial investments. The investors in Drake’s voyage round the world were also highly successful and this fuelled considerable speculation in treasure-seeking companies whose shares traded at large premiums.

⁵⁴ Scott, above n 39, 327-337. In 1695 there were an estimated 150 joint stock companies in existence of which two thirds were English and the remainder Scottish. Only about 15 per cent of these were formed before 1688. According to Scott, they had a combined capital of £4.25 million and owned 10 per cent of the wealth ‘employed in the home and foreign trade’ of England. A little over three quarters of this amount was attributed to the six largest companies: the East India, African, Hudson’s Bay and New River Companies, Bank of England and Million Bank.

⁵⁵ Stock exchanges were small and informal, located mostly in and around the Royal Exchange and adjoining coffee shops of Exchange Alley. See C F Smith, ‘The Early History of the London Stock Exchange’ (1929) 19 *American Economic Review* 206. S R Cope, ‘The Stock Exchange Revisited: A New Look at the Market in Securities in London in the Eighteenth Century’ (1978) 45 *Economica* 1 provides a detailed description of how the market operated and the stock exchange practices during this period.

⁵⁶ John Houghton, *A Collection for Improvement of Husbandry and Trade* (1692-1703). This periodical contained essays, book reviews and various price lists. It contained the prices of eight company shares in 1692. This increased to 63 companies in 1694: Cope, above n 55, 18. Douglass C North and Barry R Weingast, ‘Constitutions and Commitment: The Evolution of Institutional Governing Public Choice in Seventeenth Century England’ (1989) 49 *Journal of Economic History* 803, 826 note that the total value of stock markets in England grew from less than £1 million in 1690 to around £15 million in 1710. P S Atiyah, *The Rise and Fall of Freedom of Contract* (1979) 32 refers to an estimate that some £50 million was invested in joint stock companies by 1720.

⁵⁷ Philip Mirowski, ‘The Rise (and Retreat) of a Market: English Joint Stock Shares in the Eighteenth Century’ (1981) 41 *Journal of Economic History* 559, 576; Cope, above n 55, 8 provides evidence of the sophistication of the market noting that speculation through the purchase of options was commonly practiced in the 1690s.

market has some depth of listings and there is a critical mass of tradable securities and market participants.

The popularity of share trading and the perception held by most Members of Parliament that share speculation was undesirable can be seen from the passing of several Acts which attempted to regulate brokers and share traders.⁵⁸ These statutes were the precursors of the Bubble Act and show the polarisation of the wealthier sectors of society that either embraced and participated in share investment and share trading or were hostile to it and described it as “stock jobbing” or speculation with connotations of dishonesty and fraud.⁵⁹ Those most likely to favourably view share investment and trading and company promotions were from the emerging commercial sectors while the traditional landed classes generally took a negative attitude, possibly seeing company activity as a threat to the established order and traditional commercial morality. This hostile or unsympathetic attitude towards companies and share trading was apparent in the Parliament and the judiciary, which were largely representative of the landowning class during the eighteenth and early decades of the nineteenth centuries.⁶⁰

North and Weingast link the fiscal revolution and growth of public and private capital markets in the late seventeenth century with the evolution of political institutions after the Revolution of 1688, which resulted in Parliamentary supremacy and an independent judiciary. They claim that a critical factor in these political developments was that the Crown was bound by the new political institutions and self-enforcing rules and was subject to Parliament’s assent to fiscal changes, marking the beginnings of a separation of powers. Parliament was also constrained in its ability to expropriate bond holders’ rights by the establishment of the Bank of England which administered the national debt and ensured bond holders would be paid. The State was therefore able to credibly commit not to arbitrarily expropriate property for its own benefit as had previously occurred. This resulted in a significant increase in the security of private property rights and led to the almost immediate growth of impersonal capital markets.⁶¹

While there was certainly a great increase in the use of joint stock companies after 1688, North and Weingast appear to exaggerate the threat of expropriation by the King and the negative impact of this threat on capital formation. As shown above, the East India Company and other chartered companies were very successful in raising large amounts of capital from a broad base of investors from the beginning of the seventeenth century when the Crown’s traditional powers were still intact and despite the lack of an established stock market. The political turbulence and instability of the mid-seventeenth century, especially the Civil War and its aftermath, may well have been more significant in restraining economic growth and restricting the number and

⁵⁸ In 1697 an Act was passed to ‘restrain the number and ill practice of brokers and stock-jobbers’: 8 and 9 Wm III, c 32. This Act required brokers to be licensed and limited the number of licensees. It remained in effect until 1708, when it was replaced by a new Act under which the City assumed responsibility for licensing and regulation of brokers. See Smith, above n 55, 210.

⁵⁹ Smith, above n 55, 209-210 distinguished between ‘jobbers’, who had a property interest in shares and usually dealt on credit; and brokers, who operated on commission and did not own the shares.

⁶⁰ See Harris, above n 45, 231-235 for a discussion of the social background of the judiciary. See Atiyah, above n 56, 91-95 for a discussion of the composition of Parliament and how it operated during the eighteenth century.

⁶¹ North and Weingast, above n 56, 824-828.

size of joint stock companies. Another factor explaining the upsurge in the use of joint stock companies immediately after 1688 stemmed from the severe decline in overseas trade because of war with France which caused a shift of capital to local investment.⁶²

Rajan and Zingales⁶³ analysed the development of financial markets in terms of the need to create substantial supportive infrastructure. Their argument is that market institutions remain undeveloped when powerful incumbent social and economic interests see the establishment of free markets as threatening. This occurs because efficient markets treat all participants equally and this undermines the privileges of power and provides access to the market by outside groups. For free competitive markets to develop, the first prerequisite is that the state must respect and guarantee the property rights of all citizens. This requirement reiterates the argument developed by North and Weingast outlined above, that the state must give a credible commitment not to expropriate but rather respect property rights. Rajan and Zingales go further by arguing that it is insufficient to look at constitutional change alone as it is only the culmination of deeper political processes. It is therefore necessary to address the role of powerful incumbent groups such as the aristocracy or dominant landowners. These groups have strong incentives to suppress the establishment of the rule of law and property rights and the development of financial institutions such as stock markets.

The political history of England during the sixteenth and seventeenth centuries saw the establishment of the supremacy of Parliament and the curbing of the power of the aristocracy as well as the power of the monarchy, allowing the rise of the gentry. The necessary conditions for the emergence of property rights was thereby created and the development of financial markets and the financial revolution followed after 1688. This is not to say that the traditional incumbents were permanently deprived of their power to block the development of free markets. Each stage of development produces its own group of incumbents who may have incentives to block institutions that threaten their interests. The inter-relationship of social, economic and political groupings is to some extent generally fluid and finely balanced. As discussed below, the enactment of the Bubble Act can be seen as a reassertion of power by favoured vested interest groups and its repeal over a century later represented a victory of the new commercial interests which developed during the industrial revolution.

The boom of the 1690s was followed by a period of relative decline until the late 1710s. Boom conditions returned in late 1719 when the share prices of the three large trading companies increased by large amounts and this spilled over to smaller “bubble” companies.⁶⁴ Most “bubble” companies were unincorporated joint stock

⁶² Scott, above n 39, 328 shows that total exports and imports declined by 39 per cent between 1688 and 1696-7, and up to 1692 some 3,000 British ships were captured by the French.

⁶³ Raghuram G Rajan and Luigi Zingales, *Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity* (2003). See 136-151 for an illustration of their argument in the context of political, economic and constitutional change in England during the sixteenth and seventeenth centuries.

⁶⁴ Harris, above n 45, 61-62 numbers new company formations in the hundreds; typically each of these ‘bubble’ companies had a nominal capital of £2 to 5 million with a total estimated capital of £224 million. He notes that the share prices of the Bank of England increased by 170 per cent, the East India Company by 220 per cent and the South Sea Company by 820 per cent between October 1719 and July 1720. These three dominant companies were known collectively as the ‘moneyed companies’. Price increases of this magnitude clearly indicate a period of intense market speculation. Kindleberger, above

companies, in that their promoters did not obtain charters or acts of incorporation. Formal incorporation of the large numbers of “bubble” companies formed in 1719 and 1720 was not feasible given the time and expense involved, the likelihood of opposition from vested interests and the limited resources of Parliament and Crown law officers to deal with a flood of incorporation applications.

The Bubble Act

The Bubble Act of 1720 provided that organisations which “presumed to act as a corporation” or which issued transferable shares, were public nuisances and illegal, and imposed criminal liability for breaches of the Act. Its broad aim can be seen from part of its full title: “An Act to Restrain the Extravagant and Unwarrantable Practice of Raising Money by Voluntary Subscriptions for Carrying on Projects Dangerous to the Trade and Subjects of this Kingdom”. However, its provisions were ambiguous and uncertain at least partly because the legislation made clear that it did not interfere with the carrying on of trade in partnership. Unincorporated joint stock companies evolved as a type of partnership, so it was unclear as to whether or not they came within this exclusion to the operation of the Act.

There have been several explanations as to why the Bubble Act was passed. A number of earlier explanations incorrectly asserted that the Bubble Act was a response to the collapse and was passed after the crash.⁶⁵ The traditional explanation for the Bubble Act being passed maintains the view that it was in response to a period of undesirable, intense speculation in joint stock “bubble” company shares, although it predated the bursting of the bubble.⁶⁶

Alternative approaches explaining the passing of the Bubble Act emphasise political economy or vested interest factors. Margaret Patterson and David Reiffen interpret the passing of the Bubble Act from the perspective of the vested interest of Parliament to protect its ability to raise revenue from the granting of charters or incorporation Acts. They argue that the Bubble Act was a response to increasing numbers of unincorporated joint stock companies seeking incorporation or successfully raising capital from a limited number of investors despite remaining unincorporated. By so doing, they were competing with incorporated joint stock companies for capital, thereby reducing the value of incorporation charters and threatening the ability of Parliament to raise revenue by granting further incorporation charters. According to this argument, the Bubble Act was passed so that formally incorporated corporations

n 49, 191 estimates that there were 195 new joint stock companies formed between September 1719 and August 1720.

⁶⁵ Harris, above n 45, 73 traces a long line of writers including William Blackstone, F W Maitland and J H Plumb who maintained this mistaken sequence. He suggests that this may have been caused by the change in 1751 from the Julian to Gregorian calendar which starts the year on a different date and may have caused confusion as to the year of the Bubble Act.

⁶⁶ See Davies, above n 40; J H Farrar and B M Hannigan, *Farrar’s Company Law* (4th ed, 1998) 17-18; Scott, above n 39, ch XXI; Bishop C Hunt, *The Development of the Business Corporation in England 1800-1867* (1936) 6-9; A B DuBois, *The English Business Company After the Bubble Act 1720-1800* (1938) 1; Micklethwait and Wooldridge, above n 41, 39-41; Ron Harris, ‘The Bubble Act: Its Passage and Its Effects on Business Organization’ (1994) 54 *The Journal of Economic History* 610, 661. See Harris, above n 45, 65-68 for a detailed discussion of the background to the legislation and a description of its main provisions.

could restrict the ability of unincorporated companies to access capital markets and also restrict the resale of existing corporate charters.⁶⁷

Another interpretation also sees the Bubble Act from a vested interest perspective, but one which emphasises the political influence of the South Sea Company and associated economic interests represented in Parliament.⁶⁸ The directors of the South Sea Company saw the boom in new “bubble” companies as threatening competition for investment capital and used their political influence to have the Bubble Act passed so as to make it more difficult to form unincorporated joint stock companies. It was in the interests of the government that investment capital found its way to the South Sea Company rather than other enterprises and that its share price increased, as the more attractive the shares, the greater the extent to which government debt would be converted by bond holders into South Sea Company shares.⁶⁹ From the Company’s point of view, the higher the share price, the more favourable the conversion ratio of government bonds to shares, as it enabled the company to issue shares at a higher par value which reflected the market price for the shares. The directors were concerned to focus investor demand on share issues of the Company rather than those of other companies which were taking advantage of rising share prices for which the South Sea Company was largely responsible.

Harris makes the point that despite its drafters’ intentions, the Bubble Act was not successful in causing capital to be diverted to the South Sea Company as it collapsed soon after the Act was passed. Nevertheless, he argues that the Company was the prime force behind the Bubble Act which was a response to immediate rather than long term concerns.⁷⁰ This interpretation is plausible given the way Parliament operated during the eighteenth century. Legislation was mostly comprised of Private Acts and was mostly of a local and temporary nature. Attempts to address broad issues of a social or economic nature were not common and when such attempts were made, the resultant legislation was often ineffective and incomprehensible. This was

⁶⁷ Patterson and Reiffen, above n 51, 169. As Harris, above n 45, 75-76 points out, this interpretation is difficult to reconcile with the reluctance of officials and Parliament to grant incorporation charters and Acts after the Bubble Act was passed for much of the eighteenth century. If they were concerned to safeguard this avenue of business, it raises the question why were greater barriers to incorporation erected? The number of incorporation bills remained low for many years after 1720 and they therefore did not significantly increase the revenue of the State or the private income of individual politicians.

⁶⁸ Henry Butler, ‘General Incorporation in Nineteenth Century England: Interaction of Common Law and Legislative Processes’ (1986) 6 *International Review of Law and Economics* 169, 171-173. Butler argues that the Bubble Act was ‘a governmentally-created entry barrier designed to put out of business (and hinder the development of) all business associations which were competing with Parliament’s chartering business’. Harris, above n 45, 68-70 points out the many connections between those actively involved in the passage of the Bubble Act and the South Sea Company. The Committee of Secrecy discovered that the Company offered large amounts of shares on favourable terms to politicians and kept their names secret. Nearly 600 Parliamentarians and several ministers received shares in one subscription valued at over £3.5 million.

⁶⁹ The South Sea Company was founded in 1711 with the monopoly right to trade with South America. Its full title was ‘The Governor and Company of Merchants of Great Britain trading to the South Sea and other parts of America and for encouraging the Fishery’. The Company was unsuccessful largely because of the outbreak of war with Spain so in conjunction with the government, the directors embarked on a grandiose scheme to acquire the entire national debt in exchange for company shares. The method used was to convert government bonds which paid fixed interest into company shares which were made attractive investments by the conferral of monopoly trading rights. The Company was then able to finance its trading activities through its large holding of government bonds.

⁷⁰ Harris, above n 45, 78.

partly because of the absence of an effective bureaucracy and skilled public service capable of properly understanding the problem and the best way to tackle it. Atiyah claims that Parliament “did not so much *initiate* and *impose* policies and law changes on people, as respond to outside initiatives and pressures.”⁷¹

In explaining the passing of the Bubble Act and its content, it is useful to consider the strong influence of mercantilism at the time. The Bubble Act can be seen as an implementation of mercantilist policies aimed at protecting the South Sea Company, which was carrying out state objectives in retiring debt, from competition for investment capital from business organisations seen not to be connected to government policy.

The immediate cause of the bursting of the bubble in 1720 was the bringing of legal proceedings to forfeit the charters of a number of companies on the grounds that they were no longer operating in accordance with the provisions of their charters. In several cases, companies were wound up so their stock became valueless. The consequent financial panic extended to the South Sea Company itself, which was the main bubble company, and its share price soon after crashed. Later investigations revealed fraud and corruption which involved senior government members and the royal household.⁷²

The Bubble Act is traditionally seen as having had the effect of significantly inhibiting the use and development of both corporations and unincorporated companies.⁷³ DuBois claimed that the most significant and permanent effect of the Bubble Act was to paradoxically encourage the widespread use of unincorporated joint stock companies. This was because an indirect result of the Act was that it created an atmosphere which inhibited the grant of charters and the passing of incorporation acts in line with the apparent policy of the Bubble Act, and when incorporation was granted, various restrictive conditions, such as limits on the amount of capital which could be raised, were often imposed.⁷⁴ On the other hand, the Act expressly allowed the use of partnerships and this allowed scope for the formation of unincorporated companies which arguably came within the meaning of “partnerships” and therefore fell outside the prohibition. The Bubble Act may also have caused

⁷¹ Atiyah, above n 56, 94. See 91-95 for a discussion of how Parliament operated during the eighteenth century.

⁷² Davies, above n 40, 26; Harris, above n 66, 616.

⁷³ Scott, above n 39 vol 1, 437-438; Hunt, above n 66, 6-9; Davies, above n 40, 27 commented that even though the Bubble Act was rarely enforced, ‘If the legislators had intended the Bubble Act to suppress companies they had succeeded beyond their reasonable expectations...’. Frederic W Maitland, *Collected Papers* (1911) 390 described the passing of the Bubble Act in the following way: ‘a panic stricken Parliament issued a law, which even now when we read it seems to scream at us from the Statute Book.’ DuBois, above n 66, 12 commented that not only were unincorporated companies directly discouraged by the Bubble Act. At 2 he described the Bubble Act as ‘The product of an emergency situation, it was ambiguous in the extreme’ and at 11 ‘For good and for ill, Parliament had committed the business company to the ward of administrative officials, and to this accountability, company law of the succeeding century owes its amorphousness’. H A Shannon, ‘The Coming of General Limited Liability’ in E M Carus-Wilson, *Essays in Economic History* (1954) vol 1, 358-359 thought the Bubble Act checked for many years the introduction of legislation allowing incorporation as a matter of right. Ronald R Formoy, *The Historical Foundations of Modern Company Law* (1923) 47 said ‘The Act was intended to suppress joint stock trading, but owing to its severity, it remained nearly a dead letter until the beginning of the nineteenth century...’.

⁷⁴ DuBois, above n 66, 39.

promoters to adopt a cautious approach for fear of contravening its prohibitions which were criminal offences, and by the common practice of seeking legal advice which may well have led to the legalistic and complex development of English company law and its practice.⁷⁵

Therefore in a direct sense, the Bubble Act did not have the dramatic long term effects that are traditionally attributed to it. Rather, it was a “dead letter” which had minimal direct impact on the development of joint stock companies and stock markets during the remainder of the eighteenth century. Enforcement of the Act was weak – there being only one instance of a criminal prosecution during the eighteenth century – although the Act was revived in a different economic context early in the nineteenth century.⁷⁶

In an indirect sense, the Bubble Act may have played some part in the decline in the use of joint stock companies and stock exchanges in the decades following its introduction.⁷⁷ This may be seen as the result of the bursting of the bubble, which was caused by a variety of financial factors, and not the Bubble Act itself which had little impact on the operation of stock markets.⁷⁸ This decline of share markets and joint stock company formations after the Bubble Act, may have reflected increased public criticism of the joint stock company and associated share trading by some influential sectors of society as a consequence of the Bubble Act and the crash of 1720. Later periodic booms and crashes reinforced this attitude and led to various Acts which prohibited certain market practices such as dealings in options and futures and, as described in the Bubble Act, “the infamous practice of stockjobbing”.⁷⁹

The hostility of some sectors towards the stock market, and companies generally, remained very strong until the time of the canal boom in the latter part of the eighteenth century. The period after 1760 saw a great increase in the number of canal companies and a broadening of the shareholder base which led to a greater

⁷⁵ DuBois, above n 66, 3.

⁷⁶ Harris, above n 66, 623-626 disputes the traditional view that the Bubble Act was a decisive turning point in the history of the joint stock company.

⁷⁷ Philip Mirowski, above n 57, 559 suggests that this decline lasted for the remainder of the century, although he does not claim that this decline was a result of the Bubble Act. At 576, Mirowski challenges the notion that the rise of the share market is a necessary precondition for economic development. He argues that in eighteenth century England, the stock market in fact declined because there was a lack of demand for publicly traded share capital. North and Weingast, above n 56, 826 indicate that while growth in share market trading of private securities fell after the early 1710s, the market was far larger in the period 1715 to 1750 than it was before 1688.

⁷⁸ Harris, above n 45, 78-81. P L Cottrell, *Industrial Finance 1830-1914* (1980) 10 notes that the Bubble Act had little impact upon the financing and organisation of manufacturing industries because these remained as sole proprietorships, family businesses or partnerships and were able to raise the finance they required, mainly from internal sources. The predominance of the family firm and partnership in manufacturing remained until the last quarter of the nineteenth century.

⁷⁹ ‘Stockjobbing’ refers to dealers in the market who operate as principals as opposed to brokers who act as agents for their clients. Dealers generally held stock and made a market in a particular security by quoting a price to brokers who bought for their client and received commission. A jobber made a profit by selling stock at a higher price than its purchase price. Stock jobbing came to be associated with exploitative and dishonest speculation and was viewed very negatively by many. See Cope, above n 55, 1-2. The ‘chief apostle of financial purity’ was Sir John Barnard, who sponsored five bills between 1733 and 1756 aimed at preventing or regulating stock market speculation.

legitimation of share investment.⁸⁰ The canal companies provided an important public purpose, and most shareholders in canal companies were local landholders and businessmen who stood to gain from improved transport infrastructure and were generally long term shareholders with little interest in transferring their shares.⁸¹ These shareholders were largely wealthy, respectable and influential in their local communities and were far removed from the stereotype of bubble company share speculators who were viewed very unfavourably.⁸² Some canal companies were very large, having over 1000 shareholders, and in most cases had dispersed shareholdings, with a large proportion of shareholders holding only a few shares. Acts of incorporation typically restricted the size of shareholdings and voting rights were often reduced in proportion to the size of shareholdings, so holders of one share could exercise one vote while holders of 10 shares may have had only five votes. This encouraged the splitting of shareholdings among family members and nominees.⁸³

The Concurrent Use of Incorporated and Unincorporated Joint Stock Enterprises

Despite the “shadow of the Bubble Act”,⁸⁴ the period from the mid-eighteenth to the mid-nineteenth century saw important developments in the use of joint stock enterprises, both incorporated and unincorporated, which were instrumental in important economic areas such as canals, docks, railways and other public utilities, overseas trading, banks, insurance and mining.⁸⁵ These were industries which generally had substantial capital investment requirements, uncertainty of ultimate success, or a long wait for returns to investors and this meant that ordinary partnerships were generally inappropriate or an inefficient form of business organisation for carrying on these activities.⁸⁶ Joint stock companies were relatively

⁸⁰ The construction of canals was largely to transport coal and other mining commodities which were too bulky to move economically by road. Between 1730 and 1790, canals in Britain doubled in length and 165 canal Acts came before Parliament in the period between 1758 and 1803; 81 Acts were passed between 1791 and 1794. See Kindleberger, above n 49, 192-193.

⁸¹ John Ward, *The Finance of Canal Building in Eighteenth Century England* (1974) 172; and George Evans, *British Corporation Finance 1775-1850: A Study of Preference Shares* (1936) 11. Evans, 31-34 noted that 71 per cent of the original shareholders of the Leeds and Liverpool Canal resided in Yorkshire and Lancashire, the two counties through which the canal ran. Over 60 per cent of shareholders in 1789 were still shareholders in 1795 and over 80 per cent of those shareholders remained shareholders in 1800.

⁸² Evans, above n 81, 21.

⁸³ *Ibid* 27-30, indicating that in the case of the Leeds and Liverpool Canal as at 1789, there were 469 shareholders of whom 84 per cent held fewer than 5 shares.

⁸⁴ The title of ch 1 of DuBois, above n 66.

⁸⁵ Adam Smith thought that joint stock companies were appropriate forms of business organisation only for those trades that involved routine matters such as banks, insurance, canal building and water suppliers. For other industries, he thought companies were inefficient because of the necessity of delegating control to directors and so they were against the public interest: Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776, reprinted 1976) 756. Ward, above n 81, 164 shows that between 1750 and 1800 there were 648 Acts passed incorporating companies for the purposes of river navigation and canals, harbour improvements and turnpike trusts. Robin Pearson, ‘Shareholder Democracies? English Stock Companies and the Politics of Corporate Governance during the Industrial Revolution’ (2002) 117 *English Historical Review* 840 at 842, claims that over 200 insurance companies were established in Britain and Ireland between 1700 and 1850. The great majority of these were unincorporated. Unincorporated companies also predominated in urban water provision and gas (at 845).

⁸⁶ Lynn Stout and Margaret Blair, ‘Specific Investment and Corporate Law’ (2006) 7 *European Business Organization Law Review* 473 observed that the public company form is particularly

little used in manufacturing enterprises which largely remained as sole proprietorships, family businesses or partnerships able to raise the finance they required from internal sources and borrowings. The predominance of the family firm and partnership in manufacturing remained at least until the last quarter of the nineteenth century and probably later.⁸⁷

This raises interesting questions as to why these two forms of joint stock companies, incorporated and unincorporated, remained; and in particular, why the unincorporated joint stock company not only persisted, but despite statutory prohibition, became more significant in terms of its contribution to economic development in the latter part of the eighteenth century and early nineteenth century. DuBois suggests that the unincorporated joint stock company became widely used largely because of the reluctance of government officials and Parliament to grant incorporation in the post Bubble Act environment. The imposition of great difficulties in the path to incorporation resulted in promoters seeking other avenues.⁸⁸ The widespread use of unincorporated companies meant that there was little government regulation of companies as they rarely came into contact with Parliament, the courts or government officials.⁸⁹

Harris explains the reluctance of Parliament to pass incorporation Acts in the aftermath of the Bubble Act as being due to political economy factors and the role of vested interest groups. This also explains why some industries such as the transport infrastructure sector were largely in the hands of incorporated joint stock companies, while others such as insurance and banking were largely conducted by unincorporated

appropriate for those businesses in industries that require large amounts of 'enterprise specific' assets, meaning assets that cannot be withdrawn from the enterprise without destroying most of their value. Transport infrastructure typifies these types of industries because of the large amount of development costs which must be expended on assets specific to the enterprise before any return can be gained. Once profits are earned, the machinery and equipment is of a highly specialised nature so as to be virtually worthless in other uses apart from as scrap. In these types of industries, incorporation serves the necessary purpose of locking in investors' capital so that it cannot be withdrawn by the investors, their successors or creditors as could be the case with partnerships. Investor contributions belong to the company as a separate entity under the control of its directors. This analysis explains why canal and railway joint stock companies were formed and why businesses in some industries remained as partnerships.

⁸⁷ Cottrell, above n 78, 10.

⁸⁸ DuBois, above n 66, 13. DuBois, 169, footnote 135 provides a detailed description of the complicated administrative process leading to a grant of a charter of incorporation. Application was made to the Privy Council which referred the application to a sub-committee. If it approved, the matter went to the Attorney General and Solicitor General. A report was then issued which often included detailed clauses imposing various restrictions and which formed the basis of the Privy Council's decision whether or not to grant a charter. The law officers often held hearings at which opponents of the application could object. In the case of Parliamentary incorporation, the usual procedure for the passing of an Act was carried out. A petition for incorporation was referred to a House committee which heard the petitioners and opponents. If the committee approved, the Act was drafted and the committee's report referred to the House for approval, amendment or rejection.

⁸⁹ DuBois, above n 66, 438 notes that: 'The average company was permitted to proceed placidly on its unregulated way'. Davies, above n 40, 28 suggests that a consequence of this development was that the Government relinquished control over the development of company law until 1844. Despite the uncertainties stemming from the Bubble Act, there were a number of developments which implicitly recognised that unincorporated joint stock companies had legitimacy, especially in the insurance sector. Promoters of insurance companies which unsuccessfully sought charters were advised by the Attorney General and senior judges that it was more appropriate to conduct business as voluntary associations rather than as corporations. See Pearson, above n 85, 845.

joint stock companies. Harris claims this was due to the different interest groups present in these industries. Vested interests in the insurance industry, which had become established in the late seventeenth and early eighteenth centuries, were keen to block applications to Parliament for incorporation of insurance businesses as newcomers could directly compete with existing incorporated businesses.⁹⁰ Therefore new insurance companies generally operated as unincorporated joint stock companies. The legal structure and characteristics of unincorporated joint stock companies is discussed below. In transport, most existing enterprises operated more or less as regional monopolies, so newcomers did not threaten operators of existing roads or canals to a great extent and so did not provoke the same degree of opposition. Harris also suggests that among transport operators, it was easier to arrive at settlements whereby existing operators could be placated by being issued shares in the new competing enterprise.⁹¹

A further explanation could be that an Act of Parliament was more important for transport infrastructure companies because it was necessary for the company to acquire land and various rights in order to construct a canal or railway and this could only, or best, be achieved by legislation. The shareholders of companies which constructed and conducted canals and railways were mainly local businessmen and landowners who stood to gain commercially from transport improvements. This meant that they were generally wealthy and prominent local citizens who may well have had considerable political influence with little vested interest opposition.⁹²

Therefore, whether or not corporations or unincorporated joint stock companies predominated in particular industries was largely due to the strength of vested interests in that industry and their influence in Parliament, and their ability to erect barriers of entry which blocked incorporation applications presented by potential competitors. This resulted in an *ad hoc* approach to incorporation on the part of Parliament, characterised by influence-peddling and the absence of any clear policy or criteria in determining applications for incorporation. This is not surprising given the composition of Parliament and the relatively unsophisticated nature of Government.⁹³

The influence of vested interest groups also resulted in many cases where incorporation was granted but charters contained restrictive clauses inserted at the behest of competitors or interest groups. The importance of the terms of the charter was underlined by the *ultra vires* doctrine which developed after the Bubble Act. It required a corporation's activities to be strictly limited to the purposes and powers specified in its charter and there was a judicial reluctance to imply further powers.⁹⁴

⁹⁰ DuBois, above n 66, 29 describes the long drawn out and ultimately unsuccessful attempt by the Society for Equitable Assurances to gain a charter of incorporation as it was opposed by the established life assurance corporations, the Royal Exchange and the London Assurance. As a result the Equitable Society conducted its business without a charter.

⁹¹ Harris, above n 45, 107-109. Harris ch 4 provides an explanation of why the different company forms persisted and how this is illustrated by developments in the transport and insurance industries.

⁹² Ward, above n 81, ch II. See also the discussion of the investment role of landowners in ch VI.

⁹³ Harris, above n 45, 135-136. See Atiyah, above n 56, 17-24 for a description of the machinery of Government and the operation of Parliament in the eighteenth century.

⁹⁴ DuBois, above n 66, 109-110. A number of corporations were prohibited from lending money or dealing in other than specified products in order to protect the interests of the Bank of England and other chartered banks. Corporations were sometimes limited in the amount of capital they could raise or were prohibited from allowing the transfer of shares for a certain period after incorporation.

In order to change the restraints imposed by a corporation's charter, it was necessary to go through the long and expensive process of applying for an amended charter.⁹⁵ While corporations had the advantages of limited liability and a clear separate identity, unincorporated companies could more easily change their constitutions by majority vote of shareholders.

This discussion indicates that both incorporated and unincorporated joint stock companies operated during the century of operation of the Bubble Act. The unincorporated form persisted not so much because it was able to successfully compete with corporations, but rather because the influence of vested interest groups in certain industries and sectors and the increased difficulty of obtaining incorporation Acts after 1720, excluded certain types of businesses from obtaining incorporation. As discussed below, the lack of enforcement of the Bubble Act and the creativity of entrepreneurs and their lawyers enabled the unincorporated form to be used and both types of joint stock companies to co-exist.

The Legality and Legal Structure of Unincorporated Companies

At common law, unincorporated companies were a category of partnerships and the law of partnership was modified and adapted to accommodate the needs of a large and fluctuating number of members. The major differences between unincorporated joint stock companies and traditional small partnerships, were found in their commercial nature rather than in fundamental legal distinctions. Joint stock companies were generally larger, had a larger number of shareholders who often did not know each other, had a greater proportion of passive investors who did not expect to participate in management and allowed for greater ease of transfer of ownership interests.⁹⁶ Unincorporated companies were not expressly recognised at common law and while it was suggested by some, most notably Lord Eldon, that companies were illegal at common law and this was merely restated by the Bubble Act,⁹⁷ Lindley, writing in 1860, considered that this was not so.⁹⁸

During the second half of the eighteenth century, the deed of settlement company was developed by entrepreneurs and their lawyers in order to provide the unincorporated company with the main features of a corporation. The main way by which the Bubble Act prohibition was side-stepped and the difficulties imposed by the application of partnership law was addressed, was by the creation of a trust. Under this trust, the firm's property was placed in the names of trustees, usually chosen from the

⁹⁵ DuBois, above n 66, 113 provides the example of the Chelsea Water Company as an illustration of the rigidity of administrative policy regarding the amendment of charters.

⁹⁶ Nathaniel Lindley, *A Treatise on the Law of Partnership: Including its Application to Joint Stock and Other Companies* (1860) vol I, 4 defined such companies as 'associations of persons intermediate between corporations known to the common law and ordinary partnerships, and partaking of the nature of both.' Perhaps the best known nineteenth century texts in these areas were written by the famous judge Nathaniel (later Baron) Lindley. The titles of his books reflect the changing basis of company law. He wrote *A Treatise on the Law of Partnership: Including its Application to Joint Stock and Other Companies*, which was first published in 1860. A supplement of the 1862 *Companies Act* was added in that year, and in 1889 *A Treatise on the Law of Companies: Considered as a Branch of the Law of Partnership* was published. These two works later became *Lindley on Partnerships* and *Lindley on Companies*. See also Paddy Ireland, 'Property and Contract in Contemporary Corporate Theory' (2003) 23 *Legal Studies* 453, 457-461.

⁹⁷ See *Kinder v Taylor* (1825) 3 LJ Ch 68.

⁹⁸ Lindley, above n 96, vol I, 3.

shareholders, who were appointed by the subscribers (later to become shareholders) and authorised under a deed of settlement which contained the constitution of the company, to conduct the management of the enterprise. A person generally became a member by signing the deed. A provision which was commonly inserted in a deed purported to limit the liability of the shareholders. Such a provision only had effect as between the shareholders themselves. It did not limit the liability of a shareholder as regards an action brought by an outsider.⁹⁹ The complexity of this form of business organisation is indicated by the various strands of law which were utilised. The basis was partnership law because a central feature was the concept of profit sharing. The appointment of directors involved the application of agency law. The internal relationships within the company were based on a contract comprised of the deed of settlement. This deed also established trust relationships based on equitable principles designed to overcome the lack of a clear, separate legal entity distinct from its shareholders.

The trust deed usually provided for free transferability of shares, as this was one of the main advantages sought by the founders of the company and its investors. This created uncertainty for trustees seeking to sue on behalf of a company where new members had been admitted after the cause of action arose. It was held in *Metcalf v Bruin*¹⁰⁰ that despite changes in the composition of membership of the company, trustees could sue on a bond. The debtor was taken to have known of the fluctuating nature of the company's membership and so intended that the trustee could enforce the bond. The appointment of trustees attempted to overcome the difficulties in suing faced by an organisation of constantly changing membership, as the action was brought by the trustees on behalf of the company. Trust deeds also sometimes provided for limited shareholder liability. While not having a distinct legal personality which was recognised by the law, an unincorporated company could act through its trustees and this had an effect to some extent similar to the right to sue and be sued in the name of an incorporated company, although as discussed below, it was cumbersome for large companies to bring and defend legal proceedings and it was generally a complicated and imperfect device. The appointment of trustees served a useful commercial purpose, because it facilitated a division of ownership and control as management responsibility vested with the trustees who acted in the role of directors.

The unincorporated joint stock company evolved to meet the commercial demand for a suitable pooled investment mechanism when this was difficult to achieve by the simpler means of incorporation. Further complexity arose from jurisdictional and procedural issues because partnership law was governed by common law while trust law jurisdiction lay with the courts of equity. Despite these cumbersome features, unincorporated joint stock companies largely succeeded in replicating the essential features of incorporated entities by modifying partnership law and introducing concepts of trust law. The concepts and relationships of shareholders and directors, transferability of shares, the corporate right to sue, the liability of shareholders to pay

⁹⁹ *Hallett v Dowdall* (1852) 18 QB 2; 118 ER 1, 50-51 (per Martin B) held that as against outside parties who have no notice of the terms of the deed, the shareholders were liable to the same unlimited extent as partners. In the case of insurance policies issued by an unincorporated insurer, it was usual to expressly provide in the policy that the shareholders of the insurer had limited liability. As the insured knew of this provision and agreed to it, he was bound by it when making a claim.

¹⁰⁰ (1810) 12 East 400; 104 ER 156.

calls and limited liability were based on those found in Acts of incorporation and charters.

Harris argues that the deed of settlement company was a highly flawed form of business organisation whose limitations prevented it from becoming a highly preferable alternative to the business corporation. Despite the considerable efforts by businessmen and their lawyers to overcome the inherent difficulties of this form, they were unable to achieve separate legal entity, limited liability or the ability to resolve internal disputes or effectively bring legal actions. For these reasons Harris argues that deed of settlement companies never became very popular outside the insurance and Birmingham metals industries.¹⁰¹ This argument appears to understate the popularity of unincorporated joint stock companies in a number of other significant industries, most notably in banking, insurance and mining.¹⁰²

The problems faced by unincorporated joint stock companies in the late eighteenth century stemmed from the fundamental notion that they were considered as partnerships, and were not legally recognised as separate legal entities in the same way as corporations which were formally incorporated by the State. The courts made few concessions to the commercial realities that joint stock companies usually had large numbers of shareholders and were generally unsympathetic to the problems faced by this form of business enterprise. Despite this indifference displayed by the law and the complexities of adapting other business forms, unincorporated companies were widely used in those industries where there was a commercial need for pooled investment but difficulties in obtaining incorporation charters.

The shareholders of a joint stock company stood in a contractual relationship with other shareholders and with outside parties such as company creditors in the same way as partners. Before the concept of the company as a separate legal entity evolved in the mid nineteenth century, shareholders were seen as being liable for the contractual debts incurred by the company. Thus, attempts by shareholders to transfer their shares so as to place the purchaser in the shoes of the vendor, were seen as attempts by vendors to assign contractual liabilities which could not be done at common law without the authority of Parliament or the Crown.¹⁰³

Under partnership law the liability of partners is unlimited so that each partner is jointly and severally liable for the debts of the partnership. In the case of an unincorporated company, the prospect of unlimited liability would appear to have been a major concern and discouragement to investors, although in practical terms it was difficult for a creditor of a company to successfully bring legal actions against its shareholders. Some improvised attempts were made to limit liability with varying degrees of success. It was possible to provide for limited liability in partnership agreements and deeds of settlement but this was unlikely to be binding on third parties who were unaware of this limitation. It was also possible to include a clause in each contract that the partners or shareholders were not personally liable for company

¹⁰¹ Harris, above n 45, 166 cites some contemporary commentators who stressed the shortcomings of unincorporated companies.

¹⁰² Ibid 194.

¹⁰³ *Duvergier v Fellows* (1828) 5 Bing 248; 130 ER 1056 and *Blundell v Winsor* (1837) 8 Sim 601; 59 ER 238. Ireland, above n 96, 459-460; Harris, above n 45, 230-249.

debts, however this was generally cumbersome and difficult to negotiate and was not common outside certain industries such as insurance.

There were procedural difficulties where a partner sought to bring an action against another partner, because all partners were required to be parties to the action¹⁰⁴ and the action could not be brought in the name of the company as it was not recognised as a legal person capable of bringing or defending a legal action. This meant companies faced difficulties in enforcing calls on partly paid shares against shareholders, because the equity courts were reluctant to look into the affairs of a company in order to enforce a contribution from some shareholders as this would entail an inquiry into the entire state of the partnership accounts.¹⁰⁵ An action to enforce a call could not be brought by the directors or other officials as representatives of the company or firm, as there was no contract between the officials and shareholders and even if there was such a contract, it was invalid unless the official was a corporation sole.¹⁰⁶ This reluctance by the courts to interfere in internal partnership matters meant that all partners were required to be parties to an action to dissolve the partnership. There was a conceptual difficulty in allowing a member to sue the company or *vice versa* because, in effect, the member in question must be both a plaintiff and defendant.¹⁰⁷

The difficulties faced by a company seeking to enforce payment of a call or other debt owing by a shareholder led to various innovative measures being devised by companies. The practice developed of framing shareholder agreements so as to enable a partner to be sued by the other partners, and where this occurred, the sued partner was unable to share in the proceeds of the litigation and the suing partner was not under an obligation to contribute to his own payment.¹⁰⁸ Lindley refers to the practice of “putting a creditor on a shareholder” which involved inducing a creditor of the company to single out the debtor shareholder and sue him personally for the company’s debt with the company meeting the costs. This type of action usually resulted in the shareholder seeking to come to terms with the directors. The courts of equity could restrain the proceedings by the creditor, who gained no greater rights than the company would have had, and the company could be required to deal fairly with the shareholder.¹⁰⁹

¹⁰⁴ Lindley, above n 96, vol II, 718-719.

¹⁰⁵ Henry Thring, *The Law and Practice of Joint Stock and Other Companies*, 4th ed (1880) 8-9.

¹⁰⁶ Lindley, above n 96, vol II, 722. A corporation sole is a corporation comprising a particular office, such as the Official Trustee in Bankruptcy, which is occupied by a natural person. The corporation continues as a legal person regardless of the individual who happens to occupy the position at any particular time. See Robert P Austin and Ian M Ramsay, *Ford’s Principles of Corporations Law* (13th ed, 2007) 33-34; *McVicar v Commissioner for Railways (NSW)* (1951) 83 CLR 521, 534; and *Crouch v Commissioner for Railways (QLD)* (1985) 159 CLR 22, 35.

¹⁰⁷ Lindley, above n 96, vol II, 720. See *Van Sandau v Moore* (1826) 1 Russ 441, 460 and 472 per Lord Eldon. In that case, a shareholder sought to dissolve a company and have proper accounts taken on the grounds that the deed of settlement contained provisions which were inconsistent with the prospectus, on the faith of which he had accepted shares in the company. It became practically impossible for the plaintiff to proceed with the action after the court held that each of the 14 directors and 300 shareholders were entitled to respond to the claims separately. The effect of this case was to make it extremely difficult, or virtually impossible, for an individual shareholder to obtain a dissolution of a company with many shareholders or an adjustment of claims between shareholders.

¹⁰⁸ Lindley, above n 96, vol II, 721.

¹⁰⁹ *Ibid* 722-723.

There were also similar difficulties in resolving disputes between companies and third parties. The company could only be a party to a legal action if all the shareholders were before the court as plaintiffs or defendants. This meant that if there were a large number of shareholders, the company was practically unable to bring an action.¹¹⁰ It was to overcome these types of procedural difficulties that applications to Parliament were made for private Acts which enabled the company to sue in the name of its public officer. Proceedings against a member in the name of a public officer were not always successful because the public officer represented all the members as individuals. Therefore the public officer may have been unable to bring an action against a member because the public officer also represented that member.¹¹¹ It was also difficult for a creditor of an unincorporated company to enforce payment of a debt against a shareholder despite the unlimited liability of shareholders. Creditors of a company faced practical difficulties in ascertaining the identity of members and the composition of its membership where there was a constantly changing membership. These practical and procedural difficulties in enforcing shareholder liabilities, in effect, meant that there was an informal limited liability.

Through the application of partnership law, unincorporated joint stock companies were not seen as legal entities separate from their joint stock holders. This presented problems of continuity, because under partnership law the death, retirement or bankruptcy of a partner required the partnership to be reorganised at considerable expense. In the case of unincorporated joint stock companies, this was a particular problem because the main purpose of the company was to provide for free transferability of shares and a constantly changing membership.

At the end of the eighteenth century, the joint stock company played a very important role in several important sectors of the economy where there was a need for pooled investment. This was despite the prohibitions of the Bubble Act and the lobbying activities of vested interest groups who opposed the granting of incorporation charters to real or potential competitors. The last decades of the century saw a boom in canal construction carried out by corporations, to be followed by a greater boom in railways in the first half of the nineteenth century.

V The Joint Stock Company as an Institution

Joint stock companies emerged from regulated companies¹¹² during the sixteenth century at a time of increased growth of overseas trade and competition between states. This resulted in a greatly increased demand for capital to finance overseas trading companies that served the strategic geo-political interests of the state. There must also have been a potential supply of capital from merchants and other commercial groups who sought to participate as passive investors in various ventures. Regulated companies, which had earlier evolved from guilds and were adapted for

¹¹⁰ Formoy, above n 73, 33-36 provides an example of the practical complexities of suing an unincorporated joint stock company.

¹¹¹ Lindley, above n 96, 719-720. Lindley, writing in 1860, noted that Acts of that time avoided this problem by making the public officer the representative of the company rather than the individuals composing it, thereby enabling the public officer to bring legal proceedings in the same way as a corporation. See *Lawrence v Wynn* (1839) 5 M & W 355.

¹¹² 'Regulated' companies evolved from guilds and were the precursor of the joint stock trading companies. See the discussion in n 42 above.

trading purposes, were characterised by memberships limited to the members of particular merchant groups and so were too restricted in their pool of potential members and sources of investment funds to meet the greater demand for capital and management skills.

By the early seventeenth century, many of the features of modern listed companies had been established by provisions in charters and commercial practice which included separation of membership from management, regular meetings of members, the provision of financial information to members, the conferral of powers of appointment and removal of directors by the members and distribution of profits by payment of dividends. These characteristics of joint stock companies served as strong signals by insiders that outsider investors could participate in governance, and that they would be provided with financial information and be fairly treated. This fostered a high degree of co-operation and trust between insider directors and outsider capital providers which played an important role in the ability of the chartered trading companies, such as the East India Company, to raise large amounts of capital by being able to tap impersonal sources of funding. The institutional changes which enabled the joint stock company to evolve beyond an organisation of a particular merchant association also facilitated the development of specialised management with the creation of a skilled director and manager class.

The joint stock company was an institution which mitigated the concerns a member may have had in investing money in a company, such as the business turning out to be poorly managed or the directors engaging in self dealing, misusing company funds or other opportunistic behaviour. The institution of the joint stock company provided a mechanism which encouraged co-operation and trust between the various parties by providing for internal constraints such as monitoring company performance and shareholder participation in appointment of directors. This institutional evolution can be seen in the early years of the East India Company.¹¹³ The means by which this trust and co-operation was fostered were largely outside the law and appear to have involved endogenous constraints such as informal social sanctions, social norms and fear of loss of reputation and future business.¹¹⁴ These informal constraints were based on cultural factors and beliefs within the merchant community, including internal codes and sanctions which established a path dependency of trust and trustworthiness. This encouraged investment in joint stock companies and fostered their development over several centuries when the law and enforcement environments were weak. John Coffee suggested that norms may matter most when the formal law is weak and does not adequately protect shareholders. Social norms become more important because they provide a functional substitute for law.¹¹⁵ A number of economic historians have found this to be the case in studies of particular institutions.¹¹⁶

¹¹³ For a full discussion see generally Harris, above n 40.

¹¹⁴ On the important role of social norms in corporate law see Eisenberg, above n 9; Coffee, above n 13; Blair and Stout, above n 12; and Edward B Rock and Michael L Wachter, 'Islands of Conscious Power: Law, Norms and the Self-Governing Corporation' (2001) 149 *University of Pennsylvania Law Review* 1619.

¹¹⁵ Coffee, above n 13, 2175.

¹¹⁶ See again Greif, *Institutions and the Path to the Modern Economy* above n 7, and 'Reputation and Coalitions in Medieval Trade', above n 15; see also Paul R Milgrom, Douglass C North and Barry R Weingast, 'The Role of Institutions in the Revival of Trade: The Medieval Law Merchant, Private Judges and the Champagne Fairs' (1990) 2 *Economics and Politics* 1.

During the early stages of the development of joint stock companies, trust and social norms were the predominant constraints on opportunistic conduct by company insiders and formal law played a minor role, mainly through facilitative charter provisions. An investor in the East India Company, for example, could participate in the lucrative opportunities available in long distance trade with Asia only through membership of the Company. However without supporting institutions, investors would be reluctant to hand over large sums of money to insiders because of the risk that insiders could misappropriate the funds, provide misleading information about the profitability of the business or act in other opportunistic ways. To overcome these concerns, it was necessary that an institution be developed that enabled the company insiders to commit in advance to be honest after they received the investors' funds. In the absence of strong external legal enforcement, the joint stock company developed as an institution based on internalised trust and trustworthiness¹¹⁷ and those organisations that developed trust gained a competitive advantage in long distance trade over organisations which were unable to develop trust.

The fostering of trust within the institution of the joint stock company was a critical aspect of the development of a large number of joint stock companies engaged in a wide variety of commercial activities.¹¹⁸ An important group of these joint stock companies engaged in long distance trade and the furthering of state geo-political objectives. The evolution of joint stock chartered companies after the mid-sixteenth century played a vital role in the opening of sea routes for long distance trade and colonialism because they were able to mobilise the necessary large amounts of capital. This development was part of the emergence of a number of related and complementary economic and political institutions which enhanced the wealth of Western Europe and laid the foundations for the development and growth of capitalism. These complementary institutions included political constitutions which imposed checks on arbitrary royal power, secure property rights¹¹⁹ and effective financial systems and stock markets.¹²⁰ These institutions enabled the merchant class to gain access to the lucrative commercial opportunities associated with long distance trade to the Americas, Africa and Asia.¹²¹

¹¹⁷ Blair and Stout, above n 12, 1739-1740 describe 'trust' as a 'willingness to make oneself vulnerable to another, based on the belief that the trusted person will choose not to exploit one's vulnerability'. They define 'trustworthiness' as an 'unwillingness to exploit a trusting person's vulnerability even when external rewards favour doing so.'

¹¹⁸ Scott, above n 39, Volumes 2 and 3 describes the histories of 63 joint stock corporations which, before 1720, were engaged in diverse activities including foreign trade to many parts of the world, colonisation, planting in Ireland, drainage of marshlands and mines, fisheries, mining, treasure salvage, provision of water supply, postage, street lighting, manufacturers, banking and insurance. A table setting out a summary for each company of size of capital, type of incorporation, composition of board and number of shareholders is in Scott, Volume 3, 461-481.

¹¹⁹ North and Weingast, above n 56; and Rajan and Zingales, above n 63.

¹²⁰ See Larry Neal, 'How It All Began: The Monetary and Financial Architecture of Europe During the First Global Capital Markets, 1648-1815' (2000) 7 *Financial History Review* 117, 123-128; and Mirowski, above n 57.

¹²¹ Daron Acemoglu, Simon H Johnson and James A Robinson, 'The Rise of Europe: Atlantic Trade, Institutional Change and Economic Growth' (2005) 95 *American Economic Review* 546 put forward the argument that the Rise of Western Europe between 1500 and 1850 was due to both direct and indirect effects of the Atlantic trade. The indirect effects included the establishment of capitalist institutions which enriched the emerging commercial interests by enabling them to participate in the Atlantic trade and colonial activity. The increasing political and economic power of this group enabled them to successfully push for institutional reforms which protected and enhanced their interests. This in

This examination of the history of the joint stock company calls into question the argument that law and legal institutions are central to a country's financial development.¹²² This "law and finance" theory attempts to explain why some countries have well developed stock markets and financial systems and other countries do not. It is based on the premise that law and legal institutions matter, and argues that financial markets flourish where the legal system encourages investment by protecting property rights and especially investor rights. Cross country differences in investor protection laws can be explained by legal origin. Those countries whose legal systems originated from the English common law are more likely to have strong investor protections and therefore more developed financial institutions than civil law based systems. The evidence put forward in support of this theory by La Porta et al is an empirical comparison of 13 shareholder and creditor protection laws and regulations across 49 countries whose legal systems stemmed from the different legal traditions.¹²³

The development of the joint stock company took place in England around a century before the development of stock exchanges. The development of both these institutions took place at a time of few, if any, formal legal rules, although a number of shareholder rights were provided for in company charters. The joint stock company and share markets developed because of powerful internal and informal institutional constraints, such as social norms, and strong cultural factors which compensated for the lack of formal legal investor protection. Therefore, to focus entirely on the "law in the books" does not present a full picture of investor rights; nor does it explain the preparedness of investors to co-operate and trust company insiders. In this context, law in the formal sense is not necessarily critical because it is only one form of institutional constraint that influences behaviour, and is not necessarily the most important.¹²⁴

turn encouraged further investment and trade. The evolution of institutions reflects the relative political and economic power of groups in the society. The growth of capitalist institutions reflects the growing power of the bourgeoisie.

¹²² Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'Legal Determinants of External Finance' (1997) 52 *Journal of Finance* 52; 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113; 'Investor Protection and Corporate Governance' (2000) 58 *Journal of Financial Economics* 1.

¹²³ 'Law and Finance', above n 122, 1113, Table 1 defines eight shareholder rights including oppression remedy rights, meeting rights and dividend rights, and five creditor rights including reorganisation rights. For a survey of the law and finance literature and an overview of its critiques, see Thorsten Beck and Ross Levine, 'Legal Institutions and Financial Development', National Bureau of Economic Research Working Paper 10417 at

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=476083; and Michael Graff, 'Legal Origin and Financial Development: New Evidence for Old Claims? The Creditor Rights Index Revisited' (2008), 5-12 at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1135595.

¹²⁴ There is considerable debate on the role of law, whether it matters or is trivial in the context of comparative corporate governance, and whether corporate law should be mandatory or waivable. See for example Brian R Cheffins, 'Does Law Matter? The Separation of Ownership and Control in the United Kingdom' (2001) 30 *Journal of Legal Studies* 459; John C Coffee, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control' (2001) 111 *Yale Law Journal* 1, 59-71; Bernard S Black, 'Is Corporate Law Trivial? A Political and Economic Analysis' (1990) 84 *Northwestern University Law Review* 542; and 'The Legal and Institutional Preconditions for Strong Securities Markets' (2001) 48 *UCLA Law Review* 781 (arguing that a large number of legal and institutional conditions are requirements of a strong share market); and Frank H

If it is correct that common law countries in fact have the most developed stock markets, this would appear to be so because cultural factors and social norms established centuries ago created a path dependency of co-operation and trust which fostered investment in joint stock companies and the development of stock exchanges. The development of these institutions was based upon informal and internal constraints rather than external formal laws. It is possible that once strong financial markets are established because of conducive cultural factors, the law may respond in a functional way to further the needs of interest groups associated with financial institutions, and this may explain the introduction of strong investor protection laws after financial markets have already been established. This sequence of causation seems intuitively more plausible because legal protection without supportive social norms is unlikely to result in flourishing financial markets, whereas the development of the joint stock company in England shows that legal protections and effective enforcement mechanisms are not necessary preconditions for the development of strong financial markets.¹²⁵

The next stage in the evolution of joint stock companies occurred after the Revolution of 1688. The constitutional supremacy of Parliament was established and led to a fiscal revolution in the following years. Parliament granted incorporation charters to many companies formed to carry out a broad range of public infrastructure works. This period also saw the adaption of the joint stock company form by entrepreneurs who did not seek, or were unable to obtain, incorporation charters. Unincorporated joint stock companies evolved from the law of partnership, with adaptations to their internal rules which recognised that they had large numbers of shareholders who were able to freely transfer their shares without requiring the consent of other shareholders as would generally be the case with partnerships. This boom in both incorporated and unincorporated company formations coincided with the development of share markets and a marked growth in share trading. This period saw the joint stock company experience significant institutional change as it came to be used in a wide range of economic activities, it was no longer restricted to incorporated bodies and in a complementary development, share markets developed as more companies were formed and share trading became more widespread. The development of share markets in turn enhanced the attractiveness of the joint stock company to investors, by making their shares more freely transferable and thereby encouraged the formation of more companies. These developments resulted in share market booms in the 1690s and 1719 and 1720, culminating in the South Seas Bubble.

Easterbrook, 'International Corporate Differences: Markets or Law?' (1997) 9 *Journal of Applied Corporate Finance* 23.

¹²⁵ Amir N Licht, 'The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems' (2001) 26 *Delaware Journal of Corporate Law* 147 claims that it is necessary to take into account the crucial role of cultural factors in comparative corporate governance systems. See also Bebchuk and Roe, above n 29, who argue that corporate rules including corporate law and securities law are affected by earlier corporate ownership structures which create a path dependency; and Coffee, above n 124, 59-64 suggesting that self-regulation and private self-help measures were more important than strong legal rights as catalysts for the growth of share markets in the US; however, strong minority shareholder rights need not necessarily come from legislation. Coffee also suggests that comprehensive securities law was introduced in the US and UK after securities markets had been well established on the basis of self-regulation.

Up to the Bubble Act of 1720, the joint stock company can be seen as an institution which evolved to facilitate impersonal exchange and co-operation and trust between insider directors and entrepreneurs, and outsider investors. This co-operation and trust was enhanced by the early development of internal rules governing member participation in governance through the election and removal of directors, the disclosure of financial information and payment of dividends, and social norms which resulted in the relative absence of rent-seeking conduct by insiders. This established a path dependency which ensured the persistence of the joint stock company as a capital raising mechanism despite the prohibitions of the Bubble Act and the common law which did not recognise unincorporated bodies, and arguably made it illegal for unincorporated bodies to act as if they were incorporated.¹²⁶

The Bubble Act changed the environment in which joint stock companies operated, although it appears to have had relatively little effect on inhibiting their development. Incorporation Acts became more difficult to attain, however this may have been the result of opposition from vested interest groups in certain industries and not necessarily because of the operation of the Bubble Act.¹²⁷ The difficulty of obtaining incorporation Acts resulted in promoters seeking other avenues to raise capital. The deed of settlement company evolved as a complex structure which simulated incorporated companies in most respects by amalgamating elements of partnership and trust law. These companies were widely used in the banking and insurance sectors. It was largely successful in providing for transferable shares and a separation of management and share ownership. In some cases, especially insurance companies, the trust deed provided for limited liability. The development of the deed of settlement company can be seen in evolutionary terms as an inefficient form of business organisation in some respects because of its inherent complexity and the difficulties of suing and being sued. However, overall it was a “serviceable but inelegant resultant of a path-dependent process of evolutionary improvisation”,¹²⁸ capable of serving its purpose and playing an important role in the financing of key infrastructure and finance sectors during the industrial revolution.

A powerful factor explaining the success of the joint stock company despite the Bubble Act was the common inclusion of constitutional provisions and practices which were aimed at enhancing investor confidence, conferring participatory rights and mitigating concerns that the insiders would deal unfairly with investors. Unincorporated banks only required a small proportion, some 17 per cent of nominal capital, to be paid up.¹²⁹ This practice may have had the effect of providing an incentive to directors to make investment in their company attractive, so that members would pay calls when they were made as it was difficult to enforce payment of calls, especially in the case of unincorporated companies. Directors were typically required

¹²⁶ Harris, above n 66, 623. *Kinder v Taylor* (1825) 3 LJ Ch 68 per Lord Eldon stated that unincorporated companies were illegal at common law. Lindley, above n 96, vol I, 3 thought this was incorrect.

¹²⁷ Harris, above n 45, ch 4 provides an explanation of why the different company forms persisted and how it was difficult to obtain incorporation acts in the insurance industry.

¹²⁸ David, above n 3, 217.

¹²⁹ Mark Freeman, Robin Pearson and James Taylor *The Politics of Business: Joint Stock Company Constitutions in Britain, 1720-1844* (2004), 3. This paper was presented at the European Business History Association Eighth Annual Conference, Barcelona and may be accessed at <http://www.econ.upf.es/ebha2004/papers/7F2.doc>.

to hold a sizeable share qualification.¹³⁰ This may have made companies appear more attractive because their directors included wealthy businessmen and often aristocrats. It could also have fostered investor confidence that the directors were also significant shareholders, and therefore there was an alignment of interests between the directors and shareholders signalling a reduction in agency costs. Company constitutions generally provided for directors having fixed terms of office and were therefore required to come up for election, typically every three or four years.¹³¹ It was also common for shareholders to have the express right to remove directors and even appoint managers.¹³² General meetings of shareholders were required to be held at least once per year. A number of companies required two meetings per year.¹³³ Canal companies generally allowed shareholders the right to gain access to the companies' books. The general meeting of shareholders was often given the right to appoint a committee of inspection or auditor if it was dissatisfied with the accounts.¹³⁴ While these participatory provisions varied considerably from industry to industry, within industries, and over time, they represented a clear signal to investors that the joint stock company was an institution that encouraged prospective shareholders to enter into a mutually beneficial exchange relationship with the company.

Enforcement mechanisms during the eighteenth century were weak, and businessmen and their lawyers were creative enough to work around the law or adapt it so that it ultimately served their needs. By the time of the Bubble Act, the institution of the joint stock company had been firmly established and a path dependence created which made this form of business organisation very attractive to those interests that utilised it both as entrepreneurs and as investors. The development and use of the unincorporated joint stock company after the Bubble Act can be seen as an example of the "law in action" despite the "law in the books". It highlights the importance of seeing the concept of "law" in broad terms and viewing legal history from the perspective of the users of legal institutions, and stressing "the centrality of fictions, bypasses, and other flexibilities in the common law system".¹³⁵ This interpretation addresses the apparent contradiction that England's industrial revolution occurred during a time when its legal structure dealing with business organisations "in the books" appeared to be more restrictive than was the case in many other less advanced economies.

VI Conclusion

The joint stock company developed as a capitalist institution which provided incentives to investors to enter into mutually beneficial exchange relationships, and to a significant extent it overcame the "fundamental problem of exchange". This development occurred at a time when the capital requirements of long distance trade exceeded the amounts that could be raised within a particular merchant group. This change from personal to impersonal economic relationships was facilitated by the establishment of an institution that engendered investor confidence, through a system

¹³⁰ Ibid 4.

¹³¹ Ibid. Longer terms of office became more common in the 1840s.

¹³² Ibid 6.

¹³³ Ibid 7.

¹³⁴ Ibid 7-10.

¹³⁵ Harris, above n 45, 7.

of rules and norms which constrained the actions of company insiders so that they would not engage in opportunistic or dishonest behaviour.

The fundamental shareholder rights characteristic of modern public companies were largely established at the time of the formation of the East India Company. This created a path dependency that encouraged investment in joint stock companies during the following two and a half centuries. This path dependency was strong enough to overcome the apparent restrictions imposed by the Bubble Act and enabled the joint stock company to play a major role in the key sectors of infrastructure and finance, especially canals and docks, insurance and banking during the period of the industrial revolution. The historical analysis in this paper supports the view that, in the evolution of the joint stock company, law does not matter. At a time when the legal system was relatively weak and undeveloped, social norms and beliefs played a more important role than the law in the success of joint stock enterprise.

The development and use of the unincorporated joint stock company, despite the restrictions of the Bubble Act, also highlights the importance of seeing the concept of “law” in broad terms so as to encompass how the law is applied or avoided; and viewing legal history from the perspective of the users of legal institutions and not just from the “law in the books”. To focus on the provisions of the Bubble Act would create a misleading impression of the development of joint stock companies during the period when the Act was in operation. This perspective of focussing on the “law in action” enables the addressing of the apparent contradiction that England’s industrial revolution occurred during a time when the country’s legal regulation of business organisations seemed more restrictive than was the case in many other less advanced economies.