LIMITED LIABILITY IN HISTORICAL PERSPECTIVE

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There is no attribute of the modern business corporation more closely connected with it, in the thinking of the general public, than the limited liability of its shareholders. From the point of view of the investor limited liability permits him to submit to the vagaries of fortune solely the amount of money he originally chose to invest in the corporation. To the lawyer limited liability is a rational conclusion to be drawn from the fact that a corporation is an entity; for if it is an entity, it alone is responsible for its debts. To the economist the concept is essential, for without limited liability capital acquisition would be difficult indeed.[1] To the creditor it is at worst a necessary evil, or, perhaps an obstacle to be by-passed by requiring the personal liability of others to be added to corporate liability in specific instances as a condition to the granting of credit.

Nevertheless it is a matter of historical record that such unanimity of opinion on the question of limited liability did not always exist. Indeed, the corporate device was not adapted to business purposes until the eighteenth century, and it was not until the early nineteenth century that controversy emerged on the extent of the liability of shareholders in business corporations. This conflict raged for a period of approximately 50 years. It was during that time that the economic development of this nation proceeded at a rapid pace, and laid the basis for the tremendous growth of economic power that took place after the Civil War.

In this significant half-century, however, whirls and eddies of conflicting doctrine shook the legislatures of all industrial states, inducing them to adopt policies toward shareholders that seem strict to us today. Calm did not descend suddenly upon the corporate scene, but only slowly, after cases and statutes had hammered out an appropriate compromise that left us with limited liability, but did not permit that concept to survive unscathed.

The Nature of the Case: Stockholders v. Creditors

The corporation can be viewed financially, as well as legally, as an entity. The assets and liabilities of the corporation are kept separate from those of its stockholders. The interests of the stockholders are, to be sure, reflected on the corporate balance sheet, and so are the interests of its creditors.

[1]This appears to be a basic assumption of the writers of standard texts on economics, e.g. Weiler and Martin, *The American Economic System* 28 (1957).

Modern accounting practice treats the interests of the stockholders and creditors alike as liabilities. It must be stated at the outset, however, that the liability of the corporation to stockholders comes into existence only after the claims of outside corporate creditors have been met, for it is elementary learning that the shareholders are entitled to share in assets of the corporation only at the dissolution of the corporation and after payment of corporate debts.[2]

Essentially the question whether or not limited liability is to be an attribute of corporate existence depends on the relative weight to be given to the interests of stockholders and creditors. During the running of a corporation, and prior to its dissolution, many conflicts can arise between stockholders and creditors concerning the disposition of the assets of the corporation. Questions can arise concerning the appropriateness of dividends, the disposition of surplus which theoretically arises when the par value of capital stock is reduced, the disposition of surplus attributable to the rise in market value of fixed assets over cost, and the purchase by a corporation of its own outstanding shares of stock. These, of course, are problems cast in a modern mold. The concept of limited liability has now found firm ground, and therefore limits the problem to the disposition of currently existing corporate assets, and is not concerned with great actions by corporate creditors against shareholders.

From a philosophical point of view, however, the problem must be considered in another light. The question then becomes: To what extent should stockholders be liable for corporate debts? Should only their contributed capital be the source of satisfaction for creditors of the business, or should they also put at risk their personal fortunes?

It is the purpose of this article to trace the development of this philosophical conflict in American law, and to ascertain the nature of the compromise between these two interests, of shareholders on the one hand and creditors on the other, that made the modern theory of limited liability an actuality.

The English Heritage

It is neither necessary nor expedient for this purpose to enter into a full discussion of the long history of the corporate form of organization in England.[3] Certain things, however, must be mentioned by way of preface, for our forbears did have at hand some English experience with the problem.

The end of the 18th century marks, for all practical purposes, the time of emergence of the modern industrial community. Even by that time, however, England did not grant charters to limited liability business corporations created solely for private profit. The closest developments to it were the joint-stock company and the equitable trust.

The joint-stock company, originally developed as a means of amassing capital, had only one attribute of the modern corporation, and that was the ability to transfer shares. It was not a recognized entity, and the shareholders were unlimitedly liable.

Equitable trusts used for business purposes, however, had, in addition to

[2]According to Cooke, *Corporation, Trust and Company* 78 (1950), this concept dates back as far as Naylor v. Brown (1673), Rep. Temp. Finch. 83.

[3]An excellent essay on this development is Cooke, *supra* n. 2.

transferable shares, the privilege of limited liability in Chancery. This privilege was achieved by incorporating in the trust agreement a clause freeing the beneficiaries from liability to third parties for debts incurred by the trustees on behalf of the trust, and was effective for the purpose so long as third party creditors were aware of the claimed exemption from liability at the time they extended credit to the trust.[4] In addition, since title to trust assets was held by the trustees, their ability to sue and be sued was not encumbered by the necessity of joining all the certificate holders as parties. In the case of joint-stock companies, at least, however, there was the constant threat that they would be considered a violation of the Bubble Act of 1719.[5]

The chartered corporation was, of course, known to English law. The oldest corporations, the universities, the church, and the Inns of Court, however, were corporations by prescription or ancient usage. Well into the nineteenth century corporate charters were jealously guarded privileges because, in accordance with prior usage and theory, a charter carried with it not only corporate existence, but also a monopoly of trade in a restricted class of merchandise or market area. This conceptual connection continued, in England, well into the nineteenth century.[6]

As a result, English precedent gave our eighteenth-century businessmen two models: the first was the formally granted corporate charter, rarely given, and coupled with the concept of monopoly; the second was the voluntary association of investors, agreeing to joint trade either as a joint-stock company or an equitable trust.

Limited Liability in English Thought

It is a matter of dispute whether or not the chartered corporation was fully associated with the concept of limited liability in English legal thought.[7] Cases exist, but are few in number. There is a case dating from 1441[8] which states that the debts of a corporation are not the debts of its members. This was reiterated in the case of the *City of London* by stating that "for a Duty or Charge against a Corporation, every particular member thereof is not liable. . . ."[9]

The most cited authority, however, is the decision by the House of Lords in *Dr. Salmon v. The Hamborough Company*.[10] In that case the theory was advanced that although the members of a corporation were not liable directly for its debts, nevertheless if the corporation had a right to levy assessments on

[4]The English use of the contraction "Ltd." after the company name can probably be traced to this equitable principle, for it indicated to the dealing public the claim to limited liability.

[5]6 Geo. 1, c. 18.

[6]Hunt, "The Joint-Stock Company in England, 1800-1825," 43 *J. Pol. Econ.* 1, 5-6 (1935).

[7]See, for instance, Goebel, *Cases and Materials on the Development of Legal Institutions* 428 (1946), where he presents the thought that ". . . it was only toward the end of the 18th century that the English began to regard limited liability as a (sic) attribute of corporateness." Compare Cooke, *Corporation, Trust and Company* 77 (1950), where it is stated that it was firmly established that corporate debts were not debts of the members, and also Warren, "Safeguarding the Creditors of Corporations," 36 *Harv. L. Rev.* 509, 519 (1923), who said that no English court ever held members liable for corporate debts.

[8]Anon., Y. B. Hy. VI, 80, cited in Cooke, *Corporation, Trust and Company* 77 (1950).

[9]1 Ventr. 351 (1680).

[10]1 Ch. Cas. 204 (1671).

its members, the creditors of the corporation could force the officers of the corporation to do so for their benefit, and if these levies were not paid, the members may be proceeded against in their individual capacities. This was referred to as the theory of "leviation."

Philosophical thought in England, likewise, did not touch much upon the problem of limited liability. Adam Smith, who published his famous volume in 1776, castigated the corporation as he knew it because of its association with monopolies. He reasoned that corporations should be used only in cases where the common weal required their formation because of the amount of capital required or where there was a necessity for spreading risk; that the charter should result in some public benefit, and that it might be used in cases in which government could not conveniently handle the matter. Therefore he approved corporations formed for the purposes of banking, insurance, the construction of turnpikes and water systems, and the like.[11] The high incidence of these types of corporations in early United States history does much to bear out his analysis at that time.

Limited liability remained beyond the articulated concern of English thought through to the time of John Stuart Mill. By then, however, American experience had approved the attribute of limited liability, and Mill could draw on American experience. In his *Principles of Political Economy,* it might be noted, his discussion of limited liability referred, in significant part, to the writings of the minor American economist, Henry C. Carey.[12]

This, then, was our English heritage. The concept of the corporation as a body or entity, properly chartered; the concept of transferability of shares derived from the trading companies; the idea of limited liability subject to the doctrine of leviation when associated with the chartered form, and the equivalent of limited liability in Chancery in the case of the equitable trust.

The truth of the matter is that it finally was the example of American experience which provided the model for the ultimate English result, the Companies Act of 1862,[13] which permitted the creation of the modern corporation in England.

American Doctrine Prior to 1800

Material on the nature of the corporation before 1800 in the American colonies is scanty. There are apparently no decisions concerning corporations before 1800.[14] The device was not used for business purposes until the latter half of the 1700's and, in general, the partnership and its brother, the joint adventure, were the usual modes of business organization.[15]

Limited liability in chartered companies seems not to have been a matter of concern. One authority ascribes this to the fact that there was, apparently, no case of loss to creditors of business corporations before 1800.[16] On the other

[11] Smith, *The Wealth of Nations* (Mod. Lib. ed., 1937) Bk. V, Ch. 1, p. 713 et seq.

[12] *Principles of Political Economy* 547-548 (7th ed., 1911). The original edition of this work appeared in 1848. On the failure of economists in this period to comment on the institutions of economic organization, see Schumpeter, *History of Economic Analysis* (1954).

[13] 25 and 26 Vict., c. 89.

[14] Davis, *Eighteenth Century Business Corporations in the United States* 309 (1917).

[15] Goebel, *Cases and Materials on the Development of Legal Institutions* 418 (1946).

[16] Davis, op. cit. supra n. 14, at 294.

hand limited liability appears generally to have been assumed to be an attribute of the corporate form. Some indication of this may be derived from the instance of the subscriber to stock in the Bank of New York who, in 1784, refused to pay his subscription because, the desired charter having been refused, he would have been submitted to the risks of unlimited liability.[17]

Approximately 250 business corporation charters were granted between 1789 and 1800 in the American states.[18] Probably the earliest colonial charter was granted in 1768.[19] One charter is found which denied a corporation the privilege of limited liability[20] but, to offset the rather unique nature of that charter there was also one instance of the granting of limited liability without incorporation.[21]

In all instances the idea that corporations should be formed only in view of public benefit seems to have continued. Leaving out of consideration organizations with charitable, literary and like purposes, industrial or business corporations were authorized with the hope of spurring domestic manufactures, and with the aim of assisting the growth of the infant economy.

American Doctrine—The Nineteenth Century

The development of the doctrine of limited liability in the nineteenth century is an excellent example of an ancient principle coming into contact with different conditions. Some ancient principles, such as that of wager of law, were, on meeting new conditions, found to be anachronous, and were abandoned. Other ancient institutions, such as the jury, managed to survive new conditions, but are objects of both grudging admiration and serious criticism. Limited liability, also an apparently ancient principle, was tested in the crucible of the modern industrial era and not found wanting, but a price was paid for its continuance.

Political Pressure for Corporate Privilege

Corporations, in this country, have always been creatures of the various legislatures. From the beginning of the nineteenth century, however, the legislators were subject to two divergent forces. First, and in favor of the formation of corporations, was the deep desire to industrialize the new nation, and free it of reliance on European, particularly British, manufactures. To accomplish this result capital was needed, and some form of organization with wide division of ownership was indicated. The contrary pull on the legislatures, however, came from their desire to protect creditors in their claims against these fictitious entities. The fact that corporations had not, historically, been the form of organization of manufacturing enterprises, and therefore were an innovation, must in itself have been a strong influence against the free granting of charters. Also, corporations had long been associated with the concept of monopoly.[22] In-

[17]Davis, id. at 317.

[18]Cooke, *Corporation, Trust and Company* 93 (1950).

[19]This was the Philadelphia Contributionship for the Insuring of Houses from Loss by Fire, which is still in existence. Hartz, *Economic Policy and Democratic Thought: Pennsylvania,* 1776-1860 37 (1948).

[20]Davis, op. cit. supra n. 14, at 318.

[21]Davis, id. at 260.

[22]The grant of monopoly in order to encourage manufacture is found, for instance, in the Massachusetts Act of June 17, 1793, Laws of Mass. 1780-1807, Vol. 2, p. 575, granting a ten year monopoly in glass manufacture to an unincorporated group.

deed, the granting of corporate privilege, with limited liability, was itself considered to be a type of monopoly, by way of legal privilege if not by way of trade or product, that was anti-democratic in nature.[23] If the small, unincorporated businessman was subject to total financial ruin in a business failure, the argument ran, why should the corporate stockholder be exempt from the same risk?[24]

In addition, business, for a time, could be handled by some voluntary organization.[25] It was only when capital requirements became enormous that pressure for incorporation became overwhelming. One might say that roughly by 1820 some corporations had reached the point of large numbers of shareholders, but before that time the corporate form was, it appears, not entirely necessary, although desired by the investing or, more particularly, the entrepreneurial community.

Legislative Response to the Desire for Incorporation

The reactions of the various legislatures to these divergent pressures took two forms. In most of the then existing states corporate charters were granted to manufacturing companies with a niggardly hand. These were the Middle Atlantic and Southern states, however, in which manufacturing was as yet undeveloped, and other business opportunities existed. In the Southern states, for instance, vast returns could be had in agriculture, while manufacture and trade were of lesser status as a means of livelihood.

On the other hand agricultural opportunities were not particularly abundant in the stony soil of New England. It was there, and in New York state, that the importunity of business for the corporate form first found an affirmative answer in a significant number of instances.

In New England legislative response to the pressure took another tack, and that was to couple the grant of corporate status with the elimination or withholding of the privilege of limited liability. In this the New England legislatures were not without precedent, for the structure of New England towns was such that their inhabitants were individually liable for the unpaid debts of their towns.[26]

Another factor may have been the classical association of corporate privilege with a possible public benefit to be derived from its grant. It is interesting that the so-called "limping charters," with unlimited liability, were granted to ". . . those groups which appeared to be seeking license for operation in fields where private gains seemed to outweigh the potential public benefit. . . ."[27]

In any event it appears to be generally agreed that limited liability, although extremely desirable as an attribute of corporate existence, was not, virtually by definition, essential in the earlier stages of industrialization when the capital

[23]Hartz, op. cit. supra n. 19, at 69.

[24]Id. at 256. Raymond, *Thoughts on Political Economy* 427 (1820).

[25]The development of the limited partnership, copied after the French "commandite," was also of importance in this connection. New York adopted the first limited partnership act on this side of the Atlantic in 1822. Laws of N.Y., 1822, Ch. 244, p. 259.

[26]Child v. Boston and Fairhaven Iron Works, 137 Mass. 516 (1884), dictum.

[27]Livermore, "Unlimited Liability in Early American Corporations," 43 *J. Pol. Econ.* 674, 686 (1935).

requirements of industry were relatively low. A sufficiently broad investment base could, for a while, be obtained without limited liability.[28]

Judicial Thought on Limited Liability

The state of judicial thinking on limited liability is indicated by three cases which cast an uncertain light on the matter. All of the cases involved charters granted by Massachusetts before its unlimited liability act of 1809. In the earliest of these, *Nichols v. Thomas*,[29] an 1808 case, a judgment was obtained by a creditor of the Union Turnpike Corporation against the "President, Directors & Company of the Union Turnpike Corporation." On failing to find corporate assets, the sheriff arrested a stockholder, who brought an action against the sheriff for assault and battery and false imprisonment. It was held that the judgment was not obtained in the name of any individual who could be arrested, and therefore the plaintiff recovered. Since the case did not involve the question of the liability of shareholders for corporate debts, but was on a point of pleading, the case is unsatisfactory as an authority on this matter. In the same year the case of *Tippets v. Walker*[30] was decided, but in that case the liability of the directors for the debt involved was clear, for they had individually agreed, by deed with the contractors, to be liable for work done for their corporation. By Massachusetts law the form of the seals used made them their own, and did not constitute an affixation of the corporate seal.

The next case, decided in 1809,[31] was a bit closer to the point. In that case the charter of a turnpike corporation, which had power to take land by eminent domain, provided that ". . . the corporation shall be liable to pay all damages, which may arise to any person by taking his land for the road. . . ."[32] The plaintiff recovered judgment against the corporation and the court order provided that if the judgment were not paid in six months, a warrant of distress could be issued against the corporators. On appeal it was held that the charter provision warranted the imposition of liability on the corporation alone. The plaintiff attempted an analogy: that town inhabitants are liable personally for road assessments. The court found the analogy to be inapt for two reasons. First, that town inhabitants could in turn recover against the town and, second, that the town may assess its inhabitants for the cost of the road but if the corporation assesses its stockholders and they refuse to pay, the corporation's only recourse is to sell the stock of the non-paying members. Because of the wording of the statute of incorporation in this case, it cannot logically be said that it stands for the proposition that limited liability is a necessary attribute of corporate existence, but it is fair authority for the idea that unlimited liability, if it is to be found, must be expressly provided by the legislature.[33]

Pennsylvania, seven years later in 1816, had something to say on this question in *Myers v. Irwin*.[34] Apparently individual associations engaged in banking

[28]Dodd, *American Business Corporations until 1860* 436 (1954); Fairchild, Furniss and Buck, *Elementary Economics* 80 (4th ed., 1939); Livermore, id. at 676.

[29]4 Mass. 232 (1808).

[30]4 Mass. 595 (1808).

[31]Commonwealth v. The Blue Hill Turnpike Corp., 5 Mass. 420 (1809).

[32]Id. at 421.

[33]See, Dodd, op cit. supra n. 28, at 371.

[34]2 S. & R. (Pa.) 368 (1816).

in that state had attempted to achieve limited liability by generally publishing that claim to the world. An act of 1808 provided, to counter that claim, that individual members of banking associations were to be liable for the debts of their associations. It was contended that this statute was, by implication, an incorporating act. The court did not agree, stating that ". . . the personal responsibility of the stockholder is inconsistent with the nature of a body corporate."[35]

If one leaves out of account for the moment the question of cases involving liquidating dividends, it appears that prior to the late 1820's limited liability had not yet been held to be a necessary attribute of a corporation as a matter of law. Chancellor Kent, in his famous *Commentaries on American Law,* first published in 1827, although deeming corporations to be an evil which even the provision of the 1821 Constitution of New York, requiring approval of two-thirds of each branch of the legislature for incorporation, had failed to mitigate,[36] did not consider limited liability a matter worthy of extended mention. Rather, he devoted his time, in discussing the attributes of a corporation, to the concept of the separate entity.[37] Only when we get to the earliest American text on corporation law, Angell and Ames, which appeared in 1832, do we find the clear statement that "No rule of law we believe is better settled, than that, in general, the individual members of a private corporate body are not liable for the debts, whether in their persons or in their property, beyond the amount of property which they have in the stock."[38]

We may say, then, that by 1830 it was generally agreed that limited liability was a part of the corporate scheme. However it is distinctly clear that its application to business ventures incorporated for purely private profit was not viewed with approval in all jurisdictions—and that leads us to our next consideration.

Statutory Experiments with Unlimited Liability[39]

Unlimited liability, as it first emerged in early New England, found expression in two different ways. First, most of the early nineteenth-century charters expressly included a provision for unlimited liability in the charters themselves. Second, Massachusetts, in 1809, was the first state to adopt a general statute imposing unlimited liability on the stockholders of all manufacturing corporations,[40] thus obviating the need for express inclusion of such a provision in each separate charter.

Problems in the Application of Unlimited Liability

The imposition of unlimited liability, however, created its own problems. Three strictly legal problems will be discussed. They are the questions that arose in procedure and pleading, the question of the liability of a transferor of shares, and the constitutional objections raised to the policy.

[35]Id. at 371.
[36]At 219.
[37]At 224.
[38]Angell and Ames, *The Law of Private Corporations Aggregate* 349 (1832).
[39]The most complete exposition of these experiments is to be found in the posthumously published work of Dodd, *American Business Corporations until 1860* (1954), Parts V and VI.
[40]Act of 1809, c. 65 §6.

Procedure and Pleading

The 1809 Massachusetts act was quite general in its terms, and provided that if an execution were levied against a corporation, and it did not within fourteen days show sufficient property to cover it, the execution might be levied on the person or property of any member of the corporation. It is to be noticed that the act did not authorize an action against the members directly, but only authorized an execution against the members after an action had been successfully brought against the corporation and it could not show ability to pay the judgment. This, procedurally, was important, for the execution against the shareholders had to be made on the same levy as that against the corporation. In an 1820 case arising under the 1809 statute it was indicated that a levy on an alias execution was improper.[41]

That unlimited liability was applied differently in other jurisdictions can be seen from the 1819 Connecticut case of *Southmays v. Russ*.[42] In that case the charter of the Middletown Manufacturing Company, granted in 1810, provided "That the persons and property of the members of said corporation, shall, at all times, be liable for all debts due by said corporation."[43] It was held that the stockholder's liability accrued as soon as the debt was incurred, and that a separate action against the member was required.[44] It was held to be improper to attempt to collect from a stockholder by means of a scire facias on a judgment against the corporation.

Liability of Transferors of Stock

In addition to the problems of pleading and procedure, the courts were concerned with the question of the liability of a stockholder who had transferred his stock after the debt arose. The earliest Massachusetts case involving this problem was *Bond v. Appleton*,[45] decided in 1812. It involved a New Hampshire charter to the Hillsborough Bank. The charter provided that ". . . if the said corporation at any time thereafter should refuse or neglect to pay any of their said bills, when presented for payment in the usual manner, the original stockholders, their successors, assigns, and the members of the said corporation, should in their private capacities be jointly and severally liable to the holder of any bill or bills. . . ."[46] The defendant was not an original stockholder and had sold his stock by the time plaintiff held his bill. The court stated, relying heavily on the fact that the charter also gave the stockholder recourse against "remaining members," that the stockholders had to be such at the time payment was refused in order to be held liable.

It appeared in an 1820 Massachusetts case, applying the 1809 statute, that a stockholder had to be a member at the time of the levy against the corporation to be liable, and that prior transfer of his shares would free him of liability.[47]

[41]Leland v. Marsh, 16 Mass. 389 (1820).
[42]3 Conn. 52 (1819).
[43]Id. at 55.
[44]However, the variety of forms of language used in Connecticut charters make the position of the Connecticut courts on the question when one must be a shareholder to be liable for corporate debts unclear. See, Dodd, op. cit. supra n. 39, at 412.
[45]8 Mass. 472 (1812).
[46]Id. at 472.
[47]Leland v. Marsh, supra n. 41.

Another 1820 case[48] held that the estate of a "corporator" who had died before the action commenced was not liable under the 1809 act, indicating that membership at time of the commencement of the action fixed the liability of stockholders.

A Massachusetts act of 1818,[49] apparently proposed in order to stop the possibility of a shareholder transferring his stock to an insolvent in order to avoid personal liability, provided that shareholders who were such when the debt accrued were liable for it. This, however, may have been unnecessary by hindsight, for an 1821 case[50] held that a transfer under the 1809 act did not absolve the transferor of liability. The case, however, went a bit further by way of a dictum which stated that even a bona fide transfer would not protect the transferor from liability.

This harsh dictum, however, was not adopted in an 1823 Connecticut case involving a special charter of incorporation.[51] The court was confronted with the problem of a bona fide transfer and the majority asked: "Was it the intention of the legislature that a man should be in jeopardy all his lifetime if he should purchase a single share, in the stock of this company?"[52] Again, the analogy of inhabitants of towns arose, for the court pointed out, in support of its decision, that the liability of a town inhabitant ceased when he moved from the town.

On the other hand it appears that one who became a shareholder after a debt accrued was liable for prior debts, again on the analogy of town dwellers who, stated the 1821 Massachusetts court, "are in the same predicament."[53]

These conflicting decisions indicate that unlimited liability was not an automatic panacea for the financial ills of creditors. Whether to pursue the shareholders who held stock at the time the debt accrued, or the time payment was refused, or the time of the commencement of the action or the time of levy, was complicated by the factor of a possible transfer of the stock to a bona fide transferee.

Constitutional Objections to Unlimited Liability

Another objection that arose to the liability imposed by the Massachusetts act was that the stockholders were deprived by the imposition of unlimited liability of their opportunity to be heard, and of trial by jury, since the action was brought against the corporation, not against the stockholders. This objection was countered, in *Marcy v. Clark,* by the argument that ". . . all who are members of the corporation are virtually defendants in the action, and have an opportunity to be heard in the form they have chosen by joining the company."[54]

The Doctrine of Unlimited Liability

After another act, apparently still further increasing the liability of stock-

[48] Child v. Coffin, 17 Mass. 64 (1820).
[49] Mass. Laws, May Sess. 1817, c. 183, p. 618, February 24, 1818.
[50] Marcy v. Clark, 17 Mass. 330 (1821).
[51] Middletown Bank v. Magill, 5 Conn. 28 (1823).
[52] Id. at 67.
[53] Marcy v. Clark, supra n. 50, at 336.
[54] Id. at 335.

holders in business corporations,[55] a counter-movement set in,[56] and culminated in the act of 1830[57] which granted the privilege of limited liability. The argument used to obtain this result from the legislature was the alleged flight of capital to other states which afforded investors greater protection from liability.[58] It may be significant to note that shortly after Maine separated from Massachusetts, in 1820, it passed a statute granting limited liability to stockholders.[59]

Unlimited liability, as a New England policy, took the two forms indicated. Massachusetts had one act covering all manufacturing corporations,[60] and the other jurisdictions, such as Connecticut, Rhode Island and New Hampshire, preferred, apparently, to include the provision for unlimited liability directly in corporate charters.

Both methods proved cumbersome, for not only were procedural difficulties involved, but also there was the question as to the duration of the liability of a stockholder for corporate debts. More to the point was the constant pressure of the investing community, plus the development of sounder accounting procedures for the protection of creditors, that cleared the way for the development of the modern theory of limited liability.

The Price of Limited Liability

Having considered the nature of the experiments with unlimited liability as a policy directed toward all manufacturing corporations, it would be well to look at the status of stockholder liability in those jurisdictions that, purportedly, followed the policy of limited or double liability, and to the liability of shareholders after limited liability became the general rule.

It is the thesis of this paper that limited liability cannot be viewed alone, but is merely a part of a broader picture. At no time in the history of American corporations have stockholders been permitted to handle corporate financial affairs with complete disregard for the interests of corporate creditors. The interests of corporate creditors in the assets of the corporation always have been

[55]Laws of Mass., 1818-1822, p. 619, Jan. 28, 1822.

[56]Dodd. op. cit. supra n. 39, at 378.

[57]General Laws of Massachusetts 1828-1831 (Metcalf), c. 53. p. 296, February 23, 1830.

[58]According to Child v. Boston & Fairhaven Iron Works, 137 Mass. 516 (1884), no Massachusetts case ever held a shareholder liable for torts of his corporation.

[59]Public Acts of the State of Maine, Jan. Sess. 1823, c. 221, p. 929, February 5, 1823. This was probably the earliest legislation setting forth limited liability as a general policy. It subjected limited liability to certain requisites which, however, were repealed by an act of February 12, 1828, Laws of the State of Maine, Jan. Sess. 1828, c. 385, p. 1152. However, the Maine legislature changed positions on the question whether or not to have limited liability a number of times between 1836 and 1857. The first act imposing unlimited liability is in Public Acts of Maine, Jan. Sess. 1836, c. 200, p. 320. The last act finally establishing limited liability is in the Revised Statutes of Maine, 1857, c. 48, §9, p. 349.

[60]Although the Massachusetts experience with unlimited liability is probably the most significant due to the importance of that state in manufactures, and the duration of the experiment, other states also experimented with unlimited, or double, liability policies by general statutes directed at all corporations, as well as by provisions contained in special charters. These general experiments occurred between the 1830's and 1850's, and ordinarily reflected economic or political pressures. New Hampshire had unlimited liability between 1842 and 1846; the Maine experiments have been mentioned; Pennsylvania experimented with unlimited liability for one year between 1853 and 1854. It should be noted, however, that unlimited liability was imposed on manufacturing corporations only. Banking, for instance, was commonly subject to double liability, perhaps because it was common for banks' authorized limit on issue of notes to be measured by twice the value of their capital stock.

afforded legal protection in one form or another. Limited liability has had its price, and it is the nature of that price that we must now examine.

Accounting Practice

First, however, a word must be said about the practicalities of accounting practice. If we delve into the matter we find that the late adoption of the Arabic system of noting numbers impeded the development of accounting. Indeed the Roman system was used as late as the sixteenth century in England.[61] Double entry bookkeeping, so essential to the keeping of separate accounts between investors and company, is inconceivable in that cumbersome mode.

It appears that accounting practices in the earlier part of the nineteenth century were in a primitive state. Although it must be admitted that there is a high degree of ignorance concerning their exact nature, certain scholars have obtained information indicating that usages were hardly the same as they are today. Professor Goebel, for instance, has said that "At the beginning of the nineteenth century few companies had a specific stock, and the banks and insurance companies alone had shares of fixed par value.[62]

Assuming that the statement is true, it must follow that the protections for creditors that now exist, which depend largely upon the maintenance of the integrity of the capital stock account, were hardly imaginable, let alone feasible, at this time. Professor Goebel continues with the assertion that "Funds were collected by assessment against shareholders as need arose. A 'share' signified a proportional participation in the enterprise and was, in the circumstances, highly contingent."[63]

This is borne out to some extent by the additions made to the 1830 Massachusetts Corporations Act by the 1836 act. The later act, which was largely a reorganization of the prior act, made one change which is significant in this connection. The original 1830 act provided that stock should "be fixed and limited, and divided into shares at its first meeting."[64] This has a modern sound to our ears, but apparently was in need of some clarification on the question of assessments, for it also provided that the corporation had the power to assess shareholders for necessary money.[65] In this latter provision, however, no limit of the assessment power was stated. The 1836 Act clarified the matter by stating that the amount of such assessments should not exceed "the amount at which each share shall be originally limited."[66]

Under a practice which sets no definite end to the possible capital stock account, modern procedures of creditor protection are made difficult if not impossible. To a large extent, therefore, creditor protection depended on the development of adequate accounting devices.

[61]Cooke, *Corporation, Trust and Company* 46 (1950).

[62]Goebel, *Cases and Materials on the Development of Legal Institutions* 432 (1946).

[63]Goebel, ibid. For instance, the charter of the Newbury-Port Woollen Manufactory permitted unlimited assessment of shares. Mass. Acts and Resolves, Records of the States of the United States (microfilm), May 1793-Jan. 1794, p. 1, Mass. B. 2a:b, Reel 4, Unit 1.

[64]General Laws of Massachusetts, 1828-1831 (Metcalf) c. 53, §3, p. 296, February 23, 1830.

[65]Id. at §5.

[66]Mass. Revised Statutes of 1836, Ch. 38, §13, pp. 327, 329-30.

Creditors' Rights on Dissolution

The question of creditors' rights against shareholders naturally does not arise until the creditors find themselves unpaid and without corporate assets from which to obtain satisfaction of their claims. Normally such a situation presages the dissolution of the corporation. Consequently it is not surprising to find that the first type of protection for corporate creditors came exactly at this point in time of corporate existence—the time of dissolution.

The English Background

Ancient dogma from the English cases held that on the dissolution of a corporation there were three results to its rights and liabilities. First, it was stated that its real property reverted to the party who had originally granted the realty to the corporation. Second, it was believed that its personal property went to the state. Last, and most important from the point of view of this discussion, it was stated that its debts, whether due to or from the corporation, were extinguished by dissolution. Although some courts by way of dicta continued to repeat this trilogy of consequences until the 1850's, it appears to have met its effective end by 1834, at the latest.[67]

In any event, those horrible consequences were largely moot, for such actions against shareholders as would arise, would arise in that frustrating interval between insolvency and actual legal dissolution.

American Treatment of Dissolution Problems

It may have been the echo of such sentiments that inspired the Massachusetts General Aquaduct Act of 1799.[68] In that act it was provided that on dissolution the "last proprietors" were to carry out contracts, but that if no corporate property could be discovered, and the creditors' judgments were not satisfied for six months, those same proprietors were to be liable for debts of the corporation. Another example of the express continuation of liability after dissolution is to be found in an act dissolving rather than creating a corporation. The Union Marine and Fire Insurance company was dissolved in 1815, and the act effecting the dissolution provided that the shareholders were to be responsible for all the outstanding corporate debts.[69] Such legislation was not uncom-

The most famous general incorporation act of this era was the New York Act of 1811.[71] It provided for the incorporation of companies which proposed to manufacture certain specified types of goods, for a period of only twenty

[67]Mumma v. Potomac Company, 33 U.S. 280 (1834).

[68]Laws of Mass. 1780-1807, Vol. 2, p. 843, February 21, 1799. This may, according to Dodd, op. cit. supra n. 39, at 264-265, "probably be regarded as the earliest general act of incorporation for business enterprise in Anglo-American law."

[69]Mass. Laws, Oct. 1814-Jan. 1815, c. 123, p. 626, February 25, 1815.

mon in the case of banks.[70]

[70]According to Dodd, op. cit. supra n. 39, at 376-377, from 1811 onward those who owned shares of bank stock at the time the charter expired (usually twenty years after incorporation) were liable in proportion to their holdings for outstanding bills of the bank. This was in addition to the double liability imposed on them in the event of insolvency caused by mismanagement by the officers. This liability was determined, in Crease v. Babcock, 10 Metc. 525 (Mass. 1846), to be several in nature.

[71]Laws of N.Y., 1811, Ch. 67, p. 111, March 22, 1811.

years, and with a capital not to exceeed $100,000. The act provided "that for all debts which shall be due and owing by the company at the time of its dissolution, the persons then composing such company shall be individually responsible to the extent of their respective shares of stock in the said company and no further. . . ."[72]

Litigation arose under this act in 1821 in the celebrated case of *Slee v. Bloom*.[73] The Dutchess Cotton Manufactory had been formed under this act with a capital stock of 600 shares at $100 each. Four calls were made for fifty per cent of the subscriptions, but most of the shareholders never paid their calls. The shareholders were then permitted, by a by-law passed by the managers, to surrender their shares on paying thirty per cent of their subscriptions. The sheriff then sold all corporate property, and the unsatisfied creditors brought a bill in equity against some of the shareholders under the 1811 act. The court held that the corporation was effectively dissolved when its assets were sold, and that the statutory liability then came into effect. The creditors were permitted to collect, apparently to the extent of the unpaid assessments of the shareholders. The opinion appeared, also, to adopt the principle of the *Salmon*[74] case, for the court indicated that relief would have been forthcoming under the doctrine of that case had the corporation not been dissolved, but that the statute gave the creditor's heir rights in equity since there had been a dissolution.[75]

Five years later, in 1826, the case of *Briggs v. Penniman*[76] arose on a creditors' bill in equity under the 1811 statute. In that case the shareholders had paid the full par value of their stock to the corporation. Nevertheless the creditors pursued them at the dissolution of the corporation. It was decided that the liability of the shareholders under the 1811 act was greater than that imposed in *Slee v. Bloom*[77] and was in double the amount of their subscription[78]—a standard of liability like that imposed on stockholders in national banks down to the 1930's.[79]

Maintaining the Integrity of Corporate Capital before Dissolution

Today creditors' rights depend almost exclusively on legislative devices designed to maintain the integrity of the capital stock account. Restrictions on the

[72]Id. at §7. A tendency to retreat from this liberal policy toward the grant of the corporate privilege was indicated by Art. VII, §9 of the 1821 Constitution of the State of New York, which required two-thirds approval of each branch of the legislature for special acts of incorporation, which type, of course, continued for corporate purposes not within the purview of the 1811 act.

[73]19 John. 456 (N.Y. 1821).

[74]Dr. Salmon v. The Hamborough Company, 1 Ch. Cas. 204 (1671).

[75]Whether this view is correct is a matter of no small doubt. It appears that, absent a charter provision so empowering the creditors, the English courts did not give corporate creditors a direct right against shareholders under the theory of leviation. Goebel, op. cit. supra n. 62, at 434; Warren, "Safeguarding the Creditors of Corporations," 36 Harv. L. Rev. 509, 519 (1923).

[76]8 Cowen 387 (N.Y. 1826).

[77]Supra n. 73.

[78]The rationale of the opinion was that a contrary decision, imposing liability merely to the extent of the unpaid subscriptions of the shareholders, would merely be declarative of the common law.

[79]Double liability was also imposed, at dissolution, on shareholders in New Jersey corporations from 1816 to 1819, and even thereafter was generally imposed in special charters granted by that state. Dodd, op. cit. supra n. 39, at 388.

declaration of dividends, restrictions on the reduction of the par value of capital stock, and restrictions on purchases of stock to be held in the corporation's treasury, are all designed to assure the creditors of the corporation that the original capital contributed by the stockholders to the corporation shall remain as a fund from which they can be satisfied. This is based, possibly, on the theory that credit is not extended to the corporation without an examination by the creditors of these accounts to assure themelves of the ability of the corporation to pay its obligations. This dogma does not require that reliance actually exist, but grants the creditor the benefit of the doubt.

Apparently there was no policy, by statute or otherwise, requiring the maintenance of the integrity of capital stock accounts before the Revolution.[80] The natural way for such restrictions to appear, absent decided cases, was in the special charters of corporations. Perhaps the earliest example of this type of restriction is to be found in the charter of the second insurance company to be formed in the Commonwealth of Massachusetts, the charter of the Boston Marine Insurance Company, granted on February 13, 1799.[81] This charter provided that no dividends should be paid by the company "until a sum equal to such diminution shall have been added to the capital."[82] This clearly recognized the principle of the undesirability, from the point of view of creditors at least, of a dividend which constituted a partial distribution of contributed capital.

Liability of Directors for Illegal Dividends

Pennsylvania recognized this principle in the case of banking corporations in its legislative session of 1803-1804, when it was provided that the directors of The Philadelphia Bank should be liable for dividends that impaired capital stock.[83] The principle was extended, some twelve years later, to a manufacturing company, the Whitestown Manufacturing Company, in its charter.[84]

In the interim one may notice the charter of the Philadelphia Society for the Encouragement of Domestic Manufactures,[85] Section 8 of which provided that ". . . if at any time a greater dividend than the actual profits of the institution should be made, and the capital be thereby impaired, the managers consenting to such dividend, shall from their personal estates make good the loss which the capital has sustained in consequence thereof." This policy was subsequently extended to all banking corporations in 1814.[86] Pennsylvania likewise continued this policy with regard to manufacturing corporations in the act of 1849,[87] where it provided that directors who consent to such dividends "shall be jointly and severally liable in their individual capacities for all the debts of the company then existing, and all that shall thereafter be contracted," unless the director involved shall have dissented from the dividend.

[80] Warren, op. cit. supra n. 75, at 516.
[81] Mass. Acts and Resolves, 1798-99, c. 50, p. 62.
[82] Ibid.
[83] Laws of Pa., 1803-04, c. 51, Art. 17, pp. 246-247, March 5, 1804.
[84] Acts of Pa., 1814-17, Sess. of 1815-16, c. 17, p. 24, Jan. 29, 1816.
[85] Acts of Pa., 1806-07, c. 50, p. 72.
[86] Laws of Pa., 1812-14, Sess. of 1812-13, c. 98, §7, p. 167, enacted March 21, 1814, over the veto of the governor.
[87] Laws of Pa., 1849, Act No. 368, Section 14, pp. 566-567.

Massachusetts also believed there was merit in providing that the directors should be liable for declaring or assenting to dividends while the corporation was insolvent, or which rendered the corporation insolvent. A statute to that effect was passed in 1830.[88] This act did not indicate whether liability was or was not imposed on shareholders who had received such liquidating dividends, however, and in this the act did not differ from the Pennsylvania acts mentioned above.

This type of liability, although it evidences a concern with the problems of creditors, was directed solely at the managers of the corporation and did not concern the shareholders. Nevertheless concern for the position of creditors as against shareholders appeared in cases involving the division of the capital of the corporation among the various shareholders prior to dissolution.

Liability of Shareholders for Returned Capital—Case Law

Three celebrated cases arose out of the dissolution of the Hallowell and Augusta Bank. The bank had been chartered by Massachusetts in 1804 with a capital stock of $200,000, divided into 2000 shares of $100 each. In January 1813, the shareholders received a dividend of fifty per cent of the capital stock, and in October 1813, they received another 25 per cent. The first of these cases to reach the highest court of Massachusetts was decided in 1819.[89] The plaintiff in that case became the holder of bills of the bank in 1816. It was admitted that the division of capital was made in the bona fide belief that sufficient funds would remain to protect the holders of outstanding bank bills, but that hope proved to be unfounded. The plaintiff's case was brought in trespass on the case, and since he could not prove the alleged fraud, the action was unsuccessful. The court went on to point out that if the plaintiff's contention were to prevail, there would be three undesirable consequences. First, any shareholder could be sued alone, for a tort was alleged and the liability was therefore several. Second, such a shareholder would, since it was a tort, be liable individually for the whole amount of damages. Third, since there was no contribution among joint tort-feasors, he could not require his co-shareholders to reimburse him for their proportion of the obligation. The court then suggested resort to a court of Chancery, where the equities could be taken into account.

In the next case, *Spear v. Grant*,[90] decided in 1819, the plaintiff was likewise unsuccessful, although this time the basis of the suit was an action on the case based on a promise implied in law rather than on fraud. The court held that the action would not lie because the note had been issued by the corporation, and the shareholders, because of the Statute of Frauds, could not be liable. As in the prior case of *Vose v. Grant*,[91] the court went on to set forth the imponderable problems that might accompany a recovery for the plaintiff. The judges wondered who was the promisee of the promise alleged to have been

[88] General Laws of Mass., 1828-31 (Metcalf) c. 53, §9, p. 299, March 1, 1830.
[89] Vose v. Grant, 15 Mass. 505 (1819).
[90] 16 Mass. 9 (1819). This case, of course, established the principle of the limited liability of shareholders for obligations of the corporation in the absence of a statutory or charter provision to the contrary. One authority, Goebel, op. cit. supra n. 62, states that Parker, C. J., ". . . has no authority on which to rest his belief in limited liability."
[91] Ibid.

made by the shareholders, and whether the shareholders' responsibilities were limited to their interests. They were intrigued with the question of which creditor could sue—for instance, could a purchaser of bank notes, who had picked them up for a pittance, sue for their full face value? Also the plaintiff's theory raised the problem whether a single shareholder, owning one share, might be liable to all the creditors. The court, however, did recognize that stock should be considered as a pledge, and that when shareholders took money from the corporate coffers before the creditors were satisfied, they should be required to return it to creditors who, subsequently, were not fully satisfied. However, the court asserted that the action was not enforceable at common law, but only in equity, where all claimants could be considered. An action at law would lie, so said the court, only in the event of a fraudulent withdrawal of capital intended to harm the creditors.

Finally a suit in equity was brought in the federal courts and the decision in the Circuit Court for the District of Maine (which had separated from Massachusetts in 1820) was made in the case of *Wood v. Dummer,*[92] in 1824. There the statement was flatly made, in deciding for the plaintiffs, holders of the bank's notes, that ". . . the capital stock of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank."[93] The charter, it was stated, relieved the shareholders from liability, but substituted for them the capital stock of the corporation. The shareholders had a right to the capital account only after the debts were paid. Since there were 2000 shares outstanding, and the defendants owned 320 of them, they were to pay 320/2000ths of the amount received by them to satisfy the plaintiff's claims, because it was this amount that they held in trust.

Subsequent courts have wrestled with the problems posed by the "trust fund theory" created by this case, and it may be that the doctrine has been rejected more than it has been used. Critical approval of the theory, however, has not been lacking for, as was maintained by Professor Dodd, ". . . it is apparent today that Justice Story's analysis of the situation was more realistic than that of those of his critics who have sought to assimilate the rights of corporate creditors completely to the rights of creditors of an individual."[94]

These three cases, therefore, appear to have oriented judicial thinking toward corporate balance sheets and, particularly, the capital stock account. It must be kept in mind, however, that this development depended on the adoption of par value stock for its further development. This leads us to the next step—that of the statutory implementation of the theory.

Liability of Shareholders for Returned Capital—Statutory Provisions

In the case of manufacturing corporations the General Court of Massachusetts, perhaps impressed by the cases of *Vose v. Grant*[95] and *Spear v. Grant,*[96] took time in 1830 to pass a statute making shareholders liable for amounts

[92] 3 Mason 308 (C.C.D. Me., 1824).
[93] Id. at 311.
[94] Op. cit. supra n. 39, at 92.
[95] Supra n. 89.
[96] Supra n. 90.

withdrawn and paid to them on reduction or division of capital stock, if the result of the action was to render the corporation bankrupt or insolvent.[97] This act also, as we have seen, adopted preliminarily the doctrine of limited liability for the first time since 1809 in Massachusetts manufacturing corporations. That these provisions were combined in one statute appears clearly to indicate that this residual liability of shareholders was intended to be a more equitable way to protect the claims of creditors than was the old unlimited liability rule.

At about the same time the newly emerged State of Maine concerned itself with this problem. In its Laws of 1823,[98] which was the first act passed by any northeastern legislature adopting the principle of limited liability,[99] Maine subjected the limited liability of shareholders for debts of the corporation to the requirement, among others, that the corporation "shall make no division of the capital stock, or any part thereof, or of any other property or debts belonging to the corporation, until all the debts due therefrom shall have been paid; saving however the right to make dividends of the net profits arising from the capital stock. . . ."[100]

The problem of reduction of capital also intrigued other states. For instance Connecticut charters, from 1826 onward, made directors liable when they reduced capital. The liability ran, however, to then existing and subsequent shareholders,[101] rather than creditors. This was altered, in an 1833 charter to the Clelsea Manufacturing Company, to a liability imposed on the shareholders who consented to the action,[102] and, in the 1834 charter to the Connecticut Soap manufacturing Company, to shareholders who received distributions on a reduction of capital.[103] The Connecticut act of 1837, creating a general policy of limited liability, nevertheless subjected limited liability to the condition that shareholders were to be liable for the amount of capital refunded to them, to the extent of the amount received.[104]

New Hampshire provided a more drastic sanction in 1837. By that act it provided that if a corporation distributed capital to its shareholders without first seeing to the satisfaction of corporate creditors, the shareholders were to be unlimitedly liable.[105] A like provision was enacted in Rhode Island in 1847, making shareholders liable unlimitedly for all debts contracted before the division of capital was accomplished.[106] Vermont, in 1853, limited the shareholders' liability in such cases "to the amount of the sum so refunded to them,"[107] and continued this extent of liability in an 1870 statute.[108]

[97]General Laws of Mass., 1828-31 (Metcalf) c. 53, §7, p. 298, March 1, 1830.

[98]Public Acts of the State of Maine, Jan. 1823 Session, c. 221, p. 929, February 5, 1823.

[99]Supra n. 59.

[100]The entire long list of requirements for limited liability was repealed in Laws of Me. (1831) ch. 385, p. 234, Feb. 12, 1828.

[101]Livermore, "Unlimited Liability in Early American Corporations," 43 *J. Pol. Econ.* 674, 682 (1935).

[102]Ibid.

[103]Ibid.

[104]Public Statute Laws of Conn., May 1836-May 1837 Session, c. 63, §19, pp. 52-53.

[105]N. H. Laws 1837, c. 322, §19, p. 300.

[106]Rhode Island Act entitled "An Act Relating to Manufacturing Corporations," §5, p. 31, June, 1847.

[107]Vt. Acts and Resolves, 1853, Public Act No. 71, §20, p. 65, 70.

[108]Vt. Acts and Resolves, 1870, Public Act. No. 6, §18, p. 26, 31.

It is apparent, therefore, from these few instances, which might be further expanded, that limited liability was considered to have this cost as well—and it is one that remains with us as a price of limited liability: the integrity of the capital account. From these have developed the various modern rules concerning dividend distribution, return of capital, purchase of treasury shares, and other devices intended to protect the capital stock account. Behind them is a presumed reliance on the balance sheet by the corporate creditors. This reliance it is impossible either to prove or to disavow.

Members' Duty to Pay for Shares of Stock

It appears that when it became the practice to issue shares of stock of a fixed par value there was a coterminous legislative movement to make limited liability of shareholders depend on the payment into the corporate treasury of the par value they had agreed to pay. No-par stock was unknown in the 19th century and, indeed, did not come into use until after 1912.[109] The time of emergence of this requirement was in the 1830's, shortly after limited liability, in principle, had come to be recognized as a business fact of life in the New England states. Some twenty years later John Stuart Mill agreed that such a measure was necessary for the protection of corporate creditors. He maintained that, in order to protect third parties, "the amount of capital on which they profess to carry on business should either be actually paid up or security given for it."[110]

The Massachusetts manufacturing corporation act of 1836[111] adopted this principle by making shareholders jointly and severally liable for corporate debts until all the capital had been paid in, and a certificate noting that fact had been deposited in a certain public office. Notes of shareholders were not to be considered payment. This, according to one authority, was proposed in place of the previous unlimited liability of shareholders in Massachusetts manufacturing corporations.[112] The principle took on a more modern aspect in 1870[113] when it was provided that no corporation was to begin business until the whole of its capital stock had been paid in cash, and an appropriate certificate filed testifying to that fact.

The problem of payment for capital stock was vexed by the fact that stock might be paid for in property rather than in cash, and while the earlier acts contemplated a cash payment a law was enacted, in 1875, permitting property to be used in payment for stock if the valuation of the property given in return for the stock was approved by the Commissioner of Corporations.[114] The Commissioner of Corporations was apparently removed from ruling on this question in 1903, when the provision was adopted, in Massachusetts, that stock could be paid for in cash or property actually received.[115] The problem then was a matter

[109]Berle and Means, *The Modern Corporation and Private Property* 158 (1933).
[110]Mill, Principles of Political Economy 542 (7th ed., 1911).
[111]Mass. Rev. Stats. (1836) c. 38, §16, p. 327, 330.
[112]Warren, "Safeguarding the Creditors of Corporations," 36 Harv. L. Rev. 509, 532 (1923).
[113]Mass. Stats. 1870, c. 224, §32, p. 154, 162.
[114]Mass. Stats. 1875, c. 177, §2, p. 769.
[115]Miss Stats. 1903, c. 437.

of the application of the so-called "good faith" or "fair value" rules, which have been the subject of decisions during the past seventy-five years.[116] By a statute of 1920 Massachusetts was willing to authorize the issue of no-par stock which, in a very real way, made nugatory the prior attempts to protect creditors by guaranteeing the contribution of a certain amount of cash or property.[117]

Pennsylvania, in an act to recharter the Bank of Pittsburgh, in 1834,[118] also responded to this movement in an affirmative way. That act provided that "should the said bank fail to meet its engagements, each person holding stock at the time of said failure shall be individually liable for the debts of the bank, to the amount of the balance unpaid on the stock of such stockholder."

New Hampshire, in its general act of 1837,[119] followed the lead of Massachusetts by providing that limited liability of the shareholders was subject to payment in full of the entire capital stock of the corporation, and a certification to that effect filed with the town clerk. Vermont, in 1853, adopted the same type of policy,[120] as did Rhode Island in 1847.[121]

This solution, of course, posed many problems of its own which subsequent cases had to solve, but was one more price paid by shareholders for the privilege of limited liability.

Creditors' Rights to Financial Statements

Another experiment with a means to protect creditors is the requirement that the corporation give publicity to its financial affairs.

Once again we can refer to John Stuart Mill. At the time of his writing, in 1848, England still lagged behind the American states in the matter of granting charters containing the privilege of limited liability. Mill spent a few pages discussing this problem, and recommended the adoption of limited liability as a spur to investment. He understood quite well that unlimited liability was purportedly for the benefit of creditors, but maintained that they were perfectly capable of taking care of themselves "provided no false representation is held out."[122] As a consequence he urged that it be required, in connection with limited liability, that accounts be accessible to individuals and, if necessary, required to be published. Then, he claimed, if the company were unskilfully managed this fact would be apparent to prospective creditors, with the consequence that such unskilfully managed companies could not maintain "equal competition" with those that were skilfully managed.

Although in the case of fire insurance companies Massachusetts required advertising to the general public as early as the beginning of the nineteenth century,[123] apparently the earliest general advertising requirement for manufacturing corporations appeared in the 1830 Massachusetts act.[124] This act provided

[116]Ballentine, *Corporations* 789 et seq. (1946).
[117]Mass. Stats. 1920, c. 349, §1, p. 361.
[118]Pa. Laws, 1833-34, Act. No. 9.
[119]N. H. Laws 1837, c. 322, §14, p. 299.
[120]Vt. Acts and Resolves, 1853, Public At. No. 71, §16, p. 65, 68.
[121]Rhode Island Act entitled "An Act Relating to Manufacturing Corporations," p. 30, June, 1847.
[122]Op. cit. supra n. 110, at 542.
[123]Dodd, op. cit. supra n. 39, at 219.
[124]Supra n. 97.

for unlimited shareholder liability unless the corporation filed an annual statement of all assessments voted and paid in, together with a statement of the amount of its existing debts.[125] This was repeated in the 1836 act,[126] as well as the 1851 joint-stock companies act,[127] and was slightly altered in 1854.[128] The 1851 act had also added a requirement for the filing of certain financial information with a public officer, the penalty for failure to file being imposed on the officers responsible for the filing. By an act of 1857[129] newly formed special charter corporations were freed of the requirements of the 1836 act—in other words, shareholder liability was no longer connected with failure to meet the publicity requirement. The result of this "was to limit the cases in which shareholders in new manufacturing corporations should be personally liable for debts (other than debts to operatives) to situations in which the amount of initial capital as fixed at the first meeting had not been paid in and those in which capital had been refunded to the shareholders, pursuant to a vote for capital reduction, without payment of all debts contracted prior to the recording of a copy of that vote."[130]

Maine, in 1823, required the publication of an annual statement of the amount of assessments voted.[131] Limited liability was conditioned on, among other things, the fact that the "corporation shall once every year, give public notice in some newspaper in the county, wherein such corporation is established . . . of the amount of all assessments voted and paid in by such corporation. . . ."[132] Likewise, by an 1841 act of the State of Maine annual publication was to be made of capital paid in and of debts.[133] Failure to do so resulted in a loss of the privilege of limited liability on the part of the shareholders. This provision was dropped in its 1844 act, and a criminal liability on the treasurer substituted for shareholders' civil liability.[134]

Pennsylvania likewise experimented with publication requirements extensively in special charters.[135] In its act of 1849[136] it required annual publication, for two successive weeks in December, of capital stock subscribed, the amount of capital stock paid in, the amount of debts on the last day of November, and the advertisement was to be signed by the president, secretary and treasurer of the corporation.

Other states that made publication of pertinent financial data a condition of limited liability were New Hampshire, in 1837[137] and Rhode Island, in 1847.[138]

125Id. at §7, p. 298.
126Supra n. 111, at §22, p. 327, 331.
127Mass. Acts and Resolves, 1849-51, c. 133, §9, p. 633, 635, May 15, 1851.
128Mass. Acts and Resolves, 1854-55, c. 438, p. 346, April 29, 1854.
129Mass. Acts and Resolves, 1857, c. 276, p. 623, May 30, 1857.
130Dodd, op. cit. supra n. 39, at 321.
131Public Acts of the State of Maine, Jan. 1823 Session, c. 221, p. 929, February 5, 1823.
132Ibid.
133Rev. Stats. of Me. (1841) c. 192, p. 777, April 16, 1841.
134Public Laws of the State of Maine, 1844, c. 109, §1, p. 99.
135Hartz, *Economic Policy and Democratic Thought*: *Pennsylvania*, 1776-1860 263 (1948).
136Laws of Pa., 1849, Act No. 368, §11, p. 566, April 7, 1849.
137N. H. Laws 1837, c. 322, §14, p. 299.
138Rhode Island Act entitled "An Act Relating to Manufacturing Corporations," §9, p. 30, 33, June 1847.

The acts requiring publicity were decidedly unpopular, and enforcement difficult. It has been noted that "(S)triking breakdowns of the reporting system were common."[139] As a price of limited liability the resistance of the companies had some justification. Where the limited liability of shareholders was conditioned on compliance with the reporting requirements, the shareholders were being made responsible for the acts of others, for the officers had the duty of making the reports. It is well that in this form at least the publicity requirements have not come down to us.

Responsibility for Mismanagement

The determination of nineteenth-century legislatures to make shareholders liable to creditors is evidenced by another unusual type of liability, which was the liability of the shareholders for mismanagement of the firm by its directors and officers. This liability is, essentially, unfair, for it makes the shareholders liable for what they cannot directly control. The only control shareholders can have over the acts of the directors is after the fact—that is, they can refuse to re-elect them if they determine that there has been mismanagment.

In addition, the shareholders are harmed by the mismanagement of the directors and officers at least as much as are the creditors. They may even be injured more than the creditors are injured, for they do not, almost by definition, receive the return of any of their invested capital until the outside creditors have been satisfied.

Not too many examples exist of the imposition of this type of liability. It was, apparently, imposed in Massachusetts only in the case of banks. The first instance was the charter of the Merchants Bank, granted in 1811.[140] In that charter shareholders were liable to the extent of the par value of their stock for impairment of corporate capital due to mismanagement up to the amount of stock held by such shareholder. This provision eventually became a part of the banking law of 1836,[141] which also imposed double liability in case of mismanagement causing impairment of capital.

Pennsylvania also attempted to do something about liability for the mismanagement of banks, but its approach was more rational, for it imposed liability on the directors for the mismanagement of the bank. In the charter of the Lehigh County Bank, granted in 1844, section 15 provided that the directors were to be liable to shareholders and creditors for losses occasioned by "fraudulent insolvency."[142] The law failed to define what was meant by the term "fraudulent insolvency," but this deficiency was cleared up in 1850, when a statute regulating banks defined the insolvency of any bank as fraudulent "unless its affairs shall appear, upon investigation, to have been fairly and legally administered, and with the same care and diligence that agents, receiving a compensation for their services, are bound by law to observe."[143]

[139]Hartz, op. cit. supra n. 135, at 264.

[140]Mass. Laws 1809-12, c. 82, p. 494.

[141]Mass. Revised Laws of 1836, c. 36, §30, p. 308, 312. In the interim this provision was also contained in the 1829 banking code, Laws of Mass., Jan. 1829, c. 96, p. 149, 150, Feb. 28, 1829.

[142]Laws of Pa., 1844, Act No. 276, §15, p. 415.

[143]Laws of Pa., 1850, Act No. 322, Art. 15, §41, p. 492.

In this form, subject to alterations in the exact nature of the directors' liability, this type of responsibility has come down to the twentieth century. In this form the liability is rational, since it is imposed on the one group of persons in the corporate scheme who should be responsible for mismanagement, and that group is the directors.

Shareholders' Liability to Employees

The common understanding that shareholders are not liable individually for the debts of the firm is not true even today, in most states, in the case of the claims of employees for wages.[144] This would appear to be in accordance with the spirit behind the desire of John Stuart Mill for limited liability corporations, for his claim was that outside creditors were able, if they had sufficient information, to protect themselves.[145] Employees, however, although they are creditors of the corporation, do not stand in that position, for their bargaining power in relation to that of the company is meager or nonexistent.

The desire to protect these individuals received recognition in the 1851 Massachusetts corporation statute which provided that shareholders were to be liable for debts due laborers, servants, apprentices, and so forth, or their wives or minor children, for the six months preceding demand.[146] This was extended, the same year, to corporations formed by special charter since 1831, in a somewhat altered form.[147]

Pennsylvania, in 1853, adopted the principle of unlimited liability for the first time in its history.[148] The experiment ended with an act of 1854,[149] which nevertheless continued unlimited liability to shareholders to two classes of persons. The act provided for such liability to "miners, quarrymen, and other laborers employed by such companies, and for machinery, provisions, merchandise, country produce, and materials furnished for said companies respectively. . . ."[150] Obviously, only the policy directed toward the protection of employees has survived.[151]

Conclusion

This short survey of the development of the concept of limited liability in the United States serves in some measure to show the nature of the price paid for the privilege of limited liability. It is not the purpose of this article to explore the modern law on the devices for the protection of creditors, but rather to indicate that the emergence of these devices was coupled with the granting of the desired privilege of limited liability.

It was only when it became assured that the equities of shareholders and

[144]Stevens, *Handbook on the Law of Private Corporations* 840 (2d ed., 1949).
[145]Op. cit. supra n. 110.
[146]Mass. Acts and Resolves, 1851, c. 133, §15, p. 636.
[147]Mass. Acts and Resolves, 1851, c. 252, p. 749.
[148]Laws of Pa., 1853, Act No. 356, p. 637.
[149]Laws of Pa., 1854, Act No. 184, p. 215.
[150]Id. at §2.
[151]Today a double liability standard exists for wage claims in Pennsylvania, according to Section 514 of the Pennsylvania Business Corporation Law. This has recently been determined, in Bernstein v. Cosmopolitan Food Plan, Inc., 14 D. & C. 2d 197 (1957), to protect officers of the corporation.

creditors were in a state of relative balance that the privilege of limited liability came to be freely granted. The New England states led the rest of the nation toward this conditional grant of limited liability, for it was in that section that manufacturing corporations were formed in greatest number in the early nineteenth century. When the pressure for incorporation was finally felt and met in the other states, the experience of New England was at hand to copy. The law, since that time, has had to refine these devices for the protection of creditors' interests, but the groundwork had been laid by the 1850's.

Limited liability is now firmly fixed in the legal constellation known as corporation law. The basic conflict, however, still exists—latent beneath the surface. The protective devices originally fashioned in the first half of the 19th century, however, are the things that made it possible for limited liability to become an actuality. Limited liability was not applied to business because it was a logical conclusion from the entity theory, but rather because its application was made just and equitable. The conflict still is kept from becoming a matter of over-concern only because the shareholders have certain residual responsibilities to creditors—for the wages of employees, and to maintain the integrity of the capital stock account by avoiding illegal dividends or dividing the capital and by paying in full for their shares of stock.